March 2013

Exposure Draft ED/2013/3

Financial Instruments: Expected Credit Losses

Comments to be received by 5 July 2013

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Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to Standards. Comments on the Exposure Draft, the Basis for Conclusions and the Illustrative Examples should be submitted in writing so as to be received by **5 July 2013**. Respondents are asked to send their comments electronically to the IASB website (www.ifrs.org), using the 'Comment on a proposal' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

Summary and invitation to comment

Why is the IASB issuing this Exposure Draft?

The delayed recognition of credit losses that are associated with loans and other financial instruments was identified during the financial crisis as a weakness in existing accounting standards. Because the incurred credit loss impairment model ('incurred loss model') that is currently in existence delays the recognition of credit losses until a credit loss event occurs, the Financial Crisis Advisory Group recommended exploring alternatives to the incurred loss model that would use information that is more forward-looking.[1] The complexity of having multiple impairment models was identified as an additional weakness of existing accounting standards.

The main objective in developing this proposal is to provide users of financial statements with more useful information about the expected credit losses on financial assets and on commitments to extend credit. This objective is addressed through the proposed model, which provides information about expected credit losses and changes in expectations about credit losses, and also requires a broader range of reasonable and supportable information to be used to determine expected credit losses. The complexity that currently arises in practice is also addressed in these proposals by applying the same impairment model to all financial instruments that are subject to impairment accounting.

This Exposure Draft is part of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Ultimately, the new requirements for impairment accounting will be added as a chapter to IFRS 9 *Financial Instruments*.

Who would be affected by the amendments in this Exposure Draft?

Entities that hold financial assets and commitments to extend credit are affected by these proposals. Financial instruments to which the proposals apply are:

(a) financial assets measured at amortised cost or mandatorily measured at fair value through other comprehensive income ('FVOCI');[2]

(b) trade receivables and lease receivables; and

(c) other financial instruments that are subject to credit risk, such as:

  (i) some loan commitments; and

  (ii) some financial guarantee contracts.

1 As part of their joint approach to dealing with the financial reporting issues arising from the financial crisis, the IASB and the US-based standard-setter, the Financial Accounting Standards Board (FASB), set up the Financial Crisis Advisory Group in October 2008 to consider how improvements in financial reporting could help to enhance investor confidence in financial markets.

2 FVOCI is a new mandatory measurement category that is proposed in the Exposure Draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (the 'Classification and Measurement ED').

What are the main proposals?

The main proposals would require an entity to recognise expected credit losses on financial assets and on commitments to extend credit, using current estimates of expected shortfalls in cash flows on those financial instruments as at the reporting date. The entity would recognise those expected credit losses as a loss allowance (for financial assets) or as a provision (for commitments to extend credit). Under the proposals, recognition of credit losses would no longer be dependent on the entity first identifying a credit loss event. In addition, the range of information that an entity must consider when assessing credit risk and measuring expected credit losses would be broader. More specifically, the estimate of expected credit losses would be based on the relevant information that is available without undue cost or effort, including information about:

(a) past events, such as the historical loss experience for similar financial instruments;

(b) current conditions; and

(c) reasonable and supportable forecasts that affect the expected collectability of future cash flows on the financial instrument.

An estimate of expected credit losses would always reflect the *probability* that a credit loss might occur and, implicitly, that it might not occur. Accordingly, the proposals would prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome (that is, the statistical mode).

The proposals provide information about *changes* in the credit quality of financial instruments. In particular, the main proposals require an entity to distinguish between:

(a) financial instruments that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk (for example, that are 'investment grade') at the reporting date—for these items, 12-month expected credit losses are recognised; and

(b) financial instruments that have deteriorated significantly in credit quality since initial recognition (unless they have low credit risk at the reporting date)—for these items, lifetime expected credit losses are recognised.

Lifetime expected credit losses are the expected shortfalls in contractual cash flows, taking into account the potential for default at any point during the life of the financial instrument. 12-month expected credit losses are the expected shortfalls in contractual cash flows, taking into account only the potential for default in the next 12 months. Subject to some simplifications set out below, the expected credit losses that are recognised would be calculated in this way for all financial instruments that are subject to impairment accounting (including those that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED).

The IASB generally expects that entities will be able to use their current risk management systems as a basis for implementing the proposals (both to assess whether lifetime expected credit losses are required to be recognised and to measure expected credit losses). However, adjustments are likely to be required, for example, to adjust historical loss experience for expectations of future credit losses and to assess the extent of the deterioration in credit quality.

The three stages in the proposed expected credit loss model

There are three stages in the main proposals to reflect the general pattern of the deterioration of a financial instrument that ultimately defaults. The differences in accounting relate to the recognition of expected credit losses and, for financial assets, the calculation and presentation of interest revenue.

(a) **Stage 1:** financial instruments that *have not* deteriorated significantly in credit quality since initial recognition or that have low credit risk at the reporting date. For these items, 12-month expected credit losses are recognised and interest revenue is calculated on the gross carrying amount of the asset (ie without reduction for expected credit losses).

(b) **Stage 2:** financial instruments that *have* deteriorated significantly in credit quality since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of a credit loss event. For these items, lifetime expected credit losses are recognised but interest revenue is still calculated on the gross carrying amount of the asset.

(c) **Stage 3:** financial assets that *have* objective evidence of impairment at the reporting date. For these items, lifetime expected credit losses are recognised and interest revenue is calculated on the net carrying amount (ie reduced for expected credit losses).

What are the differences between current IFRS requirements and the proposals?

Current IFRS uses different impairment models for financial instruments within the scope of this Exposure Draft. The existing models generally require the recognition of credit losses when there is objective evidence of impairment or when a credit loss is incurred (a 'recognition threshold'). This recognition threshold is perceived to have caused delay in the recognition of credit losses. The Exposure Draft proposes to eliminate this threshold; instead, expected credit losses would always be recognised and updated for changes in credit loss expectations.

Furthermore, when credit losses are measured in accordance with current IFRS, an entity may only consider those credit losses that arise from past events and current conditions. The effects of future credit loss events cannot be considered. The proposals would broaden the information that an entity is required to consider when determining its estimates of credit losses. Specifically, this Exposure Draft would require an entity to measure expected credit losses using relevant information about past events, including historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts that affect the expected collectability of cash flows on financial instruments. As a result, an entity would consider quantitative and qualitative factors that are specific to the borrower, including the entity's current evaluation of the borrower's creditworthiness. An entity would also consider general economic conditions and an evaluation of both the current point in, and the forecast direction of, the economic cycle.

What is the simplified approach?

The IASB noted that the cost of determining whether to recognise 12-month or lifetime expected credit losses may not be justified for trade receivables and lease receivables. Consequently, the IASB proposes that, in general, for 'short-term' trade receivables an entity should always recognise a loss allowance at an amount equal to lifetime expected credit losses.[3] For 'long-term' trade receivables and lease receivables, the proposals would allow entities to choose an accounting policy to always recognise a loss allowance at an amount equal to lifetime expected credit losses.[4] This simplifies the application of the model because it removes the need for an entity to consider whether the credit quality of these financial assets has deteriorated significantly since initial recognition.

How would the main proposals differ from the IASB's previous proposals?

The IASB has previously issued two exposure documents proposing models to account for expected credit losses: an Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the '2009 ED'), published in November 2009, and a Supplementary Document *Financial Instruments: Impairment* (the 'SD'), published jointly with the FASB in January 2011. In all cases, the information used to estimate expected credit losses has been the same and is as set out in this Exposure Draft. In addition, in all cases, the IASB has proposed that an entity should recognise expected credit losses from the initial recognition of financial instruments. Recognition would no longer be contingent on a credit loss event occurring. However, the manner in which expected credit losses are recognised has varied between the proposals.

Throughout this project, the IASB has observed that the initial expectations of credit losses are priced into financial assets both when they are originated and when they are purchased. As a result the IASB has held the view that credit losses expected from the time of the origination or purchase of a financial asset should ideally be reflected in the yield on the financial asset, and that economic gains and losses should be recognised when there is a change in credit loss expectations, as those changes are not priced into the asset. The IASB has therefore sought to reflect the relationship between initial estimates of credit losses and pricing. As a result, the IASB considers that it is inconsistent with the economics of lending to recognise a loss that is equal to lifetime expected credit losses on the initial recognition of a financial instrument.

The 2009 ED would have achieved this most appropriately. The 2009 ED proposed an integrated measurement of amortised cost. The effective interest rate was adjusted for initial expectations of credit losses, and the carrying amount of financial assets measured at amortised cost was always equal to the present value of the expected future cash flows, discounted at the credit-adjusted effective interest rate. All changes in the carrying amount resulting from changes in the expected future cash flows would have been recognised immediately in profit or loss. However, concerns were raised about the operational challenges of applying this approach.

3 Specifically, for trade receivables that do not constitute a financing transaction in accordance with IAS 18 *Revenue*.

4 Specifically, for trade receivables that constitute a financing transaction in accordance with IAS 18.

As a result of these concerns and in response to requests to find a common solution with the FASB, the IASB and the FASB issued the SD. The SD required that an entity should recognise an allowance for expected credit losses at an amount that depended on whether a financial asset was in the 'good book' or the 'bad book'. For the bad book, an entity recognised lifetime expected credit losses, whereas for the good book an entity recognised an amount equal to the greater of:

(a) credit losses that are expected in the foreseeable future; and

(b) a time-proportionate amount of lifetime expected credit losses.[5]

Like the proposals in this Exposure Draft, the SD 'decoupled' interest revenue from expected credit losses so that the effective interest rate was not adjusted for credit loss expectations.

In both the SD and the current proposals, the IASB has sought to approximate the outcome of the 2009 ED, in order to reflect the economic relationship between the pricing of financial instruments and credit loss expectations, while seeking to overcome the operational challenges of those proposals. The IASB has proposed to do this by recognising lifetime expected credit losses on some financial instruments and a portion of lifetime expected credit losses on others.

When would the proposals be effective?

As for all of its projects, the IASB establishes the effective date of the requirements only on completion of its redeliberations. In deciding an appropriate date, responses to the question in this Exposure Draft about the necessary implementation period would be considered.

How do the proposals differ from the FASB's expected credit loss proposals?

Like current IFRS, US GAAP uses an incurred loss impairment model that includes an initial recognition threshold. In addition, as is the case for current IFRS, when credit losses are measured under current US GAAP an entity generally considers past events and current conditions when measuring impairment.

The boards have been working to develop a more forward-looking impairment model based on expected credit losses. After issuing the SD, the boards worked together to jointly develop the proposals that formed the initial basis for the proposals in this Exposure Draft.

In July 2012, the FASB decided to revisit its previous tentative decisions on that joint model and has since decided to develop an expected credit loss model in which no distinction has been made between those financial instruments that have deteriorated in credit quality since initial recognition and those that have not. Under the FASB's proposed Current Expected Credit Loss ('CECL' model), expected credit losses are always recognised at what is described as 'lifetime expected credit losses' in the IASB's proposals. This is in contrast to the IASB's proposal to measure expected credit losses for some financial instruments at an amount equal to 12-month expected credit losses.

5 This term, and the method for calculating the time-proportionate amount, are explained in detail in the SD.

There is a difference in the timing of the recognition of lifetime expected credit losses between the two models. However, they do share common features. Both models require the recognition of expected credit losses on all financial instruments, and they both require the use of the same information when estimating expected credit losses. In addition, for financial instruments that have deteriorated significantly in credit quality since initial recognition, the amount of expected credit losses recognised under the two models should be the same.

The comment periods on this Exposure Draft and on the FASB's CECL Exposure Draft overlap. This will enable interested parties to compare the proposals. This Exposure Draft also includes questions that pertain to the CECL model (see questions 1(b) and 2(c)). This will enable interested parties to provide responses to the IASB both about our own proposals and also about aspects of the CECL model.

The IASB and the FASB plan to discuss jointly the comments received on their respective proposals after the comment periods end. This will provide each board with the opportunity to consider the views received by the other and for the boards to consider whether it is possible to more closely align their expected credit loss models.

Contents of this Exposure Draft

The IASB proposes:

(a) to clarify which financial instruments are subject to accounting for expected credit losses under IFRS 9;

(b) a general approach to recognising and measuring expected credit losses for financial instruments;

(c) a simplified approach for trade receivables and lease receivables;

(d) the measurement of financial assets that are credit-impaired at initial recognition; and

(e) presentation and disclosure requirements to accompany the above.

Invitation to comment

The IASB invites comments on all matters in this Exposure Draft and, in particular, on the questions set out in the following paragraphs. Comments are most helpful if they:

(a) respond to the questions as stated;

(b) indicate the specific paragraph or paragraphs to which the comments relate;

(c) contain a clear rationale; and

(d) describe any alternatives that the IASB should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional matters. However, the IASB is not seeking comments on aspects of IFRS 7 *Financial Instruments: Disclosures*, IFRS 9 or IAS 39 that are not addressed in this Exposure Draft. In addition, this Exposure Draft presents the IASB's conclusions in the following areas that have been subject to previous Exposure Drafts and thus the IASB is not specifically seeking comments on these issues:

(a) amortised cost and the measurement of the gross carrying amount;

(b) write-off of financial assets; and

(c) measurement of expected credit losses at an expected present value.

The IASB will consider all comments received in writing by 5 July 2013.

Objective of an expected credit loss impairment model

Many respondents to the 2009 ED and the SD agreed that a new impairment approach should be more forward-looking and be based on expected credit losses.

In the IASB's view, expected credit losses are most faithfully represented by the proposals in the 2009 ED. Those proposals reflected the economic link between the pricing of financial assets and the expected credit losses at initial recognition, and required the immediate recognition of the effects of changes in expected credit losses subsequent to initial recognition.

To overcome the operational challenges of the 2009 ED, the IASB simplified the approach for the recognition of expected credit losses in the SD and this Exposure Draft. The SD and this Exposure Draft still reflect the link between the pricing of financial instruments and the initial credit quality, and the effects of changes in credit quality, by requiring the recognition of a loss allowance or a provision at an amount equal to:

(a) a portion of expected credit losses from initial recognition; and

(b) lifetime expected credit losses after significant deterioration in the credit quality of a financial instrument.

Like the 2009 ED, both documents proposed that, at each reporting date, expected credit losses would be remeasured by considering updated information.

In the IASB's view, recognising a loss allowance at an amount equal to lifetime expected credit losses at initial recognition does not faithfully represent the underlying economics of financial instruments. Likewise, recognising expected credit losses only when a credit loss event has occurred results in the delayed recognition of economic losses.

Question 1

(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:

(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and

(ii) the effects of changes in the credit quality subsequent to initial recognition?

If not, why not and how do you believe the proposed model should be revised?

(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

The main proposals in this Exposure Draft

The IASB proposes that, except for financial assets that are credit-impaired at initial recognition or that qualify for the simplified approach (see 'Exceptions to the general model' on page 17), the loss allowance for a financial asset (or the provision for a loan commitment or financial guarantee contract) shall be measured at an amount equal to 12-month expected credit losses. This is the case unless significant deterioration in credit quality occurs after initial recognition, in which case the loss allowance (or provision) shall be measured at an amount that is equal to lifetime expected credit losses. As an exception, 12-month expected credit losses are recognised on financial instruments for which the credit risk is low at the reporting date.

The IASB compared the information provided by, and the costs of implementing, the SD with the proposals in this Exposure Draft. In so doing, the IASB considered the SD *excluding the foreseeable future floor* (ie assuming that, for the good book, expected credit losses would be recognised using the time-proportionate approach, whereby an amount that is equal to lifetime expected credit losses would be recognised over the expected life of a portfolio). Like the approach in this Exposure Draft, the SD proposed that on some financial assets (those in the bad book) a loss allowance at an amount equal to lifetime expected credit losses would be recognised, whereas on other financial assets (those in the good book) a portion of those credit losses would be recognised. The bad book referred to those financial assets for which it was deemed inappropriate to recognise expected credit losses over a time period because of the degree of uncertainty about the collectability of the financial asset.

In the IASB's view, the model proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation compared to the model that was proposed in the SD (without the foreseeable future floor).

Question 2

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

Scope

The proposed scope of this Exposure Draft will include:

(a) financial assets measured at amortised cost in accordance with IFRS 9, including trade receivables;

(b) financial assets that are mandatorily measured at fair value through other comprehensive income ('FVOCI') in accordance with the Classification and Measurement ED;

(c) loan commitments when there is a present contractual obligation to extend credit, except any loan commitments that are accounted for at fair value through profit or loss in accordance with IFRS 9;

(d) financial guarantee contracts within the scope of IFRS 9 that are not accounted for at fair value through profit or loss; and

(e) lease receivables within the scope of IAS 17 *Leases* and the tentative decisions in the IASB's Leases project.

In November 2012, the IASB proposed limited amendments to the classification and measurement requirements for financial assets in IFRS 9. The Classification and Measurement ED proposes to introduce a mandatory FVOCI measurement category for particular financial assets that contain contractual cash flows that are solely payments of principal and interest. The objective of that measurement category is to provide users of financial statements with information about both fair value and amortised cost. To achieve that objective, the IASB proposed in the Classification and Measurement ED that an entity shall calculate interest revenue and account for expected credit losses in a manner that is consistent with the requirements applicable to financial assets measured at amortised cost. Thus, the proposals in this document will apply to that FVOCI measurement category.

Question 3
(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?
(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

12-month expected credit losses

The IASB proposes that the loss allowance (or provision) shall be measured at an amount equal to the 12-month expected credit losses in specific circumstances. 12-month expected credit losses are the expected shortfalls in contractual cash flows over the life of a financial instrument that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

Question 4
Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Assessing when an entity shall recognise lifetime expected credit losses

The IASB proposes that an entity shall measure a loss allowance (or provision) at an amount equal to lifetime expected credit losses when the credit risk on a financial instrument has increased significantly since initial recognition. In making that evaluation, the entity shall compare the initial credit risk of a financial instrument with its credit risk as at the reporting date, taking into consideration its remaining life and initial credit risk. The entity shall also consider whether there is a significant increase in the *credit risk* rather than in the *expected credit losses* (ie the assessment is based on changes in the probability of a default occurring).

The IASB proposes the following operational simplifications for evaluating whether lifetime expected credit losses should be recognised:

(a) if the entity estimates that the financial instrument has a low credit risk at the reporting date (for example, it is 'investment grade'), then the loss allowance (or provision) is measured at an amount equal to 12-month expected credit losses regardless of whether there has been a significant increase in credit risk; and

(b) a rebuttable presumption that a significant increase in credit risk has occurred when payments are more than 30 days past due if no other borrower-specific information is available, without undue cost or effort, to decide whether a loss allowance (or a provision) at an amount equal to lifetime expected credit losses shall be recognised.

In addition, the IASB proposes that a loss allowance (or a provision) measured at an amount equal to 12-month expected credit losses shall be re-established for financial instruments if there is no longer a significant increase in credit risk since initial recognition.

Question 5

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

Interest revenue

The IASB proposes that an entity shall present interest revenue in the statement of profit or loss and other comprehensive income as a separate line item.

Interest revenue shall usually be calculated using the effective interest method on the *gross* carrying amount of the financial asset. However, interest revenue shall be calculated using the effective interest method on the *net* carrying amount (amortised cost) if, at the reporting date, there is objective evidence of impairment.

In addition, if there is objective evidence that the financial asset is credit-impaired at initial recognition (purchased or originated credit-impaired financial assets), interest revenue shall be calculated by applying the credit-adjusted effective interest rate to the amortised cost.

The calculation of interest revenue is proposed to be 'symmetrical'. An entity that calculates interest revenue on the amortised cost in one period shall calculate interest revenue on the gross carrying amount in a subsequent period if there is no longer objective evidence of impairment.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

Disclosure

The IASB proposes that an entity shall disclose information that identifies and explains:

(a) the amounts arising from expected credit losses, including:

  (i) a reconciliation of the gross carrying amount and loss allowance (or provision) for financial instruments; and

  (ii) the inputs and assumptions used in measuring 12-month and lifetime expected credit losses.

(b) the effect of the deterioration and improvement in the credit risk of financial instruments, including:

  (i) the gross carrying amount, by credit risk rating grades, of financial assets and the provisions associated with loan commitments and financial guarantee contracts;

  (ii) the inputs and assumptions used in determining whether a significant increase in credit risk has occurred; and

  (iii) the gross carrying amount of financial assets and the amount recognised as a provision for financial instruments that are evaluated on an individual basis and whose credit risk has increased significantly since initial recognition.

This Exposure Draft also proposes that an entity shall disclose information about write-offs, financial assets that have not been derecognised but on which contractual cash flows have been modified, financial instruments that have been secured by collateral or other credit enhancements, and significant effects on the loss allowance (or provision) caused by a particular portfolio or geographical area.

For the purpose of disclosure, the entity shall group financial instruments into classes that are appropriate to their characteristics and to the nature of the information disclosed. Exceptions to some disclosure requirements are provided for trade receivables and lease receivables for which the loss allowance is measured under the simplified approach.

Question 7	
(a)	Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
(b)	Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.
(c)	What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

Application of the model to assets that have been modified but not derecognised

The IASB proposes that if the contractual cash flows of a financial asset are renegotiated or otherwise modified and that modification does not result in a derecognition, the entity shall adjust the gross carrying amount of the asset to reflect the revised contractual cash flows. The gross carrying amount should be discounted at the present value of the estimated future contractual cash flows at the asset's original effective interest rate. For the purpose of determining whether a significant increase in credit risk has occurred, the entity shall consider the credit risk at the reporting date under the modified contractual terms of the asset. This shall be compared to the credit risk at initial recognition under the original, unmodified contractual terms of the financial asset. When a significant increase in credit risk is determined not to have occurred, or the asset is determined to have low credit risk at the reporting date, expected credit losses shall be measured at 12-month expected credit losses.

Question 8
Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

Application of the model to loan commitments and financial guarantee contracts

The IASB proposes, for loan commitments and financial guarantee contracts that are within the scope of this Exposure Draft, to estimate expected credit losses:

(a) for undrawn loan commitments, as the difference between:

  (i) the present value of principal and interest cash flows due to the entity if the holder of the loan commitment draws down the loan; and

  (ii) the present value of the cash flows that the entity expects to receive if the loan is drawn down.

(b) for financial guarantee contracts, the entity is only required to make payments in the event of a default by the debtor in accordance with the terms of the instrument guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party.

An entity shall estimate expected credit losses consistently with its expectations that the loan commitment will be drawn down. That is, it shall consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the remaining life of the loan commitment when estimating lifetime expected credit losses.

The IASB proposes that the remaining life of a loan commitment and financial guarantee contract should be the remaining contractual period, or shorter period, over which it is exposed to credit risk. The maximum period to consider when estimating expected credit losses is the maximum contractual period over which the entity is exposed to credit risk and not a longer period, even if that would be consistent with business practice.

In addition, the Exposure Draft proposes that provisions for expected credit losses from financial guarantee contracts or loan commitments should be presented in a separate line item in the statement of financial position as a liability.

Question 9

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

Exceptions to the general model

Simplified approach for trade receivables and lease receivables

The IASB proposes a simplified approach for trade receivables and lease receivables. It proposes that the loss allowance should be measured at an amount equal to lifetime expected credit losses at initial recognition and throughout the asset's life for trade receivables that do not constitute a financing transaction in accordance with IAS 18 *Revenue*. For trade receivables that do constitute a financing transaction in accordance with IAS 18, and for lease receivables, it proposes separate options to elect an accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses at initial recognition and throughout the asset's life. The IASB believes that the simplified approach provides operational relief for these assets by eliminating the need to:

(a) calculate 12-month expected credit losses; and

(b) determine when lifetime expected credit losses are required to be recognised.

The IASB also proposes to amend IFRS 9 to measure trade receivables that have no significant financing component at the invoice amount on initial recognition when [draft] IFRS X *Revenue from Contracts with Customers* is published.

Question 10
(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?
(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

Financial assets that are credit-impaired on initial recognition

The IASB proposes that when a financial asset has objective evidence of impairment on initial recognition, an entity is required to include the initial expected credit losses in the estimated cash flows when computing the effective interest rate. The proposed scope of assets for which this adjusted effective interest rate would apply is consistent with the existing requirements in paragraph AG5 of IAS 39. In addition, interest revenue from assets that are subject to this measurement approach shall be calculated using the effective interest method on the amortised cost. The IASB thinks that this approach more faithfully represents the underlying economics for these assets than the general approach does, and the benefits of this better representation outweigh the costs for these financial assets.

A loss allowance is recognised on these financial assets at an amount equal to all changes in lifetime expected credit losses since initial recognition.

Question 11
Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

Effective date and transition

The IASB proposes that an entity shall apply these requirements retrospectively, except when it is not possible to determine (without undue cost and effort) whether the credit risk of a financial instrument has increased significantly since initial recognition. For such financial instruments, a loss allowance (or provision) at an amount equal to lifetime expected credit losses will be recognised until the financial instrument is derecognised, unless the financial instruments have low credit risk at a reporting date. This relief is not available for financial instruments whose past-due status is used to assess changes in credit risk, because it is assumed that the information will be available to make the assessment.

In addition, comparative information is not required to be restated. Entities are, however, permitted to provide restated comparative information if it is possible to do so without the use of hindsight.

The mandatory effective date of IFRS 9 is 1 January 2015. All phases of IFRS 9 (ie classification and measurement, impairment and hedge accounting) have the same effective date.

Question 12
(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain. (b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why? (c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?

Effects analysis

Paragraphs BC164–BC216 in the Basis for Conclusions set out the IASB's assessment of the effects of the proposed requirements.

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

[Draft] International Financial Reporting Standard [X] *Financial Instruments: Expected Credit Losses*

Objective

1 **The objective of this [draft] Standard is to establish principles for the recognition, measurement, presentation and disclosure of expected credit losses that will provide useful information for users of financial statements for their assessment of the amount, timing and uncertainty of future cash flows.**

Scope

2 **An entity shall apply this [draft] Standard to:**

(a) **financial assets that are measured at amortised cost in accordance with IFRS 9 *Financial Instruments*;**

(b) **financial assets that are mandatorily measured at fair value through other comprehensive income (FVOCI) in accordance with the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (the 'Classification and Measurement ED');[6]**

(c) **loan commitments when there is a present contractual obligation to extend credit, except any loan commitments that are measured at fair value through profit or loss in accordance with IFRS 9;**

(d) **financial guarantee contracts to which IFRS 9 is applied and that are not accounted for at fair value through profit or loss; and**

(e) **lease receivables that are within the scope of IAS 17 *Leases*.[7]**

Recognition and Measurement

General approach

3 **An entity shall recognise expected credit losses in the statement of financial position as an expected credit loss allowance ('loss allowance') if**

6 This Exposure Draft refers to proposals in the Classification and Measurement ED. Whether the proposals relating to financial assets that are mandatorily measured at FVOCI are included in the final version of IFRS 9 *Financial Instruments* will depend not only on the redeliberations of impairment but also on the outcome of redeliberations on the classification and measurement project. It is proposed that the requirements for the measurement of the loss allowance will be applied when measuring the accumulated impairment amount for financial assets that are mandatorily measured at FVOCI. The Classification and Measurement ED includes additional requirements for the recognition of gains and losses and the presentation and disclosure for such financial assets.

7 The IASB decided that lease receivables that are recognised in accordance with the proposals that are to be included in the forthcoming Exposure Draft on leases would be subject to the proposed impairment model. Consequently, references to lease receivables in this document will ultimately relate to lease receivables recognised by lessors in accordance with that Exposure Draft. The forthcoming revised Exposure Draft on leases will illustrate how to apply the impairment guidance in this [draft] IFRS to lease receivables.

those expected credit losses relate to a financial asset measured at amortised cost or a lease receivable and as a provision if they relate to a loan commitment or financial guarantee contract. An entity shall apply the requirements for the measurement of a loss allowance in this [draft] Standard to the measurement of the accumulated impairment amount for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED. The accumulated impairment amount is not separately presented in the statement of financial position, however the measurement of this amount is required to calculate the impairment gains or losses to be recognised in profit or loss in accordance with paragraph 5.7.1A of the Classification and Measurement ED and it is a loss allowance for the purposes of the disclosure requirements in this [draft] IFRS.

4 **Subject to paragraphs 12–15, at the reporting date an entity shall measure the expected credit losses for a financial instrument at an amount equal to the *12-month expected credit losses* unless the requirements of paragraph 5 are met.**

5 **At the reporting date, the entity shall measure the expected credit losses for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.**

6 As an exception, if the credit risk on a financial instrument is low at the reporting date, the criterion in paragraph 5 is not met. For the purposes of this [draft] IFRS the credit risk is low if a 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 on the financial instrument. For example, a loan that has an internal credit risk rating equivalent to the external credit rating of 'investment grade' would be considered to have a low credit risk.

7 An entity shall ensure that its assessment of whether the credit risk on a financial instrument has increased significantly since initial recognition (see paragraph 5) is consistent with the guidance in paragraphs 16(a) and 17.

8 When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition in accordance with paragraph 5, an entity shall use the change in the probability of a default occurring on the financial instrument rather than the change in the expected credit losses. To make that assessment, an entity shall compare the probability of a default occurring over the *remaining life* of the financial instrument as at the reporting date with the probability of a default occurring on the financial instrument over its remaining life as at initial recognition. For the purpose of this assessment, a simple comparison of the absolute probabilities of a default occurring is not sufficient. The term of the financial instrument and the initial credit quality shall also be considered (see paragraphs B11–B16).

9 Typically, information that is more forward-looking than past-due information will be available that shall be used to determine whether there has been a significant increase in credit risk as at the reporting date. However, there is a

rebuttable presumption that the criterion in paragraph 5 is met when contractual payments are more than 30 days past due. This presumption is rebutted if other persuasive information is available that indicates that the credit risk has not increased significantly even though the contractual payments are more than 30 days past due. For example, historical evidence demonstrates that there is no causal link between a significant increase in the probability of a default occurring on financial assets and financial assets on which payments are more than 30 days past due, but it does identify such a link for financial assets on which payments are more than 60 days past due.

10 An entity (except for entities that are applying paragraphs 12–15) shall assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 5 at each reporting date. Accordingly, if an entity has measured the loss allowance, or the provision, at an amount equal to the lifetime expected credit losses for a financial instrument in the previous reporting period but determines at the current reporting date that the criterion in paragraph 5 is no longer met, the entity shall then measure the loss allowance, or the provision, at an amount equal to 12-month expected credit losses at the current reporting date.

11 An entity shall recognise in profit or loss the amount of expected credit losses (or reversal) that is required to adjust the loss allowance or provision at the reporting date to the balance that is required to be recognised in accordance with this [draft] IFRS.

Simplified approach for trade receivables and lease receivables

12 Notwithstanding paragraphs 4 and 5, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses (see paragraphs B33–B35) for:

(a) trade receivables that result from transactions that are within the scope of IAS 18 *Revenue*, and that:

(i) do not constitute a financing transaction in accordance with IAS 18; or

(ii) constitute a financing transaction in accordance with IAS 18, if the entity has made an accounting policy election to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied by the entity to all such trade receivables.[8]

8 The IASB also decided that an entity shall measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables resulting from transactions within the scope of [draft] IFRS X *Revenue from Contracts with Customers* that have:
(a) no significant financing component (or when the entity applies the practical expedient for contracts that are one year or less) in accordance with the [draft] IFRS X *Revenue from Contracts with Customers*; or
(b) a significant financing component as determined in accordance with the [draft] IFRS X *Revenue from Contracts with Customers*, if the entity has made an accounting policy election to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied by the entity to all such trade receivables.

(b) lease receivables, if the entity has made an accounting policy election to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied by the entity to all lease receivables.

13 An entity may apply the policy election for trade receivables and lease receivables independently of each other.

Purchased or originated credit-impaired financial assets

14 Notwithstanding paragraphs 4 and 5, at the reporting date, an entity shall recognise the cumulative changes in lifetime expected credit losses since initial recognition in the statement of financial position as a loss allowance for *purchased or originated credit-impaired financial assets*.

15 At each reporting date, an entity shall recognise in profit or loss the amount of the change in lifetime expected credit losses as an impairment gain or loss. An entity shall recognise favourable changes in lifetime expected credit losses as an impairment gain even if the cumulative changes in lifetime expected credit losses are positive and exceed the amount of expected credit losses that were included in the estimated cash flows on initial recognition.

Basis for an estimate of expected credit losses

16 An estimate of expected credit losses shall reflect:

(a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (see paragraphs 17 and B28); and

(b) the time value of money (see paragraphs B29–B31).

17 The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate a best-case scenario. Rather, an estimate of expected credit losses shall always reflect the possibility that a *credit loss* occurs and the possibility that no credit loss occurs even if the most likely outcome is no loss. In estimating expected credit losses, an entity:

(a) need not necessarily identify every possible scenario. However, an entity shall consider the probability of credit losses, even if that probability is very low.

(i) For 12-month expected credit losses, an entity shall estimate the probability of a default occurring on the financial instrument in the next 12 months.

(ii) For lifetime expected credit losses, an entity shall estimate the probability of a default occurring on the financial instrument during its remaining life.

The maximum period to consider when estimating expected credit losses is the maximum contractual period over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

(b) shall incorporate the best available information (see paragraphs B5–B8). For the purpose of this [draft] IFRS, the best available information is that which is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. Information is reasonably available if obtaining it does not involve undue cost or effort. Information that is available for financial reporting purposes is available without undue cost or effort.

18 An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. However, those approaches must satisfy the requirements in paragraphs 16–17. An approach, such as a credit loss rate, can be consistent with those requirements even if it does not include an explicit probability of a default occurring as an input (see, for example, paragraphs B33–B35). An entity may apply different approaches for different financial instruments.

Modifications

19 If the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in a derecognition of that financial asset in accordance with IFRS 9, the entity shall recalculate the *gross carrying amount* on the basis of the renegotiated or modified contractual cash flows and shall recognise a *modification gain or loss* in profit or loss.

20 From the date of the modification of the contractual cash flows of a financial instrument, the entity shall assess whether the criterion in paragraph 5 is met in accordance with paragraph B22.

Write-off

21 An entity shall directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovery. A write-off constitutes a derecognition event.

22 Write-offs can relate to a financial asset in its entirety or to a portion of it. For example, after an entity has enforced the collateral and recovered 30 per cent of a financial asset, the remaining 70 per cent might be written off if the entity has no reasonable expectations of recovering any further amounts from that financial asset.

Presentation[9]

[In addition to the requirements set out below, the Classification and Measurement ED includes requirements for the presentation of the loss allowance for financial assets that are mandatorily measured at FVOCI (see paragraph 4.1.2A of that Exposure Draft). In

9 The proposed presentation requirements are presented together with the related recognition, measurement and disclosure requirements in order to promote an understanding of the proposals. When finalising the proposals the IASB may treat the presentation requirements as amendments to IAS 1 *Presentation of Financial Statements*.

Appendix C of that Exposure Draft, the IASB proposes to add paragraph 16A to IFRS 7 *Financial Instruments: Disclosures*, which would prohibit the presentation of an accumulated impairment amount or loss allowance in the statement of financial position for such assets.]

Interest revenue

23 An entity shall present interest revenue in the statement of profit or loss and other comprehensive income as a separate line item.

24 Interest revenue is calculated differently for financial assets that:

(a) are purchased or originated credit-impaired financial assets (see paragraph 25(a));

(b) are not purchased or originated credit-impaired financial assets but that have *objective evidence of impairment* at the reporting date (see paragraph 25(b)); and

(c) all other financial assets (see paragraph 25).

25 Interest revenue shall be calculated by using the *effective interest method* and applying the *effective interest rate* to the gross carrying amount of a financial asset except for:

(a) purchased or originated credit-impaired financial assets. For those financial assets, the entity shall apply the *credit-adjusted effective interest rate* to the *amortised cost* of the financial asset from initial recognition.

(b) a financial asset that is not a purchased or originated credit-impaired financial asset but that has objective evidence of impairment at the reporting date. For those assets, the entity shall apply the effective interest rate to the amortised cost of the financial asset in the subsequent reporting period.

26 An entity that, in one period, calculates the interest revenue by applying the effective interest method to the amortised cost in accordance with paragraph 25(b), shall, in a subsequent period, calculate the interest revenue by applying the effective interest method to the gross carrying amount if the amount of expected credit loss decreases and can be related objectively to an event occurring after the requirements in paragraph 25(b) were applied (such as an improvement in the borrower's credit rating).

Impairment losses or gains

27 An entity shall present impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with this [draft] IFRS as a separate line item in the statement of profit or loss and other comprehensive income.

Disclosure[10]

28 **An entity shall disclose information that identifies and explains:**

(a) the amounts in its financial statements that arise from expected credit losses that are measured in accordance with this [draft] IFRS; and

(b) the effect of deterioration and improvement in the credit risk of financial instruments that are within the scope of this [draft] IFRS.

29 To meet the requirements in paragraph 28, an entity shall consider:

(a) the level of detail that is necessary to satisfy the disclosure requirements;

(b) how much emphasis to place on each of the disclosure requirements;

(c) how much aggregation or disaggregation is appropriate; and

(d) whether users of financial statements need additional information to evaluate the quantitative information that has been disclosed.

30 If the disclosures provided in accordance with the requirements in this [draft] IFRS and other relevant Standards are insufficient to meet the objectives in paragraph 28, an entity shall disclose additional information to meet those objectives.

31 Other Standards (eg IFRS 7) may require disclosures that may satisfy the disclosure requirements in accordance with this [draft] IFRS. Entities need not duplicate the information and are permitted to cross-refer to these disclosures.

32 The disclosure requirements in this [draft] IFRS shall either be given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a risk report and disclosures, that is available to users of financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

33 The disclosure requirements in this [draft] IFRS apply to all financial instruments that are in the scope of this [draft] IFRS. However, an entity that measures the loss allowance at an amount equal to lifetime expected credit losses either for trade receivables or for lease receivables in accordance with paragraph 12–13 need not apply the disclosure requirements in paragraphs 35(a), 38(a), 42–43 and 45 to those financial assets. In addition, paragraph 40(a) does not apply to lease receivables.

Classes of financial instruments and levels of disclosure

34 For the purpose of the disclosures provided in accordance with this [draft] IFRS, an entity shall group financial assets, loan commitments and financial guarantee contracts into classes that are appropriate to the nature of the

10 The proposed disclosure requirements are presented together with the related recognition, measurement and presentation requirements in order to promote an understanding of the proposals. In finalising the proposals the IASB may treat the disclosure requirements as amendments to IFRS 7 *Financial Instruments: Disclosures*.

information disclosed and that take into account the characteristics of those financial instruments (including their grouping into portfolios). An entity shall provide sufficient information to permit reconciliation to the line items that are presented in the statement of financial position.

Amounts arising from expected credit losses

35 An entity shall provide a reconciliation from the opening balance to the closing balance of the gross carrying amount and the associated loss allowance for:[11]

(a) financial assets with a loss allowance measured at an amount equal to 12-month expected credit losses;

(b) financial assets with a loss allowance measured at an amount equal to lifetime expected credit losses;

(c) financial assets that have objective evidence of impairment at the reporting date but that are not purchased or originated credit-impaired financial assets; and

(d) purchased or originated credit-impaired financial assets. In addition to the reconciliation for these assets, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition.

36 An entity shall provide a reconciliation from the opening balance to the closing balance of the provision for loan commitments and financial guarantee contracts consistent with paragraph 35.

37 An entity shall disclose its write-off policy (for example, the entity's indicators for write-off), including whether there are assets that have been written off that are still subject to enforcement activity. In addition to including any write-offs and recoveries in the reconciliation in accordance with paragraph 35, an entity shall disclose the nominal amount of financial assets written off that are still subject to enforcement activity.

38 An entity shall disclose at the end of the reporting period during which the contractual cash flows on a financial asset have been modified the amortised cost and the modification gain or loss for financial assets that have been modified while they had a loss allowance at an amount equal to lifetime expected credit losses. The entity shall also disclose at each reporting date subsequent to such modification throughout the remaining life of the financial asset:

(a) the gross carrying amount of financial assets that have been modified during their life and for which the measurement of the loss allowance has changed from an amount equal to lifetime expected credit losses to an amount equal to 12-month expected credit losses; and

(b) the re-default rate on such financial assets that have been modified while in default (ie the percentage of financial assets that defaulted again subsequent to modification).

11 This disclosure requirement, as well as all other disclosure requirements in this [draft] IFRS, also apply to financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED (see paragraph 33).

The disclosure requirements in this paragraph, other than paragraph 38(a), also apply to trade receivables or lease receivables on which lifetime expected credit losses are always recognised in accordance with paragraph 12 but only if modified while more than 30 days past due.

39 An entity shall explain the inputs, assumptions and estimation techniques that it used when estimating the 12-month and lifetime expected credit losses. For this purpose an entity shall disclose:

(a) the basis of inputs (for example, 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 in accordance with paragraph B25;

(b) an explanation of the changes in estimates of expected credit losses and the cause of those changes (for example, severity of loss, change in portfolio composition or changes in volume of financial instruments purchased or originated);

(c) any change in the estimation technique and the reason for that change; and

(d) information about the discount rate that the entity has selected in accordance with paragraph B29(a), including:

(i) what discount rate an entity has elected to use (ie risk-free rate, effective interest rate, or something in between) and the reasons for that election;

(ii) the discount rate (percentage) used; and

(iii) any significant assumptions made to determine the discount rate.

40 If an entity has financial assets, loan commitments or financial guarantee contracts secured by collateral or other credit enhancements, it shall disclose:

(a) a description of the collateral held as security and other credit enhancements, including a discussion on the quality of the collateral held (for example, the stability of the asset value and liquidity) and an explanation of any changes in the quality as a result of deterioration or changes in the collateral policies of the entity;

(b) the gross carrying amount of financial assets that have an expected credit loss of zero because of the collateral; and

(c) for financial instruments that have objective evidence of impairment at the reporting date, quantitative information about the extent to which collateral and other credit enhancements reduce the severity of expected credit loss.

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

The effect of changes in credit risk

42 An entity shall explain the inputs, assumptions and estimation techniques used when determining whether the credit risk of the financial instruments has increased significantly since initial recognition and when determining if it has objective evidence of impairment (see paragraphs 5, 14–15 and 25(b)). For this purpose an entity shall disclose:

(a) the basis of inputs (for example, 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 in paragraph 5 is assessed on a collective basis, in accordance with paragraphs B17–B18);

(b) an explanation of the changes in the estimates of the credit risk and the cause of those changes; and

(c) any change in the estimation technique and the reason for that change.

43 If an entity has rebutted the presumption that financial assets more than 30 days past due have a significant increase in credit risk, the entity shall disclose how it has rebutted that presumption (see paragraph 9).

44 An entity shall disclose, by *credit risk rating grades*, the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts in a grade. An entity shall disclose this analysis separately for financial assets, loan commitments and financial guarantee contracts for which the loss allowance or provision is measured in accordance with paragraphs 4, 5, 12 and 14–15. The number of credit risk rating grades used for this disclosure shall be sufficient to enable users of the entity's financial statements to assess the entity's exposure to credit risk. The number of grades shall not exceed the number that the entity uses for internal credit risk management purposes except that an entity shall always disaggregate its portfolio across at least three grades, even if that entity uses fewer credit risk rating grades internally. For trade receivables and lease receivables to which an entity applies paragraph 12, this disclosure may be based on a provision matrix (see paragraphs B34–B35).

45 An entity shall disclose the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts that are assessed on an individual basis and whose credit risk has increased significantly since initial recognition.

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

12-month expected credit losses	The **expected credit losses** that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.
amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.
credit loss	The present value of the difference between all principal and interest cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive. An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) through the expected life of that financial instrument or, when appropriate, a shorter period. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.
credit risk rating grades	Rating of credit risk based on the probability of a default occurring on the financial instrument.

credit-adjusted effective interest rate

The rate that exactly discounts the estimated future cash payments or receipts through the **remaining life of the financial asset** to the **amortised cost of a financial asset** that is a **purchased or originated credit-impaired financial asset**. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, call and similar options) and **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

effective interest method

The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

effective interest rate

Except for **purchased or originated credit-impaired financial assets**, the rate that exactly discounts estimated future cash payments or receipts through the **remaining life of the financial asset or financial liability** to the **gross carrying amount of a financial asset** or to the **amortised cost of a financial liability**. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18), **transaction costs**, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

expected credit losses

The weighted average of **credit losses** with the respective probabilities of default as the weights, for example, **credit losses** of CU100 × probability of a default occurring 5 per cent + CU0 × probability of no default occurring 95 per cent is equal to **expected credit losses** of CU5.

gross carrying amount of a financial asset	The **amortised cost amount of a financial asset**, excluding any **loss allowance**.
lifetime expected credit losses	The **expected credit losses** that result from all possible default events over the life of the financial instrument.
loss allowance	The allowance for **expected credit losses**.[12]
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** (or group of financial assets) to reflect the renegotiated or modified contractual cash flows. The entity recalculates the **gross carrying amount of a financial asset** as the present value of the estimated future contractual cash flows that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 92 of IAS 39.[13] When estimating the future contractual cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**.

12 For FVOCI it is the accumulated impairment amount as described in the Classification and Measurement ED.

13 This reference will ultimately be updated to reflect [draft] Chapter 6 *Hedge Accounting* in IFRS 9.

objective evidence of impairment

One or more events that have occurred that have an impact on the expected future cash flows of the financial instruments. It includes observable data that has come to the attention of the holder of the financial instrument about the following events:

(a) significant financial difficulty of the issuer or the borrower;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) 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 have caused objective evidence of impairment.

past due

A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.

purchased or originated credit-impaired financial asset

Purchased or originated financial asset(s) that have **objective evidence of impairment** on initial recognition.

remaining life of a financial asset or financial liability

The remaining contractual period, or a shorter period (for example, as a result of prepayments), over which there is exposure to credit risk on the financial instrument.

transaction costs

Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B4). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

The following terms are defined in paragraph 11 of IAS 32 or Appendix A of IFRS 9 and are used in this [draft] IFRS with the meanings specified in these Standards:

(a) financial asset

(b) financial guarantee contract

(c) financial instrument

Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

Effective interest rate

B1 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the effective interest rate over the remaining life of the financial instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the financial instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating-rate financial instrument reflects the interest that has accrued on that financial instrument since the interest was last paid, or changes in the market rates since the floating interest rate was reset to the market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to the market rates. If, however, the premium or discount results from a change in the credit spread over the floating-rate specified in the financial instrument, or other variables that are not reset to the market rates, it is amortised over the expected life of the financial instrument.

B2 For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a floating-rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

B3 If an entity revises its estimates of payments or receipts (excluding modifications as per paragraph 19 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial

assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92 of IAS 39.[14] The adjustment is recognised in profit or loss as income or expense.

Transaction costs

B4 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Best available information

B5 In accordance with paragraph 17(b), an entity shall consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.

B6 An entity need not undertake an exhaustive search for information but shall consider all available information that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, which may be internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no entity-specific or insufficient sources of data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

B7 An entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based and to remove the effects of the conditions in the historical period that do not exist currently. Estimates of changes in expected credit losses reflect, and are directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall

14 This reference will ultimately be updated to reflect [draft] Chapter 6 *Hedge Accounting* in IFRS 9

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

B8 When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group to be associated with information about past credit loss experience in groups of assets with similar risk characteristics and with relevant observable data that reflects current conditions.

Recognition and measurement

B9 At initial recognition an entity shall determine whether the financial instrument is a purchased or originated credit-impaired financial asset. A financial instrument shall not be considered to be a purchased or originated credit-impaired financial asset solely because of its credit risk on initial recognition. For a financial instrument to be a purchased or originated credit-impaired financial asset, there must be objective evidence of impairment at initial recognition.

B10 When applying this [draft] IFRS to loan commitments and financial guarantee contracts, the entity shall consider the probability of a default occurring on the loan commitment or, for financial guarantee contracts, the probability of a default occurring of the specified debtor.

Assessment of a significant increase in credit risk

B11 An entity measures the loss allowance (or provision) at an amount equal to lifetime expected credit losses if, at the reporting date, the credit risk has increased significantly since initial recognition (see paragraph 5). An entity shall use the lifetime probability of a default occurring when deciding whether the credit risk has increased significantly since initial recognition. However, an entity may use the 12-month probability of a default occurring to determine whether credit risk has increased significantly since initial recognition if the information considered does not suggest that the outcome would differ.

B12 The assessment of whether there has been a significant increase in credit risk is based on an increase in the probability of a default occurring since initial recognition rather than on evidence of an actual default or on objective evidence of impairment at the reporting date. Generally, there is a significant increase in credit risk before a default occurs or before there is objective evidence of impairment.

B13 The probability of a default occurring on financial instruments that have equivalent credit quality is higher the longer the remaining life of the instrument—for example, the probability of a default occurring on an AAA-rated bond with a remaining life of 10 years is higher than that on an AAA-rated bond with a remaining life of 5 years. Paragraph 8 requires an entity to consider the

probability of a default occurring over the remaining life of a financial instrument when assessing whether to recognise a loss allowance at an amount equal to lifetime expected credit losses.

B14 Because of the relationship between the remaining life and the probability of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute probability of a default occurring over time. For example, if the probability of a default occurring for a financial instrument with a remaining life of 10 years at initial recognition is identical to the probability of a default occurring on that financial instrument when its remaining life in a subsequent period is only 5 years, that may indicate an increase in credit risk. It may indicate an increase in credit risk because the probability of a default occurring over the remaining life usually decreases as time passes if the credit risk is unchanged and the financial instrument gets closer to maturity (see paragraphs 5 and 8).

B15 The significance of a change in the credit risk depends on the probability of a default occurring at initial recognition. Thus, a given change, in absolute terms, in the probability of a default occurring will be more significant for a financial instrument with a lower initial probability of a default occurring compared to a financial instrument with a higher initial probability of a default occurring. For example, an absolute change of 2 per cent in the probability of a default occurring will be more significant for an asset with an initial probability of a default occurring of 5 per cent, than for an asset with an initial probability of a default occurring of 20 per cent.

B16 If the credit risk of a financial instrument at the reporting date is low (see paragraph 6), the criterion for the recognition of lifetime expected credit losses is not satisfied and no analysis of the change in the credit risk since initial recognition of the instrument is required. An entity should therefore continue to recognise a loss allowance at an amount equal to 12-month expected credit losses for such financial instruments in accordance with paragraph 4.

Assessment of a significant increase in credit risk on an individual versus collective basis

B17 An entity shall assess whether a loss allowance or provision equal to an amount of 12-month or lifetime expected credit losses should be recognised on an individual instrument basis. However, an entity may perform this assessment on a collective basis (for example, on a group or portfolio basis) if the financial instruments have shared risk characteristics that are indicative of the borrowers' ability to pay all of the amounts due in accordance with the contractual terms. When assessed on such a basis, if a group of financial instruments have shared risk characteristics that result in the group of instruments having a significant increase in their probability of a default occurring since initial recognition, then lifetime expected credit losses would be recognised for each instrument in that group.

B18 Financial instruments shall not be grouped and assessed on a collective basis if the measurement of lifetime expected credit losses is appropriate for only some of the financial instruments in the group. An entity shall reassess its

aggregation of financial instruments as new information becomes available to ensure that the collective assessment for a group of instruments remains appropriate.

B19 Risk characteristics may include but are not limited to:

(a) instrument type;

(b) credit risk ratings;

(c) collateral type;

(d) date of origination;

(e) remaining term to maturity;

(f) industry;

(g) geographical location of the borrower; and

(h) the value of collateral relative to the commitment if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions).

Information to consider when making the assessment

B20 When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider the best information available that might affect the credit risk of the financial instrument in accordance with paragraphs 17(b) and B5–B8. Consideration of the following may assist the entity when making that determination:

(a) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same term. Changes in market indicators of credit risk include, but are not limited to:

  (i) the credit spread;

  (ii) the credit default swap prices for the borrower;

  (iii) the length of time and extent to which the fair value of a financial asset has been less than its amortised cost; and

  (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments;

(b) an actual or expected significant change in the financial instrument's external credit rating;

(c) significant changes in internal price indicators of credit risk as a result of a change in credit quality since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date;

(d) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher

income coverage) because of changes in the credit risk of the financial instrument since initial recognition;

(e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies;

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in a borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates;

(g) significant changes in operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's ability to meet its debt obligations;

(h) a significant credit deterioration on other financial instruments of the same borrower;

(i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology;

(j) significant changes in the value of the collateral supporting the obligation and the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;

(k) a significant change in the quality of the guarantee provided by a 100 per cent shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion;

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are

expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security);

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or a significant increase in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount);

(o) changes in the entity's credit management approach in relation to the financial instrument, ie based on emerging indicators of changes in credit quality of the financial instrument, the entity's credit risk management practice is expected to become more active or focused on managing the instrument, including an instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower; and

(p) past-due information as set out in paragraph 9.

B21 In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion in paragraph 5 for the recognition of a loss allowance or provision at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, ie qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

Modifications

B22 When determining whether there has been a significant increase in the credit risk of a financial instrument for which the contractual cash flows have been modified but for which the modification did not result in the derecognition of the instrument, an entity shall compare:

(a) the credit risk at the reporting date (based on the modified contractual terms); and

(b) the credit risk at initial recognition (based on the original, unmodified contractual terms).

B23 If the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification results in a derecognition of that financial asset, when this [draft] IFRS is applied to the modified financial asset the date of the modification shall be treated as the date of the initial recognition of that financial asset.

B24 For financial instruments that are assessed on the basis of past-due information and whose contractual cash flows have been modified, but for which that modification did not result in a derecognition, evidence that the criterion in paragraph 5 is no longer met may include a history of full and timely payment performance against the revised contractual cash flows, or other information that indicates that the borrower has improved its situation. A loan is not automatically considered to have improved in credit quality merely because the contractual cash flows have been modified.

Measurement

Measurement of loss allowance on an individual or collective basis

B25 An entity shall measure the loss allowance by estimating expected credit losses on an individual basis, or on a collective basis if the financial instruments have shared risk characteristics that are indicative of the borrowers' ability to pay all amounts due in accordance with the contractual terms (see paragraph B19 for examples of similar credit risk characteristics).

B26 An entity may change the basis for estimation of expected credit losses during the life of a financial instrument. For example, after a credit loss event occurs or when changing from recognising a loss allowance at an amount equal to 12-month expected credit losses to lifetime expected credit losses, a financial instrument (or subgroup) may be removed from a portfolio and added to a different portfolio, or the expected credit losses may be estimated individually for that financial instrument (or subgroup).

Credit losses

B27 Expected credit losses are an estimate of the present value of all cash shortfalls over the remaining life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due. Accordingly:

(a) for financial assets, a cash shortfall is the difference between:

  (i) the present value of the principal and interest cash flows due to an entity under the contract; and

  (ii) the present value of the cash flows that the entity expects to receive;

(b) for undrawn loan commitments, a cash shortfall is the difference between:

(i) the present value of the principal and interest cash flows due to the entity if the holder of the loan commitment draws down the loan; and

(ii) the present value of the cash flows that the entity expects to receive if the loan is drawn down;

an entity shall estimate expected credit losses consistently with its expectations that the loan commitment will be drawn down, ie it shall consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the remaining life of the loan commitment when estimating lifetime expected credit losses. Once a loan commitment is drawn down, the entity shall recognise the amount drawn down as a financial asset, and estimate its cash shortfalls in accordance with paragraph B27(a); and

(c) for a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

Probability-weighted outcome

B28 Paragraph 16(a) requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. In practice, this may not need to be a complex analysis. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes are likely to be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with paragraph 17.

Time value of money

B29 Except for purchased or originated credit-impaired financial assets, when determining the discount rate used to reflect the time value of money for the calculation of expected credit losses in accordance with paragraph 16(b):

(a) an entity shall, at initial recognition of a financial asset, determine as the discount rate for that asset any reasonable rate that is between (and including) the risk-free rate and the effective interest rate; and

(b) for undrawn loan commitments and financial guarantee contracts, an entity shall use a discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows but only if, and to the extent that, the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted. However, if the risk-adjustment is included by adjusting the discount rate, the adjusted discount rate will be lower than the risk-free rate.

In accordance with paragraph B29(a), the entity shall determine at initial recognition what discount rate to apply within the permitted range. An entity is permitted to select a current rate (for example the risk-free rate) when discounting the expected credit losses, but in subsequent periods the discount rate may be outside the permitted range that existed at initial recognition (for example, in the periods after initial recognition, the risk-free rate at the reporting date may exceed the effective interest rate determined on initial recognition).

B30 For purchased or originated credit-impaired financial assets expected credit losses shall be discounted using the credit-adjusted effective interest rate.

B31 Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date.

Collateral

B32 The estimate of expected cash flows on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure less costs for obtaining and selling the collateral, irrespective of whether foreclosure is probable (ie the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the recognition criteria for an asset in other Standards. An entity is required to disclose the gross carrying amount of financial instruments that have an expected credit loss of nil because of the value of collateral (see paragraph 40(b)).[15]

Lease receivables

B33 When measuring a loss allowance for a lease receivable, the cash flows used for the measurement should be consistent with the cash flows used in measuring the lease receivable in accordance with IAS 17. In addition, when selecting the

15 In a lease transaction, the cash flows due to a lessor are secured by the underlying leased asset because the lessor owns the underlying asset and will reclaim that asset in the event of default. In accordance with the guidance in the forthcoming revised Exposure Draft on leases, a lessor will, for some leases, recognise a lease receivable and a residual asset representing components of the underlying asset. In those cases, the lessor should consider the value of the collateral related to the right-of-use asset underlying the lease receivable when measuring the loss allowance.

discount rate to be used in accordance with paragraph B29(a), the upper limit of the range of discount rates is the discount rate used in the measurement of the lease receivable in accordance with IAS 17.

Practical expedients

B34 An entity may use practical expedients when estimating expected credit losses if they are consistent with the principles in paragraphs 16–17.

B35 An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs B7–B8) for trade receivables to estimate the expected credit losses that are possible in the next 12 months or over the remaining life of the assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 3 per cent if less than 90 days past due, 20 per cent if 90–180 days past due etc). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

Financial assets that have objective evidence of impairment subsequent to initial recognition

B36 For a financial asset that has objective evidence of impairment at the reporting date, but that is not a purchased or originated credit-impaired financial asset, an entity shall measure the expected credit losses as the difference between the asset's amortised cost and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The adjustment is recognised in profit or loss as an impairment reversal or impairment expense. The adjustment may include an amount that does not relate to impairment if the expected credit losses have been discounted at a rate other than the effective interest rate before objective evidence of impairment has been obtained.

Appendix C
Effective date and transition

This appendix is an integral part of the [draft] IFRS and has the same authority as the other parts of the [draft] IFRS.

C1 Paragraphs C2–C4 contain specific transition requirements for this [draft] IFRS. IFRS 9 *Financial Instruments* (issued in October 2010) and [draft] IFRS X *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) set out additional effective date and transition requirements for IFRS 9. For the purposes of the transition provisions in paragraphs C2–C4 the date of initial application is the beginning of the first reporting period in which the entity adopts this [draft] IFRS.

C2 An entity shall apply this [draft] IFRS retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except:

(a) if, at the date of initial application of this [draft] IFRS, determining the credit risk as at the initial recognition of a financial instrument would require undue cost or effort, the loss allowance or provision shall be determined only on the basis of whether the credit risk is low (paragraphs 6 and B16) at each reporting date until that financial instrument is derecognised; and

(b) the entity is not required to restate prior periods. However, the entity may restate prior periods if, and only if, this is possible without the use of hindsight.

If an entity does not restate prior periods it shall adjust the opening balance of its retained earnings (or other component of equity, as appropriate) for the effect of applying this [draft] IFRS at the beginning of the annual reporting period that includes the date of initial application.

C3 In the reporting period in which IFRS 9 is initially applied, an entity is not required to disclose the line item amounts that would have been reported in accordance with the expected credit loss and impairment requirements of:

(a) this [draft] IFRS for prior periods; and

(b) IAS 39 for the current period.

C4 On the date of initial application of this [draft] IFRS, an entity is required to disclose information that would permit the reconciliation of the ending impairment allowances under IAS 39 or the provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening loss allowances or provisions determined in accordance with this [draft] IFRS. For financial assets, this disclosure shall be provided by the related financial assets' measurement categories in accordance with IAS 39 and IFRS 9, and shall show separately the effect of the changes in the measurement category on the loss allowance at that date.

Appendix D
[Draft] Amendments to other IFRSs

Except where otherwise stated, an entity shall apply the amendments outlined in this [draft] Appendix when it applies the version of IFRS 9 issued on [date to be inserted after exposure] and at the same time apply the amendments in Appendix C of IFRS 9 issued in 2010 (including amendments resulting from ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9) *(2010)), and Appendix C of [draft] IFRS 9 incorporating Chapter 6* Hedge Accounting *issued in [year].*

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

In Appendix D, paragraph D19C is amended. New text is underlined and deleted text is struck through.

Designation of previously recognised financial instruments

...

D19C If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the ~~impairment~~ requirements for the recognition of expected credit losses in [draft] IFRS X ~~paragraphs 58–65 and AG84–AG93 of IAS 39~~, the fair value of the financial asset at the date of transition to IFRSs shall be the new amortised cost of that financial asset at the date of transition to IFRSs.

IFRS 7 *Financial Instruments: Disclosures*

Paragraph 4 is amended. Deleted text is struck through.

Scope

...

4 This IFRS applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of IFRS 9. Unrecognised financial instruments include some financial instruments that, although outside the scope of IFRS 9, are within the scope of this IFRS ~~(such as some loan commitments)~~.

Paragraph 16 is deleted and paragraph 20 is amended. New text is underlined and deleted text is struck through.

Allowance account for credit losses

16 [deleted] ~~When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.~~

...

Items of income, expense, gains or losses

20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

...

(d) [deleted] ~~interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39 *Financial Instruments: Recognition and Measurement*~~

(e) [deleted] ~~the amount of any impairment loss for each class of financial asset.~~

Paragraph 36 is amended and paragraph 37 and its related heading are deleted. Deleted text is struck through.

Credit risk

36 An entity shall disclose by class of financial instrument:

...

(c) [deleted] ~~information about the credit quality of financial assets that are neither *past due* nor impaired.~~

...

~~*Financial assets that are either past due or impaired*~~

37 [deleted] ~~An entity shall disclose by class of financial asset:~~

~~(a) an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and~~

~~(b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.~~

~~(c) [deleted]~~

In Appendix A, the definition of 'past due' is deleted and incorporated into IFRS 9. Deleted text is struck through.

~~**past due**~~ ~~A financial asset is past due when a counterparty has failed to make a payment when contractually due.~~

In Appendix B, paragraphs B5 and B9 are amended. New text is underlined and deleted text is struck through.

Other disclosure – accounting policies (paragraph 21)

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

...

(d) [deleted] ~~when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:~~

(i) ~~the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and~~

(ii) ~~the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 16).~~

...

(f) [deleted] ~~the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 20(e)).~~

(g) [deleted] ~~when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 36(d)).~~

...

Maximum credit risk exposure (paragraph 36(a))

B9 Paragraph 36(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

...

(b) any ~~impairment losses~~ loss allowance recognised in accordance with ~~IAS 39~~ [draft] IFRS X.

IFRS 9 *Financial Instruments*

Paragraphs 4.2.1 and 5.1.1 are amended. New text is underlined and deleted text is struck through.

4.2 Classification of financial liabilities

4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost using the *effective interest method*, except for:

...

(c) *financial guarantee contracts* as defined in Appendix A. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:

(i) the amount of the provision determined in accordance with ~~IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*~~ [draft] IFRS X and

...

(d) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 4.2.1(a) applies) subsequently measure it at the higher of:

(i) the amount of the provision determined in accordance with ~~IAS 37~~ [draft] IFRS X and

...

5.1 Initial measurement

5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at ~~At~~ initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Paragraph 5.1.3 is added. Note that the proposed new paragraph 5.1.3 refers to a [draft] Standard that the IASB has yet to complete. The IASB expects to issue a new Standard *Revenue from Contracts with Customers*, which is based on the Exposure Draft of the same name (ED 2011/6), before it completes these amendments to IFRS 9. The proposed new paragraph 5.1.3 and the proposed amendment to paragraph 5.1.1 of IFRS 9 would become effective when or after that new Standard becomes effective.

5.1.3 Notwithstanding the requirement in paragraph 5.1.1, at initial recognition, an entity shall measure trade receivables that do not have a significant financing component in accordance with IFRS [X] *Revenue from Contracts with Customers* at their transaction price as that term is defined in IFRS [X].

Paragraph 5.2.1 is amended and paragraph 5.2.2 is deleted. New text is underlined and deleted text is struck through.

5.2 Subsequent measurement of financial assets

5.2.1 After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1–4.1.5 at fair value or amortised cost[16] (see ~~paragraphs 9 and AG5–AG8~~ Appendix A and paragraphs B1–B3 of [draft] IFRS X ~~of IAS 39~~).

5.2.2 [deleted] ~~**An entity shall apply the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39 to financial assets measured at amortised cost.**~~

Paragraphs 5.3.1, 5.7.2 and 5.7.4 are amended. New text is underlined and deleted text is struck through.

5.3 Subsequent measurement of financial liabilities

5.3.1 After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1–4.2.2 (see paragraphs 5.4.1–5.4.3, ~~and~~ B5.4.1–B5.4.17 and Appendix A and paragraphs B1–B3 of [draft] IFRS X ~~9 and AG5–AG8 of IAS 39~~).

...

5.7 Gains and losses

5.7.2 A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89–102 of IAS 39) shall be recognised in profit or loss when the financial asset is derecognised, ~~impaired~~ adjusted for a loss allowance or reclassified in

16 The Classification and Measurement ED proposes amendments to this paragraph for the inclusion of the mandatory FVOCI measurement category to which this [draft] IFRS is proposed to apply.

accordance with paragraph 5.6.2, and through the amortisation process. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89–102 of IAS 39) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process.

...

5.7.4 If an entity recognises financial assets using settlement date accounting (see paragraph 3.1.2 and paragraphs B3.1.3 and B3.1.6), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets measured at amortised cost (other than ~~impairment~~ expected credit losses). For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 5.7.1.[17]

Paragraphs 7.1.1 and 7.2.10 are amended. New text is underlined and deleted text is struck through.

7.1 Effective date

7.1.1 An entity shall apply this IFRS for annual periods beginning on or after ~~1 January 2015~~ [date to be inserted]. Earlier application is permitted. However, if an entity elects to apply this IFRS early and has not already applied IFRS 9 issued in 2009, it must apply all of the requirements in this IFRS at the same time (but see also paragraph 7.3.2). If an entity applies this IFRS in its financial statements for a period beginning before 1 January 2015, it shall disclose that fact and at the same time apply the amendments in Appendix C.[18]

...

7.2 Transition

7.2.10 If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method ~~or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39~~, the entity shall treat the fair value of the financial asset or financial liability at the end of each comparative period as its amortised cost if the entity restates prior periods. If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method ~~or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39~~, the fair value of the financial asset or financial liability at the date of initial application shall be treated as the new amortised cost of that financial asset or financial liability at the date of initial application of this IFRS.

17 The Classification and Measurement ED proposes amendments to this paragraph for the inclusion of the mandatory FVOCI measurement category to which this [draft] IFRS is proposed to apply.

18 The Classification and Measurement ED proposes amendments to this paragraph to eliminate the phased implementation of IFRS 9.

In Appendix A, the list of terms defined in other Standards is amended as follows. New text is underlined and deleted text is struck through.

The following terms are defined in paragraph 11 of IAS 32, paragraph 9 of IAS 39 or Appendix A of IFRS 7 and are used in this IFRS with the meanings specified in IAS 32, IAS 39 or IFRS 7:

(a) [deleted] ~~amortised cost of a financial asset or financial liability~~

(b) credit risk

(c) [deleted] ~~effective interest method~~

(d) equity instrument

(e) financial asset

(f) financial instrument

(g) financial liability

(h) hedged item

(i) hedging instrument

(j) [deleted] ~~transaction costs.~~

(k) past due.

In Appendix B, paragraph B3.2.13 is amended. New text is underlined and deleted text is struck through.

Continuing involvement in transferred assets

B.2.13 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 3.2.16.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis (see IAS 18) and the gross carrying amount of the asset is reduced by any ~~impairment losses~~ loss allowance for the expected credit losses.

IAS 10 *Events after the Reporting Period*

Paragraph 9 is amended. Deleted text is struck through.

Adjusting events after the reporting period

...

9 The following are examples of adjusting events after the reporting period that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

...

(b) the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:

(i) [deleted] ~~the bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable; and~~

IAS 18 *Revenue*

Paragraph 30 is amended. New text is underlined and deleted text is struck through.

30 Revenue shall be recognised on the following bases:

(a) interest shall be recognised using the effective interest method as set out in ~~IAS 39, paragraphs 9 and AG5–AG8~~ [draft] IFRS X;

IAS 33 *Earnings per Share*

Paragraph 34 is amended. New text is underlined and deleted text is struck through.

Earnings

...

34 After the potential ordinary shares are converted into ordinary shares, the items identified in paragraph 33(a)–(c) no longer arise. Instead, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. Therefore, profit or loss attributable to ordinary equity holders of the parent entity calculated in accordance with paragraph 12 is adjusted for the items identified in paragraph 33(a)–(c) and any related taxes. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method (see [draft] IFRS X ~~paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*, as revised in 2003~~).

IAS 36 *Impairment of Assets*

Paragraph 4 is amended. New text is underlined and deleted text is struck through.

Scope

...

4 This Standard applies to financial assets classified as:

(a) subsidiaries, as defined in IFRS 10 *Consolidated Financial Statements*;

(b) associates, as defined in IAS 28 *Investments in Associates and Joint Ventures*; and

(c) joint ventures, as defined in IFRS 11 *Joint Arrangements*.

For impairment of other financial assets, refer to [draft] IFRS X ~~IAS 39~~.

IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraphs 2 is amended. New text is underlined and deleted text is struck through.

Scope

2 This Standard shall be applied by all entities to all types of financial instruments except:

...

(h) loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply [draft] IFRS X ~~IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*~~ to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of IFRS 9 ~~this Standard~~.

Paragraph 8 is amended. In paragraph 9 the heading and the definitions relating to recognition and measurement are deleted and included in IFRS 9, subject to the amendments proposed in Appendix A of this [draft] IFRS. Deleted text is struck through.

Definitions

8 The terms defined in IFRS 9 and IAS 32 are used in this Standard with the meanings specified in Appendix A of IFRS 9 and paragraph 11 of IAS 32. IFRS 9 and IAS 32 define the following terms:

- amortised cost
- derecognition

- derivative
- effective interest method
- effective interest rate
- equity instrument
- fair value
- financial asset
- financial guarantee contract
- financial instrument
- financial liability
- transaction costs

and provide guidance on applying those definitions.

9 **The following terms are used in this Standard with the meanings specified:**

~~Definitions relating to recognition and measurement~~

[deleted] ~~**The *amortised cost of a financial asset or financial liability* is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.**~~

[deleted] ~~**The *effective interest method* is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period**~~.

[deleted] ~~**The *effective interest rate is the rate* that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).**~~

[deleted] ~~***Transaction costs* are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.**~~

...

The heading before paragraph 58 and paragraphs 58–65 are deleted.

~~Impairment and uncollectibility of financial assets measured at amortised cost~~

58 [deleted] ~~**An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.**~~

59 [deleted] ~~A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:~~

~~(a) significant financial difficulty of the issuer or obligor;~~

~~(b) a breach of contract, such as a default or delinquency in interest or principal payments;~~

~~(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;~~

~~(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;~~

~~(e) the disappearance of an active market for that financial asset because of financial difficulties; or~~

~~(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:~~

(i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

(ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

60 [deleted] The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

62 [deleted] In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

63 [deleted] **If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.**

64 [deleted] An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets

~~that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.~~

65 [deleted] **~~If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.~~**

In Appendix A, paragraph AG4 is amended. Paragraphs AG5–AG8, AG13 and AG84–AG93 and their related headings are deleted. New text is underlined and deleted text is struck through.

Scope (paragraphs 2–7)

...

AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 4 if the risk transferred is significant, the issuer applies this Standard and IFRS 9. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard and IFRS 9 or IFRS 4 to such financial guarantee contracts. If this Standard and IFRS 9 apply, paragraph 5.1.1 of IFRS 9 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 of IFRS 9 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance [draft] IFRS X ~~with IAS 37~~; and

...

~~Effective interest rate~~

AG5 [deleted] ~~In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.~~

AG6 [deleted] ~~When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.~~

AG7 [deleted] ~~For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.~~

AG8 [deleted] ~~If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense.~~

...

~~Transaction costs~~

AG13 [deleted] ~~Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.~~

~~Impairment and uncollectibility of financial assets measured at amortised cost (paragraphs 58–65)~~

AG84 [deleted] ~~Impairment of a financial asset measured at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a financial asset measured at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a financial asset measured at amortised cost has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset measured at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.~~

AG85 [deleted] ~~The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.~~

AG86 [deleted] ~~The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period.~~

AG87 [deleted] ~~For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.~~

AG88 [deleted] ~~Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.~~

AG89 [deleted] ~~Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.~~

AG90 [deleted] ~~As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.~~

AG91 [deleted] ~~When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.~~

AG92 [deleted] ~~Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (eg for smaller balance loans) as long as they are consistent with the requirements in paragraphs 63–65 and AG87–AG91. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.~~

~~Interest income after impairment recognition~~

AG93 [deleted] ~~Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.~~

Approval by the Board of *Financial Instruments: Expected Credit Losses* published in March 2013

The Exposure Draft *Financial Instruments: Expected Credit Losses* was approved for publication by thirteen of the fifteen members of the International Accounting Standards Board. Mr Cooper voted against its publication. His alternative views are set out after the Basis for Conclusions. Ms Tokar abstained in view of her recent appointment to the IASB.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Martin Edelmann	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Patricia McConnell	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

Illustrative examples

These examples accompany, but are not part of, this [draft] IFRS. They illustrate aspects of the [draft] IFRS but are not intended to provide interpretative guidance.

IE1 These examples portray hypothetical situations illustrating the judgements that might be used when applying the [draft] IFRS. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying this [draft] IFRS.

Example 1—12-month expected credit loss measurement using an explicit 'probability of a default occurring' (PD) approach

IE2 Entity A originates a single loan for CU1,000,000. Taking into consideration the expectations for instruments of similar credit quality (using the most relevant information available, such as holder-specific data or industry data), the credit quality of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the instrument has a 0.5 per cent PD in the next 12 months. Entity A assumes that 25 per cent of the gross carrying amount will be lost if the loan defaults (ie the loss given default or 'LGD'). Entity A recognises a loss allowance at an amount equal to 12-month expected credit losses using the 0.5 per cent 12-month PD. Implicit in that calculation is the 99.5 per cent probability that there is no default.

The loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

IE3 Entity B acquires a portfolio of 1,000 loans for CU1,000 each (ie CU1,000,000 in total). Entity B estimates that there is an average 0.5 per cent PD in the next 12 months for the portfolio, and an average LGD of 25 per cent.[19] No individual item has yet been identified as being different from the portfolio characteristics so the entity assesses that the PD and LGD of the portfolio equals the PD and LGD of each item. Entity B recognises a loss allowance equal to 12-month expected credit losses based on the average 0.5 per cent 12-month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default.

The loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Example 2—12-month expected credit loss measurement based on loss rate approach

IE4 Bank A originates 100 personal loans with a total carrying amount of CU500,000. Bank A segments its portfolio into borrower groups X and Y on the basis of common risk characteristics that are indicative of the borrower's ability to pay all amounts that are contractually due. Groups X and Y make up CU200,000 and CU300,000 of the carrying amount respectively. The principal

19 Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.

per client is CU4,000 for Group X and CU6,000 for Group Y. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

IE5 Bank A estimates expected credit losses based on a loss rate approach for groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. It also updates that information for current economic conditions as well as reasonable and supportable forecasts of future events and economic conditions.

IE6 Historically, for a population of 50 loans in each group, Group X's per annum average was four defaults in the first year, and Group Y's per annum average was two defaults in the first year. Over the entire contractual term of those loans that defaulted in the first year after origination, the present value of the observed credit loss was CU12,000 for Group X and CU8,000 for Group Y. This resulted in historical loss rates for the first year of 6 per cent and 2.7 per cent respectively.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	50	CU4,000	CU200,000	4	CU16,000	CU12,000	6%
Y	50	CU6,000	CU300,000	2	CU12,000	CU8,000	2.7%

IE7 At the current reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates six defaults in the next 12 months for 50 loans in Group X and four for 50 loans in Group Y. It estimates that the present value of observed credit loss per client will remain consistent with the historical loss per client.

IE8 On the basis of its forecasts, Bank A estimates expected credit losses in the first year on the 50 loans it originated equal to CU18,000 and CU16,000 respectively, which equates to a loss rate in the first year of 9 per cent for Group X and 5.3 per cent for Group Y.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	50	CU4,000	CU200,000	6	CU24,000	CU18,000	9%
Y	50	CU6,000	CU300,000	4	CU24,000	CU16,000	5.3%

IE9 Bank A uses the loss rates of 9 per cent and 5.3 per cent to estimate 12-month expected credit losses on other loans in Group X and Group Y, respectively, which Bank A originated during the year.

Example 3—Recognising lifetime expected credit losses

IE10 Company Y has a funding structure that is comprised of CU400 million of senior secured loans with different tranches (all with a five-year maturity) and a CU150 million subordinated unsecured bond (with a six-year maturity).[20] Company Y also has CU50 million cash on its balance sheet plus CU30 million of undrawn revolving facilities. Company Y is rated as non-investment grade by external rating agencies.

IE11 Bank X participates in the senior secured loan financing, which is not rated by an external ratings agency. At the time of origination, although Company Y's leverage was high compared with issuers with similar credit quality, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. Company Y was expected to generate an operating profit of CU100 million per year and was not expected to spend on restructuring its business. However, on origination, there was some business risk related to the ability to grow gross margins within its existing businesses. In the past, Company Y has focused on growth through acquisition. This has resulted in a constant decrease of cash reserves, which has lowered Company Y's capacity to meet its financial commitments.

IE12 At initial recognition, because of the considerations outlined in paragraph IE11, Bank X considers that its loan to Company Y does not have low credit risk. Instead, Bank X determines that the economic conditions and business risk to which Company Y is exposed, and the drain on its cash reserves, could have a severe impact on its ability to meet its financial commitments, leading to default on the senior secured loan financing. Bank X recognises a loss allowance at an amount equal to 12-month expected credit losses at initial recognition.

20 The security on the loan affects the loss that would be realised if a default occurs, but does not affect the probability of a default occurring, so it is not considered when determining whether a loss allowance at an amount equal to 12-month or lifetime expected credit losses is required (which is determined by paragraph 5).

Despite the high credit risk at initial recognition, the loan is not considered to be an originated credit-impaired loan because it does not have objective evidence of impairment at initial recognition.

IE13 Company Y has subsequently underperformed on its business plan by 15 per cent on revenue generation and by 20 per cent on net cash flow generation. Macroeconomic changes have had a negative effect on the total sales volume. Spending on inventory has increased but anticipated sales have not materialised. In addition, in contrast to previous expectations, Company Y continued to spend on restructuring its acquired businesses, which increased cash outflows. To increase liquidity, Company Y has drawn CU20 million of its senior revolving facility increasing its indebtedness. Consequently, Company Y is now close to breaching its covenants on the senior secured loan facility. Recently, the fair values for Company Y's loans as well as the subordinated bond have fallen, but the rating agencies have not yet reacted to the latest developments.

IE14 Bank X makes an overall assessment of the credit risk on its loan to Company Y at the reporting date by taking into consideration all reasonably available information that is relevant for the estimate. Bank X determines that if it were to newly originate the loan, it would do so on significantly different terms (for example, interest rates would be higher) because of the significant increase in the credit risk on the loan. This is demonstrated by factors that include:

(a) Its expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to deleverage.

(b) Contrary to management's initial projections, the ongoing restructuring expenses continue to impose cash outflows on the business. Bank X is of the view that Company Y may be unable to prevent these cash outflows continuing.

(c) Company Y is closer to breaching its covenants, which may result in a need to reset the covenants.

(d) Its assessment that the trading prices for Company Y's loans have been going down, reflecting the increase in credit risk—the reduced price is not explained by changes in the market environment (for example, benchmark interest rates, liquidity etc) and a further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's loans have probably been caused by company-specific factors (instead of, for example, price fluctuations that were caused by the general market sentiment).

(e) A downgrade of Company Y's rating would not be unexpected, even though rating agencies have not reacted so far. Bank X has already reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the deterioration in credit quality.

IE15 The senior secured loan to Company Y does not have a low credit risk at the reporting date and there has been a significant increase in the credit risk since initial recognition. Consequently, Bank X recognises lifetime expected credit losses on its senior secured loan to Company Y.[21]

Example 4—No recognition of lifetime expected credit losses

IE16 Company C is a group holding company that has senior unsecured loan funding of CU1 billion (CU200 million in an undrawn revolving credit facility, CU300 million in Term Loan A with a 2-year remaining tenor and a CU500 million senior unsecured bond with a 3-year remaining tenor). The group's operating profit is expected to reach CU350 million at the end of the year. Company C has CU100 million of cash. At the time of origination, leverage was in line with that of other issuers with similar credit quality and the company's leeway in coverage ratios before it hits default is high, based on projections for the life of Loan A.

IE17 Company C operates in a cyclical production industry and is currently at the mid-level of industry cycle performance in terms of revenue and operating profit generation. The prospects for the industry are positive, given expectations of further increases in global demand. However, input prices are volatile. In addition, in the past Company C has been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast cash that will be available at the holding company level. Even though leverage is at acceptable levels, creditors are concerned about Company C's ability to refinance its debt given the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries. This concern is increased by Company C's aggressive acquisition strategy.

IE18 Bank B participates in Term Loan A. Bank B applies its own internal rating methods to manage credit risk and allocates a specific internal rating score to its loans. Bank B's internal rating categories are based on historical, current and forward-looking information and reflect the credit quality for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. Bank B recognises a loss allowance at an amount equal to 12-month expected credit losses at initial recognition because the loan does not have objective evidence of impairment at initial recognition.

IE19 After initial recognition, Company C has announced that sales for three of its five key subsidiaries dropped by 15 per cent due to market conditions. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure that will streamline its subsidiaries under one major operating company (ie the operating company rather than the holding company

21 As determined by assessing the criterion in paragraph 5.

will be the owner of the subsidiaries). This restructuring will increase the flexibility to refinance existing debt and the ability of subsidiaries to pay dividends to Company C.

IE20 If Bank B were to newly originate the loan, it would not do so on significantly different terms (such as interest rates or covenants), despite the increased credit risk. Given all the reasonably available and supportable information, Bank B decides that, although there is a deterioration in some indicators that affect the probability of a default occurring on Loan A, that decline is not significant because:

(a) the decrease in sales is within the range expected during the full industry cycle;

(b) given the increased flexibility to refinance existing debt at the operating companies and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some concern about the ability to refinance the existing debt at the holding company; and

(c) Bank B's credit risk department, which monitors Company C, considers that the latest developments are not significant enough to justify a change of its internal rating.

IE21 Although Company C is exposed to adverse conditions that could lead to default, Bank B assesses that the increase in credit risk since initial recognition is not significant. As a consequence, Bank B does not recognise lifetime expected credit losses for Term Loan A. However, it updates the estimate of 12-month expected credit losses for the increased probability of a default occurring in the next 12 months and for current expectations of the credit loss that would arise if a default were to occur.

Example 5—Highly collateralised debt

IE22 Company H owns and operates three private hospitals. The three real estate assets (the hospitals) are financed by a five-year loan from Bank Z with a Loan-to-Value (LTV) ratio of 50 per cent—the value of the three assets is CU800 million, and the notional value of the loan is CU400 million on origination. The loan is secured with first-ranking security over the real estate assets.

IE23 The hospitals' revenues and operating profits have been constantly increasing over the last five years. On origination, Bank Z decides that the credit risk on the loan is low. Credit risk is low because default is not imminent and adverse economic conditions or changing circumstances may lead, at most, to a weakened capacity of the borrower to meet its financial commitments on the obligation.

IE24 In order to upgrade the quality of service, a refurbishment of key parts of the hospitals has recently commenced. This has led to a reduction in in-patient treatments of approximately 10 per cent.

IE25 Recently, the level of demand at the hospital has come under pressure. The economic recession has reduced the number of international in-patients by

more than 20 per cent. In addition, regulations that require the treatment of public patients in private hospitals are at risk of being introduced. That change would have the potential to further negatively affect revenue and operating profit. These negative effects on the hospitals' operations could be significant and ongoing.

IE26 As a result of these recent events, free cash flow is expected to be reduced so that the coverage of scheduled loan payments could be tight. Bank Z estimates that a further deterioration in cash flows would probably result in an event of default under the loan agreement.

IE27 Recent third party appraisals have valued the three real estate properties at close to CU600 million. The current outstanding amount on the loan is still CU400 million, resulting in a current LTV ratio of 66 per cent.

IE28 Bank Z's overall assessment is that the credit risk on the loan is not low at the reporting date. Instead, the loan is subject to considerable credit risk at the reporting date because a further deterioration in cash flows could result in an event of default as defined in the loan agreement. As a result, Bank Z determines that the credit risk has increased significantly since initial recognition. Although Bank Z does not expect to suffer a credit loss if a default occurred (ie the LGD is assessed to be zero per cent), the probability of a default occurring that would cause recourse to the collateral has increased significantly. Consequently, Bank Z recognises lifetime expected credit losses for the loan. Although lifetime expected credit losses shall be recognised, the amount is nil as the loan is expected to be fully recoverable through the collateral held.

Example 6—Public investment-grade bond

IE29 Company A is a large, listed, national logistics company. The only debt in the capital structure is a five-year public bond. The only bond covenant is a restriction on further borrowing. Company A reports quarterly to its shareholders. Company B is one of many public bond investors and holds a portion of the notional amount of the bond. Company B makes an initial credit assessment that the bond is subject to low credit risk. Company A's capacity to meet its financial commitments is very strong and the bond had an investment-grade rating when it was acquired. Company B recognises a loss allowance at an amount equal to 12-month expected credit losses (because the loan does not meet the definition of a purchased credit-impaired financial asset).

IE30 The main credit concern is the continuing pressure on the total volume of sales that has caused operating cash flows to decrease.

IE31 Because Company B relies only on quarterly public information and does not have access to private credit information (because it is a bond investor rather than a bilateral lender), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

IE32 Subsequent to initial recognition, Company B evaluates again whether the bond has a low credit risk at the reporting date, using all reasonably available and

supportable information. In making that evaluation, Company B determines that the internal rating of the bond is not equivalent to investment grade because:

(a) the latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent;

(b) rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade;

(c) the bond price has also declined significantly, which has resulted in a higher yield to maturity. Company B assesses that the bond prices have been declining as a result of the deterioration in the issuer's credit quality. This is because the market environment has not changed (for example, benchmark interest rates, liquidity etc) and comparison with the bond prices of peers show that the reductions are probably company specific (instead of being, for example, price fluctuations due to the general market sentiment).

IE33 While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions may lead to it defaulting on the bond. As a result of the factors described in paragraph IE32, Company B assesses that the bond does not have low credit risk at the reporting date. It decides that the credit risk has increased significantly since initial recognition. Company B therefore recognises a loss allowance at an amount equal to lifetime expected credit losses for the bond.

Example 7—Portfolio of credit cards

IE34 Bank A provides co-branded credit cards in conjunction with a local department store. The credit cards are cancellable after a one-day notice period. The department store originates the credit cards according to an agreed set of credit criteria. A behavioural score can only be determined once the credit card has been active for an initial period of six months and, as a result, a pseudo-origination score is determined from the behavioural credit score over this initial period. Because no credit score is determined at origination, Bank A uses the past-due status as the primary measure of credit risk until a behavioural score can be determined.

Determining a significant increase in credit risk using an automated scoring process

IE35 At each reporting date, Bank A is able to determine if there has been a significant increase in the credit risk since initial recognition by means of the behavioural scoring process which incorporates factors such as:

(a) the utilisation of credit limit;

(b) the level of monthly payments, in particular differentiating 'transactors' (ie those who pay off their balance in full each month) and 'revolvers' (ie those who usually only pay the minimum monthly amount required, letting the remaining balance accrue interest);

(c) previous limit excesses; and

(d) previous past due statuses.

IE36 The automated process enables Bank A to determine the probability of a customer defaulting on their obligations.

IE37 At the end of each reporting period, Bank A compares the probability of a default occurring to the pseudo-origination score to determine whether there has been a significant increase in the credit risk.

Recognition and measurement of expected credit losses

IE38 At initial recognition, Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses. In subsequent periods, Bank A recognises a loss allowance at an amount equal to lifetime expected credit losses for the drawn amounts of those customers for which there has been a significant increase in credit risk and a 12-month loss allowance for the drawn amounts of all other customers.

Liability for undrawn amount

IE39 As the credit cards have a one-day notice period, after which Bank A has the ability to revoke its commitment to make further credit advances, it has a present contractual obligation to extend credit over this one-day period. Bank A does not expect to exercise its cancellation rights on any of the credit cards; however, at the reporting date, it only has a present contractual obligation to make the undrawn facility available for one day. Bank A determines the expected use over this one-day commitment period and repayment period to determine the expected credit losses for which a provision should be recognised.

Deterioration in economic conditions

IE40 During a subsequent reporting period, economic conditions deteriorate and Bank A anticipates significant increases in unemployment. As a result, Bank A expects increases in credit card defaults. A significant increase in credit risk due to unemployment is generally detected by the behavioural scoring process due to increased credit card use or an increase in customers approaching or exceeding their credit card limit in combination with changing from being 'transactors' to 'revolvers'. The behavioural scoring process has not yet reflected these expected increases in defaults at the reporting date but Bank A incorporates this forward-looking information in its estimates of expected credit losses.

IE41 However, this forward-looking information cannot be attributed to specific customers and relates to the portfolio as a whole. As the credit card portfolio continues to have shared risk characteristics, Bank A continues to assess the portfolio on a collective (portfolio) basis and determines that, except for those financial instruments that are newly originated, there has been a significant increase in the credit risk of the portfolio since initial recognition. As a result, Bank A changes the measurement of the loss allowance to lifetime expected credit losses.

Example 8—Portfolio of retail mortgages

IE42 Bank ABC provides mortgages to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups.

IE43 Bank ABC sets its acceptance criteria based on credit scores, and loans with a credit score above the 'acceptance level' are approved as these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Bank ABC uses the credit score to determine the probability of a default occurring as at initial recognition.

IE44 During the current reporting period economic conditions have deteriorated significantly in all regions. Unemployment levels have increased and the value of residential property has decreased, causing the LTV ratios to increase. Bank ABC also expects default rates on the mortgage portfolio to increase.

Region One

IE45 In Region One, Bank ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past-due statuses, levels of customer indebtedness, LTV ratios, customer behaviour on their other loans with Bank ABC, the loan size and the time since the origination of the loan.

IE46 Bank ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a customer has less economic incentive to make scheduled mortgage repayments, and the lessened incentive to make the repayments increases the probability of a default occurring. Bank ABC updates the current LTV measures on a regular basis through the automated processes that re-estimate property values using recent sales in each postal code area. Through the impact of the LTV measure in the behavioural scoring model, an increased risk due to a decline in residential property value accurately adjusts the behavioural scores.

IE47 For each loan in this region, Bank ABC assesses the probability of a default occurring by monitoring behavioural scores and past-due statuses. Bank ABC considers that there has been a significant increase in credit risk since initial recognition if there has been a significant decrease in the behavioural score or if the mortgages are more than 30 days past due. For loans meeting either of these criteria, a loss allowance at an amount equal to lifetime expected credit losses is recognised.

IE48 Bank ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, ie the LGD. The higher the LTV measure, the higher the expected credit losses all else being equal.

Subsequent improvement in economic conditions

IE49 If economic conditions in the following reporting period improve to such an extent that there is no longer a significant increase in credit risk as measured by the behavioural score compared to the origination score, and the mortgages are

no longer more than 30 days past due, the allowance for expected credit losses is reduced to an amount equal to the 12-month expected credit losses.

Regions Two and Three

IE50 In Regions Two and Three, Bank ABC does not have an automated scoring capability. Instead, Bank ABC tracks the probability of a default occurring by means of past-due statuses. It recognises a loss allowance at an amount equal to lifetime expected credit losses for all loans that have a past-due status of more than 30 days past due. Although Bank ABC uses past-due status information as the only borrower-specific information, it also considers other forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses should be recognised on loans that are not more than 30 days past due as described in IE51 and IE52.

IE51 Region Two includes a mining community that is largely dependent on the export of coal and related products. These loans are not considered to have low credit risk at the reporting date. Bank ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. As the probability of a default occurring on mortgage loans to borrowers in these areas who rely on the coal mines is determined to have increased significantly, Bank ABC segments its mortgage portfolio to identify customers that rely on coal mining as the dominant source of employment. For such mortgages, Bank ABC recognises a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognise a loss allowance at an amount equal to 12-month expected credit losses for all other mortgages. Newly originated loans to borrowers who rely on the coal mines in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses as they would not have experienced a significant increase in their credit risk since initial recognition.

IE52 In Region Three, Bank ABC anticipates the probability of a default occurring and thus an increase in credit risk as a result of an increase in interest rates. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three. As a result of the increase in interest rates, Bank ABC determines that the credit risk on the mortgages in Region Three has increased significantly since initial recognition. The loans in Region Three are not considered to have low credit risk at the reporting date. Bank ABC is unable to attribute the significant increase in the probability of a default occurring to any specific segment of the mortgage portfolio and recognises lifetime expected credit losses for all mortgage loans issued in Region Three.

Example 9—Modification

IE53 Bank A originates a four-year loan that requires the repayment of the principal in full at maturity. Its principal amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent.

IE54 At initial recognition (period 1), Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because the loan is not a purchased or originated credit-impaired financial asset. The loss allowance balance is CU1.

IE55 In the subsequent year (period 2), Bank A determines that the credit risk on the loan has increased significantly. Also, the loan does not have low credit risk at the reporting date. As a result of this increase, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU98.

IE56 At the beginning of the third year (period 3), Bank A modifies the contractual cash flows on the loan. It reduces the principal that was due under the original contractual terms of the loan and extends the term of the loan to a total of six years. The modification does not result in the derecognition of the loan.

IE57 As a result of that modification, Bank A has a modification loss of CU300, which is the difference between the gross carrying amount of the loan and the present value of the modified interest and principal payments that are discounted at the loan's effective interest rate. Bank A recognises the restructuring loss against the gross carrying amount of the loan, reducing it to CU700, and recognises a modification loss of CU300 in profit or loss.

IE58 Bank A must also remeasure the loss allowance, taking into account the modified contractual cash flows and must evaluate whether the loss allowance for the loan shall continue to be measured at an amount equal to lifetime expected credit losses. Bank A evaluates the current credit risk taking into consideration the modified cash flows and compares that with the credit risk at initial recognition on the original (unmodified) cash flows. Bank A decides that the deterioration in credit quality is still significant and continues to measure the loss allowance at an amount equal to lifetime expected credit losses, which is CU156 at the reporting date.

IE59 Because Bank A grants the borrower a concession for economic reasons that relate to the borrower's financial difficulties that it would not otherwise do, the loan has objective evidence of impairment. Bank A presents interest revenue calculated on the amortised cost (net) amount in the period after the modification.

Period	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: F × 5%	E	F = A + C + D – E	G	H = F – G
1	CU1,000	(CU1)		CU50	CU50	CU1,000	CU1	CU999
2	CU1,000	(CU97)		CU50	CU50	CU1,000	CU98	CU902
3	CU1,000	(CU58)	(CU300)	CU35	CU35	CU700	CU156	CU544

IE60 At each subsequent reporting date until maturity, Bank A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows) and assesses whether the loan has low credit risk. Bank A also assesses whether the calculation of interest revenue on the amortised cost is still applicable.

IE61 At 24 months after the loan modification, the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. Liquidity has also improved to such an extent that the borrower makes a voluntary prepayment of CU200 on its notional exposure to Bank A. An assessment of all reasonably available information indicates that the overall risk on the loan has decreased and credit quality has improved, so Bank A adjusts the borrower's internal credit rating. Because these improvements have occurred after the modification and have caused the expected credit losses to decrease, interest revenue is no longer calculated on the amortised cost amount. Bank A once again calculates interest revenue on the gross carrying amount. However, at this point the credit risk is not considered low and credit risk is still considered to have increased significantly since initial recognition. Bank A therefore continues to measure the loss allowance at an amount equal to lifetime expected credit losses.

IE62 The borrower continues to outperform its business plan 12 months after the prepayment with a continuous positive outlook. Given the positive overall development, Bank A re-assesses the situation and concludes, using all reasonably available information, that the credit risk of the loan has been reduced to the level as of origination. The loan no longer has significant deterioration in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

Example 10—Debt instruments mandatorily measured at FVOCI

IE63 An entity purchases a debt instrument with a fair value of CU1,000 on 1 January 20X0 and classifies the debt instrument as mandatorily measured at FVOCI. The instrument carries a market-related interest rate of 5 per cent over the contractual term of ten years, and has a 5 per cent effective interest rate. At initial recognition the entity determines that the asset is not credit-impaired. The entity recognises an impairment loss in profit or loss at an amount equal to 12-month expected credit losses of CU20. The journal entries to recognise the debt instrument and the expected credit losses on 1 January 20X0 would be as follows:

	Debit	Credit
Financial asset—FVOCI	CU1,000	
Cash		CU1,000
Impairment (profit or loss)	CU20	
Other comprehensive income		CU20

IE64 Disclosure would be provided about the 'loss allowance' amount of CU20.[22]

IE65 On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates and an increase in expected credit losses. The entity determines that there has not been a significant increase in credit risk since initial recognition and that it is still appropriate to measure expected credit losses at an amount equal to 12-month expected credit losses. However, the expected credit losses have increased by CU10 (ie from CU20 to CU30).[23] The journal entries to recognise the increase in expected credit losses and the changes in the fair value of the instrument would be as follows:

	Debit	Credit
Impairment (profit or loss)	CU10	
Other comprehensive income	CU40	
Financial asset—FVOCI		CU50

IE66 Disclosure would be provided about the accumulated impairment amount (the 'loss allowance') of CU30.

IE67 On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date. The journal entries to derecognise the debt instrument and reclassify the gains and losses that have accumulated in other comprehensive income would be as follows:

22 The presentation of a loss allowance balance in the statement of financial position is prohibited (see ED 2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*, which proposes to add paragraph 16A to IFRS 7). However, disclosure of 'loss allowance' information is still required.

23 For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Cash	CU950	
Financial asset—FVOCI		CU950
Loss on sale (profit or loss)	CU20	
Other comprehensive income		CU20

Example 11—Short-term trade receivables

IE68 Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20XX and operates only in one geographical region. The trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The majority of the trade receivables have a maturity of less than one year and do not have a significant financing component in accordance with IAS 18 *Revenue*. The customer base consists of a large number of small clients.

IE69 To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on Company M's historical observed default rates over the life of the trade receivables and is additionally adjusted by a forward-looking estimate that includes the probability of a worsening economic environment within the next year. At every reporting date the historical observed default rates are updated and changes of forward-looking estimates are analysed.

IE70 On that basis, Company M estimates the following provision matrix:

	Not past due	1–30 days past due	31–60 days past due	61–90 days past due	Over 90 days past due
Lifetime expected credit loss rate	0.3%	1.6%	3.6%	6.6%	10.6%

IE71 The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance
Not past due	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
Over 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

Example 12—Disclosures: reconciliation

IE72 The following example illustrates one way of applying the disclosure requirements as set out in paragraph 35. The below reconciliation does not illustrate the requirements for financial assets for which there is objective evidence of impairment on initial recognition, and does not disaggregate the disclosures by class.

Reconciliation of the gross carrying amount of those assets with the loss allowance measured at an amount equal to 12-month expected credit losses	**20XX '000**
	CU
Gross carrying amount at 1 January	112,500
Financial assets changed to have a loss allowance at an amount equal to 12-month expected credit losses	3,200
Financial assets changed to have a loss allowance at an amount equal to lifetime expected credit losses	(8,500)
Interest revenue using the effective interest method	5,650
Repayments of principal and interest	(29,500)
New financial assets originated or purchased	20,600
Recoveries of amounts previously written off	650
Foreign exchange and other movements	(1,400)
At 31 December	103,200

Loss allowance measured at 12-month expected credit losses	**20XX '000**
	CU
Loss allowance at 1 January	5,400
Amount charged to profit or loss	800
Other movements	(400)
At 31 December	5,800

Reconciliation of the gross carrying amount of those assets with the loss allowance measured at an amount equal to lifetime expected credit losses	**20XX '000**
	CU
Gross carrying amount at 1 January	45,000
Financial assets changed to have a loss allowance at an amount equal to lifetime expected credit losses	8,500
Financial assets changed to have a loss allowance at an amount equal to 12-month expected credit losses	(3,200)
Interest revenue using the effective interest method	4,250
Repayments of principal and interest	(3,400)
Amounts written off	(2,000)
Modification of cash flows	(600)
Recoveries of amounts previously written off	450
Other movements	(750)
At 31 December	48,250

Loss allowance measured at an amount equal to lifetime expected credit losses	**20XX '000**
	CU
Loss allowance at 1 January	13,500
Amounts written off	(2,000)
Amounts charged to profit or loss	3,900
Other movements	100
At 31 December	15,500

Example 13—Disclosures: Risk profile

IE73 The following example illustrates forms of application of the disclosure requirements in paragraph 44.

Gross carrying amount for consumer loan credit risk profile by internal rating grades and by the associated loss allowance

20XX	Consumer—Credit Card		Consumer—Automotive	
	Lifetime	12-month	Lifetime	12-month
Internal Grade 1	CUxx,xxx	xx,xxx	CUxx,xxx	xx,xxx
Internal Grade 2	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 3	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 4	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 5	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 6	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 7	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Internal Grade 8	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Total	xx,xxx	xx,xxx	xx,xxx	xx,xxx

Gross carrying amount for corporate loan credit risk profile by external rating grades and by the associated loss allowance

20XX	Corporate—Equipment		Corporate—Construction	
	Lifetime	12-month	Lifetime	12-month
AAA	CUxx,xxx	xx,xxx	CUxx,xxx	xx,xxx
AA	xx,xxx	xx,xxx	xx,xxx	xx,xxx
A	xx,xxx	xx,xxx	xx,xxx	xx,xxx
BBB	xx,xxx	xx,xxx	xx,xxx	xx,xxx
BB	xx,xxx	xx,xxx	xx,xxx	xx,xxx
B	xx,xxx	xx,xxx	xx,xxx	xx,xxx
CCC	xx,xxx	xx,xxx	xx,xxx	xx,xxx
CC	xx,xxx	xx,xxx	xx,xxx	xx,xxx
C	xx,xxx	xx,xxx	xx,xxx	xx,xxx
D	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Total	xx,xxx	xx,xxx	xx,xxx	xx,xxx

Gross carrying amount for corporate loan risk profile by probability of default and by the associated loss allowance

	Corporate—Unsecured		Corporate—Secured	
	Lifetime	**12-month**	**Lifetime**	**12-month**
0.00 – 0.10	CUxx,xxx	xx,xxx	CUxx,xxx	xx,xxx
0.11 – 0.40	xx,xxx	xx,xxx	xx,xxx	xx,xxx
0.41 – 1.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
1.01 – 3.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
3.01 – 6.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
6.01 – 11.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
11.01 – 17.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
17.01 – 25.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
25.01 – 50.00	xx,xxx	xx,xxx	xx,xxx	xx,xxx
50.01+	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Total	xx,xxx	xx,xxx	xx,xxx	xx,xxx

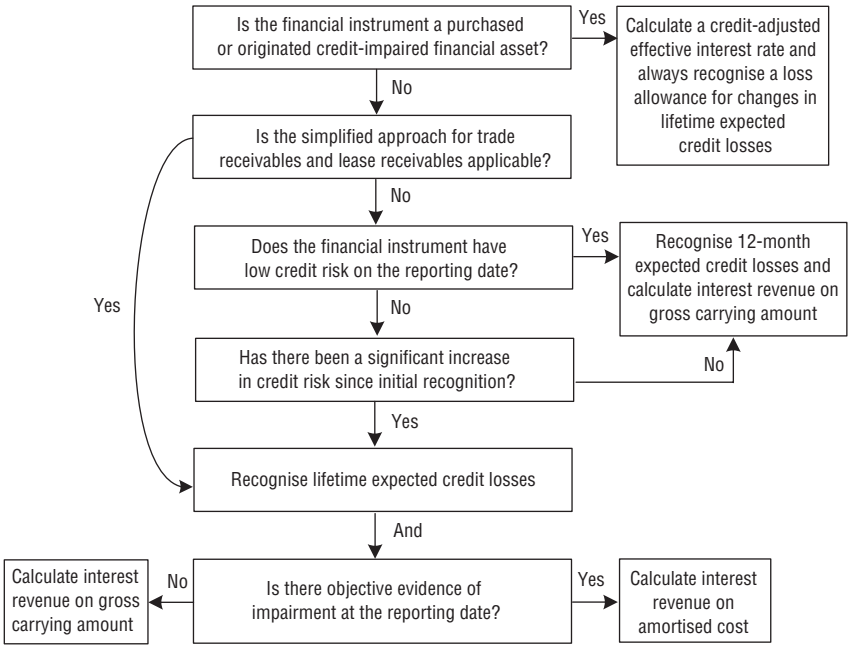
IE74 Entity A manufactures cars and provides financing to both dealers and end customers. Entity A discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach:

20XX '000	**Trade receivables** **Days past due**				
	Current	**More than 30 days**	**More than 60 days**	**More than 90 days**	**Total**
Dealer financing					
Expected credit loss rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	CU20,777	CU1,416	CU673	CU235	CU23,101
Lifetime expected credit losses—dealer financing	CU21	CU28	CU34	CU31	CU114
Customer financing					
Expected credit loss rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	CU19,222	CU2,010	CU301	CU154	CU21,687
Lifetime expected credit losses—customer financing	CU38	CU60	CU24	CU23	CU145

Illustration of proposed expected credit loss model

This illustration accompanies, but is not part of, the [draft] IFRS.

Application of the main proposals on a reporting date



CONTENTS

Basis for Conclusions on Exposure draft *Financial Instruments: Expected Credit Losses*

This Basis for Conclusions accompanies, but is not part of, the [draft] IFRS. This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) when developing the proposals in this [draft] IFRS. Individual IASB members gave greater weight to some factors than to others.

Introduction

BC1 The IASB has long accepted the need to improve the financial reporting of financial instruments. Following the global financial crisis, the IASB and the US Financial Accounting Standards Board (FASB) took different approaches to their Financial Instruments projects to address the needs of their respective stakeholders. In April 2009, the IASB and the FASB announced their timetables for replacing their respective financial instruments standards. In setting these timetables, the boards considered the views and information that they had received as a result of their work when responding to the global financial crisis, the G20 leaders' conclusions and the recommendations of other international bodies such as the Financial Stability Board (FSB).

BC2 The IASB decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* and divided the project to do so into several phases. This Exposure Draft sets out the proposals of the IASB's second phase of that project: the impairment of financial instruments.

BC3 This Basis for Conclusions discusses:

(a) the background of the proposals in this Exposure Draft (see paragraphs BC4–BC14);

(b) the IASB's objective for accounting for expected credit losses and its considerations in selecting the model proposed in this Exposure Draft over alternative models (see paragraphs BC15–BC51);

(c) the scope of the proposals in this Exposure Draft (see paragraphs BC52–BC55);

(d) the proposals in this Exposure Draft in further detail (see paragraphs BC56–BC163); and

(e) an analysis of the effects of this Exposure Draft (see paragraphs BC164–BC216).

Background

BC4 In October 2008, as part of a joint approach to dealing with the financial reporting issues arising from the financial crisis, the IASB and the FASB set up the Financial Crisis Advisory Group (FCAG). The FCAG considered how improvements in financial reporting could help to enhance investor confidence in financial markets. In its report, published in July 2009, the FCAG identified weaknesses in the current accounting standards for financial instruments and their application. Those weaknesses included the delayed recognition of credit

losses on loans (and other financial instruments) and the complexity of multiple impairment approaches. One of the FCAG's recommendations was to explore alternatives to the incurred credit loss model that would use more forward-looking information.

BC5 Following a Request for Information that the IASB posted on its website in June 2009, the IASB published, in November 2009, the Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the '2009 ED'). The 2009 ED proposed that an entity should measure amortised cost at the expected cash flows discounted at the original credit-adjusted effective interest rate.

BC6 Comments received on the 2009 ED and during outreach indicated support for the concept of such a model, but highlighted the operational difficulties of applying it. In response, the IASB decided to modify the model to address those operational difficulties while replicating the outcomes of the model that it proposed in the 2009 ED as closely as possible. The IASB also established a panel of credit risk experts, the Expert Advisory Panel (EAP), to advise it on the operational implications of an expected credit loss model.

BC7 In May 2010, the FASB published a proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the '2010 proposed Update') that included proposals for impairment as part of its comprehensive approach to replacing the accounting requirements for financial instruments in US Generally Accepted Accounting Principles (US GAAP). The FASB's objective for credit impairment was to ensure that the loss allowance balance reflected all estimated credit losses for the remaining life of the instrument. To accomplish this objective, the FASB proposed that an entity should recognise credit impairment when it does not expect to collect all contractual amounts due. Unlike existing guidance in US GAAP, the FASB's proposal meant that credit losses would not need to be considered 'probable' to be recognised in accordance with the 2010 proposed Update. For the purposes of measuring credit impairment, the 2010 proposed Update would have required that an entity must assume that the economic conditions that exist at the reporting date would remain unchanged for the remaining life of the financial assets. Furthermore, the FASB proposed that interest income should be recognised by applying the effective interest rate to the amortised cost basis, net of any loss allowance.

BC8 Many respondents to the FASB's 2010 proposed Update agreed with the recognition of the entire credit loss in the estimated period. In addition, the elimination of the current probability threshold for recognising credit losses was widely supported. Many investors noted that the 'probable' threshold may have prevented financial institutions from recognising credit losses that were imminent in 2007 and 2008. While most stakeholders supported the objective of having a single impairment model, some asserted that the 2010 proposed Update should retain three different impairment models (that is, one for pools, one for individual assets and one for purchased assets). In addition, stakeholders expressed concern about the proposal to require an entity to assume that economic conditions as of the reporting date would remain unchanged in the future. Finally, stakeholders (including users of financial statements) generally opposed the proposal that interest income should be recognised by applying the

effective interest rate to the amortised cost basis net of any loss allowance, preferring instead to maintain the approach in existing US GAAP that measures interest income and credit losses separately.

BC9 Many respondents to both the IASB's 2009 ED and the FASB's 2010 proposed Update stated that achieving a common outcome for impairment accounting is highly desirable. The boards agreed and, in January 2011, published jointly a Supplementary Document *Financial Instruments: Impairment* (the 'SD') to their individual original exposure drafts. The SD asked for further input on a proposed common impairment model. That model incorporated the objectives of both boards' original impairment proposals. The SD proposed that an entity should divide financial assets into two groups: those for which the recognition of lifetime expected credit losses over time would be appropriate ('the good book') and those for which the immediate recognition of the lifetime expected credit loss would be appropriate ('the bad book'). The loss allowance for the good book would have been calculated at the greater of:

(a) a time-proportionate loss allowance (the IASB's preferred approach); and

(b) expected credit losses for the foreseeable future, ie a 'floor' for expected credit losses (the FASB's preferred approach).

BC10 Overall, the boards did not receive strong support for the proposals in the SD. The concern that many respondents expressed was that the SD required an entity to make two calculations to measure the loss allowance balance for the good book. They viewed the dual calculation as operationally difficult, lacking conceptual merit and providing confusing information to users of financial statements. The feedback received about the floor for the good book was geographically split, with respondents outside the US generally opposing it and respondents from the US generally supporting it. Furthermore, respondents expressed concerns about the calculation of expected credit losses for the foreseeable future, with many expressing confusion about the underlying conceptual basis for such a limitation to the time period. Many also noted that, notwithstanding the conceptual concerns, the boards had not sufficiently defined the term 'foreseeable future' to ensure consistent application.

BC11 The importance of achieving convergence compelled the boards to jointly develop a different model. In May 2011, the boards decided to develop a model that would reflect the general pattern of deterioration in the credit quality of financial instruments, the so-called 'three-bucket model'. In the three-bucket model, the amount of the expected credit losses recognised as a loss allowance or provision would depend on the level of deterioration in the credit quality of financial instruments since initial recognition.

BC12 In July 2012, the IASB and the FASB finished deliberating all the joint matters in the development of a general framework for the three-bucket model. However, in August 2012, in response to feedback received from interested parties in the US about that model, the FASB began exploring an alternative expected credit loss model that:

(a) did not use a dual-measurement approach; and

(b) reflected all credit risk in the portfolio at each reporting date.

BC13 Following the FASB's announcement, the IASB conducted outreach to help it decide whether it should continue to develop the three-bucket model. Overall, the majority of participants in the IASB's outreach supported a model that distinguishes those financial instruments that have deteriorated in credit quality from those that have not. However, some noted that their support for the model was dependent on whether the benefits of the information provided outweighed the costs of determining when financial instruments have deteriorated in credit quality. Consequently, the IASB decided to propose the model in this Exposure Draft, which is similar to the three-bucket model. However the IASB clarified and simplified that model to address the views that it had received.

BC14 In December 2012, the FASB published the proposed Accounting Standards Update *Financial Instruments—Credit Losses*. That proposed Update would require an entity to measure the net amortised cost at the present value of cash flows it expects to collect, discounted at the original effective interest rate. To achieve this, an entity would recognise a loss allowance or provision for expected credit losses from initial recognition at an amount equal to the lifetime expected credit losses measure that is proposed in this Exposure Draft. The comment period for that proposed Update ends on 30 April 2013.

Objective and selection of an expected credit loss model

BC15 This section discusses:

(a) the IASB's objectives for depicting expected credit losses (see paragraphs BC16–BC20);

(b) the model that, in the IASB's view, most faithfully represents expected credit losses, and the operational challenges that model presents (see paragraphs BC21–BC26);

(c) the simplifications required to address those operational challenges (see paragraphs BC27–BC30);

(d) an overview of the costs and benefits of the alternative models considered by the IASB when selecting the model proposed in this Exposure Draft (see paragraphs BC31–BC43); and

(e) why, in the IASB's view, recognising lifetime expected credit losses, discounted at the original effective interest rate, does not faithfully represent expected credit losses (see paragraphs BC44–BC51).

Objectives for depicting expected credit losses

BC16 In accordance with IFRS 9 *Financial Instruments*, an entity measures a financial asset at amortised cost if it holds that asset within a business model whose objective is to hold assets in order to collect contractual cash flows, and those contractual cash flows represent payments of principal and interest only. For such assets, the effect of changes in credit quality are more relevant to a user's understanding of the likelihood of the collection of future contractual cash flows than the effects of other changes, such as changes in market interest rates.

BC17 A model that faithfully represents the economic phenomenon of expected credit losses should provide users of financial statements with relevant information about the amount, timing and uncertainty of an entity's future cash flows. It should also ensure that the amounts that an entity reports are comparable, timely and understandable. In so doing, the expected credit loss model should address criticisms of the existing incurred loss model in IAS 39, including the concerns that the model in IAS 39 results in entities overstating interest revenue in periods before a credit loss event occurs and that it delays the recognition of credit losses.

BC18 Some interested parties would prefer a model that results in a conservative, or prudential, depiction of expected credit losses. Those parties argue that such a depiction would better meet the needs of both the regulators who are responsible for maintaining financial stability and of investors. However, the faithful representation of expected credit losses implies that the depiction of those credit losses is neutral and free from bias. This is consistent with the objectives of financial reporting and the qualitative characteristics in the *Conceptual Framework*. The depiction of expected credit losses in an unbiased way informs the decisions of a broad range of users of financial statements, including the regulators who are responsible for maintaining financial stability, and investors, and is compatible with prudential regulatory requirements. Including a degree of conservatism would be arbitrary, producing a lack of comparability. In the IASB's view, the risk of an outcome beyond the probability-weighted expected outcome is relevant for particular purposes, such as determining the extent of economic or regulatory capital requirements. Thus, depicting expected credit losses as faithfully as possible will provide users of financial statements and regulators with the most relevant information to determine the sufficiency of an entity's capital to cover the risk of an outcome beyond the probability-weighted expected outcome.

BC19 In developing a model that depicts expected credit losses, the IASB observed that:

(a) when an entity prices a financial instrument, part of the yield, the credit risk premium, compensates the entity for the initial expected credit losses. Thus, an entity will typically demand a higher yield for those instruments with higher expected credit losses. Consequently, no economic loss is suffered at initial recognition simply because a financial instrument has a lower credit quality at that time, because those expected credit losses are implicit in the initial pricing of the instrument.

(b) an entity considers those credit losses that are expected at initial recognition when pricing the financial instrument. Pricing is not typically adjusted for changes in expected credit losses in subsequent periods. Consequently, subsequent changes in expected credit losses are economic losses (or gains) of the entity in the period in which they occur.

BC20 Expected credit losses, in isolation, are not directly observable. However, because the credit risk premium is a component of the market yield for financial instruments, the indirect measurement of expected credit losses is a daily occurrence in the pricing of such instruments in the market. A number of models exist to assist market participants and regulators in the measurement of

expected credit losses. But, because expected credit losses are not directly observable, and their measurement is inherently based on judgement, any model that attempts to depict expected credit losses will be subject to measurement uncertainty. This uncertainty will require disclosures so that users of financial statements can understand and compare measurements of expected credit losses.

The model that most faithfully represents expected credit losses

BC21 In the IASB's view, the model in the 2009 ED most faithfully represents expected credit losses. Those proposals would have required an entity to measure a financial asset at amortised cost at the present value of expected cash flows discounted at the credit-adjusted effective interest rate. This single, integrated calculation would determine the carrying amount, interest revenue and impairment gains or losses recognised. Thus, an entity would have recognised:

(a) the initial expected credit losses over the life of the asset through the effective interest rate; and

(b) any changes in expected credit losses when those changes occurred.

BC22 Users of financial statements have told the IASB that they support a model that distinguishes between the effect of initial estimates of expected credit losses and subsequent changes. They note that such a distinction would provide useful information about changes in credit quality and economic losses. This Exposure Draft retains the model in the 2009 ED for purchased or originated credit-impaired financial assets, for which recognition and measurement of expected credit losses in any other way would not faithfully represent the economics (see 'purchased or originated credit-impaired financial assets' in paragraphs BC137–BC141).

BC23 Many other respondents, and the EAP, also supported the concepts in the 2009 ED, but said that the proposals would present significant operational challenges. In particular, they highlighted the following significant operational challenges:

(a) Estimating the full expected cash flows for all financial instruments.

(b) Applying a credit-adjusted effective interest rate to those cash flow estimates.

(c) Maintaining information about the initial estimate of expected credit losses.

BC24 The operational challenges outlined in paragraph BC23 arise because entities typically operate separate accounting and credit risk management systems. To have applied the 2009 ED, entities would have had to have integrated those separate systems, which would have required substantial costs and lead time. Respondents noted that these operational challenges would be especially acute for open portfolios.

BC25 To address these operational challenges, the IASB explored different ways of implementing the model proposed in the 2009 ED, including:

(a) a 'gross-up' method. 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, but increase the gross carrying amount of the asset by the same amount, and thus eliminate the effect of double-counting the lifetime expected credit losses at initial recognition. 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.

(b) using a risk-free rate as a proxy for the credit-adjusted effective interest rate. This would require an entity to recognise a loss allowance for the difference between the gross carrying amount and the expected cash flows discounted at the risk-free rate.

(c) reducing lifetime expected credit losses by expected future interest revenue. This would require an entity to recognise a loss allowance at the value of lifetime expected credit losses less the present value of expected future interest revenue discounted at the original effective interest rate.

(d) identifying the lifetime expected credit losses at initial recognition of the financial asset and amortising them over the life of the asset, similarly to how discounts and premiums are amortised in practice.

BC26 The different approaches set out in paragraph BC25 would maintain the overall mechanics of the model. However, they would still require an entity to estimate the full expected cash flows for all financial assets. Thus, one of the operational challenges identified by respondents would remain. Consequently, since the 2009 ED, the IASB has discussed alternative models that would address the operational challenges while replicating the outcomes of the 2009 ED to the maximum extent possible.

Simplifications to address operational challenges

BC27 To address the operational challenges outlined in paragraph BC23, and as suggested by the EAP, the IASB decided to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate (except for purchased or originated credit-impaired financial assets). Thus, an entity would measure the financial asset and the loss allowance separately using the original effective interest rate (ie not adjusted for credit).

BC28 As a result of the decoupling simplification, an entity would measure the present value of expected credit losses using the original effective interest rate. This presents a dilemma because measuring expected credit losses using such a rate double-counts expected credit losses priced into the financial asset. Thus, the IASB concluded that recognising the lifetime expected credit losses from initial recognition would be inappropriate. Paragraphs BC44–BC51 continue the discussion about the recognition of lifetime expected credit losses and the effect of double-counting.

BC29 The IASB concluded that a recognition mechanism is required that preserves, to as great an extent as possible, the objective of the 2009 ED and reduces the effect

of double-counting. Thus, the IASB decided to pursue a model that recognises two different amounts for different phases of deterioration in credit quality. Such a dual-measurement model would require that an entity must recognise:

(a) a portion of the lifetime expected credit losses from initial recognition as a proxy for recognising the initial expected credit losses over the life of the financial asset; and

(b) the lifetime expected credit losses when credit quality has deteriorated since initial recognition (ie when the recognition of only a portion of the lifetime expected credit losses is no longer appropriate because the entity has suffered a significant economic loss).

BC30 The IASB considered the timing of the recognition of the full lifetime expected credit losses together with the size of the portion of the lifetime expected credit losses that are recognised from initial recognition. The IASB considered the interaction between these decisions to be a determinant of what would provide a more faithful representation of the economic loss, and what would best approximate the outcome of the model in the 2009 ED. Thus, if an entity recognises a smaller portion of the lifetime expected credit losses initially, it should recognise the full lifetime expected credit losses earlier than if it were required to recognise a larger portion of the lifetime expected credit losses initially.

Overview of alternative models considered

BC31 The IASB has explored two primary alternatives for implementing a model that recognises two different amounts for different phases of the deterioration in credit quality:

(a) the model proposed in the SD (see paragraphs BC34–BC37); and

(b) the model proposed in this Exposure Draft (see paragraphs BC38–BC43).

BC32 As a result of the simplifications, the IASB acknowledges that these models cannot perfectly replicate the outcome of the model in the 2009 ED. Furthermore, while there is always recognition of some expected credit losses, both models that the IASB considered retain a criterion for when lifetime expected credit losses are recognised (the 'lifetime expected credit loss criterion'). Once that criterion is met, the recognition of lifetime expected credit losses results in a gain or loss representing the difference between the portion that was recognised previously and the lifetime expected credit losses (a 'cliff effect'). In the IASB's view, any approach that seeks to approximate the outcomes of the model in the 2009 ED without the associated operational challenges will include a recognition threshold for lifetime expected credit losses and a resulting cliff effect.

BC33 The extent to which either model approximates the outcome of the model in the 2009 ED depends on the pattern of changes in expected credit losses. The model proposed in this Exposure Draft results in a more timely recognition of the deterioration in credit quality. However, in the absence of significant deterioration in credit quality, an entity recognises a loss allowance at an amount equal to 12-month expected credit losses, regardless of the passage of time or the age of the financial instrument (or portfolio). The model in the SD

results in a better allocation of the initial expected credit losses over time, but in the case of credit deterioration, an entity recognises lifetime expected credit losses later than it would when applying the model proposed in this Exposure Draft.

The model proposed in the Supplementary Document

BC34 The SD proposed that a loss allowance would be recognised as follows:

(a) the higher of a time-proportionate allowance (TPA) or expected credit losses for the foreseeable future for the good book. If applying a TPA, an entity would recognise the lifetime expected credit losses over the weighted average life of the portfolio of assets; and

(b) the lifetime expected credit losses for the bad book—financial assets would be moved to the bad book if the collectability of an asset became so uncertain that the entity's credit risk management objective changes from receiving the regular payments to recovery of all, or a portion of, the asset.

BC35 The SD attempted to reflect the relationship between expected credit losses and interest revenue using the TPA. The TPA reflects this relationship through the allocation of expected credit losses over time, 'adjusting' the contractual interest. However, it does this through a short-cut, and therefore the result does not represent the economics as faithfully as the 2009 ED did. Because the TPA allocates over time both the initial expected credit losses and the subsequent changes in lifetime expected credit losses, the measurement results in an understatement of changes in expected credit losses until the entity recognises lifetime expected credit losses. This effect is particularly problematic for financial assets that deteriorate in credit quality, and thus whose expected credit losses increase early. Allocating the change in estimated expected credit losses in this way results in the deferred recognition of the full amount of the change and, consequently, the TPA closely replicates the outcome of the model in the 2009 ED only in situations in which expectations of credit losses do not change or the credit losses emerge at, or close to, maturity (extremely back-ended losses). The boards partially addressed this shortcoming of the TPA by including the foreseeable future floor in the SD. However, respondents raised significant concerns about the need to perform two separate calculations (see paragraph BC10).

BC36 The costs of implementing the SD model would include the effort required to decide which financial assets are in the bad book and to calculate the TPA amount for assets in the good book. The recognition of lifetime expected credit losses is determined on the basis of how close the asset is to default. Consequently, the basis of the assessment is the credit quality at a specific point in time. This assessment is consistent with current credit risk management systems. Consequently, compared to the model proposed in this Exposure Draft, the costs of implementing the lifetime expected credit loss criterion of the SD would be lower, because no tracking of initial credit quality would be required. That is, the SD would not have required entities to assess how much credit quality has changed since initial recognition; they would only have needed to decide whether an asset should be in the bad book at the reporting date.

BC37 The TPA calculation in the SD is unique and would not be required for other purposes. This would have required entities to estimate the full lifetime expected credit loss for all financial assets that are subject to impairment accounting. They would then have been required to allocate that amount to a portfolio according to the weighted average age over the weighted average life of the portfolio. Some of the identified operational challenges to the proposals in the 2009 ED would still exist, including the need to change systems to calculate the weighted average age and the weighted average life of open portfolios and the need to estimate the full expected cash flows for all financial assets. Requiring entities to estimate lifetime expected credit losses for all financial assets that are subject to impairment accounting would be more costly than the model proposed in this Exposure Draft, which limits the estimation of lifetime expected credit losses to financial assets that have deteriorated significantly in credit quality. On the other hand, the SD model might be less costly to reconcile to a model that always recognises lifetime expected credit losses from initial recognition.

The model proposed in this Exposure Draft

BC38 This Exposure Draft proposes to convert the model in the 2009 ED to a tiered model, whereby an entity recognises a loss allowance or provision at an amount equal to lifetime expected credit losses if the credit quality deteriorates significantly after initial recognition and at 12-month expected credit losses for all other instruments.[24] Paragraphs BC56–BC163 discuss the proposals in this Exposure Draft in more detail.

BC39 The model proposed in this Exposure Draft eliminates the operational challenge of having to estimate the full expected cash flows for all financial instruments by limiting the measurement of lifetime expected credit losses to financial instruments that have significantly deteriorated in credit quality after initial recognition. Overall, the majority of participants in the outreach conducted by the IASB while developing the proposals, including users of financial statements, supported a model that distinguishes between instruments that have deteriorated in credit quality from those that have not. Some participants noted that their support for such a model was dependent on whether the benefits of the information provided outweighed the costs of determining which financial instruments have deteriorated in credit quality. In particular, some noted that if financial instruments were to move too quickly to a lifetime expected credit loss measurement (for example, on the basis of minor credit deterioration) the costs of the model might not be justified. In the IASB's view, the recognition requirements for lifetime expected credit losses as proposed in this Exposure Draft strike the best balance between the benefits of making distinctions on the basis of the deterioration in credit quality and the costs and complexity of making that assessment (see paragraphs BC67–BC77). The proposals limit the information that an entity would be required to maintain about the initial credit quality by using information that preparers have said is consistent with current credit risk management systems. To further reduce the cost of assessing the deterioration in credit quality, the Exposure Draft proposes that an entity

24 Except for purchased or originated credit-impaired financial assets (see paragraphs BC137–BC141) and trade receivables and lease receivables (see paragraphs BC142–BC149).

need not recognise lifetime expected credit losses for financial instruments for which credit risk is low (eg credit risk equivalent to investment grade) at the reporting date.

BC40 While the proposal to require an entity to recognise 12-month expected credit losses for financial instruments that have not significantly deteriorated in credit quality will be less costly and complex than estimating the full expected cash flows for all financial instruments, the calculation will increase the cost and complexity compared to current requirements (see paragraphs BC61–BC66). This cost will be lower for entities that are already required to measure a similar amount to comply with prudential regulations. However, even those entities would have to adjust the measurement to meet the requirements of the proposals in this Exposure Draft. The requirements will increase the costs of implementation for entities that are not required to measure 12-month expected credit losses to comply with prudential regulations, because it will be a unique calculation that would not normally be required for other purposes. Notwithstanding these costs, measuring 12-month expected credit losses will be less costly and complex than a measurement that would require the entity to estimate all expected cash flows, such as the 2009 ED and the model in the SD. In addition, in some cases, entities can use information such as credit loss rates for measuring 12-month expected credit losses, thus building on information that they have already used for credit risk management purposes.

BC41 This Exposure Draft also proposes a simplified approach for trade receivables and lease receivables. The IASB considered that the cost and complexity of the general model proposed in this Exposure Draft outweighs the benefits of applying it for these financial assets. The simplified approach avoids the need to measure 12-month expected credit losses and to assess whether the lifetime expected credit loss criterion is applicable.

BC42 A few participants in the outreach that the IASB conducted in late 2012 would have preferred some or all of the proposals in the SD instead of some or all of the proposals in this Exposure Draft. In addition, some suggested that to better approximate the outcomes of the model in the 2009 ED, the IASB should replace the recognition of a loss allowance at an amount equal to 12-month expected credit losses proposed by this Exposure Draft with the TPA calculation. In the IASB's view, such a model would combine the most complex mechanics of this Exposure Draft (the deterioration assessment) and of the SD (the TPA calculation). Thus, the IASB concluded that the benefits of such a model would not exceed the costs when compared to the 2009 ED.

BC43 On balance, given the usefulness of the information and the responsiveness to credit deterioration, the IASB decided to propose the model in this Exposure Draft. In doing so, the IASB observes that the proposed model will improve financial reporting because:

(a) users of financial statements will be able to distinguish between financial instruments that have deteriorated significantly in credit quality from those that have not;

(b) entities will be required to recognise a loss allowance at an amount equal to at least 12-month expected credit losses throughout the life of their assets, reducing the systematic overstatement of interest revenue in current IAS 39 requirements, and acting as a proxy for the recognition of initial expected credit losses over time;

(c) entities will be required to recognise a loss allowance at an amount equal to lifetime expected credit losses when the credit quality deteriorates significantly from initial recognition, ensuring the timely recognition of expected credit losses; and

(d) amounts reported in accordance with this model will better reflect the effective return and the changes in the credit quality compared to current IAS 39 requirements.

Recognising lifetime expected credit losses from initial recognition

BC44 Notwithstanding the views of the respondents to the 2009 ED, noted in paragraphs BC21–BC26, some interested parties have expressed concerns about the conceptual merits of that model. They believe that the value of a financial asset at amortised cost is most faithfully represented by discounting expected cash flows (ie contractual cash flows *reduced* for expected credit losses) at the original effective interest rate (ie the effective interest rate *that is not reduced* for initial expected credit losses). In other words, an entity would be required to recognise a loss allowance or provision at lifetime expected credit losses, discounted using the original effective interest rate, from initial recognition. Such a model would be equivalent to the Current Expected Credit Losses (CECL) model in the FASB's proposed Update, published in December 2012.

BC45 Those interested parties believe that, because credit losses do not occur rateably throughout the life of a loan, or throughout the life of a portfolio of loans, there is a fundamental disconnect between the 'lumpy' pattern of actual credit losses and a time-based accounting approach that attempts to link the recognition of credit losses that are anticipated at initial recognition of the financial asset with the recognition of interest revenue. The IASB rejects this view. At initial recognition, the timing of initial expected credit losses affects the amount of the adjustment to the effective interest rate. Thus, an earlier expected credit loss would give rise to a larger credit adjustment to the effective interest rate than a later expected credit loss of an equal nominal value. Because the pattern of initial expected credit losses is priced into the asset as represented by its present value, compensation is received for the amount and timing of those losses. Thus, in the IASB's view, and as proposed in the 2009 ED, if initial credit loss expectations do not subsequently change:

(a) interest revenue should reflect the credit-adjusted effective return over time; and

(b) there is no credit loss (or gain), because no economic loss (or gain) has occurred.

Furthermore, in accordance with the 2009 ED, the asset's amortised cost would never be overstated, irrespective of the pattern or timing of credit losses. The

amortised cost would always be equal to the present value of the expected cash flows that are discounted at the credit-adjusted effective interest rate at each reporting date. An entity would recognise changes in those expected cash flows immediately.

BC46 Those interested parties also believe that, because of the multitude of factors that influence the pricing of a financial asset, it is impractical (if not impossible) to reliably isolate and measure the portion of the credit spread that is intended to compensate the lender for undertaking the credit risk. Furthermore, those interested parties believe that the evaluation of the creditworthiness that influences pricing is based on historical experience for groups of similar assets. This means that, while the credit spread that is charged on the lender's overall portfolio of individual loans may be expected to compensate the entity for credit losses for a large portfolio of assets over time, the credit spread on any individual asset is not necessarily established in a way that compensates the lender for expected credit losses on that particular asset.

BC47 The IASB rejects these views. First, expected credit losses are a probability-weighted estimate of expected cash shortfalls. Thus, the pricing of individual instruments would reflect the probability of credit losses and would be no different to the pricing of an instrument that is part of a portfolio. Market participants price individual instruments consistently, irrespective of whether they will hold that instrument in isolation or as part of a portfolio. Secondly, it is not necessary to measure separately the initial expected credit losses and the compensation for those credit losses, and then precisely match the amount and timing of those credit losses and the related compensation. An estimate of expected credit losses at initial recognition (which an entity could estimate in a number of different ways) would be sufficient for the purposes of determining the credit adjustment to the effective interest rate. Indeed, any models requiring the recognition of the lifetime expected credit losses at initial recognition, including the FASB's CECL model, would require an entity to make the same estimate.

BC48 The interested parties that hold the views in paragraphs BC44–BC46 also believe that the amortised cost amount of a financial asset should reflect the present value of the cash flows that are expected to be collected, discounted at the original effective interest rate (ie a rate that is not adjusted for initial expected credit losses), and believe that it is misleading to investors to allow the balance sheet to reflect a greater amount. However, the original effective interest rate is the rate that exactly discounts the contractual cash flows of the asset to the transaction price (ie the fair value or principal) at initial recognition. Thus, the original effective interest rate already takes into consideration an entity's initial estimate of expected credit losses (ie it reflects the riskiness of the contractual cash flows). Requiring the entity to further deduct an amount from the transaction price that represents the same amount that it has already discounted from the contractual cash flows results in the entity double-counting its initial estimate of expected credit losses. The effect of this would be most apparent at initial recognition because the carrying amount of the asset would be below the transaction price.

BC49 Such an anomaly in present value amounts can also result when incorrectly discounting real cash flows using a nominal discount rate, or post-tax cash flows using a pre-tax discount rate. One of the general principles of any present value technique is that the discount rate should reflect assumptions that are consistent with those inherent in the cash flows that are being discounted. For example, a discount rate that reflects expectations about future defaults is appropriate if discounting contractual cash flows of a loan (the original effective interest rate). That same rate should not be used if discounting expected (probability-weighted) cash flows that reflect credit-loss expectations, because those expected cash flows already reflect assumptions about future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used (the credit-adjusted effective interest rate). This view was the foundation of the 2009 ED and it is consistent with the general principles of present value techniques as set out in paragraph B14 in IFRS 13 *Fair Value Measurement*.[25]

BC50 Furthermore, discounting expected cash flows at the original effective interest rate introduces a systematic bias in the accounting for financial assets. That systematic bias will result in a distortion of the reporting of the underlying economics and will lead to anomalous results depending on the extent of credit risk and maturity at initial recognition. For example, an entity might report two assets with equal fair values at initial recognition at vastly different amounts depending on the initial credit quality—ignoring the fact that the different credit qualities at initial recognition are inherent in the price, such as in a different margin. The IASB acknowledges that, for assets of good credit quality and short maturities, the initial expected credit losses would be minimal, and the original effective interest rate would be approximately the same as the credit-adjusted effective interest rate. As a result, the amounts recognised in accordance with either model would be similar. However, for assets with poorer credit quality and longer maturities, the results will differ dramatically, distorting the underlying economics throughout the life of the asset. In contrast to the 2009 ED, the systematic bias will result in amounts reported for such assets being below their economic value, regardless of the pattern of actual losses, until the credit quality improves, the entity sells the asset or the effect reverses over time. The reporting of such assets below their economic value will also be apparent on sale, particularly when the risk-free rate and the liquidity premium have not changed since initial recognition. In such situations, the gain on sale will represent the reversal of the double-counting of expected credit losses at initial recognition. Thus, the double-counting of the expected credit losses results in the recognition of losses and gains that do not represent economic phenomena throughout the life of the asset, distorting reported amounts.

BC51 Interested parties that support such a model believe that, because entities manage financial assets in a portfolio, the losses and gains would typically

25 This is reflected in paragraph B14 of IFRS 13 and paragraph 820.10.55(6)(c) of Topic 820 *Fair Value Measurement* of the *FASB Accounting Standards Codification®* and the concepts in FASB Concepts Statement No. 7 *Using Cash Flow Information and Present Value in Accounting Measurements*. In the IASB's view, this general principle is not particular to fair value measurements, but also applies to any present value measurements that discount future cash flows.

cancel each other out if the pool of assets remains in a steady state. That is, the losses on initial recognition of new assets will offset gains from reversals of previously recognised losses when the borrower settles the existing assets or the entity derecognises them, such as through the sale of the assets. In the IASB's view, such an effect would be limited to specific circumstances and furthermore would not address the effect on the recognised amounts of assets in the statement of financial position. Furthermore, in the IASB's view, it should not set the requirements of a Standard on the assumption of steady economic circumstances. Instead, the model should reflect the underlying economics as closely as possible, thus providing users of financial statements with relevant information in any economic circumstance.

Scope

BC52 The main focus of the IASB's deliberations has been those financial assets that are measured at amortised cost in accordance with IFRS 9 (including trade receivables), but the proposals in this Exposure Draft would also apply to:

(a) financial assets that are mandatorily measured at fair value through other comprehensive income (FVOCI) in accordance with the proposals in Exposure Draft 2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (the 'Classification and Measurement ED'), published in November 2012 (see paragraphs BC53–BC55 of this Exposure Draft).

(b) lease receivables that are accounted for in accordance with IAS 17 *Leases* or in accordance with the tentative decisions in the Leases project (see paragraphs BC143–BC149 of this Exposure Draft).

(c) loan commitments that are not measured at fair value through profit or loss in accordance with IFRS 9 and financial guarantee contracts to which IFRS 9 is applied and that are not measured at fair value through profit or loss. In accordance with current Standards, an entity accounts for these loan commitments and financial guarantee contracts in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This Exposure Draft proposes that an entity should recognise and measure a provision for expected credit losses on loan commitments and financial guarantee contracts in accordance with the general model in this Exposure Draft (see paragraphs BC128–BC136 of this Exposure Draft).

Classification and Measurement: Limited Amendments to IFRS 9

BC53 In November 2012, the IASB proposed limited amendments to the classification and measurement requirements in IFRS 9 for financial assets. The Classification and Measurement ED proposed the introduction of a mandatory FVOCI measurement category for particular financial assets that contain contractual cash flows that are solely payments of principal and interest. The objective of that measurement category is to provide users with information about both fair value and amortised cost by requiring an entity to disaggregate changes in fair value. An entity would recognise interest revenue and gains or losses arising

from changes in expected credit losses or from the derecognition of the financial asset in profit or loss and would recognise other changes in other comprehensive income.

BC54 To achieve that objective, the IASB proposed in the Classification and Measurement ED that an entity shall calculate interest revenue and the impairment gain or loss in a manner that is consistent with the requirements that are applicable to financial assets measured at amortised cost. Thus, the proposals in this document will apply to that FVOCI measurement category, except for some presentation and disclosure requirements that the Basis for Conclusions to the Classification and Measurement ED discusses (see paragraphs BC78–BC79 in the Classification and Measurement ED). Expected credit losses would be measured as for assets measured at amortised cost however a loss allowance would not be separately recognised. The disclosure requirements for loss allowances would however also apply to assets mandatorily measured at FVOCI.

BC55 In the IASB's view, applying a single expected credit loss model to both financial assets at amortised cost and financial assets at FVOCI ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. In addition, a single expected credit loss model reduces a significant source of complexity for entities compared with applying IAS 39.

Proposals in this Exposure Draft

BC56 This Exposure Draft proposes a general model for the accounting of expected credit losses with some exceptions (including an exception for trade receivables; discussed in paragraph BC58). In accordance with the general model, an entity:

(a) recognises a loss allowance or provision at an amount equal to 12-month expected credit losses at each reporting date unless the credit risk of the financial instrument increases significantly after initial recognition (and the financial instrument does not have credit risk that is low), in which case the entity recognises an amount equal to lifetime expected credit losses (see Recognition—paragraphs BC60–BC80);

(b) measures lifetime expected credit losses at the expected present value of all possible credit losses over the life of the financial instrument. The 12-month expected credit losses is the portion of this lifetime amount that an entity calculates by multiplying the probability of a default occurring in the next 12 months by the amount of the lifetime expected credit losses if that default were to occur (see Measurement—paragraphs BC81–BC97);

(c) calculates interest revenue on the gross carrying amount of the financial asset unless the credit quality of the asset deteriorates in such a way that there is objective evidence of impairment after initial recognition, in which case the entity calculates interest revenue on the amortised cost amount (see Presentation—paragraphs BC98–BC102);

(d) discloses information about the amounts that arise from expected credit losses and the effect of changes in the credit quality of financial instruments (see Disclosure—paragraphs BC103–BC120); and

(e) derecognises financial assets when they are uncollectible (see Derecognition—paragraph BC121).

BC57 This Exposure Draft proposes specific requirements for the application of the general model to:

(a) modifications of financial instruments (see paragraphs BC122–BC127); and

(b) loan commitments and financial guarantee contracts (see paragraphs BC128–BC136).

BC58 The IASB acknowledges that achieving an appropriate balance between the benefits of the faithful representation of expected credit losses and the operational costs and complexity may be difficult in some cases. Consequently, this Exposure Draft proposes the following exceptions to the general model:

(a) For purchased or originated credit-impaired financial assets, an entity shall measure the amortised cost at the present value of expected cash flows discounted using the credit-adjusted effective interest rate (see paragraphs BC137–BC141).

(b) A simplified approach for trade receivables and lease receivables (see paragraphs BC142–BC149).

BC59 This Exposure Draft proposes that an entity would apply the requirements retrospectively with some relief (see Transition—paragraphs BC150–BC163).

Recognition of expected credit losses

BC60 The general model proposed in this Exposure Draft would require an entity to recognise:[26]

(a) a loss allowance or provision at an amount equal to 12-month expected credit losses if a financial instrument does not meet the lifetime expected credit loss criterion at the reporting date (see paragraphs BC61–BC66); and

(b) a loss allowance or provision at an amount equal to lifetime expected credit losses if the credit risk of the financial instrument has increased significantly since initial recognition (see paragraphs BC67–BC75) unless the credit risk of the instrument is low (eg the credit risk is equivalent to investment grade) (see paragraphs BC76–BC77).

Recognition of 12-month expected credit losses

BC61 The IASB considered what measure of expected credit losses would be both appropriate and cost-effective for financial instruments at initial recognition

26 The general model does not apply to purchased or originated credit-impaired financial assets or to trade receivables and lease receivables that qualify for the simplified approach (see paragraphs BC137–BC149).

and before significant deterioration in credit quality has occurred. The IASB accepted the concerns of interested parties about the operational complexity of the methods proposed in the 2009 ED and the SD. The IASB also accepted that significant judgement would be required for any estimation technique that an entity might use. Consequently, the IASB decided that an entity should measure the loss allowance at 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the earlier recognition of the full lifetime expected credit losses, would achieve an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledges that this is an operational simplification, and that there is no conceptual justification for the 12-month time horizon.

BC62 The IASB considered whether an entity should recognise a larger portion of expected credit losses before there is significant credit deterioration. However the IASB rejected requiring a larger portion of expected credit losses to be recognised because:

(a) a larger portion would increase the overstatement of expected credit losses at initial recognition and thus, when considered with the much earlier timing of the recognition of the lifetime expected credit losses, would be a less faithful representation of the underlying economics; and

(b) 12-month expected credit losses are similar to a measurement that some regulated financial institutions already apply, and would therefore be less costly to implement for those entities.

BC63 To address concerns raised about the ambiguity of the 'foreseeable future' definition in the SD, the IASB decided to define the portion of the lifetime expected credit losses that are to be recognised initially in a better way than the SD did. 12-month expected credit losses is the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. Thus, 12-month expected credit losses are a portion of the lifetime expected credit losses. An entity would measure both amounts consistently at an expected present value (see paragraphs BC81–BC97). 12-month expected credit losses are not the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months. The IASB observed that if an entity applies the proposals properly, it would recognise lifetime expected credit losses on financial instruments on which it predicts a default to occur in the next 12 months, because they would have deteriorated in credit quality since initial recognition (unless they are purchased or originated credit-impaired financial assets). 12-month expected credit losses are not the cash shortfalls that are predicted over the next 12 months.

BC64 The similarity between the 12-month expected credit losses calculation and some prudential regulatory requirements for the 12-month probability of default also reduces the cost of implementation for some sophisticated financial institutions. However, an entity will have to adjust these regulatory measurements of the probability of default to comply with the proposed requirements in this Exposure Draft. For other entities, the measurement of the 12-month expected credit losses is a calculation that would not normally be

required for other purposes. However, in some cases, the cost can be minimised by building on information that an entity already uses for risk management purposes, such as credit loss rates.

BC65 In order to further minimise cost and complexity, the IASB proposes that a simplified approach should be available for trade receivables and lease receivables (see paragraphs BC142–BC149). Using the simplified approach would avoid the need to measure 12-month expected credit losses and to assess the criteria for the recognition of lifetime expected credit losses for those financial instruments. Many respondents and participants in outreach told the IASB that entities with trade receivables and lease receivables often do not have sophisticated credit systems and do not maintain extensive credit data. The IASB also observed that many exposures in this category are in any case short-term.

BC66 The IASB acknowledges that the 12-month expected credit losses proposal in this Exposure Draft would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, both at and immediately after initial recognition of those financial instruments. In particular, the initial carrying amount of financial assets would be below their fair value. However, isolating initial credit loss expectations for recognition over the life of financial instruments is operationally complex and this measurement of expected credit losses serves as a practical approximation. The recognition of a portion of expected credit losses for financial instruments that have not deteriorated significantly in credit quality also limits the requirement to perform the more costly and complex calculation of the lifetime expected credit losses. In addition, in the IASB's view, measuring 12-month expected credit losses for some financial instruments would be less costly than always calculating the lifetime expected credit losses as proposed in the SD.

Timing of the recognition of lifetime expected credit losses

BC67 The IASB considered whether lifetime expected credit losses should be recognised on the basis of an absolute assessment of the credit quality of a financial instrument at each reporting date. Taking that approach, an entity would recognise lifetime expected credit losses on all financial instruments at or below a particular credit quality at the reporting date. In contrast to an approach based on changes in credit quality, an approach based on the absolute credit quality at each reporting date would be much simpler to apply, because it adheres to existing credit risk management processes and is thus an approach that many preparers support. However, such an approach would provide very different information. Because it would not approximate the economic effect of initial credit loss expectations and subsequent changes in expectations, the IASB rejected this approach. In addition, if the absolute credit quality threshold for recognising lifetime expected credit losses was too low, too many financial instruments would be above the threshold and expected credit losses would be understated. If the absolute threshold was too high, too many financial instruments would be below the threshold, overstating the expected credit losses (for example, financial instruments with a low credit quality that an entity prices appropriately to compensate for the higher credit risk would

always have lifetime expected credit losses recognised). Furthermore, depending on which absolute credit quality threshold is selected, such an approach might be similar to the incurred loss model in IAS 39 (in which the absolute threshold is 'objective evidence of impairment').

Extent of deterioration required

BC68 The IASB has used the increase in credit risk that is determined by assessing the probability of a default occurring on the financial instrument to decide when an entity shall recognise lifetime expected credit losses. The IASB has proposed this because the probability of a default occurring is a measurement of the financial instrument's credit quality that does not require the full estimation of the expected credit losses. The 2009 ED would have required the tracking of the initial expected credit losses and the measurement of subsequent changes in those expected credit losses. The proposed model does not require this but will require:

(a) the tracking of the initial probability of a default occurring (a component of the expected credit losses); and

(b) an assessment of the significance of subsequent changes in the probability of default to decide whether the recognition of lifetime expected credit losses is required.

Views from participants in the outreach performed by the IASB indicated that using the probability of a default occurring on the financial instrument as the measure of credit risk would be less costly to track than using expected credit losses, because it adheres to existing credit risk management processes. Credit risk managers have told the IASB that they use the probability of default, instead of expected credit losses, to assess credit quality in their internal credit risk management processes.

BC69 The IASB considered how significant the extent of the deterioration in credit quality should be, from both an economic and practical perspective, to justify the recognition of lifetime expected credit losses. An entity initially accounts for a portion of expected credit losses. However, the IASB decided that, if an entity suffers a significant economic loss, recognition of only a portion of the lifetime expected credit losses is no longer appropriate, and it should recognise the full lifetime expected credit losses.

BC70 When developing the model jointly with the FASB, the boards had tentatively agreed that the deterioration criteria for the recognition of lifetime expected credit losses should be that the credit quality had deteriorated more than insignificantly subsequent to the initial recognition of the financial instrument. Outreach participants expressed concern that this criterion could lead to an instantaneous recognition of lifetime expected credit losses, with the result that even a minor change in the credit quality would satisfy the test. In response to that concern, this Exposure Draft proposes that the criterion for the recognition of lifetime expected credit losses is a significant increase in credit risk, expressed as an increase in the probability of a default occurring after initial recognition.

BC71 This Exposure Draft proposes that the assessment of the significance of the change in the probability of a default occurring for different financial

instruments would depend on the initial credit quality and the time to maturity. This is because it would be consistent with the structure of credit risk and therefore with the pricing of financial instruments. In the IASB's view, an entity should consider the term structure and the initial credit quality in assessing whether it should recognise lifetime expected credit losses. Doing so will improve the comparability of the requirements for financial instruments with different maturities and different initial credit qualities. For example, all other things being equal, a given increase (in absolute terms) in the probability of default reflects a greater deterioration in credit quality the shorter the term of the financial instrument and the higher its initial credit quality. This would also be consistent with the IASB's understanding of existing models for measuring credit risk, such as those underlying external credit ratings, option pricing models and their variants, including the models for measuring the probability of default for the purposes of prudential regulatory requirements.

BC72 If an entity were not required to consider the initial credit quality and time until maturity, the assessment would benefit shorter-term financial instruments with low credit risk and would disadvantage longer-term instruments with high credit risk. In addition, not reflecting the term structure might also result in the assessment that the probability of default has changed merely because of the passage of time, even if an entity had expected such a change at initial recognition. In the IASB's view, the assessment of the criteria should not change solely because the maturity date is closer.

BC73 Ideally, an entity should use changes in the lifetime probability of a default occurring to assess changes in credit risk. However, because of the difficulty in estimating lifetime probabilities of default, this Exposure Draft permits the use of 12-month probabilities of default when making the assessment, if appropriate. The IASB observed that, typically, a change in the 12-month probability of default would indicate a change in the lifetime probability of default, and thus would not be inconsistent with the requirements. Furthermore, because such a measurement is commonly used in prudential regulatory requirements, allowing the use of a 12-month probability of default will allow some financial institutions to use existing systems (with some adjustment) thus reducing the costs of implementation.

BC74 During outreach, some interested parties requested that the IASB should specify the amount of the change in the probability of default that would require the recognition of lifetime expected credit losses. Those making this request argued that this would provide clarity and improve comparability. The IASB did not pursue this approach for a number of reasons:

(a) Not all entities use the probability of default to measure or assess credit risk—in particular, entities other than regulated financial institutions. The IASB observed that entities manage financial instruments and credit risk in different ways, with different levels of sophistication and using different information. If the IASB were to propose a precise definition of deterioration, for example, a change of 5 per cent in the probability of default, then an entity would need to calculate a probability of default measurement to make the assessment. Thus, the costs of assessing changes in credit quality would increase.

(b) The probability of default selected would be arbitrary and it would be difficult to properly reflect the structure and pricing of credit that an entity should consider as a result of different types of financial instruments, maturities and initial credit qualities. Because of the arbitrariness of selecting a probability of default, the IASB questioned the perceived comparability that would result. Consequently, the IASB decided that the deterioration criterion should be clear but also broadly defined.

To assist in the application of the lifetime expected credit loss criterion, the IASB has provided application guidance, including the types of information that an entity should consider. This Exposure Draft retains the previous proposals from the 2009 ED and the SD that an entity should use the best information that is available without undue cost and effort.

BC75 Ideally, and consistently with the forward-looking nature of expected credit losses, an entity should use forward-looking information, such as the price for credit risk, probabilities of a default occurring and internal or external credit ratings, when assessing whether it should recognise lifetime expected credit losses. However, many entities manage credit risk on the basis of information about past-due status and have a limited ability to assess credit quality on an instrument-by-instrument basis in more detail. Thus, the IASB decided that an entity may consider information about past-due status, together with other, more forward-looking information, in its assessment of the deterioration in credit quality, if appropriate. To supplement the deterioration requirement, and to ensure that the criterion does not revert to an incurred loss notion, the IASB decided to include a rebuttable presumption that the criterion for the recognition of lifetime expected credit losses shall be met if an asset is more than 30 days past due and no other borrower-specific information that is forward-looking is available.

Exception for instruments with low credit risk

BC76 The IASB has included an exception for financial instruments with low credit risk at the reporting date. Irrespective of their change in credit risk, an entity shall not recognise lifetime expected credit losses on those financial instruments. The IASB introduced this exception to reduce the operational costs for entities that apply the model and to make the model more cost-effective. The IASB observed that for financial instruments with low credit risk the effect of this exception on the timing of recognition and the amount of expected credit losses would be minimal, even when considering that the recognition of lifetime expected credit losses would occur later than it would if there was no exception. Thus, the tracking of credit quality and the assessment of deterioration in credit quality is limited to financial instruments whose credit risk is low enough that adverse economic conditions or changes in business or financial circumstances could, at most, lead to the inability to fully recover cash flows in the medium or short term. Such credit risk is typically equivalent to the investment grade market convention, ie an entity need not assess financial instruments with credit risk that is equivalent to investment grade for the deterioration in credit quality. In the IASB's view, such an exception would help to achieve an appropriate balance between the benefits of distinguishing between financial

instruments on the basis of credit quality and the costs of making that distinction. The IASB also noted that financial instruments of such a quality were not the primary focus for the recognition of lifetime expected credit losses.

BC77 When the IASB was developing the model jointly with the FASB, the boards had tentatively agreed that the recognition of lifetime expected credit losses would require the satisfaction of a credit quality criterion in addition to a deterioration criterion. That credit quality criterion was initially set at a probability of default that was 'reasonably possible'. However, participants in the IASB's outreach expressed concerns that any probability of default is reasonably possible, which would imply that financial instruments would always meet this test. Consequently, the IASB decided not to use this concept in these proposals. In addition, the IASB decided to simplify the model by focusing primarily on a significant increase in credit risk and to use the exception outlined in paragraph BC76 for financial instruments with low credit risk only.

Improvements in credit quality

BC78 In the IASB's view, an entity should recognise favourable changes in credit quality that represent an economic gain consistently with unfavourable changes in credit quality, which represent an economic loss. For purchased or originated credit-impaired financial assets (to which the general model does not apply), an entity would recognise a gain if credit quality improves after initial recognition, reflecting an increase in the expected cash flows. In accordance with the general model, if financial instruments that had significantly deteriorated in credit quality since initial recognition subsequently improve in credit quality so that they no longer satisfy the lifetime expected credit loss criterion, then an entity should re-measure the loss allowance balance at an amount equal to 12-month expected credit losses with a resulting gain in profit or loss. Doing so would reflect the fact that the expectations of credit losses have moved back towards the initial expectations.

BC79 In addition, to address concerns about potential earnings management, the IASB considered requiring a higher credit quality for the change back to a loss allowance balance at an amount that is equal to 12-month expected credit losses than the credit quality that is required by the criteria for the recognition of lifetime expected credit losses. The IASB rejected such a requirement because it reduces the usefulness, neutrality and faithful representation of expected credit losses, which it should not override for anti-abuse considerations. The IASB also noted that such arbitrary distinctions can have unintended consequences, such as creating a disincentive to recognise lifetime expected credit losses because of the higher hurdle to change back to the recognition of 12-month expected credit losses.

Individual versus group evaluation

BC80 The IASB considered whether the proposals should specify whether an entity should evaluate financial instruments individually or collectively when deciding whether it should recognise lifetime expected credit losses. In accordance with IFRS 9, and using the amortised cost measurement, the unit of account is the individual financial instrument. However, this does not prohibit the use of estimation techniques that an entity could apply to a group of financial

instruments if the outcome would be the same if the entity applied those techniques to individual instruments. For example, if a single factor affects the credit quality for a group of similar financial instruments, an entity could use the deterioration in that factor to determine that the credit quality of each individual instrument in that group has deteriorated significantly or that the credit quality of the entire group has deteriorated significantly. The IASB observed that, although an entity may group financial instruments in a portfolio with similar characteristics on origination or purchase, ultimately, information will emerge that may enable an entity to distinguish between those instruments that are more likely to default from those instruments that are not. As time reduces the uncertainty about the eventual outcome, the probabilities of a default occurring on the financial instruments in the portfolio should diverge until the instruments either default or are collected in full. Consequently, the appropriate level of grouping will change over time and the IASB concluded that an entity should not group financial instruments at a higher level if a subgroup exists for which the recognition of lifetime expected credit losses is more (or less) appropriate.

Measurement

BC81 The proposals in this Exposure Draft state that expected credit losses are the expected present value of all cash shortfalls over the remaining life of the financial instrument, thus reflecting the following characteristics:

(a) an unbiased and probability-weighted amount in a range of possible outcomes (see paragraphs BC83–BC91); and

(b) the time value of money (see paragraphs BC92–BC96).

BC82 As in the 2009 ED, the IASB decided to emphasise the objective of the measurement of expected credit losses, and to keep the requirements principle-based rather than specifying techniques to measure expected credit losses. Respondents have commented that adopting such a style would help reduce complexity and mitigate operational challenges by allowing an entity to use techniques that work best in its specific circumstances. The IASB specified that the information set that the ED would require for measuring expected credit losses is the best information that is available without undue cost or effort, and this includes forward-looking information. Both the SD and the 2009 ED specified the same information set and, in the light of the views on those proposals, the IASB has retained those proposals in this Exposure Draft.

Expected value

BC83 The 2009 ED proposed that the estimates of cash flows are expected values. Hence, estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes.

BC84 The term ‘expected’ as used in the terms ‘expected credit losses’, ‘expected value’ and ‘expected cash flow’ is not a loose term, but a technical term that refers to the probability-weighted mean of a distribution and should not be confused with a most likely outcome or an entity’s best estimate of the ultimate outcome.

BC85 The 2009 ED was a forward-looking model that required an estimate of expected cash flows over the life of the financial asset to measure assets at amortised cost. Implicit in the 2009 ED is the concept that the pricing of financial assets must include a consideration of expected credit losses (explicitly or implicitly, depending on the financial assets), which is inherently derived from an expected value. If an asset were priced using a most likely outcome, no credit risk premium would be included (ie an entity would not price for risk on assets with a less than 50 per cent probability of default and an entity is not likely to issue or purchase an asset with a greater than 50 per cent probability of default).

BC86 Many respondents to the 2009 ED agreed that an expected value measurement is conceptually correct for portfolios because the actual losses on the individual loans may approximate the expected value of credit losses for the portfolio. They state that portfolios often have historical and industry data that an entity can use to predict expected credit losses, and the transactions occur frequently enough that expected values approximate actual results over time.

BC87 However, many respondents to the 2009 ED were concerned that an expected value objective would require an estimate of the probability-weighted expected cash flows of all possible outcomes (ie would require a complex statistical analysis such as a stochastic model or a Monte Carlo simulation). They believed that this would add operational complexity to the model without providing improved credit loss estimates. Respondents stated that an expected value would require significantly more data than is currently available. In particular, they were concerned that estimating the specific timing of the amounts of expected cash flows would be difficult over the life of financial assets, and that estimating the specific timing would become more difficult the longer the time frame. Many respondents stated that they would be comfortable using historical information, industry estimates and other information to estimate the amount of credit losses over the life of the financial asset but not necessarily the specific timing of when those credit losses were expected.

BC88 There was also less support for an expected value measurement for individual financial assets. While a few respondents, including a few users of financial statements, were in favour of using an expected value measurement for individual financial assets, many respondents preferred using an estimate of the most likely outcome in those situations. They stated that using an expected value for a single financial asset is inappropriate because the estimated loss, as an average of several discrete outcomes, is not necessarily equal to any of the possible outcomes. The IASB acknowledges that an expected value of credit losses on an individual financial instrument might not equate to the actual outcome; however, this does not imply that the expected value will not provide useful information about that financial instrument to users of financial statements.

BC89 In the IASB's view, an expected value measurement provides information about the timing, amounts and uncertainty of an entity's future cash flows. This is because an expected value measurement would:

(a) include a consideration of expected credit losses using all the available evidence (including forward-looking information). Thus, an entity will be required to consider multiple scenarios and possible outcomes and their probability.

(b) reflect that the pricing of financial instruments includes the consideration of expected credit losses. Although entities might not attribute specific credit loss estimates to single financial instruments, and although competitive pressures might influence pricing, entities still consider credit loss expectations for the credit quality of similar obligors in pricing loans on origination and purchase.

(c) not revert (at any time) to an incurred credit loss model—all financial instruments have a probability of a default occurring and the measurement will therefore reflect that probability of default and not the most likely outcome.

(d) have the same objective regardless of whether an entity performs the measurement at an individual or portfolio level. Consequently, there is no need to propose specific conditions or criteria for grouping financial instruments for the purposes of measurement.

(e) provide useful information to investors (ie information about the risk that the investment might not perform).

BC90 The IASB observed that an entity can use a variety of techniques to meet the objective of an expected value without requiring detailed statistical models. The calculation of an expected value need not be a rigorous mathematical exercise whereby an entity identifies every single possible outcome and its probability. Instead, in the case in which there are many possible outcomes, an entity can use a representative sample of the complete distribution for determining the expected value. The main objective is that at least two outcomes are considered: the probability of default and the probability of no default. Many preparers are already performing calculations for internal purposes that would provide an appropriate measure of expected values.

BC91 The IASB also acknowledged that an entity may use various techniques to measure expected credit losses, including, for the 12-month expected credit losses measurement, techniques that do not include an explicit 12-month probability of default as an input, such as a loss rate methodology. However, this Exposure Draft does not list acceptable techniques or methods for measuring the loss allowance. The IASB is concerned that listing acceptable methods might rule out other appropriate methods for measuring expected credit losses, or be interpreted as providing unconditional acceptance of a particular method even when such a measurement would result in an amount that is not consistent with the required attributes of an expected credit losses measurement. Instead, this Exposure Draft sets out the objectives for the measurement of expected credit losses, allowing entities to decide the most appropriate techniques to satisfy those objectives.

Discount rate

BC92 Consistent with the proposals in the SD, this Exposure Draft would allow an entity to discount expected credit losses using the risk-free rate, the effective interest rate on the related financial asset, or any rate in between these two rates.

BC93 In developing the proposals in the SD, the IASB noted that, conceptually, the discount rate for cash flows of an asset cannot be below the risk-free rate. The IASB further noted that the discount rate used in the 2009 ED is conceptually appropriate for calculations of amortised cost. However, if the IASB proposed the credit-adjusted effective interest rate from the 2009 ED as the upper limit, entities would need to calculate that rate to decide whether they could use a rate that is more readily determinable. That is, such a proposal would not avoid the operational complexity of determining that credit-adjusted effective interest rate, which would be counter-productive. Thus, the IASB proposes that an entity should use any rate between the risk-free rate and the effective interest rate, not adjusted for credit, as the discount rate.

BC94 Most respondents to the SD supported flexibility in an entity choosing which discount rate it should apply. These respondents agreed that this flexibility was helpful for easing the operational challenges of determining and maintaining the discount rate. They also felt that it was appropriate to allow preparers to choose a rate that is suitable for the level of sophistication of their systems and their operational capability. Those who did not support permitting flexibility in determining the appropriate rate wanted to maintain comparability between entities.

BC95 The IASB observed that some credit risk management systems discount expected cash flows to the date of default. The proposals will require an entity to discount expected credit losses to the reporting date.

BC96 The IASB decided to confirm the proposals in the SD, but to require the entity to disclose the discount rate it used and any significant assumptions that it made in determining that rate. This choice of discount rates does not apply to purchased or originated credit-impaired financial assets on which the amortised cost measurement always uses the credit-adjusted effective interest rate.

Definitions of default

BC97 This Exposure Draft does not define default. Instead, entities can use different definitions of default including, where applicable, regulatory definitions of default. In making this decision, the IASB observed that they did not expect that expected credit losses would change as a result of differences in the definition of default because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise given that definition of default.

Presentation of interest revenue

BC98 The 2009 ED proposed a model in which an entity would have considered initial expectations of credit losses when determining the effective interest rate on financial assets. Consequently, interest revenue would have represented the

economic yield, or effective return, on those financial assets. In contrast, the decoupled approach in this Exposure Draft considers the recognition of interest revenue and the recognition of expected credit losses separately. This means that an entity recognises interest on the gross carrying amount without taking expected credit losses into consideration. In addition, users of financial statements stressed the need for an interest revenue recognition model that allows them to continue to analyse net interest margin and credit losses separately. However, the IASB noted that there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return.

BC99 In the IASB's view, the issues about the presentation of interest revenue for financial assets that have objective evidence of impairment are similar to the issues for purchased or originated credit-impaired financial assets on which interest revenue is determined on the amortised cost amount (see paragraphs BC137–BC141). Consequently, if a financial asset has objective evidence of impairment at the reporting date, the proposals in this Exposure Draft would require an entity to calculate and present interest revenue using the effective interest rate on the amortised cost amount (ie the gross carrying amount net of the loss allowance). These requirements will only affect the calculation and presentation of interest revenue and not the measurement of the loss allowance.

BC100 The IASB decided to keep the scope of assets on which interest is calculated on the amortised cost amount consistent with paragraphs 59(a)–(e) of IAS 39. Thus, financial assets with objective evidence of impairment will be a subset of financial assets with a loss allowance measured at lifetime expected credit losses. IFRS preparers have already been determining interest on the net amortised cost amount for such assets in accordance with IAS 39. Consequently, this proposal would result in a minimal change in practice.

BC101 The IASB acknowledges the concerns of using 'incurred loss' criteria in an expected credit loss model. However, in the IASB's view, it is necessary to retain the faithful representation of interest revenue, while minimising the operational challenges of requiring entities to calculate interest revenue on the amortised cost amount for all assets.

BC102 The IASB considered an approach that would require the presentation of nil interest revenue, similar to a non-accrual approach, for this subset of financial assets. Under this approach, an entity would be required to offset interest revenue on a subset of financial assets with an equal amount of expected credit losses. The advantage of presenting nil interest revenue is the operational simplicity. The only information that an entity would need to know to apply this approach would be the interest revenue on the subset of financial assets. That is, the proposals would not require an entity to identify the loss allowance related to that subset of financial assets. However, the disadvantage of this alternative is that it would blend together the effect of the unwinding of the present value of expected cash flows with other expected credit losses. In the IASB's view, a nil interest approach applied to a broad set of financial assets will not improve the presentation of interest revenue, because it will not faithfully

represent the economic return in a manner that is consistent with the measurement of the gross carrying amount and expected credit losses at a present value.

Disclosure

Disclosure objectives

BC103 In developing the disclosure proposals, the IASB sought to supplement the existing disclosures in IFRS 7 *Financial Instruments: Disclosures* to meet those additional information needs of users of financial statements that will arise specifically from the expected credit losses model proposed in this Exposure Draft. Where relevant, the IASB has considered the comments received on the disclosure requirements proposed in the 2009 ED and the IASB-only appendix to the SD.

BC104 The IASB identified two objectives for the disclosure requirements. These are that an entity shall disclose information that identifies and explains:

(a) the amounts in its financial statements arising from expected credit losses; and

(b) the effect of deterioration and improvements in credit risk.

BC105 The proposed disclosures may overlap with some existing requirements in IFRS 7. The IASB does not intend the proposed disclosures to duplicate any existing disclosures in existing Standards; however, this Exposure Draft includes all relevant disclosures that are necessary to meet the two objectives.

Expected credit loss calculations

BC106 Requiring entities to estimate expected credit losses will increase the significance of forecasts and the use of an entity's judgement. In addition, the model will require entities to incorporate new types of information into their measurement of expected credit losses. In the IASB's view it will be helpful for users of financial statements to understand what type of information entities use in their estimate of expected credit losses.

BC107 The SD proposed disclosures to explain the estimates and the changes in estimates that are required to measure the loss allowance, for example:

(a) information about the inputs and assumptions used for determining expected credit losses;

(b) analyses of significant effects on credit losses resulting from a particular portfolio or geographical area; and

(c) information that compares previous estimates of expected credit losses with actual outcomes.

BC108 In general, respondents to the SD (users of financial statements, preparers, auditors, regulators, etc) believed that disclosing information that explains how the estimates are determined is useful information. There were a few

respondents who wanted the IASB to clearly state the specific requirements. They were concerned that the requirements in the SD were too vague, which could lead to boilerplate disclosures.

BC109 Many respondents disliked the proposed disclosure in the SD that required a comparison between previous estimates of expected credit losses with actual outcomes ('back-testing'). They stated that back-testing on expected credit loss amounts would not provide useful information, and could be misleading because estimates of expected credit losses necessarily require judgement. They also noted that the proposed disclosure only required quantitative information if the entity was already performing back-testing. Many also commented that back-testing in an open portfolio would require an entity to ascertain whether actual credit loss amounts were included in its original expectations, which would be difficult to do. Consequently, the IASB has removed the proposed disclosure for back-testing and carried forward the other disclosures.

Reconciliations of the gross carrying amount and loss allowance

BC110 The SD proposed the mandatory use of a loss allowance account for credit losses, with separate disclosure of reconciliations for the two groups of financial assets that an entity would distinguish for the purpose of determining the loss allowance (ie assets in the 'good book' and assets in the 'bad book'). Almost all respondents supported the mandatory use of a loss allowance account. Consequently, this Exposure Draft retains that proposal.

BC111 Many respondents commented that it was important to show reconciliations of the gross carrying amounts of the two groups of financial assets that an entity would distinguish between for the purpose of determining the loss allowance, and a reconciliation of the changes in each of the related loss allowance balances. A few respondents commented that showing separate reconciliations was onerous, and they felt that an entity should provide a single reconciliation for all assets in aggregate.

BC112 Many preparers noted that disclosing the effect of the change of financial assets from one group to the other would be difficult. They also commented that when loss allowances are determined on a portfolio basis, an entity does not allocate loss allowances to individual financial assets. As a result, any disclosure of the effect of the change would be arbitrary and perhaps misleading because an entity may change individual assets from a group. Preparers also stated that the costs associated with this disclosure, and any disclosure with flow information, would be substantial. In order to provide this information for open portfolios, an entity would be required to track the movement of assets and calculate the change in the loss allowance that results from new loans, derecognised assets, changes between different measurement categories of the loss allowance and changes in estimates of credit losses. However, during outreach, users of financial statements have consistently and strongly expressed their opinion that the change in the measurement category of the loss allowance and its effect is a critical element in understanding the credit quality of an entity's financial assets and its credit risk management, and that the reconciliation would greatly enhance transparency of an entity's financial asset portfolio. While these

disclosures would require systems changes and the cost of providing the information will be high, in the IASB's view the benefits to users of financial statements would outweigh those costs.

BC113 The IASB proposes narrative disclosures to complement the quantitative disclosures. In the IASB's view, users of financial statements will benefit from a qualitative discussion of changes in recognised expected credit losses in the financial statements. Estimates of expected credit losses may change, for example, because of changes in the volume of financial instruments, changes in overall market conditions or as a result of a significant event (for example, sovereign debt crisis, political events, the effects of significant industry or geographical concentrations of credit risk, and weather-related or other disasters). The disclosures should include a qualitative narrative describing how significant events have affected the entity's loss allowance calculation. Users of financial statements generally indicated that these narrative disclosures were essential to understanding the changes and calculations within existing disclosures.

Collateral disclosures

BC114 Collateral is an important factor in an entity's estimate of expected credit losses. For instance, an entity with more heavily collateralised loans will, all other things being equal, record a smaller loss allowance for credit losses than an entity with unsecured loans. Paragraph 36(b) in IFRS 7 requires the disclosure of information that is similar to that proposed in this Exposure Draft. However, the IASB received feedback that the current collateral disclosures are overly onerous and costly to prepare, and therefore proposes to limit the collateral disclosure requirements proposed in this Exposure Draft to those financial instruments for which there is objective evidence of impairment.

Assessment for the recognition of lifetime expected credit losses

BC115 The IASB acknowledges that different entities will use different information and techniques for assessing whether they should recognise lifetime expected credit losses. The Exposure Draft acknowledges and permits this. The information and techniques that an entity will use will depend on the nature of its financial instruments and other factors. Consequently, the IASB proposes that an entity should disclose the inputs, assumptions and techniques used to decide when it recognises lifetime expected credit losses.

Financial instruments evaluated on an individual basis

BC116 Paragraph 37(b) of IFRS 7 currently requires an analysis of financial instruments that are individually determined to be credit-impaired as at the end of the reporting period, including an analysis of the factors that the entity considered when determining that those financial instruments are credit-impaired. Many entities already disclose the loan balance and loss allowance amount for both collectively and individually assessed credit-impaired loans. Consequently, this Exposure Draft proposes amendments to those requirements to limit them to financial instruments that an entity assesses individually for recognition of lifetime expected credit losses.

BC117 During outreach activities, users of financial statements said that they are interested in understanding which financial instruments an entity assesses on an individual basis, especially when that individual assessment is due to a decline in credit quality and closer management of the instrument. While these financial instruments may not have deteriorated further than those evaluated on a group basis, the IASB concluded that this distinction helps users of financial statements to understand how an entity is monitoring and managing credit risk, so it is useful even when the difference is not attributable to differences in credit quality.

Risk disaggregation

BC118 Because the recognition of lifetime expected credit losses is based on significant deterioration in credit quality, there could be a wide range of initial credit qualities for which 12-month expected credit losses is required. To provide users of financial statements with information about the changes in the loss allowance and about the credit quality of the entity's financial instruments, the IASB proposes a disaggregation of the carrying amounts of financial instruments into credit risk categories, for both 12-month expected credit losses and lifetime expected credit losses.

BC119 Disaggregating by credit risk shows the credit risk profile at a given point in time. Users of financial statements indicated that they were concerned about the relative nature of the disclosure that is based on the range of credit quality relevant to the entity's portfolio and that it would lack comparability as a result (ie a high risk for one entity may only be a medium risk for another). Furthermore, without vintage information, a user would not be able to work out whether changes in the risk profile are a result of changes in credit quality or a result of the credit quality of new instruments. However, they believed that risk disaggregation would provide insight into an individual company's financial instrument portfolio and were therefore in favour of including it in the notes to the financial statements. The IASB proposes the disclosure because changes in risk will affect the measurement of expected credit losses and will therefore provide users of financial statements with information about the drivers of the change in the measurement.

BC120 The IASB considered adding language to the proposed disclosure that would have required an entity to reconcile this disclosure to internal credit rating grades. However, responses to the SD considered this internal risk-rating information to be proprietary and therefore objected to this level of specificity. Consequently, the IASB decided not to propose this reconciliation.

Derecognition

Write-off

BC121 In the IASB's view, a definition of 'write-off' is necessary to faithfully represent the gross carrying amount of the financial assets within the scope of this Exposure Draft. The definition is also necessary for the disclosure requirements. The 2009 ED included similar definitions and requirements related to the term

'write-off'. Following positive comments about those definitions, the IASB retained the definition included in the 2009 ED, with minimal changes.

Application of the general model to modified financial instruments

Recognition and measurement

BC122 Some modifications result in the derecognition of a financial instrument and the recognition of a new financial instrument in accordance with IFRS 9. However, modifications do not always result in the derecognition of a financial instrument, so the IASB considered how the proposed model will apply to these financial instruments.

BC123 This Exposure Draft proposes that, when an entity is assessing whether it should recognise a loss allowance for 12-month expected credit losses or lifetime expected credit losses, it should compare the credit quality of the modified financial instrument at the reporting date to the credit quality of the (unmodified) financial instrument at initial recognition. The exception for financial instruments with low credit risk (eg credit risk equivalent to investment grade) would also apply to modified financial instruments.

BC124 This decision reflects the fact that financial instruments that are modified but not derecognised are not new financial instruments from an accounting perspective and, as a result, the amortised cost measurement would keep the same original effective interest rate. Consequently, the expected credit losses model should apply as it does for other financial instruments, reflecting their changes in credit quality since initial recognition.

BC125 The IASB observed that it is not unusual for distressed financial instruments to be modified more than once and, therefore, the assessment of whether lifetime expected credit losses is required for modified financial instruments may be based on projections that are too aggressive or optimistic. The IASB considered prohibiting the ability for modified financial instruments to change to a loss allowance at an amount equal to 12-month expected credit losses or proposing more restrictive criteria than usual before allowing 12-month expected credit losses to be re-established. However, the IASB concluded that the proposed deterioration model should allow the loss allowance on modified financial instruments to revert to being measured at an amount equal to 12-month expected credit losses when they no longer meet the lifetime expected credit loss criterion, which is consistent with the proposed treatment of unmodified financial instruments. In the IASB's view, such a model faithfully represents the economics of the transaction and it should not override that faithful representation for anti-abuse purposes. In addition, the IASB observed that entities do not only modify financial instruments because of credit deterioration.

BC126 The IASB considered whether an entity should assess the deterioration in credit quality by comparing it to the credit quality at the point of modification. However, by using such an approach the financial instrument would, by definition, not have experienced a level of deterioration in credit quality that is more than insignificant upon modification. As a result, if the IASB took this

approach, an entity would recognise 12-month expected credit losses for every modified financial instrument at the point of modification. However, the IASB rejected this approach because the original financial instrument has not been derecognised and, as a result, the modified financial instrument is not a new financial instrument. Thus, as for all other financial instruments, the IASB proposes that an entity should compare the credit quality at the reporting date with the credit quality as at initial recognition (of the unmodified financial instrument). The IASB noted that an entity should base the credit quality that occurs after a modification on the ability to meet the modified contractual cash flows.

Adjustment of gross carrying amount

BC127 The IASB proposes a decoupled approach to interest revenue and recognition of expected credit losses for financial assets (except for purchased or originated credit-impaired financial assets). In accordance with a decoupled approach, an entity would calculate the interest revenue by multiplying the effective interest rate by the gross carrying amount (ie the amount that does not include a reduction for the loss allowance). Consequently, an entity should adjust the gross carrying amount of a financial asset if it modifies the contractual cash flows. For example, if credit losses are crystallised by a modification, an entity should recognise a reduction in the gross carrying amount. Adjusting the gross carrying amount may result in situations with upward adjustments, resulting in the recognition of a gain. Except for purchased or originated credit-impaired financial assets, the new gross carrying amount will represent the future contractual cash flows discounted at the original effective interest rate. If an entity measured expected credit losses before the modification using a current discount rate, the total adjustment to the amortised cost amount could result in a profit or loss effect that does not relate solely to credit losses upon modification. This is because of differences in the discount rate used for the gross carrying amount and the loss allowance (ie even if the contractual cash flows were unchanged, there would be a gain or loss arising because of the change in the discount rate).

Application of the general model to loan commitments and financial guarantee contracts

Recognition and measurement

BC128 The SD asked respondents whether an entity should apply the same expected credit losses model to financial guarantee contracts and loan commitments. Most respondents agreed that an entity should apply the same model, because entities manage credit risk in the same way for all of these financial instruments.

BC129 This Exposure Draft proposes that an entity should recognise a provision for expected credit losses that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit. Expected credit losses of obligations to extend credit (off balance sheet exposures) are similar to those of loans and other on balance sheet exposures. The only difference is that in the latter case, the borrower has already drawn

down the loan whereas in the former case it has not. The recognition of a liability for expected credit losses is limited to loan commitments and financial guarantee contracts with a present contractual obligation to extend credit. Without a present contractual obligation to extend credit, an entity may withdraw its loan commitment before it extends credit. Consequently, the IASB concluded that a liability does not exist for loan commitments or for financial guarantee contracts where there is no present contractual obligation to extend credit.

BC130 An entity applies the general model to these financial instruments, including the assessment of the deterioration in credit quality to decide whether it should recognise 12-month or lifetime expected credit losses. When estimating expected credit losses of loan commitments and financial guarantee contracts, additional uncertainty arises in respect to one of the input factors—the exposure at default. To measure the exposure at default of the loan commitments, the issuer needs to estimate the amount that a borrower will have drawn down at the time of default. That is, the issuer needs to estimate the part of the undrawn facility that the borrower will convert into a funded amount, typically referred to as a credit conversion factor or utilisation rate. Some financial institutions are required to make similar assessments for regulatory capital purposes.

BC131 Respondents to the SD, and participants in the IASB's outreach, noted that estimating future drawdowns over the lifetime of the financial instrument will introduce additional complexities. These additional complexities arise because of the uncertainty involved in estimating the behaviour of customers over a longer period. Interested parties are concerned that the requirements will hold entities to a standard of accuracy that they would not be able to meet.

BC132 The IASB acknowledges the complexity involved in estimating future drawdowns over the lifetime of financial instruments. Nevertheless, this estimate is necessary to have a consistent expected credit losses model. Not having it would defeat the purpose of removing the arbitrage between on balance sheet and off balance sheet exposures. Consequently, the IASB proposes that an entity shall estimate the usage behaviour over the period during which a present legal obligation exists to extend credit.

BC133 The IASB considered and rejected the following alternatives that were suggested for estimating future drawdowns:

(a) Limiting the estimate of future drawdowns to the next 12 months. While it would be less complex to use an estimate over a 12-month time period, such a limit would be arbitrary and inconsistent with estimating lifetime expected credit losses.

(b) Estimating future drawdowns based only on historical information. While it would be less complex to limit the estimate to historical information, it would be inconsistent with the objective of an expected credit loss model. Historical utilisation rates might be a good indicator for future drawdowns, however, an entity would also need to consider current and future expectations when estimating expected credit losses.

(c) Using the credit conversion factor provided by prudential regulators. Regulators typically provide credit conversion factors over a 12-month period. Generally, they are not forward-looking, specific to product types or particular to the entity. Similarly as for the issues mentioned in (a) and (b), applying such a standardised parameter when estimating expected credit losses is inconsistent with the model. It would also not address the issue for entities that are not subject to such regulations.

BC134 Because loan commitments and financial guarantee contracts are unfunded, the effective interest method and, hence, an effective interest rate, are not applicable. Loan commitments and financial guarantee contracts are a commitment to lend in the future and a promise to reimburse credit loss respectively. Hence, those financial instruments by themselves (before they are drawn down) do not give rise to the notion of interest. Instead, the cash flow profile of loan commitments and financial guarantee contracts is akin to that of derivatives. The fact that interest revenue does not apply is reflected in the accounting for loan commitments and financial guarantee contracts within the scope of IFRS 9. For those loan commitments and financial guarantee contracts, revenue recognition of the related fee income does not use the effective interest method. Consequently, the IASB cannot simply extend the requirements for the discount rate for measuring expected credit losses that arise from financial assets to the requirements for the discount rate for measuring expected credit losses that arise from loan commitments and financial guarantee contracts.

BC135 As a result, the IASB proposes that the discount rate to be applied when discounting the expected credit losses that arise from a loan commitment or a financial guarantee contract would be the rate that reflects:

(a) current market assessments of the time value of money (ie risk-free rate); and

(b) the risks that are specific to the cash flows, to the extent that the risks are taken into account by adjusting the discount rate rather than by adjusting the cash flows that are being discounted.

BC136 The IASB noted that it would be inappropriate to recognise a loss allowance for loan commitments and financial guarantee contracts, because there is no corresponding asset with which to present that loss allowance. The IASB therefore decided to require that an entity must recognise the expected credit losses for such financial instruments as a provision in the statement of financial position.

Exceptions to the general model

Purchased or originated credit-impaired financial assets

Recognition and measurement

BC137 This Exposure Draft proposes to carry forward the scope and requirements in paragraph AG5 of IAS 39, whereby an entity is required to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that have objective evidence of impairment on initial recognition. In addition, entities shall present interest revenue from

financial assets subject to this measurement requirement in the statement of profit or loss and other comprehensive income, calculated by applying the credit-adjusted effective interest rate to the amortised cost of the financial asset (adjusting for any loss allowance).

BC138 In developing the proposed general model, the IASB acknowledged the superior information that would be provided as a result of applying the proposed requirements in the 2009 ED, particularly if the credit quality of the financial asset is so low that the financial asset has objective evidence of impairment on initial recognition. In the IASB's view, this model more faithfully represents the underlying economics for these financial assets than the general model, and the benefits of this better representation outweigh the costs for these financial assets. Some users of financial statements would prefer a single expected credit loss model for all financial assets to ensure comparability. However, in the IASB's view, applying the general model to purchased or originated credit-impaired financial assets would achieve the desired comparability, because the model will not faithfully represent the underlying economics for this set of financial assets.

BC139 The IASB noted that, while the scope usually relates to purchased financial assets, in unusual circumstances financial assets could be originated that would be within this scope. However, this does not mean that all financial assets originated at a low credit quality are within the scope—there has to be objective evidence of impairment on initial recognition. The IASB considered a situation in which there was a substantial modification of a distressed asset that resulted in derecognition. In such a case, it would be possible for the modification to constitute objective evidence that the new asset is impaired.

BC140 Consistently with the 2009 ED, this model considers the initial credit loss expectations to be part of the effective interest rate and thus interest revenue will represent the effective yield on the asset. An entity will recognise changes in the initial expected credit losses as gains or losses. Paragraph BC23 sets out the operational challenges that would have arisen if the 2009 ED model had applied to all financial assets. However, in developing the proposals in this Exposure Draft, the IASB observed that this requirement in IAS 39 has not presented issues in practice and proposes to retain it, and to use a scope that is based on IAS 39 to minimise the operational challenges for preparers.

Disclosures

BC141 The IASB sought to enhance the comparability of financial assets that have objective evidence of impairment on initial recognition with those that do not. Users of financial statements have indicated that such a disclosure would be helpful in alleviating some of the complexity in this area of accounting and would allow them to see the possible contractual cash flows that an entity could collect if there was a favourable change in expectations of credit losses. Consequently, this Exposure Draft proposes that an entity should disclose the expected credit losses that are implicit in the price at initial recognition for purchased or originated credit-impaired financial assets.

Simplified approach for trade receivables and lease receivables

Recognition and measurement

BC142 This Exposure Draft proposes that trade receivables that do not have a significant financing component in accordance with ED/2010/6 *Revenue from Contracts with Customers* ('the Revenue Recognition ED') should be accounted for as follows:[27]

(a) an entity would be required to measure the trade receivable at initial recognition at the transaction price as defined in the Revenue Recognition ED (ie the invoiced amount in many cases); and

(b) an entity would be required to recognise a loss allowance for lifetime expected credit losses on those trade receivables throughout their life.

BC143 Entities would have a choice of accounting policy both for trade receivables that have a significant financing component in accordance with the Revenue Recognition ED and, separately, for lease receivables in accordance with IAS 17 *Leases* or in accordance with the tentative decisions in the Leases project. Those accounting policy choices would allow entities to decide between fully applying the proposed model and recognising a loss allowance for lifetime expected credit losses from initial recognition until derecognition (the simplified approach). The IASB noted that allowing this option for trade receivables and lease receivables would reduce comparability. However, it would alleviate some of the practical concerns of tracking credit deterioration for entities that do not have sophisticated credit risk management systems. In addition, not many trade receivables without a significant financing component would have a maturity that is longer than one year, so the lifetime expected credit losses and the 12-month expected credit losses would be the same, or very similar. In the IASB's view, the benefits of achieving comparability do not outweigh the costs to implement the full model in this case.[28]

BC144 The 2009 ED proposed that entities should apply an expected credit losses model to trade receivables and proposed a practical expedient that they could use a provision matrix. Many respondents to the 2009 ED told the IASB that applying an expected credit losses model to non-interest-bearing (for example, short-term) trade receivables would not provide more useful information than an incurred loss model because of their short maturity. They also noted that there would be operational challenges for less sophisticated financial institutions and non-financial institutions in applying an expected credit losses model. The IASB acknowledged these concerns but noted that there are different ways to apply an expected credit losses model and that entities would have the flexibility to

27 The IASB expects that it will issue a new Revenue Recognition Standard before the proposals in this Exposure Draft are finalised. In the interim, an entity shall apply these requirements to trade receivables based on whether they constitute a financing transaction in accordance with IAS 18 *Revenue*. An entity would be required to recognise a loss allowance at an amount equal to lifetime expected credit losses for receivables that do not constitute a financing transaction in accordance with IAS 18.

28 However if an entity did choose to apply the general model, past due information could be used to assess deterioration.

reduce the costs of applying an expected credit losses model without the loss of useful information. Consequently, the IASB conducted further outreach to gather information about current practice and the operational challenges of applying an expected credit losses model to trade receivables. That outreach indicated that the practical application of the current impairment requirements in IAS 39 often results in credit losses not being recognised until trade receivables become past due (unless another credit loss event for those receivables is identified). Some outreach participants believed, and the IASB agreed, that requiring entities to recognise a loss allowance on a more forward-looking basis before trade receivables become past due would improve financial reporting.

BC145 Some outreach participants also indicated that they would not have significant operational difficulty in applying an expected credit losses model to their trade receivables without a significant financing component. While these participants acknowledge that an expected credit losses model would require a change in practice, they believe that they can incorporate forward-looking information within their current methodologies. In addition, the outreach participants noted that the IASB could make the application of an expected credit losses model to current trade receivables (ie those that are not past due) more operational without the loss of useful information. In the IASB's view, a provision matrix can be an acceptable method to measure expected credit losses for these trade receivables in accordance with the objectives in these proposals. An entity would adjust historical provision rates, which are an average of historical outcomes, to reflect relevant information about current conditions as well as reasonable and supportable forecasts and their implications for expected credit losses including the time value of money. Such a technique would be consistent with the measurement objective of expected credit losses as set out in this Exposure Draft.

BC146 The IASB noted that the tentative decisions made in the Leases project result in the measurement of a lease receivable in a manner that is similar to financial assets that are measured at amortised cost in accordance with IFRS 9. However, there are some differences, including differences in the application of the effective interest method. The cash flows included in lease contracts could include features such as contingent payments that would not be present in other financial instruments that are subject to the requirements in this Exposure Draft. The existence of contingent and variable lease payments results in:

(a) specific requirements for identifying the cash flows that are included in the measurement of the lease receivable (such as the criteria for including contingent lease payments, the treatment of renewal options and the bifurcation of any embedded derivatives); and

(b) a consequential effect on determining the discount rate (ie given (a), the discount rate cannot always be determined in the same way as the effective interest rate for a financial asset at amortised cost).

BC147 Although the measurement for some lease receivables will be different from the measurement of other financial assets that are within the scope of this Exposure

Draft, the IASB does not think that is a reason to apply a different model. In the IASB's view, the proposed expected credit losses model could be applied to lease receivables as long as:

(a) the cash flows assessed for expected credit losses are consistent with those included in the measurement of the lease receivable; and

(b) the rate used to discount the expected credit losses is consistent with the rate that the IASB proposes in the Leases project.

BC148 In a lease transaction, the cash flows due to a lessor are secured by the underlying leased asset because the lessor owns the underlying asset and will reclaim that asset in the event of default. In accordance with the requirements in the forthcoming revised Exposure Draft on leases, a lessor will, for some leases, recognise a lease receivable and a residual asset representing components of the underlying asset. In those cases, the lessor should consider the value of the collateral related to the right of use asset underlying the lease receivable when measuring a loss allowance.

Disclosures

BC149 The Exposure Draft proposes exceptions to the general disclosures for trade receivables and lease receivables when an entity applies the simplified approach. This includes relief from the disclosures that relate to providing information about changes between the 12-month and lifetime expected credit losses if the entity applies the simplified approach to trade receivables or lease receivables.

Transition

BC150 This Exposure Draft proposes that:

(a) an entity shall apply the proposed requirements retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except:

(i) if, at the date of initial application of the proposed requirements, obtaining the probability of a default occurring as at the initial recognition of a financial instrument would require undue cost or effort. In that case, at each reporting date until that financial instrument is derecognised, the loss allowance measurement shall be determined only on the basis of whether the credit risk is low at that reporting date; and

(ii) the entity is not required to restate prior periods. However, the entity may restate prior periods if, and only if, this is possible without the use of hindsight.

If an entity does not restate prior periods, at the beginning of the annual reporting period that includes the date of initial application the entity shall adjust the opening balance of retained earnings (or other components of equity, as appropriate) of that annual reporting period for the effect of applying the proposed requirements.

(b) in the reporting period in which IFRS 9 is initially applied, an entity is not required to disclose the line item amounts that would have been reported in accordance with the requirements of:

(i) the proposals in this Exposure Draft for prior periods; and

(ii) IAS 39 for the current period.

(c) on the date of initial application of this Exposure Draft, an entity is required to provide a disclosure that reconciles the ending impairment allowances under IAS 39 or provisions under IAS 37 to the opening loss allowances or provisions resulting from the proposals in this Exposure Draft. An entity shall provide this disclosure by the related financial assets' measurement categories in accordance with IAS 39 and IFRS 9, and shall show separately the effect of changes in measurement category on the loss allowance at that date.

BC151 IAS 8 provides the principles and framework for changes in accounting policies in the absence of specific transition provisions in a Standard. IAS 8 states that, as a general rule, retrospective application results in the most useful information to users of financial statements, and that it is the preferred approach unless it is impracticable to calculate the period-specific effect or the cumulative effect of the change. The definition of impracticability includes situations in which it is not possible to objectively distinguish the historical information that is relevant for estimating expected credit losses from the information that would not have been available at that earlier date (IAS 8 refers to this situation as 'hindsight').

BC152 There are two main issues about retrospective application for the proposed expected credit losses model:

(a) Availability of initial credit quality data—the proposed model relies on entities assessing whether there has been an improvement in credit quality since the initial recognition of a financial instrument to decide whether they should establish a loss allowance balance at an amount equal to lifetime expected credit losses. Entities have told the IASB that they typically do not currently retain information about initial credit quality, so making this assessment on transition is likely to be difficult; and

(b) Risk of hindsight—entities have not previously been required to recognise or disclose expected credit losses for accounting purposes. Accordingly, there is a risk that hindsight would be used to recognise and measure the amount of expected credit losses in prior periods.

Availability of initial credit quality data

BC153 The proposals in this Exposure Draft would require an entity to use the information about credit quality that is available at initial recognition for existing financial instruments when it applies the proposed model for the first time, unless obtaining such information requires undue cost or effort. For financial instruments for which an entity has not used information about the initial credit quality on transition, the recognition of lifetime expected credit losses will be required for those financial instruments when their credit risk is

not low (eg their credit risk is not equivalent to investment grade) at any reporting date until they are derecognised.

BC154 Such an approach should be relatively simple to apply, because it would not require any assessment of changes in credit quality for these financial instruments relative to the initial credit quality. In addition, it corresponds with credit risk management systems that assess credit quality as at the reporting date. However, the IASB decided that this relief would not be applicable when an entity uses the past-due statuses of payments to apply the model, because it would have the necessary information to decide whether a financial instrument has deteriorated since initial recognition.

BC155 The IASB acknowledges that, if an entity uses an approach that is based solely on credit quality at the reporting date, then, when the entity is deciding the amount of expected credit losses to recognise, that approach will not allow the entity to consider the credit deterioration that has occurred since initial recognition. Thus, entities will be required to recognise lifetime expected credit losses for a financial instrument with credit risk that is not low (eg its credit risk is not equivalent to investment grade at a reporting date), even if they had priced that instrument to reflect that risk and there has not been a significant deterioration in credit quality since initial recognition. It will also have a more negative impact for entities whose business model focuses on originating or purchasing financial instruments with credit risk that is not low (eg their credit risk is not equivalent to investment grade). Requiring an assessment on the credit quality alone might encourage the use of information about the initial credit quality from transition to the proposed requirements, which will enhance comparability and the quality of the information provided. However, under some circumstances such an approach may discourage the use of information about initial credit quality, particularly if an entity is able to absorb lifetime expected credit losses on those financial instruments on transition to the proposed requirements.

BC156 While acknowledging the inconsistency with the overall model, the IASB decided that such an approach was the best way to balance the provision of useful information with the associated cost of providing it. The IASB considered and rejected the following alternatives:

(a) Grandfathering existing requirements—one approach to transition that would have addressed both of the issues set out in paragraph BC152 would have been for the IASB to 'grandfather' the existing impairment requirements for existing financial instruments at the date of initial application. That is, entities continue to apply the IAS 39 impairment requirements to all financial instruments that exist on transition to the proposed requirements. This would have been a form of prospective application of the proposed requirements. This grandfathering approach would remove the need to measure expected credit losses for periods prior to the application of the proposed requirements, and would also eliminate the problem of applying the proposed requirements to financial instruments for which information about the credit quality at initial recognition is not available or would have been very burdensome to obtain on transition to the proposed requirements.

It would also allow the IASB to specify an earlier mandatory effective date than would otherwise be possible if full retrospective application was required (ie retrospective application that also includes a restatement of comparative periods). Although those who are concerned about the potentially significant effect on equity when making the transition to the new model (which may have regulatory consequences for some) may view this approach positively, it would delay the improvements to accounting for expected credit losses and would reduce comparability. In addition, entities would need to prepare information in accordance with both the IAS 39 impairment model and the new expected credit losses model until they derecognised all grandfathered financial instruments, which would be burdensome, at least for some entities. For these reasons, the IASB rejected the grandfathering approach to transition.

(b) Resetting the credit quality at initial recognition of the financial instrument so that it reflects the credit quality at the date that the proposed model is initially applied—this would have been the least burdensome of the three alternatives to apply, because entities ignore credit history for all financial instruments. An entity would consider deteriorations or improvements in credit quality from the date of initial application of the proposed model, instead of relative to the credit quality at initial recognition. The IASB rejected this approach because it would have ignored deteriorations or improvements in credit quality that had occurred since initial recognition and would not have faithfully represented expected credit losses.

(c) Recognising a loss allowance at an amount equal to lifetime expected credit losses on transition until derecognition for financial instruments for which an entity does not use initial credit quality information—this alternative would have been relatively simple to apply because there would have been no requirement for an entity to analyse changes in credit quality either at transition or over the life of the relevant instruments. However, this alternative is inconsistent with the objective of the overall model, which is designed to reflect changes in credit quality. This approach would also result in an entity recognising lifetime expected credit losses for financial instruments whose credit quality is actually better than that on initial recognition.

Hindsight

BC157 At the date of initial application of the requirements in this Exposure Draft, the transition proposals would permit, but not require, the restatement of comparative periods if the necessary information was available without the use of hindsight. This would address the risk of hindsight being used to decide whether lifetime expected credit losses would be required to be recognised in prior periods and, more generally, in measuring expected credit losses in prior periods, because entities would not be 'looking back' to make those determinations. Instead, at the beginning of the period in which the proposed model is initially applied, an entity would adjust the loss allowance to be in accordance with the proposed model at that date, with an adjustment to an

opening component of equity. An entity would still apply the proposed model on a (modified) retrospective basis, because the loss allowance balances would be determined on the basis of information about initial credit quality (subject to the transition relief set out in paragraph BC150). As a result, an entity would use the initial credit quality to decide whether, on transition to the new requirements, it should measure the loss allowance at an amount equal to lifetime or 12-month expected credit losses. A prohibition on restating comparatives would mean that an entity would reflect the loss allowance balances that result from applying the new model in the financial statements from the beginning of the current period in which the entity applies the proposals for the first time.

BC158 The IASB noted that another way to address the risk of hindsight might be to allow a long lead time between the issuing of the new requirements and the mandatory effective date, so that an entity could calculate expected credit losses contemporaneously for comparative periods to provide restated comparative information. However, in considering a longer lead time, the IASB noted the urgency of this project. Establishing a lead time that would allow an entity to apply the proposed model on a retrospective basis, including the provision of restated comparative information, in a way that addresses the risk of hindsight, would result in a significant delay between issuing the final requirements and their mandatory application. This is because:

(a) outreach so far has indicated that entities may need as long as two to three years to prepare for the implementation of the proposed model; and

(b) although IFRS requires an entity to present only one comparative period, many jurisdictions require entities to present more prior comparative periods.

BC159 In addition, the IASB is pursuing an approach that will require the same mandatory effective date for all phases of the project to replace IAS 39. Introducing a long lead time for the impairment phase would impact on the mandatory effective date of the classification and measurement and hedge accounting requirements, or the IASB would need to reconsider requiring the same mandatory effective date for all phases of the project. Because the IASB has developed each phase with other IFRS 9 requirements in mind, having different mandatory effective dates for different project phases would add complexity and have potential consequences.

BC160 In addition, requiring the restatement of comparative periods to reflect the proposals would require the running of two models in parallel, which would be very burdensome, at least for some entities.

BC161 In the light of all of those factors, the IASB decided not to propose requiring the restatement of comparative periods in conjunction with a longer lead time to mandatory application.

Transition disclosures

BC162 On the date of initial application, the IASB proposes that an entity should disclose a reconciliation of the ending allowance account for impairment losses

prepared in accordance with IAS 39 to the opening loss allowances in accordance with IFRS 9 by measurement category, showing separately the effects of changes in classification on the loss allowance balance at that date. This would provide the necessary information for users of financial statements to understand the effect of applying the proposed model. Consequently, when the new model is initially applied, disclosure of the line item amounts that an entity would have reported in accordance with the impairment model in IAS 39 in the current period should not be required.

First time adopters of IFRS

BC163 In publishing this Exposure Draft, the IASB noted that it will reconsider the transition to IFRS 9 for first-time adopters of IFRS in the redeliberations of this project. That reconsideration will include the proposed limited modifications to IFRS 9 that were published in November 2012 to make sure that first-time adopters of IFRS are given sufficient lead time for the adoption of IFRS 9 and are not disadvantaged when compared to existing preparers. Until that time, if a first-time adopter of IFRS chooses to early apply an available version of IFRS 9, it would follow the current requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* that relate to IFRS 9.

Analysis of the effects of this Exposure Draft

Introduction

BC164 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing application costs and benefits associated with the new proposals—the costs and benefits are collectively referred to as 'effects'. The IASB notes that although the analysis of the effects of these proposals considers the directional impact of the proposed approach on the amortised cost of those financial instruments that will be subject to these proposals, it cannot quantify the magnitude of the impact. This is because the calculation of the overall magnitude will require entities to apply the proposals to their financial instruments to gather new information (such as credit quality on initial recognition) and to make system changes, all of which will require significant time, effort and cost. The impact on the loss allowance will also depend on the availability of, and access to, reliable information that can be used to apply the model and that, in turn, relies to an extent on the sophistication of an entity's credit risk management systems, which cannot be assessed until entities apply the proposals.

BC165 Furthermore, the IASB is aware that entities across different jurisdictions have applied the existing impairment requirements in IAS 39 differently, in part as a result of the interaction with local or jurisdictional regulatory definitions and requirements.

BC166 The magnitude of the proposals' impact on an entity's financial reporting will therefore depend on the financial instruments an entity holds, how the entity has applied the IAS 39 requirements, the sophistication of the entity's credit risk management systems, and the availability of information about, for example, the probabilities of a default occurring, past-due statuses and estimates of

lifetime expected credit losses for all financial instruments (for example products, geographical areas and vintages).

BC167 Given that the proposed approach is more responsive to changing economic circumstances compared to the incurred loss model, the magnitude of the impact will also be dependent on the prevalent economic conditions at the time of implementation.

BC168 Based on the limited outreach performed to date, the IASB is aware that some financial institutions have modeled the preliminary application of the proposals and anticipate that it will result in an increase in loss allowance balances. The IASB plans to undertake fieldwork during the comment period for this Exposure Draft to obtain more information on the likely effect of the proposals in different jurisdictions.

Timely recognition of deterioration in credit quality

BC169 The IASB believes that measuring the expected credit losses at the present value of expected cash shortfalls over the remaining life of a financial instrument (see paragraph B27) would provide relevant information about the timing, amounts and uncertainty of an entity's future cash flows.

BC170 Furthermore, the IASB also believes that the proposed approach will overcome the weaknesses of the IAS 39 incurred loss model as described in paragraph BC4. The incurred loss model in IAS 39 only allows for the recognition of credit losses once there is objective evidence that a loss event has occurred. As a result, the effect of future events, even when expected, cannot be considered. The proposals in this Exposure Draft always require expected credit losses to be recognised using the best available information at the reporting date. Such information includes reasonable and supportable forecast information. The proposed model would therefore be more responsive to changing economic conditions than the existing IAS 39 incurred loss model and would result in an earlier recognition of expected credit losses.

Dual measurement objective

BC171 The measurement of a loss allowance (as set out in paragraphs 4–5) is based on a dual measurement approach that reflects the deterioration in the credit quality of financial instruments. This will result in the more timely recognition of lifetime expected credit losses than the current requirements in IAS 39 or the TPA that was proposed in the SD. It also results in the recognition of credit losses when expectations of credit losses have deteriorated in comparison with the expectations that were initially priced into the financial instrument.

BC172 The IASB is aware that some interested parties favour a lifetime expected credit loss approach, whereby an entity recognises a loss allowance at an amount equal to lifetime expected credit losses on initial recognition, regardless of the credit quality and relative credit pricing of the financial asset. Under such an approach, the recognition of initial lifetime expected credit losses is triggered by the initial recognition of a financial asset rather than by the deterioration in credit quality since initial recognition. The IASB does not believe that this is appropriate because it would result in financial assets being recognised at a

carrying amount significantly below fair value on initial recognition and would therefore be inconsistent with the economics of the asset.

BC173 The IASB believes that the approach that is proposed in this Exposure Draft enables a clear distinction to be made between financial instruments where the credit risk has increased significantly since initial recognition and those financial instruments where this has not occurred. Users of financial statements, in particular, have indicated that this distinction provides useful information.

Better reflecting economic reality

Single impairment model

Mandatory FVOCI measurement category

BC174 The impairment of debt instruments that are classified as available-for-sale financial assets under IAS 39 is one of the requirements that is most heavily criticised by users of financial statements, as it is based on fair value fluctuations and not aligned with the impairment model applied to similar financial assets measured at amortised cost.

BC175 Similar to financial assets that are measured at amortised cost, the contractual cash flow characteristics of financial assets mandatorily measured at FVOCI would solely represent payments of principal and interest. The IASB therefore believes that an impairment approach that is based on expected future cash flows and changes in credit quality, rather than changes in fair value, more faithfully reflects the economic reality of expected credit losses that are associated with these financial assets. It is also consistent with both amortised cost and fair value information about these financial assets being provided to the users of financial statements.

Modified financial instruments

BC176 As noted in paragraph BC125, the IASB concluded that financial instruments with modified contractual cash flows should be permitted to change to a loss allowance at an amount equal to 12-month expected credit losses in the same way as unmodified financial instruments if there is no longer a significant deterioration in credit quality. The IASB believes that such a symmetrical approach faithfully represents the economics of the transaction and that faithful representation should not be sacrificed for anti-abuse purposes.

BC177 Some users of financial statements are concerned that these proposals will be more permissive than the current IAS 39 requirements because forbearance is currently regarded as objective evidence of impairment. However, because deterioration in credit quality is determined by reference to the initial credit risk (on the original contractual terms), financial instruments will not necessarily move to a loss allowance at an amount equal to 12-month expected credit losses as a result of a modification of contractual cash flows. Furthermore, while forbearance provides objective evidence for the recognition of an incurred loss in accordance with IAS 39, the effect of the modification of contractual cash flows is reflected in the measurement of the impairment loss.

Consequently, if a modified financial instrument is not considered to have deteriorated significantly, it is likely that only a small incurred loss would currently be recognised under IAS 39.

BC178 As a result, the IASB believes that even if, subsequent to a modification, a loss allowance at an amount equal to 12-month expected credit losses is recognised, it should not result in a smaller loss allowance than would be recognised under IAS 39. The IASB further proposes to require entities to disclose the gross carrying amount for modified financial assets that have moved back to a loss allowance measured at an amount equal to 12-month expected credit losses.

Loan commitments and financial guarantee contracts

BC179 The IASB noted that financial institutions that provide loan commitments and financial guarantee contracts often already determine the expected drawdowns for prudential regulatory and credit risk management purposes. However, the proposals in this Exposure Draft differ from those estimates in that the expected drawdown is determined over the period for which an entity has a contractual obligation to extend credit and not the period over which an entity expects to extend credit. Consequently, if an undrawn facility is immediately revocable, no provision for expected credit losses will be recognised in accordance with the proposals—even if, for credit risk management purposes, an entity assumes that the facility will not be revoked. Current credit risk analyses and systems can be used as the basis for applying the proposals but the IASB expects that adjustments to these estimates will be required.

BC180 As noted in paragraph BC131, some participants in the IASB's outreach noted that estimating future drawdowns over the life of the instrument will introduce additional complexities. However, the IASB believes that the calculation of expected drawdowns is necessary to remove the arbitrage between on balance sheet and off balance sheet exposures and achieve a consistent expected credit loss model.

Interest revenue

BC181 The IASB noted that for financial assets for which objective evidence of impairment exists, the calculation of interest revenue on the basis of the gross carrying amount reflecting the contractual return would no longer faithfully represent the effective return. The IASB believes that calculating and presenting interest revenue on the amortised cost of such financial assets (ie adjusted for any loss allowance (see paragraph 25(b))) better represents the economic return on such financial assets. IAS 39 already requires this calculation, and as financial assets to which this approach will apply are determined using criteria already in IAS 39, the implementation of this proposal should not be complex nor require system changes.

Comparability of financial information

BC182 The IASB acknowledges that the more judgement that is required in the application of an expected credit loss approach, the more subjective the estimates will be, and that this subjectivity will affect the comparability of reported amounts between different entities. Notwithstanding the concerns

about the application of judgement, in the IASB's view, the proposed approach will improve the comparability of reported amounts. This is because under the incurred loss model in accordance with IAS 39, deterioration in credit quality would not have been reported in the absence of a loss event, which limited the comparability of the reported amounts and the effective return on the financial assets.

BC183 In the IASB's view, considering the term structure and initial credit risk when assessing whether lifetime expected credit losses should be recognised will better reflect credit risk management and improve the comparability of the requirements for financial instruments with different maturities and different initial credit risk.

BC184 Any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgement and the quality of the information used. This will require both qualitative and quantitative disclosures to assist users of financial statements in understanding and comparing different measures of expected credit losses. The Exposure Draft proposes disclosure requirements that will enable users of the financial statements to identify and understand the inputs, assumptions and techniques applied, the amounts arising from expected credit losses and the effect of deterioration and improvements in credit risk. The IASB believes that this will lead to greater comparability between different reporting periods of the same entity.

BC185 Some interested parties have also indicated that it would be useful if the IASB could enhance the comparability between financial assets that are credit-impaired on initial recognition and those that are measured using the general expected credit loss approach as this would alleviate some of the accounting complexity in this area. Consequently, the IASB proposes that an entity should disclose the expected contractual cash shortfalls that are implicit in the price of such financial assets at initial recognition.

Usefulness of financial information

BC186 The IASB noted that the expected credit loss model proposed in this Exposure Draft would reflect how an entity approaches credit risk management for different classes of financial instruments and provides information on the effect of the deterioration and improvements in the credit quality of its financial instruments.

BC187 In assessing the usefulness of the information provided by the proposed approach, the IASB has compared it to the information provided by a general provisioning approach and a fair value approach. In the IASB's view, the general provisioning approach, whereby entities build up reserves to absorb both expected and unexpected credit losses (without any reference to the deterioration in credit quality) lacks any measurement objective and fails to provide a link between the loss allowance that is recognised and the deterioration in credit quality. Furthermore, explicit information on expected credit losses is not provided by a full fair value model. Changes in the fair value of a financial instrument include those arising from changes in risks other than credit risk, such as interest rate risk, liquidity risk and market risk. The IASB

does not believe that such an approach provides useful information because measuring expected credit losses using fair value information is inconsistent with a cost-based measurement that focuses on contractual cash flows.

BC188 In the IASB's view, the proposed credit deterioration criterion, together with the related proposed disclosure requirements, achieves the best balance between the benefits of distinguishing financial instruments that have deteriorated in credit quality and the costs and complexity of making that assessment.

Relevant information for economic decision-making

BC189 The IASB believes that the proposed approach provides information that is more relevant for economic decision-making by depicting changes in the credit quality of financial instruments through the use of a broad range of information, including forward-looking information and the recognition of expected credit losses on a timelier basis. The IASB is of the view that loss allowances should reflect actual credit loss expectations for financial instruments accounted for as at the reporting date.

BC190 The IASB acknowledges that the proposed approach would result in an overstatement of expected credit losses for financial assets, and a resulting understatement of the value of the related assets, through the recognition of a loss allowance for 12-month expected credit losses. However, the IASB has sought to provide a proxy for the 2009 ED that is less operationally burdensome and more cost effective. The IASB determined that the proposals provide the best balance of the benefits of providing useful information and the costs of providing it. In addition the overstatement will not be of the same magnitude as if full lifetime expected credit losses were to be recognised on initial recognition. For long-term assets and those with a high probability of default occurring at initial recognition, the difference between a 12-month and lifetime expected credit loss measure can be significant.

BC191 Furthermore, relevant information is provided by updating expected credit loss estimates for changes in expectations, through the recognition of lifetime expected credit losses when there has been significant credit deterioration and also by requiring the calculation of interest revenue on the amortised cost amount of a financial asset when there is evidence that one or more credit loss events have occurred.

Regulatory concept of expected credit losses

BC192 Some users of financial statements have asked the IASB to ensure that the proposed expected credit loss approach is both aligned to the prudential capital frameworks and is counter-cyclical, resulting in a loss allowance that is sufficient to absorb all credit losses.

BC193 Certain prudential regulation and capital adequacy systems, such as the framework developed by the Basel Committee on Banking Supervision, already require financial institutions to calculate 12-month expected credit losses as part of their regulatory capital provisions. However, these estimates only use credit loss experience based on historical events to set out 'provisioning' levels over the entire economic cycle ('through-the-cycle'). Furthermore, through-the-cycle approaches consider a range of possible economic outcomes

rather than those actually expected at the reporting date. This would result in a loss allowance that does not reflect the economic characteristics of the financial instruments at the reporting date.

BC194 The IASB notes that financial reporting, including estimates of expected credit losses, are based on information, circumstance and events at the reporting date. The IASB expects entities to be able to use these regulatory measures as a basis for the calculation of expected credit losses in accordance with the proposals in this Exposure Draft. However, these calculations would have to be adjusted to meet the measurement requirements of this Exposure Draft. Only information that is available and supportable at the reporting date should be considered. This may include information about current economic conditions as well as reasonable and supportable forecasts of future events and economic conditions, as long as the information is available (and supportable) when the estimates are made.

BC195 The IASB acknowledges that any transition adjustments arising on the initial application of these proposals will affect retained earnings, which could have a potential negative impact on regulatory capital. However, the IASB believes that the objective of financial reporting should be to provide transparent information that is useful to a broad range of users of financial statements and that prudential regulators are best placed to consider how to address the interaction between IFRS and the regulatory requirements.

BC196 Some are of the view that loss allowance balances should be used to provide a counter-cyclical effect by building up loss allowances in the good times to be used in the bad times. This would, however, mask the effect of changes in credit loss expectations. The expected credit loss approach that is proposed in this Exposure Draft is based on the information available at the reporting date and is designed to reflect economic reality, rather than adjusting the assumptions and inputs applied to achieve a counter-cyclical effect. For example, when credit quality increases the expected credit loss approach proposed will faithfully represent that change. This is consistent with the objective of general purpose financial statements.

BC197 The objective of the proposed model is to faithfully represent the economic reality of expected credit losses in relation to the carrying amount of a financial asset. The IASB has not included in this objective the recognition of a loss allowance that will be sufficient to cover unexpected credit losses because this is not the primary objective of financial reporting. Some users of financial statements would prefer a representation of credit losses with a conservative or prudential bias, arguing that such a representation would better meet the needs of regulators who are responsible for maintaining financial stability, and of investors.

The likely effect on compliance costs for preparers

BC198 The proposals seek to address the cost of identifying deteriorated financial instruments by using significant changes in credit risk as a basis for the distinction. This is intended to ensure that only meaningful changes in credit risk are captured that should align with changes that would be monitored by credit risk management.

BC199 The IASB acknowledges that the implementation and ongoing application of an expected credit loss approach is complex and costly. The costs resulting from the particular expected credit loss approach proposed include those caused by the complexities involved with:

(a) tracking financial instruments to assess the deterioration in credit quality and the difficulty of making that assessment; and

(b) calculating lifetime expected credit losses.

Cost of implementation

BC200 The IASB acknowledges that the approach proposed in this Exposure Draft is different from a credit risk management perspective because an entity needs to assess the change in credit quality since initial recognition, whereas credit risk managers assess credit risk at a particular date. In particular, entities have raised concerns that two loans to the same entity could have different loss allowances when they are originated at different times. Although such a difference in perspective is likely to add cost and complexity to the approach, the IASB believes it is justified because of the underlying concept that a loss only arises when an asset's credit loss expectations exceed those that are priced into the asset.

BC201 The implementation of the expected credit loss approach will require substantial system changes, time and resources resulting in significant costs for most entities including financial institutions that are already calculating expected credit losses for regulatory purposes.

BC202 Participants in recent outreach activities noted that the cost of implementing the proposed expected credit loss approach would depend on how entities segment their portfolios. An entity may, for example, segment its portfolios by credit quality at origination and assess deterioration by comparing the credit quality at the reporting date with the initial credit quality for only that segment of the portfolio that did not have low credit risk. Thus, the costs of applying the deterioration criteria would vary depending on the diversity of initial credit quality and the sophistication of credit risk management systems.

BC203 However, the IASB notes that significant implementation costs are not limited to the approach proposed in this Exposure Draft and that, regardless of which expected credit loss approach an entity implements, the cost and effort of implementation will be significant. The IASB believes that this Exposure Draft appropriately balances the complex requirements of an expected credit loss model, with simplifications designed to make the approach more operational, thereby reducing the cost of implementation.

Cost of ongoing application

Interest revenue recognition

BC204 The proposal to change interest revenue recognition from a gross basis to a net basis at a different level of deterioration in credit quality compared to when lifetime expected credit losses are recognised adds a further level of complexity. However, the IASB believes that the financial assets for which there is objective evidence of impairment will be a subset of the financial assets for which lifetime

expected credit losses are recognised in accordance with this Exposure Draft. As the objective evidence of impairment listed in this Exposure Draft is similar to the existing criteria in IAS 39, the IASB believes that the application of these concepts should result in a minimal change in practice and will therefore have no significant cost implications.

Allowance for 12-month expected credit losses

BC205 The calculation of a loss allowance equal to 12-month expected credit losses would also add costs and complexity. These costs will be less for financial institutions that are already required to calculate 12-month expected credit losses for prudential purposes; however, that measure would have to be adjusted to meet the measurement requirements of the proposals. In some cases, entities can use information such as loss rates to calculate the loss allowance for 12-month expected credit losses, thus building on information they already use for risk management purposes. However, the cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for non-Basel II financial institutions and entities that are not financial institutions because 12-month expected credit losses is a unique calculation that would not normally be required for other purposes. However, some relief is provided, for example because the calculation of 12-month expected credit losses is not required for trade or lease receivables.

Tracking of initial credit risk

BC206 Respondents to the 2009 ED highlighted that the proposals would have required entities to track the initial estimate of lifetime expected credit losses through the credit-adjusted effective interest rate and to measure subsequent changes in the lifetime expected credit losses. This would have led to significant operational challenges and substantial costs as the effective interest rate information is not contained in the same systems as the credit risk information.

BC207 Some preparers, particularly credit risk managers, indicated that the tracking of credit risk, in most circumstances, is simpler and more closely aligned to credit risk management practices than the tracking of expected credit losses. The proposals in this Exposure Draft require an assessment of the change in credit risk that has occurred since initial recognition separately from the determination of the effective interest rate. Entities will therefore be required to measure and track the initial credit risk to be able to determine whether there has been a significant increase in the credit risk at the reporting date.

BC208 In order to reduce the operational burden of tracking the probability of a default occurring for all financial instruments since initial recognition, this Exposure Draft does not require an entity to recognise lifetime expected credit losses on financial instruments with low credit risk at a reporting date (irrespective of their change in credit risk). Consequently, an entity will not need to assess the change in credit quality from initial recognition for financial instruments that have a low credit risk on a reporting date (eg financial instruments whose credit risk is equivalent to investment grade).

BC209 The IASB acknowledges that not all entities have advanced credit risk management systems that will enable them to track the changes in credit risk

over time. To further reduce the operational burden on such entities, the IASB proposes that entities may use past-due information to determine whether credit risk has increased significantly if no other borrower-specific information is available without undue cost or effort, rather than requiring the implementation of more sophisticated credit risk management systems.

BC210 Some preparers are concerned that the loss allowance at an amount equal to lifetime expected credit losses will need to be determined for each individual financial instrument, which will add to the operational burden of tracking. However, the proposals in this Exposure Draft do not require individual financial instruments to be identified as significantly deteriorated in credit quality. Financial instruments with common risk characteristics can be assessed, and have a lifetime loss allowance recognised, on a collective basis.

Simplified approach for trade receivables and lease receivables

BC211 The IASB proposes to address the costs and complexities for non-financial institutions and other entities through the proposed simplified approach for trade receivables and lease receivables, by removing the need to both calculate 12-month expected credit losses and track the credit deterioration on these financial assets.

The likely effect on costs of analysis for users of financial statements

BC212 The IASB believes that users of financial statements will benefit from the more timely information provided by an entity's assessment of expected credit losses using its assessment of the credit deterioration since initial recognition. The approach proposed in this Exposure Draft is in strong contrast to the incurred loss model in IAS 39, where credit losses are only recognised once there is objective evidence that a loss event has occurred. In accordance with this Exposure Draft, a loss allowance at an amount equal to 12-month expected credit losses will be recognised for all financial instruments unless the credit risk has increased significantly, in which case a loss allowance at an amount equal to lifetime expected credit losses should be recognised. Lifetime expected credit losses are therefore recognised earlier than under the incurred loss model in IAS 39 because the credit risk will generally increase significantly before one or more credit loss events occur—particularly given the use of forward-looking information.

BC213 The IASB acknowledges that, from the perspective of users of financial statements, a disadvantage of the proposed approach is that, for poor credit-quality financial instruments that are not credit-impaired on initial recognition, only a loss allowance at an amount equal to 12-month expected credit losses will be recognised until there has been a significant increase in the credit risk. However, the IASB did not want to create a disincentive for entities to lend to customers with poor credit quality. Furthermore, the IASB believes that full lifetime expected credit losses should not arise on initial recognition if the financial instruments are priced correctly.

BC214 Under IAS 39, different impairment approaches were applied to the different measurement categories. To further reduce the cost of implementation and

ongoing application, the IASB proposes that a single expected credit loss approach applies to all financial instruments within the scope of this Exposure Draft. This is more consistent with the way in which entities manage credit risk internally.

BC215 The IASB acknowledges that it would be preferable for users of financial statements if the accounting for expected credit losses was aligned between IFRS and US GAAP. The IASB notes that although it has not achieved complete convergence between the approach proposed in this Exposure Draft and the current expected credit loss model developed by the FASB, both approaches should result in the same loss allowance for financial assets that have deteriorated significantly in credit quality since initial recognition and that do not have low credit risk and for trade receivables and lease receivables where an entity measures the loss allowance using lifetime expected credit losses. Furthermore, as both models use the same data and information sets, 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 (eg credit risk equivalent to investment grade) at any time.

BC216 The IASB acknowledges that the assessment of expected credit losses inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts, which inevitably passes on the costs of analysis to users of financial statements. However, decisions about when credit losses are incurred and the measurement of impairment losses currently also involve subjectivity and there is a lack of comparability due to differences in the application of the incurred loss criteria. The proposals in this Exposure Draft would mitigate these issues to some extent by expanding the disclosure requirements to provide users of financial statements with information about the inputs, assumptions and techniques that the entity used when assessing the criteria for the recognition of lifetime expected credit losses and the measurement of expected credit losses. This Exposure Draft also proposes the disclosure of information on financial assets with a loss allowance at an amount equal to lifetime expected credit losses that have been modified, including the gross carrying amount of the financial assets, the gain or loss resulting from the modification and the re-default rate. Proposing information on modifications is responsive to requests for enhanced information in this area from users of financial statements.

Alternative Views on the Exposure Draft

Alternative view of Mr Cooper

AV1 Mr Cooper voted against the publication of this Exposure Draft because he disagrees 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. Mr Cooper believes that a 12 month period is without conceptual foundation and that the recognition of this loss allowance would result in financial reporting that fails to reflect the economics of lending activities, which could mislead users of financial statements. While Mr Cooper believes that the proposed model without the loss allowance at an amount equal to 12-month expected credit losses would be an improvement over the current IAS 39 incurred loss model, he considers it to be inferior to the original proposal in the 2009 ED. He agrees that the 2009 ED should be simplified, but believes that this could be achieved without abandoning the expected cash flow approach altogether.

The 12-month expected credit loss allowance

AV2 As acknowledged in paragraph BC66, the loss allowance at an amount equal to 12-month expected credit losses would result in a credit loss at initial recognition even when a financial asset is priced on market terms and where, consequently, no economic credit loss exists. Mr Cooper agrees with the assessment in paragraph BC61 that there is no conceptual justification for this, but he disagrees with the view of the IASB that it is nonetheless appropriate for cost/benefit reasons. He believes that the loss allowance at an amount equal to 12-month expected credit losses is contradictory to the IASB's own *Conceptual Framework*, given that the result is not neutral and it fails to faithfully represent the transaction. In no other area of financial reporting is an allowance immediately established to reduce the value of an asset that is purchased or originated on market terms. Clearly, if a financial asset is purchased at an excessive price or is originated with an off-market interest rate that is too low considering the degree of credit risk, an initial measurement at an amount below the transaction price is appropriate. However, these situations are already covered in Standards by the requirement to initially recognise financial instruments at fair value, which in these cases would be below the transaction price.

AV3 Mr Cooper also believes that the loss allowance at an amount equal to 12-month expected credit losses results in unjustifiable double-counting because the effect of credit risk at the initial recognition is already reflected in the carrying value of the financial asset. Consider, for example, a trade receivable and related revenue that are reported at a present value (ie those with a significant financing component under the proposals in the Revenue Recognition ED). Since the initial measurement of that trade receivable must take into account the credit quality of the customer by discounting at a rate that appropriately reflects the credit risk, the full expected (probability-weighted) lifetime credit loss is, in effect, already recognised in that measurement. Establishing an additional, separate loss allowance at an amount equal to 12-month expected

credit losses, as proposed by this Exposure Draft, would be double-counting. Consequently, profit is understated at the time of sale only to be overstated in subsequent periods as interest revenue is recognised using full contractual cash flows, which ignores expected credit losses. The double-counting effect would be even more pronounced if a full lifetime expected credit loss was recognised at initial recognition, which is an accounting policy choice proposed by this Exposure Draft for some trade receivables and all lease receivables.

AV4 As stated in paragraph BC43, one of the justifications for the loss allowance at an amount equal to 12-month expected credit losses is that it represents an approximation of the yield adjustment that was a feature of the 2009 ED. Mr Cooper does not agree that this is true. Only by chance would this loss allowance be equal to the component of the contractual interest that is recognised and that is, in effect, compensation for the expected credit losses. Also, recognising the loss allowance at an amount equal to 12-month expected credit losses represents a charge in the period of initial recognition (with subsequent adjustment) whereas the additional contractual interest is recognised in each period over the remaining life of the financial asset. Any proxy yield adjustment should be a periodic adjustment and not a one-off amount.

AV5 This Exposure Draft proposes that there should not be a loss allowance at an amount equal to 12-month expected credit losses for the subset of financial assets that are credit-impaired when they are purchased or originated. Mr Cooper agrees with this and with the overall approach for these assets, which is, in effect, the same as the 'gross-up' method that, he suggests below, should be applied to all financial assets. However, he questions why it is deemed necessary to have a loss allowance at an amount equal to 12-month expected credit losses for the vast majority of less risky assets when no such loss allowance is applied to the riskier credit-impaired assets.

AV6 Mr Cooper believes that an impairment model that is conditional on credit deterioration is a valid approach and would represent an improvement on the current requirements. Apart from disagreeing with recognising a loss allowance at an amount equal to 12-month expected credit losses, he is generally supportive of the other aspects of the model in this Exposure Draft and believes those aspects to be operational. He does not believe that the 12-month expected credit loss allowance is an essential component of the model. Establishing a loss allowance that will represent lifetime expected credit losses for financial assets that are subject to significant credit deterioration with no loss allowance for other financial assets must result in earlier recognition of credit losses compared to the current requirements, given that the deterioration that IAS 39 requires before an impairment loss is recognised is greater than that specified in this Exposure Draft. Also, and perhaps most importantly, the proposed model, even without the recognition of a loss allowance at an amount equal to 12-month expected credit losses, would be much more responsive to changes in credit conditions than the current IAS 39 incurred loss model.

Simplification of the model proposed in the 2009 ED

AV7 Mr Cooper continues to believe that the original expected cash flow model developed by the IASB and exposed for comment in 2009 is the most appropriate model for recognising the expected credit losses on financial assets. He recognises the operational difficulties in applying that approach but believes that these can be mitigated and would present no more of a challenge than the different operational difficulties of the model proposed in this Exposure Draft. He does not believe that the current IASB proposal is a simplification of that original model, but rather that it is a different approach that reflects credit deterioration instead of directly measuring the expected cash flows for all assets. He considers that implementing an approach based on credit deterioration represents a missed opportunity.

AV8 Mr Cooper observes that a key attraction of amortised cost as a measurement basis for financial assets is the accrual outcome for interest revenue (and expense). Amortised cost can therefore only be justified if the interest revenue and the related impairment charge or impairment credit are meaningful when considered together. In his view, only the 2009 ED model, where the impairment is integrated with the amortised cost measurement (however, decoupled for presentation proposes), or a simplification thereof, achieves this objective. Separating impairment from the underlying measurement, as proposed in this Exposure Draft, means that any answer inevitably involves arbitrary bright lines. As a result, standard-setting faces an 'adequacy of the loss allowance balance' debate that should be the focus of prudential regulators rather than of accounting standard-setters.

AV9 Mr Cooper considers that there are two potential methods to simplifying and largely replicating the outcome of the 2009 ED—the modified lifetime expected credit loss method and the gross-up method. Both of these alternative methods, similar to the 2009 ED, have the advantage that the same calculation for expected credit losses could be applied to all financial assets and would not necessitate any criteria for when to recognise lifetime credit losses or a different model for financial assets that are credit-impaired on initial recognition.

Modified lifetime expected credit loss method

AV10 Mr Cooper agrees with the analysis in paragraphs BC44–BC51 and believes that the FASB Current Expected Credit Loss (CECL) model is conceptually flawed and would not provide relevant information. Nevertheless, he believes that a lifetime expected credit loss measure could be modified to make it meaningful with an outcome that is consistent with the 2009 ED. The problem with a lifetime expected credit loss being equal to the present value of contractual cash flows that are not expected to be collected is that the calculation is incomplete. For a financial asset that is originated or purchased on market terms, the expected credit losses (taking into consideration the potential for the asset to default) must be offset at the date of origination or purchase by the expected additional interest revenue (through part of the credit spread). Mr Cooper believes that modifying the lifetime expected credit loss measure to take account of the potential for additional interest revenue to offset, or partially offset, the expected credit losses would make this model conceptually sound and

would correctly reflect the economics of a lending business. Determining the offset to the lifetime expected credit losses for future expected interest clearly adds complexity. However, Mr Cooper believes that there are approaches and practical expedients that could be used to make this operational. In any case, an approach that recognises the full lifetime expected credit losses from initial recognition misrepresents the economic phenomenon and, therefore, does not pass any cost-benefit test, regardless of how simple it might be to apply.

Gross-up method

AV11 The gross-up method is described in paragraph BC25. Mr Cooper believes that this method faithfully replicates the 2009 ED by using a decoupled approach and would ensure that full lifetime expected credit losses are always recognised while avoiding the day-one credit loss effects of the FASB's proposed CECL model. Contrary to the view of the IASB, Mr Cooper believes that this approach would not create significantly more operational challenges compared to the proposals in this Exposure Draft. If necessary, practical expedients could be applied to ensure that the tracking problems for open portfolios are mitigated. He observes that this method is currently used when applying IAS 39 and US GAAP for the accounting of loan origination costs and that the systems that are already in place to deal with these could be extended to accommodate credit losses that are estimated at the time that a financial asset is originated or purchased. He also observes that the FASB proposes to apply this method to purchased credit-impaired assets.

[Draft] Appendix
Amendments to the guidance on other IFRSs

IFRS 7 *Financial Instruments: Disclosures*

The heading before paragraph IG23 and paragraphs IG23–IG27 and IG29 are deleted. The heading before paragraph IG26 and paragraph IG28 are amended. New text is underlined and deleted text is struck through.

~~*Credit quality (paragraph 36(c))*~~

IG23 [deleted] ~~Paragraph 36(c) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:~~

~~(a) an analysis of credit exposures using an external or internal credit grading system;~~

~~(b) the nature of the counterparty;~~

~~(c) historical information about counterparty default rates; and~~

~~(d) any other information used to assess credit quality.~~

IG24 [deleted] ~~When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:~~

~~(a) the amounts of credit exposures for each external credit grade;~~

~~(b) the rating agencies used;~~

~~(c) the amount of an entity's rated and unrated credit exposures; and~~

~~(d) the relationship between internal and external ratings.~~

IG25 [deleted] ~~When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:~~

~~(a) the internal credit ratings process;~~

~~(b) the amounts of credit exposures for each internal credit grade; and~~

~~(c) the relationship between internal and external ratings.~~

Financial assets ~~that are~~ for which credit risk is assessed on past-due status ~~either past due or impaired~~ (paragraph ~~37~~ X)

IG26 [deleted] ~~A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.~~

IG27 [deleted] ~~When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.~~

IG28 Paragraph ~~37(a)~~ X requires an analysis of the gross carrying amount of financial assets by ~~class of the age~~ credit risk rating grades ~~of financial assets that are past due but not impaired~~. An entity that uses the past due status of financial assets to assess whether there has been a significant increase in credit risk, should use its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not more than three months;

(b) more than three months and not more than six months;

(c) more than six months and not more than one year; and

(d) more than one year.

IG29 [deleted] ~~Paragraph 37(b) requires an analysis of impaired financial assets by class. This analysis might include:~~

~~(a) the carrying amount, before deducting any impairment loss;~~

~~(b) the amount of any related impairment loss; and~~

~~(c) the nature and fair value of collateral available and other credit enhancements obtained.~~

IAS 18 *Revenue*

The Exposure Draft *Revenue from Contracts with Customers* proposes to move the guidance in the Illustrative Examples accompanying paragraph 14 of IAS 18, which relate to the effective interest rate in IAS 39 (see paragraph D25 of the Exposure Draft *Revenue from Contracts with Customers*). This guidance will be moved to IFRS 9.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

In Section C Example 9 is deleted.

~~Example 9 A single guarantee~~

[deleted] ~~On 31 December 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1, the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.~~

~~This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*, but is within the scope of IFRS 9 *Financial Instruments*, because it also meets the definition of a financial guarantee contract in IFRS 9. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 4 or IFRS 9 to such financial guarantee contracts. IFRS 4 permits the issuer to continue its existing accounting policies~~

~~for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits and that also complies with the requirements in IFRS 9 for financial guarantee contracts within the scope of IFRS 9.~~

~~(a) At 31 December 20X0~~

~~**Present obligation as a result of a past obligating event** – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~**An outflow of resources embodying economic benefits in settlement** – No outflow of benefits is probable at 31 December 20X0.~~

~~**Conclusion** – The guarantee is recognised at fair value.~~

~~(b) At 31 December 20X1~~

~~**Present obligation as a result of a past obligating event** – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~**An outflow of resources embodying economic benefits in settlement** – At 31 December 20X1, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.~~

~~**Conclusion** – The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 14 and 23), and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with IAS 18 *Revenue*.~~

IAS 39 *Financial Instruments: Recognition and Measurement*

In Section B, Questions and Answers (Q&As) B24–B27 and their related headings will be moved into the Application Guidance of IFRS 9, subject to any amendments that may need to be made to the guidance to align it with the requirements of IFRS 9.

In Section E, Q&As E4.1–E4.8 and their related headings will be moved into the Application Guidance of IFRS 9, subject to any necessary amendments to the guidance to align it with the requirements of IFRS 9. Q&A E4.4 will be amended to align the guidance with the requirements of [draft] Chapter 6 *Hedge Accounting*.