EFRAG Financial reporting

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PIR IFRS 9 Impairment

Purchased or originated credit-impaired financial assets

Objective

1 The objective of this session is to seek EFRAG FR TEG views on the IASB staff feedback analysis and recommendations and the IASB tentative decisions on the application of the impairment requirements in IFRS 9 *Financial Instruments* to purchased or originated credit-impaired (POCI) financial assets.

Structure of this paper

2 This paper is structured as follows:

(a) Feedback analysis and the IASB staff recommendations on application questions about POCI financial assets:

(i) Impairment approach applied to POCI financial assets under IFRS 9;

(ii) How to account for subsequent improvements in credit risk?; and

(iii) How to assess if a modified financial asset is originated credit-impaired?

(b) The IASB tentative decision; and

(c) The EFRAG Secretariat assessment.

3 Appendix A to this paper summarises other comments received and the IASB staff analysis of those comments.

4 Based on the analysis performed, the IASB staff recommended to the IASB to take no further action on matters identified in regard to the requirements in IFRS 9 for POCI financial assets. The IASB voted in favour of this recommendation.

Impairment approach applied to POCI financial assets under IFRS 9

Summary of the feedback received by the IASB

5 Most respondents said that the requirements in IFRS 9 for POCI financial assets can be applied consistently to these types of financial assets and lead to accounting outcomes that faithfully reflect the underlying economic substance of these transactions.

6 However, a few respondents suggested that the IASB instead requires the application of the general approach for recognising ECL on POCI assets because:

(a) It is burdensome to apply the POCI requirements for entities that do not manage these assets as part of their main business activity;

(b) Accounting for POCI assets applying the general approach provides more faithful representation.

EFRAG comment letter

7 EFRAG indicated in paragraphs 111 and 112 of its comment letter that application of the current POCI requirements may be burdensome for entities if the occurrence of POCI financial assets is accidental to their business model. EFRAG identified this issue as a medium priority.

IASB staff analysis and recommendations

8 The IASB staff noted that, in developing IFRS 9, the IASB considered but rejected applying the general approach to POCI financial assets. In the IASB's view, the POCI requirements represent the underlying economics for these financial assets more faithfully than the general approach, and the benefits of this better representation outweigh the costs for these financial assets.

9 In the view of the IASB staff, introducing the threshold of 'main business activity' as suggested by respondents would be arbitrary and give rise to additional operational costs, complexity, and challenges of its own. Furthermore, for economically similar assets the accounting outcome would be different depending on the entity that holds those assets. Such an outcome would reduce the usefulness of information to users of financial statements.

10 The IASB staff observed that the majority of respondents said that the general approach and POCI requirements provide an adequate basis to account for the relevant financial assets. Also, in their view, the nature of the credit risk exposure of a purchased or originated credit-impaired asset is significantly different to warrant a different outcome to a financial asset that is not credit-impaired at initial recognition.

11 As a result, **the IASB staff did not recommend to take any action on this matter.**

How to account for subsequent improvements in credit risk?

Summary of the feedback received by the IASB

12 Some respondents (mainly standard-setters and accounting firms) said that, in practice, there is diversity in how entities recognise the effect of subsequent improvements in credit risk in the statement of financial position for POCI financial assets. Some recognise it as a negative entry (i.e. reduction) to the ECL allowance, others recognise it as an adjustment to the gross carrying amount of a POCI financial asset.

13 They suggested the IASB clarify this issue to support consistency in presentation and hence, facilitate comparability of financial information. Although the different presentation practices do not ultimately affect the amortised cost of a financial asset, it affects metrics such as ECL coverage ratios.

14 The IASB staff inquired IFRS IC and ASAF. Two ASAF members noted that the matter may be important for some entities for which purchasing credit-impaired financial assets represents their main business activity to ensure consistent reporting of key ratios such as ECL coverage ratio.

EFRAG comment letter

15 EFRAG has identified this issue as medium priority in paragraph 113 of its comment letter and suggested to provide more guidance on the issue.

IASB staff analysis and recommendations

16 The IASB staff referred to paragraph 5.5.13 of IFRS 9 which states that an entity shall recognise **the cumulative changes in lifetime ECL since initial recognition as a loss allowance** for POCI financial assets.

17 The IASB staff noted that the term 'cumulative' used in this paragraph makes it explicit that **all the changes in ECL** (i.e. favourable or unfavourable) **since initial recognition of a POCI financial asset are recognised as loss allowance in the statement of financial position**. This is also consistent / symmetrical with the requirement for recognition as impairment gain in profit or loss. Specifically, paragraph 5.5.14 of IFRS 9 is explicit that an entity shall recognise in profit or loss the amount of the change in lifetime ECL as an impairment gain or loss, even if the lifetime expected credit losses are less than the amount of expected credit losses that were included in the estimated cash flows on initial recognition.

18 Therefore, the IASB staff thinks there is no ambiguity about the accounting for subsequent improvements in credit risk of a POCI asset or the related presentation in the statement of financial position or the statement of profit or loss and **does not think a clarification by the IASB is warranted**.

How to assess if a modified financial asset is originated credit-impaired?

Summary of the feedback received by the IASB

19 Some respondents said that due to insufficient application guidance or specific requirements there is diversity in how entities assess whether:

(a) modification of a restructured asset results in derecognition of the original asset and recognition of a 'new asset'; and

(b) that 'new asset' represents an originated credit-impaired asset.

20 Different conclusions reached in this assessment result in some entities concluding that modifications to restructure those assets are substantial and hence derecognise the restructured assets and recognise 'new assets' as POCI, while others conclude such modifications are not substantial, i.e. do no not result in derecognition, and hence continue to recognise them as stage 3 (credit-impaired) financial assets. This diversity could have a material effect on the related ECL amount and the ECL stage for that financial asset.

21 In addition, a few respondents also said it is challenging to determine the fair value at initial recognition for originated credit-impaired assets that arise from a substantial modification due to the lack of observable purchase prices.

EFRAG comment letter

22 EFRAG has identified this issue as medium priority in paragraphs 109 and 110 of its comment letter and suggested to provide clarifications on the issue.

IASB staff analysis and recommendations

23 The IASB staff referred to paragraph B5.5.26 of IFRS 9 which mentions that in some unusual circumstances (for example, in a situation in which there was a substantial modification of

a distressed asset that resulted in the derecognition of the original financial asset), there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset would be recognised as an originated credit-impaired financial asset.

24 The IASB staff acknowledged that diversity in how entities determine whether modification of a restructured financial asset results in derecognition of that asset might reduce the usefulness of information to users of financial statements. They noted that the matter of assessing whether modification of a restructured financial asset results in derecognition of that asset and recognition of a 'new asset' will be part of the *Amortised Cost Measurement* project.

25 The IASB staff noted that an entity is ultimately required to apply judgement to determine whether the 'new asset' originated subsequent to a restructuring of the original financial asset is credit-impaired. In their view, the definition in Appendix A of IFRS 9 provides a helpful basis to apply such judgement. Also, they observed that the PIR feedback had not provided evidence that such guidance is insufficient or inappropriate. Therefore, they **do not think that further action by the IASB is warranted for this matter.**

26 The IASB staff acknowledged that determining the fair value of a modified financial asset which is recognised as a 'new asset' might require significant judgement to be applied. They noted, however, that IFRS 13 provides detailed requirements and application guidance for determining fair value in the absence of observable inputs. Accordingly, in their view, an entity will be required to apply judgement to specific facts and circumstances in selecting the unobservable inputs to be used. Therefore, **they do not think that further action by the IASB is warranted for this matter.**

The IASB tentative decision

27 The IASB agreed with the staff recommendation to take no further action on matters identified in regard to the requirements in IFRS 9 for POCI financial assets. 14 of 14 IASB members voted in favour.

28 One IASB member noted the importance of the fact that some of the issues discussed would be carried forward to the forthcoming *Amortised Cost Measurement* project.

EFRAG Secretariat assessment

29 The EFRAG Secretariat acknowledges the IASB arguments but continues to be of view that the three above matters should be classified as medium priority and also expects some of these issues to be addressed in the scope of the *Amortised Cost Measurement* project.

EFRAG FIWG feedback

30 One EFRAG FIWG member noted that, on the basis of the comments letters from banks received by the IASB, that many, though not the majority of these respondents (five of 14) expressed strong criticism of the POCI accounting model and also mentioned that, in his view, the issues raised by the respondents may not have been sufficiently analysed by the IASB staff. This member also mentioned that the existing guidance in IFRS 13 is not helpful for the valuation of new modified financial assets as, in this case, there is only one observable input (the risk-free rate).

31 Another EFRAG FIWG member mentioned that the accounting model for POCI assets does not seem to fit well with the rest of the accounting models under IFRS 9. This member also agreed with the EFRAG Secretariat that the mentioned issues should be of medium priority as this is a clear indicator that these issues will be further addressed within the *Amortised Cost Measurement* project and not delayed by carrying them forward to future IASB projects.

Questions to EFRAG FR TEG

32 Does EFRAG FR TEG agree with the IASB staff analysis and the IASB tentative decision not to take standard-setting action on matters related to POCI financial assets?

33 Does EFRAG FR TEG have any comments on the EFRAG Secretariat analysis?

Appendix A - Analysis of other comments

PIR evaluation requirements	The IASB staff assessment	Conclusion
Are there fundamental questions (i.e. 'fatal flaws') about the clarity and suitability of the core objectives or principles in the new requirements?	PIR feedback and the staff analysis in this paper on the matters identified indicated that the POCI requirements are working as intended and that there are no fundamental questions about their clarity and suitability.	No action.
Are the benefits to users of financial statements of the information arising from applying the new requirements significantly lower than expected?	Although a few respondents suggested the IASB require an alternative approach to recognise ECL for POCI assets so that changes in credit risk are better represented, majority of respondents said the POCI requirements faithfully reflect the economics of POCI assets and can be applied consistently. Therefore, PIR feedback did not provide evidence that the benefits to users of financial statements of information arising from applying the POCI requirements are significantly lower than expected.	No action.
Are the costs of applying the new requirements and auditing and enforcing their application significantly greater than expected?	A few respondents raised concerns that applying the POCI requirements can be burdensome for entities for which managing POCI assets is not their main business activity. This is because such entities are also required to apply other ECL approaches (e.g. the general approach) to financial assets that are not POCI. Nonetheless, majority of respondents acknowledged that these requirements were carried forward from IAS 39 and said that the requirements can be applied consistently. Notwithstanding the two application questions identified by respondents, the PIR feedback did not provide evidence that the costs	No action.

PIR evaluation requirements	The IASB staff assessment	Conclusion
	of applying the new requirements and auditing and enforcing their application are significantly greater than expected.	