EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 17 June 2013 to commentletters@efrag.org

XX July 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft *Financial Instruments: Expected Credit Losses*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Financial Instruments: Expected Credit Losses* issued by the IASB on 7 March 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

We conceptually supported the integrated effective interest rate approach in the 2009 ED and we supported the time proportionate approach in the Supplementary Document; however, we acknowledge the significant operational concerns expressed by constituents regarding the implementation of those approaches.

EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound. However, in the absence of a better model, the IASB should finalise its impairment requirements having this approach as a basis and taking into account our recommendations in the appendix to this letter.

We accept the proposed approach because it will result in a more timely recognition of expected credit losses, and hence address the weakness of an incurred loss model in a pragmatic way.

EFRAG's preliminary assessment is that the proposed approach strikes an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents. However, EFRAG is undertaking a field-test with the National Standard Setters of France, Germany, Italy and the UK in order to better substantiate its final assessment on the proposals (further details about the field-test can be found here).

EFRAG understands that any impairment model – such as the model proposed by the FASB – that uses a single measurement approach that recognises lifetime expected credit losses from initial recognition will inevitably remove the need to track any changes in credit quality to determine when lifetime expected credit losses should be recognised as a result of significant credit deterioration. Nevertheless, in our view, such a model would not be less subjective and not necessarily operationally simpler compared to the proposed approach in the ED. EFRAG believes that such an approach would provide less relevant information about the effects of changes in the credit quality subsequent to initial recognition, and does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation as the double counting effect of expected loss recognition at inception is aggravated by the consideration at once of life time expected losses.

If you would like to discuss our comments further, please do not hesitate to contact Panagiotis Papadopoulos, Didier Andries or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

APPENDIX

EFRAG's responses to the questions raised in the exposure draft

Notes for EFRAG's constituents

1 *The replacement of IAS 39* Financial Instruments: Recognition and Measurement *is part of the IASB and FASB joint project to improve their respective accounting standards on financial instruments. The delayed recognition of credit losses and the complexity of multiple impairment approaches used were identified as the primary weaknesses in the existing accounting standards.*

2 *The IASB developed its original proposals on impairment of financial instruments in an Exposure Draft issued in November 2009. The FASB developed different proposals in its respective Exposure Draft, issued in May 2010. The comments received by the IASB on its November 2009 proposals highlighted support for the measurement principles, but also indicated significant operational difficulties in applying those principles, especially in the context of open portfolios.*

3 *In January 2011, the IASB and the FASB published a joint Supplementary Document (SD) that proposed an approach for open portfolios on the basis of advice received from the Expert Advisory Panel and outreach activities undertaken after the publication of the November 2009 proposals. However, the boards did not receive strong support for the joint approach in the Supplementary Document. In particular, constituents expressed operational and conceptual concerns on the calculations in the 'good book'. In addition, the feedback did not indicate a single preferred approach and was split geographically.*

4 *In May 2011, the IASB and the FASB commenced development of a variation of their previous proposals, taking into account the feedback from their original EDs and the Supplementary Document, in an attempt to arrive at a converged model. The so-called 'three-bucket model' would reflect the general pattern of credit deterioration in the credit quality of financial instruments. However, although the boards agreed on several different aspects, they did not manage to agree on a converged impairment solution and have now published separate proposals.*

5 *On 20 December 2012, the FASB issued a proposed* Accounting Standards Update Financial Instruments - Credit Losses *(the 'FASB Proposals') on impairment that, unlike the IASB's approach, does not distinguish between assets that have deteriorated and those that have not. Instead, it proposes a single measurement approach that will require an entity to recognise at each reporting date an allowance for all lifetime expected credit losses.*

6 *The ED, published by the IASB on 7 March 2013, proposes to eliminate the existing requirement to recognise an impairment loss only after a credit loss event has occurred. Instead the ED would require expected credit losses to be always recognised, even if there is not a specific credit loss event, and updated for any changes. Furthermore, the ED proposes a dual-measurement approach that will require an entity to distinguish between financial assets that have deteriorated and those that have not, and recognise an allowance for 12-month or lifetime expected credit losses depending on the extent of deterioration in the borrower's ability to meet its contractual terms.*

Objective of an expected credit loss impairment model

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 full 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 at an amount equal to all expected credit losses from initial recognition, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

Notes for EFRAG's constituents

7 *The ED proposes the following objective for an expected credit loss impairment model:*

> *'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.'*

8 *The ED proposes, that except for financial assets that are credit impaired at initial recognition or that qualify for the simplified approach (see questions 10 and 11), an entity should recognise an impairment allowance of:*

(a) *12-month expected credit losses for financial instruments for which the credit risk has not increased significantly since initial recognition. The 12-month expected credit losses are defined as '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'; and*

(b) *Lifetime expected credit losses when there is significant increase in credit risk since initial recognition.*

9 *As an exception, the ED proposes that if a financial asset has a low credit risk (i.e. its credit quality is equivalent to 'investment grade'), then the impairment allowance should be measured at the 12-month expected credit losses regardless of the extent of credit deterioration.*

10 *The ED defines a financial asset with a low credit risk as 'a financial asset has a low probability of a default occurring if default is not imminent but adverse economic conditions or changing circumstances may lead to a weakened capacity of the borrower to meet its contractual cash flow obligations on the financial asset. For example, if a bond is rated investment grade.'*

11 *Paragraphs BC14-BC17 of the FASB Proposals outline the reasons why the FASB decided to require all expected credit losses to be recognised at initial recognition:*

(a) *because credit losses do not occur rateably through the life of a loan, the FASB believes, that there is a fundamental disconnect between the economics of lending and a time-based accounting approach that attempts to link the recognition of expected credit losses at initial recognition with the recognition of interest revenue;*

(b) *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. In addition, because the evaluation of the creditworthiness that influences pricing is based on historical experience for groups of similar assets, 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; and*

(c) *the FASB believes 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 (i.e. a rate that is not adjusted for initial expected credit losses), and believes that it is misleading to investors to allow the balance sheet to reflect a greater amount.*

12 *Finally, paragraph BC193 of the ED explains how the proposed expected loss approach in the ED is aligned with the prudential capital framework*:

> *'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.'.*

It should be noted though that the prudential calculations are carried out on a different basis from that required by the ED.

EFRAG's response

EFRAG does not agree that recognising a portion of expected credit losses at initial recognition reflects the economic link between the pricing of a financial instrument and the credit quality at initial recognition when the financial instrument is priced at market terms because it ignores the revenue aspect of the transaction. However, EFRAG has no alternative at this stage to suggest in order to modify the model in a way that would both meet this concern and be operationally viable.

EFRAG supports the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and thus provides useful information about the effects of changes in the credit quality of an entity's financial assets.

EFRAG does not support an approach that requires lifetime expected credit losses to be recognised at initial recognition as in most circumstances such an approach would result in excessive front-loading of credit losses given initial expectations of credit losses are priced into a financial asset, and would provide less relevant information on credit deterioration.

Question 1(a)(i)

<u>12-month expected credit losses</u>

13 EFRAG agrees that the requirement to recognise at initial recognition a portion of the lifetime expected credit losses will result in an earlier recognition of expected

credit losses. However, we also agree with the analysis in paragraph BC66 of the ED:

> *'…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'.*

14 We therefore concur with the alternative view expressed by Stephen Cooper 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'.

<u>Link to pricing</u>

15 Paragraph BC19(a) of the ED explains that in developing the proposed expected credit loss model, the IASB observed that typically initial credit loss expectations are reflected in the initial pricing. However, paragraph BC46 of the ED notes that it may be 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.

16 While there may not always be a clear economic link for each and every financial instrument between the pricing and its credit quality at initial recognition (e.g. when a lender wishes to gain market share or in the case of a credit bubble), EFRAG believes that such a link normally does exist. Therefore, we favour a model that takes as its initial objective to reflect the effective return by allocating interest revenue, but that changes its primary objective to recognising impairment allowances when credit losses exceed those initially expected.

17 In our view, recognising an economic loss at initial recognition does not result in a faithful presentation of the transaction, since it ignores the revenue aspect of the transaction. Consequently, recognising a portion of the initial expected credit losses at initial recognition normally does not reflect appropriately the economic link between the pricing and the initial credit quality when the financial instrument has been priced at market terms.

18 However, for the reasons explained in our response to Question 2(a), EFRAG has currently no alternative to suggest in order to modify the model in a way that would both meet this concern and be operationally viable.

Question 1(a)(ii)

19 EFRAG agrees with the reasoning in paragraph BC16 of the ED that for financial instruments that are measured at amortised cost, information about changes in credit quality is more relevant to users in understanding the likelihood of the collection of future contractual cash flows than the effect of other changes such as changes in market interest rates.

20 Therefore, we support the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and thus provides useful information about the credit quality of an entity's financial assets, its credit risk management activities and the effect of those activities on the entity's financial statements (see also our response to Question 5(c)).

21 EFRAG believes that any impairment approach should take as its initial objective to reflect the effective return by allocating interest revenue and initial credit loss expectations over the life of the financial asset. However, we believe that once a significant deterioration in credit quality has occurred, an entity will be focussed on recovering principal and the primary objective of the model should be to recognise an impairment allowance based on expected lifetime losses.

Question 1(b)

22 EFRAG has taken note of the arguments in paragraphs BC14-BC17 of the FASB Proposal. However, as explained in paragraph 16, we agree with the IASB's observation that typically the initial pricing includes a compensation for initial credit loss expectations. Therefore, we agree with the IASB's analysis that 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. While we acknowledge that this element in the IASB's approach is similarly not conceptually sound, in our view, the effect would be less pronounced. Consequently, EFRAG does not support a model that requires lifetime expected credit losses to be recognised at initial recognition as it would result in most circumstances in excessive front-loading of credit losses given that initial expectations of credit losses are priced into a financial asset. Furthermore, we believe that such a model would provide less relevant information about the effects of changes in the credit quality subsequent to initial recognition.

The main proposals in this exposure draft

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 Supplementary Document (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the full 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?

EFRAG's response

EFRAG accepts the proposed approach because it will result in a more timely recognition of expected credit losses and hence addresses the weakness of an incurred loss model in a pragmatic way.

Overall, we believe that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation of the approaches in the 2009 ED and the Supplementary

Document (without the foreseeable future floor).

EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

However, as stated in the cover note, EFRAG is undertaking a field-test in order to better substantiate its final assessment on the proposals.

Question 2(a)

23 We conceptually supported the integrated effective interest rate approach in the 2009 ED and we supported the time proportionate approach in the Supplementary Document; however, we acknowledge the significant operational concerns expressed by constituents regarding the implementation of the those approaches.

24 EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound when credit risk is priced appropriately. Therefore, as noted in our response to Question 1, we would concur with the alternative view of Stephen Cooper 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'.

25 In addition, as we explain in our response to question 2(c) below, we do not believe that recognising the full lifetime expected credit losses from initial recognition results in an appropriate balance between the representation of the underlying economics and the cost of implementation.

26 However, we note also the repeated request from the G20, the Financial Crisis Advisory Group and other constituents for the IASB to develop a forward-looking model that reflects expected credit losses and results in a higher level of provisioning in general.

27 Notwithstanding our conceptual concerns about the initial recognition of the 12-month expected credit losses, the proposed approach is a step in the right direction because:

(a) it offers a pragmatic approach by using a dual measurement objective for the recognition of credit loss expectations resulting from a credit deterioration, when those expectations were not initially priced into the financial instrument;

(b) it addresses the delayed recognition of expected credit losses in the existing IAS 39;

(c) it deals with the occurrence of early loss patterns;

(d) it can also be more responsive to 'incurred but not yet reported/recognised' (IBNR) losses than IAS 39;

(e) compared to previous proposals, it is more operational and capable of being implemented in practice at a more reasonable cost.

28 In summary, EFRAG accepts the proposed approach because it will result in a more timely recognition of expected credit losses and hence address the weakness of the current incurred loss model in a pragmatic way. Based on our preliminary assessment, the proposed approach would achieve an acceptable

balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents. However, together with the National Standard Setters of France, Germany, Italy and the UK we have launched a field test to better substantiate our final assessment (further details about the filed-test can be found here).

29 Finally, in the absence of a better model, the IASB should finalise its impairment requirements having this approach as a basis and taking into account our recommendations.

Question 2(b)

30 EFRAG agrees that the approach in the 2009 ED provided the most relevant information about the amortised cost measurement by allocating initial expected credit losses and interest income over the remaining life of a financial asset. However, we acknowledge the operational challenges of such an approach.

31 In its comment letter on the IASB's Supplementary Document in 2011, EFRAG supported the time-proportionate approach for the allocation of expected credit losses, and the decoupling of interest income and expected credit losses. In that letter, EFRAG disagreed with the proposal regarding the foreseeable future to deal with early loss patterns.

32 In conducting outreach on the Supplementary Document, EFRAG learned that constituents were concerned about additional costs resulting from the requirement to perform two separate calculations on a regular basis, and the subjectivity of inputs in relation to early loss patterns and the foreseeable future. Based on that outreach, we concluded that, even without the floor, the Supplementary Document would still be operationally challenging by requiring lifetime expected credit losses to be calculated from initial recognition for all loans, and would not deal sufficiently with early loss patterns. In contrast, the ED would require lifetime expected losses to be calculated only when there is a significant increase in credit risk after initial recognition.

33 Although, we acknowledge that the 12-month expected credit loss is not conceptually sound, nevertheless, in our view, it is a clear measure that will allow entities to leverage existing credit risk management practices and deal with early losses in a pragmatic way. While we accept the 12-month expected credit loss measurement for financial assets that have not deteriorated significantly in credit quality since initial recognition, we believe that this is the maximum acceptable length and the final requirements should not be based on a larger portion of lifetime expected credit losses.

34 EFRAG understands that the requirement in the ED to track changes in the credit quality will increase the level of complexity in the model; however, we note that the ED provides a number of operational simplifications that in our view will mitigate the level complexity.

35 Overall, we believe that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation than the approaches proposed in the 2009 ED and the Supplementary Document (without the foreseeable future floor).

Question 2(c)

36 EFRAG understands that any impairment model that uses a single measurement approach that recognises lifetime expected credit losses from initial recognition will

inevitably remove the need to track any changes in credit quality to determine when lifetime expected credit losses should be recognised as a result of significant credit deterioration. Nevertheless, by having to estimate the full amount of expected credit losses over a longer period such a model would be more subjective and not necessarily operationally simpler compared to the proposed approach in the ED. Furthermore, such a model would provide users with less relevant information about credit deterioration of financial assets.

37 As noted in paragraph 13 above, such an approach would result in the initial carrying amount of the financial asset being reported below its fair value. In our view, recognising a 'day-1 loss' on any financial asset that is priced at market terms defeats the initial measurement requirements in IAS 39 and IFRS 9 *Financial Instruments* by ignoring the fact that any initial credit loss expectations have been considered in the pricing of that instrument.

38 In addition, we observe that using the original effective interest rate instead of the credit adjusted effective interest rate to discount credit losses that have been originally priced will result in significant frontloading by overstating expected credit losses on initial recognition, and overstating the performance in the following years.

39 Consequently, EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

Scope

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?

Notes for EFRAG's constituents

40 *The ED proposes that the following financial assets will be included within its scope:*

(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 (FV-OCI) in accordance with the Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9;*

(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.*

EFRAG's response

EFRAG agrees with the scope of the Exposure Draft.

Question 3(a)

41 EFRAG agrees with the proposed scope in the Exposure Draft.

42 EFRAG supports the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy.

Question 3(b)

43 To the extent that IFRS will be amended to allow a FV-OCI category for particular debt securities, EFRAG agrees that the proposed impairment requirements should also apply to that FV-OCI category. We believe it is important that both the amortised cost category and the FV-OCI category are subject to the same impairment requirements as this ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. Furthermore, we agree with the IASB that having different impairment requirements would be a source of complexity.

44 EFRAG notes that while the application of the model results in the same profit or loss pattern when applied to the amortised cost category or the FV-OCI category, there is a difference in the impact on equity. When applied to the FV-OCI category, on initial recognition the model results in a debit in profit or loss that is offset by a credit in other comprehensive income. Whilst EFRAG understands and supports this, the IASB should explain in the Basis for Conclusions how this difference should be interpreted.

Questions to EFRAG's constituents

45 Are you comfortable having the same impairment model for both the amortised cost category and the FV-OCI category? Please explain.

46 If you prefer a different impairment model for the FV-OCI category than for the amortised cost category, please explain how this model would function and how it would reflect changes in credit quality.

12-month expected credit losses

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?

Notes for EFRAG's constituents

47 *The ED proposes that an impairment allowance of 12-months' expected credit losses should be recognised for all financial assets that:*

(a) *do not qualify for the simplified approach;*

(b) *are not credit impaired on initial recognition; and*

(c) *have not experienced a significant deterioration in credit quality after initial recognition.*

48 *The ED defines the 12-month expected credit loss measurement as '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.'*

49 *EFRAG is performing a field-test that will be followed by further outreach activities, to assess whether the requirements are operational and evaluate the other aspects described in the IASB's impact analysis. Further details about this field-test and how you can apply to participate can be found here.*

EFRAG's response

EFRAG will respond to this question based on the information gathered from its field-test.

50 EFRAG acknowledges that several regulated industries make use of estimates of expected losses. However, these calculations differ from the requirements put forward by the proposed model which should be applied by entities in all industries.

Assessing when an entity shall recognise lifetime expected credit losses

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?

Notes for EFRAG's constituents

Recognition of lifetime expected credit losses

51 *The ED proposes that an entity should recognise the lifetime expected credit losses when the credit risk of a financial asset has increased significantly since initial recognition. In making this assessment, an entity should compare the current probability of default with the initial probability of default considering the remaining life of the financial asset.*

52 *The ED also proposes that the recognition of lifetime expected credit losses should be based only on changes in the probability of default without considering the loss given default (i.e. although changes in the value of collateral may be used to assess whether there is a significant increase in credit risk, collateral should be considered only in the measurement of expected credit losses).*

53 *The ED defines lifetime expected credit losses as the 'present value of all cash shortfalls expected over the remaining life of the financial asset associated with the probability of a default occurring on the financial asset over the life of the asset'.*

Application guidance

54 *The ED provides detailed application guidance to assist the evaluation of whether an impairment allowance of lifetime expected credit losses should be recognised. An entity should use the lifetime probability of default to make that evaluation. An entity may also use the 12-month probability of default, unless the evaluation would be different when using the lifetime probability of default.*

55 *The ED allows an entity to perform the above evaluation on an individual basis or on a collective basis if the financial assets that are grouped share similar credit risk characteristics. However, financial assets should not be evaluated on a collective basis, if recognition of a lifetime expected credit losses is appropriate on an individual basis.*

56 *In determining whether lifetime expected credit losses should be recognised, an entity should use the best available information. The ED provides a list of factors to help entities evaluate whether lifetime expected credit losses should be recognised. These factors include changes in external, internal and borrower specific information.*

Operational simplifications

57 *The ED proposes the following operational simplifications when evaluating whether lifetime expected credit losses should be recognised:*

(a) *if the entity estimates that the financial asset has a low credit risk at the reporting date (for example, it is 'investment grade'), then it should measure the allowance 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 evaluate whether lifetime expected credit losses should be recognised.*

EFRAG staff notes that the main effect of these operational simplifications is to reduce the amount of information an entity needs to collect about financial assets *that at first sight have a low credit risk. The simplifications only affect the level of an impairment allowance if they erroneously lead an entity to not collecting additional information about financial assets for which credit risk has increased significantly.*

When the lifetime expected credit loss criteria are no longer met

58 *The ED proposes that when the increase in credit risk since initial recognition is no longer significant, an entity should be allowed to re-establish the impairment allowance to the 12-months' expected credit losses. However, this would not apply to financial assets that use the simplified approach and financial assets that are credit impaired on initial recognition.*

EFRAG's response

EFRAG supports the proposed approach to recognise lifetime expected credit losses when there is a significant deterioration in the borrower's ability to meet its contractual terms since initial recognition.

We agree with the approach in paragraph BC202 of the ED that an entity can apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner, and believe that it would be helpful if the IASB could state this explicitly in the body of the final standard.

EFRAG agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default.

We agree with the operational simplifications that the IASB has proposed as they are necessary to make the model workable for every entity.

Question 5(a)

59 EFRAG believes that there are two distinct objectives in accounting for credit losses; (1) to reflect the effective return by allocating interest revenue and (2) to recognise an impairment allowance for credit losses in excess of those initially expected. The first objective is only appropriate to the extent that the interest revenue is expected to cover any credit losses, while the second objective is appropriate when credit losses significantly exceed the original expectations.

60 EFRAG agrees with the proposal to recognise lifetime expected credit losses on the basis of a significant deterioration in the borrower's ability to meet its contractual terms, because that credit deterioration would not have been reflected in the original pricing (i.e. interest rate) of the financial asset. While we agree that it is appropriate to base the approach on a relative deterioration of the credit quality, practical expedients are required to make the model more operational in practice.

61 Paragraph 8 of the ED, states that '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'. However, we note that IFRS 7 *Financial Instruments: Disclosures refers to financial loss when it defines credit risk.* Therefore*, w*e suggest the IASB should consider this inconsistency in drafting the final standard on impairment.

Question 5(b)

62 EFRAG supports the IASB's decision to include extensive application guidance on the assessment of a significant increase in credit risk that is also suitable to non-lending businesses.

63 EFRAG agrees with the reasoning in paragraph BC67 of the ED that a single absolute credit quality threshold would not be appropriate for all different types of financial instruments.

64 However, we note that paragraph BC202 in the ED implies that an entity can segregate its portfolios and apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner. We agree with that approach and believe that it would be helpful if the IASB could state this explicitly in the body of the final standard. This would reduce the cost of the requirement to assess the relative credit deterioration, by allowing entities to use an absolute threshold to individual portfolios.

Question 5(c)

65 EFRAG agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default, as it does not require the full estimation of expected credit losses and is aligned with existing credit risk management processes. In addition, we note that grounding the assessment to changes in the probability of default will provide users with additional information about credit quality and explain whether the entity is mainly focussed on collecting interest revenue or focussed on recovering principal.

66 Although we agree with the proposed requirement, we note that recognising lifetime expected credit losses based only on changes in the probability of default, might not deal appropriately for certain loan agreements where the interest rate is automatically adjusted for changes in credit risk (e.g. in certain syndicated loans and certain consumer loans in markets such as Sweden). While some of those loans might not meet the cash flow characteristics test in IFRS 9, we believe that the IASB should explicitly consider the impact of the proposed impairment model on those loans that would qualify for measurement at amortised cost.

Question 5(d)

67 EFRAG acknowledges that the requirement to track changes in the credit quality will be operationally challenging. Therefore, we agree that operational simplifications are necessary to make the model workable for every entity.

68 EFRAG notes that the '30 days past due' rebuttable presumption would not drive the accounting but would mainly affect the amount of work required in order to assess whether there is a significant increase in credit risk. There is no conceptual basis for a 30-day period; however, given that this provides some degree of relief to preparers without significantly affecting the level of the impairment allowance, we believe it is appropriate. We also believe that – given that '30 days past due' is already a lagging indicator – it would generally not be appropriate to use a longer period for the purposes of this relief.

69 Some constituents believe that the rebuttable presumption that a significant deterioration in the borrower's ability to meet its contractual terms has occurred when payments are more than 30 days past due if no other borrower-specific information is available would not provide relief in practice, because the condition would be triggered in many cases when payments are late but no concern exists about the underlying credit risk. They believe that when the condition is triggered,

an entity would need to rebut the presumption, which in itself could be burdensome. EFRAG does not agree with this reasoning because, in our view, an entity could rebut the presumption based on historical statistical information on portfolios with similar credit risk characteristics. Nevertheless, we would appreciate it if the IASB could state this explicitly in the standard.

Question to EFRAG's constituents

70 Do you believe that the '30 days past due' rebuttable presumption appropriately reflects when there is a significant increase in credit risk? If not, please explain why and what alternative period you would recommend.

71 EFRAG supports the proposed simplification for financial instruments with low credit risk and agrees that the primary focus of the model should be when there is a significant increase in credit risk. In our view, the proposed definition of low credit risk is meaningful and consistent with our understanding that the probability of default increases at an exponential rate as a financial asset deteriorates in credit quality (i.e. where significant changes in credit risk rating grades do not result in significant changes in the absolute probability of default). Therefore, we believe it strikes the right balance between the benefits of making the distinction between financial assets that have deteriorated significantly in credit quality and the costs of making that distinction.

72 However, we observe that many financial instruments that are purchased or originated today will have a credit quality that will likely be below the 'investment grade' level. Consequently, the proposed simplification might only apply in a relatively limited range of circumstances. Furthermore, we note that the use of the phrase 'investment grade' leads many constituents (e.g. those who apply the Basel Standardised Approach and non-banks) to understand that they would be required to use ratings provided by external ratings agencies. We believe that the IASB should make clear in the standard that there is no requirement to obtain external credit ratings for the purposes of applying the impairment model.

73 The FASB ED proposes a practical expedient for debt securities classified at FV-OCI that will allow an entity to not recognise expected credit losses when both (1) the fair value of the debt security is greater than (or equal to) the amortised cost and (2) expected credit losses are insignificant. However, as noted in paragraph 43 above, EFRAG believes that such a practical expedient would be inconsistent with the conceptual approach underlying the proposed FV-OCI category, since this approach intends to reflect in profit or loss the effects of carrying those instruments at amortised cost. Furthermore, in our view, recognising expected credit losses based on the fair value of a debt security would not be appropriate because a fair value also reflects changes in factors other than credit risk.

Question 5(e)

74 EFRAG believes that both unfavourable and favourable changes in credit quality should be recognised in a consistent manner using the same principles and criteria, as this would provide comparability in the way entities account for like items. Consequently, we agree that an entity should be allowed to remeasure the loss allowance back to the 12-month expected credit loss when the criteria for the recognition of the lifetime expected credit losses are no longer met.

Interest revenue

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 and presented 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 and presentation 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?

Notes for EFRAG's constituents

75 *Interest revenue should be usually calculated using the effective interest method on the gross carrying amount of the financial asset. However, the ED proposes that the calculation should be based on the net carrying amount in the following circumstances:*

(a) *when there is objective evidence that the financial asset is credit impaired on initial recognition, an entity should calculate interest revenue by applying the credit-adjusted effective interest rate to the amortised cost; and*

(b) *when there is objective evidence that the financial asset is credit impaired after initial recognition, the ED proposes that the calculation should change from the gross basis to a net basis.*

76 *The existing indicators in paragraph 59 of IAS 39 on whether there is an objective evidence of impairment have been largely carried forward in the ED.*

77 *Finally, the ED is symmetrical in that it requires the calculation to revert from the net basis to the gross basis when the there is no longer an objective evidence of impairment.*

EFRAG's response

EFRAG agrees that interest revenue should be calculated on a net basis when there is objective evidence of impairment.

Question 6(a)

78 EFRAG notes that the decoupled approach in the Exposure Draft considers the recognition of interest revenue and the recognition of expected credit losses separately, which means that an entity recognises interest on the gross carrying amount without taking expected credit losses into consideration. However, we agree with the IASB's conclusion in paragraph BC98 of the ED 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'. We believe that this would provide more useful information for users analysing the net interest margin.

Question 6(b)

79 The requirement to calculate interest revenue based on a net carrying amount when there is objective evidence of impairment increases the complexity of the impairment model. However, EFRAG agrees with the IASB that, as preparers have been determining interest on the net amortised cost in a similar way under IAS 39, no new complexity is added.

80 Interest is seen as compensation for expected credit losses. When credit losses become so important that they cannot longer be compensated by the interest revenue, different approaches can be used to measure the interest revenue. EFRAG believes that the IASB approach to calculate the interest revenue based on a net carrying amount when there is objective evidence of impairment is better than the non-accrual approach used by the FASB-model. The use of a non-accrual principle may permit an entity to postpone the remaining expected cash shortfalls in time without any effect on the allowance and does therefore not appropriately reflect the time value of the expected cash shortfalls.

81 EFRAG agrees with the IASB's analysis that there are concerns about using 'incurred loss' criteria in an expected credit loss model, but accepts that it is necessary to retain the faithful representation of interest revenue, while minimising the operational challenges.

Question 6(c)

82 We agree with the proposal that the interest revenue approach shall be symmetrical, as this would provide comparability in the way entities account for like items.

Disclosure

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?

Notes for EFRAG's constituents

83 *The disclosure objective of the ED is that an entity should disclose information that identifies and explains:*

(a) *the amounts in its financial statements arising from expected credit losses measured in accordance with the ED; and*

(b) *the effect of deterioration and improvement in credit quality of financial instruments that are within the scope of the ED.*

84 *An entity should disclose information that identifies and explains the amounts arising from expected credit losses, including:*

(a) *a reconciliation of the gross carrying amount and loss allowance (or provision); and*

(b) *the inputs and assumptions used in measuring the 12-month and lifetime expected credit losses;*

85 *An entity should also disclose information about:*

(a) *the undiscounted expected credit losses at initial recognition relating to purchased or originated credit-impaired financial assets;*

(b) *its write-off policy and whether there are financial assets that have been written off that are still subject to enforcement activity;*

(c) *financial assets where the contractual cash flows have been renegotiated or modified, but for which the modification did not lead to derecognition;*

(d) *financial assets that have been secured by collateral or other credit enhancements; and*

(e) *significant effects on the impairment allowance caused by a particular portfolio or geographic area.*

86 *An entity should disclose information that explains and identifies the effect of deterioration and improvement in credit risk of financial assets, including:*

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

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

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

EFRAG's response

EFRAG supports the proposed disclosures. In our view, they will increase transparency and comparability and provide relevant information about the credit quality of an entity's financial assets and its risk management activities.

We suggest the IASB should develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates.

However, as stated in the cover note, EFRAG is undertaking a field-test in order to better substantiate its final assessment on the proposals.

Disclosure objectives

87 EFRAG agrees with the proposed disclosure objectives as they are aligned with the recognition and measurement principles of the ED.

Proposed disclosures

88 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from applying the proposed impairment model, as this model requires the application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the effects of credit risk of financial instruments on an entity's financial position and performance.

89 EFRAG agrees with the IASB's assessment in paragraph BC184 of the ED that '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'. Therefore, while the proposed disclosures are likely to be excessive for non-financial institutions, they are clearly appropriate for financial institutions. We believe that the disclosures increase transparency and comparability, and provide relevant information about the credit quality of an entity's financial assets, its risk management activities and the effect of those activities on the entity's financial position and performance. In our view, the disclosures on reconciliations, and the inputs and assumptions used to estimate expected credit losses are necessary to achieve the disclosure objective. Having said that, in practice, disclosures will reach the appropriate level of relevance only if the IASB ensures – with short-term amendments to IAS 1 as currently envisaged and/or otherwise – that the final requirements lead to sound practice.

Back-testing

90 EFRAG acknowledges the concerns about providing 'back-testing' disclosures in the context of open portfolios as described in paragraph BC109 of the ED. Nevertheless, consistent with the recommendation in our comment letter on the IASB's Supplementary Document, we suggest the IASB should develop an alternative form of disclosure about experience adjustments. This would allow users to understand the quality of earlier accounting estimates.

Write-off policy and modifications

91 EFRAG notes that the timing of a write-off of a financial asset in accordance with paragraph 21 of the ED would depend on an entity's 'reasonable expectations of recovery', which would in part depend on the legal system in the relevant jurisdiction (e.g. legal systems may move at different speeds and an entity's legal options may be exhausted sooner in some jurisdictions). Similarly, we note that the details underlying modifications are often specific to jurisdictions. Therefore, we support the disclosures regarding the write-off policies and modifications as they will provide relevant information and increase comparability between jurisdictions.

92 Paragraph 22 in the ED states that write-offs can relate to a portion of a financial asset, but does not explain when such write-offs would be appropriate or required. In order to mitigate the effects of inconsistent application of the notion of partial write-offs, which would be based on an entity's individual assessment of the facts and circumstances, we believe the IASB should provide application guidance that explains when partial write-off would be appropriate.

93 Finally, we believe that the drafting in paragraph 38 could be made clearer to indicate that the disclosure requirements in that paragraph should apply only to modifications of financial assets on which lifetime expected credit losses are recognised as a result of a significant increase in credit risk and assets held under

the simplified approach that are modified when more than 30 days past due - or the equivalent number of days under the rebuttable approach.

Other

94 Paragraph 31 in the ED requires preparers to decide which disclosures in IFRS 7 and in the ED result in duplication. EFRAG believes that it is the task of the IASB, as a standard setter, to avoid duplicating disclosure requirements between standards as this would reduce costs for preparers and avoid divergence in practice.

95 Paragraph 32 in the ED allows an entity to provide disclosures by cross-reference to other statements or risk reports, noting that without that information incorporated by cross-reference, the financial statements are incomplete. EFRAG agrees with the proposal and supports such cross-referencing as it allows entities to cope with a possible overlap between mandatory requirements emanating from IFRS applied to financial statements and national law to other parts of the financial report.

96 EFRAG also believes the IASB should develop a proper disclosure framework which would specify not only what information needs to be disclosed, but also what leeway might be appropriate in terms of where the information is disclosed.

Questions to EFRAG's constituents

97 Do you believe that any of the proposed disclosures give rise to operational concerns or are unnecessarily burdensome? If so, please specify those disclosures and explain why the concern arises.

98 Do you believe that the proposed disclosures are appropriate for all types of entities?

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

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?

Notes for EFRAG's constituents

99 *The ED 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 should adjust the gross carrying amount of the asset to reflect the revised contractual cash flows. The gross carrying amount should be discounted to the present value of the estimated future contractual cash flows at the asset's original effective interest rate.*

100 *For the purpose of determining whether a significant increase in credit risk has occurred, the entity should compare the credit risk at the reporting date under the modified contractual terms of the asset to the credit risk at initial recognition under the original, unmodified contractual terms of the financial asset.*

101 *When the entity determines that the modified financial asset has a low credit risk at the reporting date, the impairment allowance should be measured at the 12-months' expected credit losses.*

102 *If the modification leads to derecognition, the ED proposes that the new financial asset should be treated like all other financial assets at initial recognition.*

EFRAG's response

EFRAG agrees with the proposed treatment of financial assets whose contractual cash flows are modified but is of the opinion that the standard needs to clarify when a modification results in derecognition.

103 The ED requires an entity to compare the credit quality of the modified financial instrument at the reporting date with the credit quality of the unmodified financial instrument at initial recognition. EFRAG agrees with this approach when the modification does not result in derecognition as it will more appropriately reflect the deterioration in credit risk that has occurred. At the same time it should be made clear that the expectation of credit losses should also take into account any experience of how such modified assets behave.

104 The impairment proposals would affect modified financial assets where the modification does not result in derecognition. EFRAG notes that it is not always clear when a modification as a result of a debt restructuring results in derecognition and when not. In our letter of 26 July 2012 to the IFRS Interpretations Committee, we noted that 'it would be helpful if the standards explicitly dealt with debt restructurings more generally, which would be particularly relevant in the light of the current financial crisis. In this respect we note the absence of certain definitions that are critical for the derecognition assessment process, and the lack of an explicit discussion in IAS 39 of when a modification of a financial asset (or exchange of debt instruments) results in derecognition. Therefore, we suggest that the Interpretations Committee recommend to the IASB that accounting for debt restructurings and modifications be addressed as part of the finalisation of IFRS 9 *Financial Instruments*.'[1]

Application of the model to loan commitments and financial guarantee contracts

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 provisions arising from expected credit losses on financial guarantee contracts or loan commitments as a separate line item in the statement of financial position? If yes, please explain.

[1] Letter to IFRS Interpretations Committee, 26 July 2012, *IAS 39 Financial Instruments: Recognition and Measurement – Accounting for different aspects of restructuring Greek government bonds.*

Notes for EFRAG's constituents

105 *The ED proposes that an entity should 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, if the entity is only required to make payments in the event of a default by the holder of that contract. Consequently, expected credit losses 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.*

106 *An entity should also 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.*

107 *The remaining life of a loan commitment and financial guarantee contract should be 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 the business practice.*

108 *In addition, an entity should present provisions for expected credit losses from financial guarantee contracts or loan commitments in a separate line item in the statement of financial position as a liability.*

109 *EFRAG is performing a field-test that will be followed by further outreach activities, to assess whether the requirements are operational and evaluate the other aspects described in the IASB's impact analysis. Further details about this field-test and how you can apply to participate can be found here.*

EFRAG's response

EFRAG will respond to this question based on the information gathered from its field-test.

110 As with regard to the application of the impairment model to loan commitments and financial guarantees, we refer to our preliminary response on question 3 on the scope of the impairment project.

Question to EFRAG's constituents

111 Do you believe that a different impairment model should apply to loan commitments? If so, please explain how the model would function and reflect changes in credit quality.

Exceptions to the general model

Simplified approach for trade receivables and lease receivables

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?

Notes for EFRAG's constituents

112 *The ED proposes a simplified approach for trade receivables and lease receivables that will:*

(a) *require an entity to measure an allowance for the lifetime expected credit losses throughout their life for those trade receivables that do not have a significant financing component in accordance with the Revenue Recognition Exposure Draft;*

(b) *permit an entity to choose an accounting policy to measure the allowance at the lifetime expected credit losses for lease receivables and trade receivables that have a significant financing component in accordance with the Revenue Recognition Exposure Draft;*

113 *The IASB believes that the simplified approach will provide operational relief by eliminating the need to calculate 12-month expected credit losses, and determine when lifetime expected credit losses should be recognised.*

114 *The ED permits an entity to apply the simplified approach to trade receivables without a financing element, while permitting an accounting policy choice for trade receivables with a financing element. However, in respect of lease receivables, the ED provides a less granular approach, by permitting an accounting policy choice to apply the simplified approach either to all or none of the lease receivables (i.e. short-term lease receivables must be treated in the same way as long-term lease receivables).*

115 *The ED also proposes to amend IFRS 9 to measure trade receivables that do not have a significant financing component at the invoice amount on initial recognition once the standard on revenue recognition is published.*

116 *In the upcoming Exposure Draft on leases, lessors will apply two different accounting approaches:*

(a) *If the lessee is expected to consume more than an insignificant portion of the benefits embodied in the underlying asset, the lessor will derecognise a* *portion of the carrying amount of the underlying asset and recognise a receivable (these are referred to as Type-1 leases);*

(b) *If the lessee is not expected to consume more than an insignificant portion of the benefits embodied in the underlying asset, the lessor will recognise income on a straight-line basis over the lease term (these are referred to as Type-2 leases).*

117 *Under the expected lease proposals, it is likely that more arrangements will qualify as Type-1 leases compared to the current finance leases, and therefore lessors will recognise more lease receivables compared to the current IAS 17 requirements.*

EFRAG's response

EFRAG supports the proposed simplified approach for trade receivables and lease receivables. However, we believe that further application guidance is necessary regarding the application of the proposals to lease receivables.

Simplified approach

118 As a matter of principle, EFRAG would be in favour of requiring the same impairment model to all financial assets, as this would ensure comparability and provide more useful information about the effect of changes in credit quality.

119 However, from a pragmatic point of view, we accept that applying the full impairment model to lease receivables and trade receivables would not result in an appropriate trade-off between costs and benefits. In particular, we understand that application of an expected credit loss model and particularly the requirement to track changes in credit quality would be challenging for certain lessors and most corporates as they do not maintain the same level of granular information as banks or other financial institutions. In addition, we agree that the benefits of applying the general model to trade receivables that do not have a significant financing component would not outweigh the cost of implementation given the short-term nature of these receivables. Therefore, EFRAG supports the proposed simplified approach for trade receivables and lease receivables.

120 We acknowledge that the simplified approach would reduce comparability across entities. However, in our view, also allowing entities to apply the general model would increase comparability within entities, especially for group entities with different activities that wish to apply the same impairment model within the group.

Proposed amendment to IFRS 9

121 EFRAG agrees with the proposed amendment to IFRS 9 to measure trade receivables that do not have a significant financing component at the transaction price as this would align the requirements of IFRS 9 with those proposed in the revenue recognition project.

Application to lease receivables

122 Under the proposed approach, lessors will recognise separately in their statement of financial position a lease receivable and a residual asset (measured as an allocation of the carrying amount of the underlying asset). EFRAG understands that the IASB intends that the recoverable amount of the underlying asset should be allocated in part to test the lease receivable for impairment, and in part to test the residual.

123 EFRAG agrees that the entity should not test the lease receivable and the residual as a single unit of account. An increase in the fair value of the underlying asset is not a transfer of economic resources from the debtor to the lessor and therefore should not offset the effects of deterioration in the lessee's creditworthiness.

124 In addition, we understand that the IASB will include an illustrative example on how to allocate the recoverable amount of the underlying asset in the Leases Exposure Draft. We recommend that all relevant guidance should be included in a single standard, and therefore suggest that the illustrative example be placed in the final standard on impairment.

125 EFRAG notes however that there are some specific application issues in the context of lease receivables, and we recommend that the IASB provides clarification:

(a) The ED refers to 'cash shortfalls', defined as the difference between the principal and interest due under the contract, and the cash flows that the entity expects to receive. EFRAG notes that lease arrangements may include variable lease payments which, under the upcoming Leases exposure draft, are normally not included in the measurement of the lease receivable. Paragraph B33 of the ED tries to address the issue by requiring that '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'. However, we are not convinced that this drafting is clear enough to result in a consistent application in practice.

(b) The upcoming Leases exposure draft contains specific requirements regarding options to extend (or terminate early) a lease. Consequently, the lease receivable recognised relates to a period that is often significantly shorter than the maximum contractual period and usually different from the expected duration of the lease. EFRAG believes that these issues should be addressed more clearly in the application guidance to the ED.

(c) In a lease, the lessor retains legal ownership of the underlying asset. EFRAG believes that the application guidance should clarify how a lessor should treat the value (and possible changes in its value) of a right-of-use asset that serves as collateral in measuring the loss allowance.

(d) The ED refers to the application of the proposed impairment model to undrawn loan commitments. Under a Type-2 lease, a lessor is contractually bound to provide access to the underlying asset. We recommend that the IASB specifies if the lessor's obligation under a lease could constitute an undrawn loan commitment.

Financial assets that are credit impaired on initial recognition

Question 11

126 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?

Notes for EFRAG's constituents

127 *The ED proposes that when there is objective evidence of impairment on initial recognition of a financial asset, an entity will be required to include the initial*

lifetime expected credit losses in the estimated cash flows when calculating the effective interest rate.

128 *No impairment allowance will be recognised on initial recognition; instead the impairment allowance for these assets will represent changes in the lifetime expected credit losses since initial recognition.*

129 *The ED also proposes that interest revenue for these financial assets should be calculated by applying the adjusted effective interest rate on the amortised cost (i.e. the net carrying amount).*

130 *We note that the proposed scope for assets to which the credit-adjusted effective interest rate would apply is consistent with the existing requirements in paragraph AG5 of IAS 39.*

EFRAG's response

EFRAG agrees with the proposals for financial assets that are credit impaired on initial recognition.

131 EFRAG agrees with the proposal in the ED to carry forward the scope and requirements in paragraph AG5 of IAS 39, which require an entity 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.

Effective date and transition

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?

Notes for EFRAG's constituents

132 *The ED proposes that an entity should apply the requirements retrospectively, except when it is not possible to determine without undue cost and effort whether the credit risk of a financial asset has increased significantly since initial recognition.*

133 *For those financial assets, a loss allowance (or provision) at an amount equal to lifetime expected credit losses should be recognised until the financial asset is derecognised, unless the financial asset has a low credit risk at a reporting date. The relief would not be available for financial assets where delinquency information is used to assess changes in credit risk.*

134 *An entity would not be required to provide restated comparative information, however, it will be permitted to provide such information if it is possible to do so without the use of hindsight.*

135 *In addition, on the date of initial application, an entity would be required to provide disclosures that will allow reconciliation of the ending impairment allowances under IAS 39 to the opening allowances under the ED by measurement category.*

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

EFRAG's response

EFRAG strongly believes that entities should have at least three years to implement IFRS 9 after the completion of all phases of IFRS 9.

However, as stated in the cover note, EFRAG is undertaking a field-test in order to better substantiate its final assessment on the proposals.

137 EFRAG believes that rather than setting a fixed effective date, it would be more appropriate to allow entities at least three years to implement IFRS 9 after the completion of all phases of IFRS 9. Furthermore, in our view, the IASB should strive to ensure that IFRS 9 and the standard on insurance contracts become effective at the same time. The IASB should reconsider the transitional requirements of IFRS 9 to ensure that the restated comparative information is meaningful. If the IASB were to conclude that it is not possible to revise the transitional requirements such that the comparative information is meaningful, we would recommend that relief from restating comparative information be granted.

138 While EFRAG agrees that it might not be possible to apply the requirements of the ED without the use of hindsight, we believe that the IASB should consider that not requiring restatement of comparative information would force users to make certain adjustments for which they have far less information than preparers.

139 Finally, we suggest that the IASB provides, as soon as feasible, a realistic timetable for implementation of the standard in order to allow constituents to anticipate and manage the proposed changes in a cost-effective manner.

Effects analysis

Question 13

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

Notes for EFRAG's constituents

140 *Paragraphs BC164-BC216 in the Basis of Conclusions, include the IASB's assessment of whether the proposed model would result in a timely recognition of expected credit losses and reflect the economic reality in a better way. The assessment also includes the comparability and usefulness of the information that would result from the ED and the likely effect on the costs for prepares and users of financial statements.*

EFRAG's response

We agree that the proposed model should result in an earlier recognition of expected credit losses. In addition, we also agree with the conclusion in paragraph BC164 of the ED.

141 EFRAG appreciates the step forward that the IASB has taken integrating the effect analysis into the standard setting process. In our view, paragraphs BC164-BC216 include useful information that will enable users, preparers and other interested parties to understand and evaluate the potential effect of the requirements.

142 EFRAG observes that the proposed model will remove the existing incurred loss threshold in IAS 39 and would require expected credit losses and changes in those expectations to be always recognised. Therefore, we agree that the proposed model should result in an earlier recognition of expected credit losses.

143 We note that users have indicated that the distinction, between financial instruments that have deteriorated significantly and those that have not, provides useful information about expected credit losses and changes in expectations, and the way entities manage their lending portfolios. Therefore, we agree with the conclusion in paragraph BC164 of the ED.