

# Applying IFRS

ITG discusses IFRS 9  
impairment issues at  
December 2015 ITG  
meeting

December 2015



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## What you need to know

The December ITG meeting provided useful clarification on a number of important IFRS 9 implementation issues. Some of the most significant items where there appeared to be agreement include the following:

The ITG members appeared to agree that the IFRS 9 requirement for unbiased and probability-weighted estimates extends to the use of multiple economic scenarios rather than just a single consensus estimate. Doing so will pose a considerable challenge for even the most sophisticated banks and will need to be urgently assessed to determine its potential impact on systems and processes and the possible financial impact (see Paper 1).

Useful clarification was provided as to the period over which an entity measures expected credit losses ('ECLs') on revolving facilities such as credit cards and overdrafts. When determining the period, an entity should consider the credit risk management actions that management expects to carry out and that serve to mitigate losses. Credit risk management actions were confirmed to be those that actually reduce outstanding undrawn limits. Revolving facilities should be segmented appropriately to reflect the various possible outcomes for those that are not expected to default. Possible future reinstatement of withdrawn limits should not be considered in this assessment (see Paper 4).

Credit enhancements such as guarantees do not have to be explicitly 'part of the contractual terms' to be considered 'integral' to those terms, and thus should be included in the ECL calculation, consistent with practice under IAS 39 (see Paper 5).

## Introduction

On 11 December 2015, the Transition Resource Group for Impairment of Financial Instruments (ITG) held its fourth and, potentially, final meeting to discuss ten implementation issues on the new ECL impairment requirements of IFRS 9 *Financial Instruments*.<sup>1</sup>

The issues discussed to date are listed in the appendix to this publication. For more details on the previous substantive meetings, please refer to the following documents at [ey.com/ifrs](http://ey.com/ifrs):

- ▶ 22 April 2015 meeting: [IFRS Developments Issue 105: The ITG discusses IFRS 9 impairment implementation issues](#)
- ▶ 16 September 2015 meeting: [IFRS Developments Issue 112: ITG discusses IFRS 9 impairment implementation issues](#)

The International Accounting Standards Board (the IASB or the Board) set up the ITG to provide a discussion forum for stakeholders on implementation issues arising from the new impairment requirements that could create diversity in practice, as well as to assist the IASB to determine what action, if any, is needed to address any issues. However, as the ITG is non-authoritative and does not vote on the issues discussed, consensus is not required, and the ITG will not issue any guidance.

No future ITG meetings are scheduled. However, the ITG will continue to exist on standby emerge.

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

The IASB plans to provide a summary of the implementation issues discussed during this ITG meeting. No further future meetings are currently scheduled for the ITG, however, the IASB announced its intention to not discharge the ITG and to keep the submission portal on its website open for constituents to submit their issues to the Board should the need arise. Information about future meetings will be posted on the IASB's website.

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<sup>1</sup> See our recent publications, *Applying IFRS - Impairment of financial instruments under IFRS 9*, *IFRS Developments Issue 100: Basel Committee proposes guidance on accounting for expected credit losses* and *IFRS Developments Issue 87: IASB issues IFRS 9 Financial Instruments - expected credit losses*.

# Paper 1 - Incorporation of forward-looking information

When incorporating forward-looking economic scenarios, an entity should consider a range and the probabilities of different outcomes.

The ITG members discussed two questions concerning the incorporation of forward-looking scenarios. In particular:

1. How to incorporate forward-looking scenarios in the measurement of ECLs. Four different approaches were presented (see Illustration 1).
2. How to incorporate forward-looking scenarios in the assessment of whether there has been a significant increase in credit risk.

## Measurement of expected credit losses

ITG members acknowledged that the objective of IFRS 9 is to reflect an unbiased and probability-weighted measure of expected credit losses from a range of possible outcomes.<sup>2</sup> 'Unbiased' is generally understood to mean a neutral, balanced estimate that is neither overly prudent nor overly optimistic.

The IASB members who attended the meeting expressed concern regarding the first two approaches (Illustration 1) that they do not reflect the varying credit losses associated with the different scenarios. In particular, there is a concern that the level of ECLs is 'non-linear' that is, the additional expected losses associated with a more severe economic scenario with a given probability will tend to be greater than the reduction in losses associated with a more benign scenario with a similar probability. The IASB members confirmed that there is no single prescribed or best approach set out in IFRS 9, but expressed the view that the non-linearity of ECLs needs to be addressed in any implemented approach.

### Illustration 1 – Approaches to calculation of expected credit losses incorporating forward looking information (Question 1)

1. Using a single forward looking economic scenario that represents the most likely scenario from all the scenarios considered, to derive the expected credit loss;
2. Using a single forward looking economic scenario that represents the weighted average of all the scenarios considered, weighted by the likelihood of occurrence of each scenario, and using that weighted scenario to derive the expected credit loss;
3. Taking the weighted average of the credit loss determined for each of the scenarios, weighted by the likelihood of occurrence of each scenario; and
4. Using the most likely scenario to derive an expected credit loss (Approach 1) and then applying an overlay adjustment to that expected credit loss to reflect the less likely scenarios.

<sup>2</sup> IFRS 9.5.5.17.

ITG members agreed that the integration of different scenarios will inevitably require judgement, especially when it comes to assigning probabilities to the scenarios. They also agreed that the information used for this exercise must be reasonable and supportable, and available without undue cost or effort.<sup>3</sup>

Some ITG members stressed that any scenario will involve a number of factors and will need to be adapted for each portfolio, depending on their sensitivities. Also, because of the subjectivity of determining the probabilities of different scenarios and the availability of reliable supporting information, some members considered that method four above might be more transparent, as the complexity and subjectivity required to reflect non-linearity would be embedded in a distinct overlay estimate. Basing the calculation on a single scenario may also allow consistency with other processes within the bank and so would enhance governance and control. It may also allow banks to provide a clearer explanation of the dynamics of the impairment allowance from one period to another.

ITG members acknowledged that IFRS 9 requires that the scenarios should represent an entity's own expectations and view.<sup>4</sup> However, they appeared to agree that in order to achieve an unbiased measure of ECLs, an entity should consider external sources of information, even though it may ultimately decide not to incorporate all external sources of information into its calculation of ECLs. Reasons for rejecting sources of information, particularly those that provide contradictory evidence to that which the entity ultimately uses should be adequately documented. Significant judgements in this area, including sources of information considered, should also be disclosed.

ITG members also appeared to agree on the need to consider internal consistency with other forward-looking information used for other purposes, albeit keeping in mind the objectives and conceptual measurement requirements of IFRS 9. Some also noted that less sophisticated entities and less material portfolios would require proportionate approaches.

Finally, some ITG members pointed out that models are often built for specific data ranges and might not work effectively for inputs that are outside those ranges, but there was little discussion on how to calculate non-linearity in such cases. The situation where a macro-economic factor, like unemployment or interest rates, is forecast to move to levels that have not been seen in recent historical experience will also pose significant challenges and give rise to measurement uncertainty.

## **Assessment of significant increases in credit risk**

Concerning the second question, ITG members appeared to agree that the standard contains no specific approach and that the information used for the assessment can be a mix of qualitative and quantitative inputs, provided it meets the objective of the standard.

ITG members considered the operational challenges of incorporating forward-looking information into the assessment of significant increases in credit risk. They appeared to agree that the more lagging the factors used to assess significant deterioration, the greater the need for a forward-looking adjustment.

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<sup>3</sup> IFRS 9.B5.5.15.

<sup>4</sup> IFRS 9.B5.5.50 and IFRS 9.B5.5.54.

ITG members appeared to agree that the economic scenarios and the approaches considered for the incorporation of forward-looking information in the assessment of significant increases in credit risk need not be restricted by an entity's approach to the measurement of the ECLs, as discussed for the first question, and therefore, there should not necessarily be a direct mapping.

## How we see it

- ▶ The development of probability-weighted macro-economic scenarios has not, until now, been part of most banks' implementation plans for IFRS 9. In our experience, most banks were contemplating using a single consensus estimate for most macro-economic variables. The use of consensus estimates is already part of many other budgeting and forecasting exercises currently in operation. The use of probability-weighted scenarios will require significant urgent attention by most banks.
- ▶ The key challenge is whether banks can assess multiple scenarios and assign probabilities to the outcomes based on supportable and reliable information.
- ▶ Given potential information limitations, an overlay approach as set out in method four above may prove more practical than method three. It may also be easier to communicate and, hence, more transparent to users of financial information. If banks choose to apply an overlay approach, as in method four, then there will be considerable additional effort to determine when an overlay will be required and how it will be calculated and approved.
- ▶ An entity's economic forecasting scenarios will need to be well informed and adequately justified by supporting evidence. This will inevitably require banks to consider external sources of information. The whole process will need to be adequately documented in order to demonstrate that it is unbiased.
- ▶ To achieve consistency and push for the more robust implementation of IFRS 9, some regulators might feel the need to issue guidance on this topic, such as on the required sources of information, the outlook period for these scenarios, or the number of scenarios that are required to be incorporated into the expected loss calculation.
- ▶ Discussion will continue about whether probability-weighted approaches are required for determining whether significant increases in credit risk have occurred. However, the ITG members appear to have clarified that there does not need to be a direct mapping between the methods used to measure expected credit losses and the stage 2 transfer criteria. This will simplify implementation.

## Paper 2 - Scope of paragraph 5.5.20 of IFRS 9

The features set out in paragraph B5.5.39 for revolving facilities were intended as supplemental guidance to the principle for what is included in the exception, rather than as required characteristics.

The ITG members discussed a submission relating to the scope of paragraph 5.5.20 of IFRS 9, which sets out a narrow exception as to the maximum period to consider when measuring ECLs<sup>5</sup> for specific types of financial instruments. The product described in the submission was a multi-product facility. It involved an undrawn commitment to lend on potentially a number of bases, at the option of the borrower, such as a loan that is repayable on demand or an amortising term loan. The submitter asked whether such a multi-purpose facility, documented in a single contract and with any drawdown secured by the same piece of collateral, would be in the scope of paragraph 5.5.20, either partly or in its entirety, when determining its expected life under IFRS 9.

The IASB members pointed out that the scope of paragraph 5.5.20 of IFRS 9 was intended to be limited in nature. It was designed specifically to deal with credit cards and unsecured lines of credit. For these products, risk management does not differentiate between drawn and undrawn amounts and is reliant on information such as delinquency, resulting in a lack of early risk mitigation. Furthermore, the IASB members stressed that the characteristics listed in the application guidance for paragraph 5.5.20 of IFRS 9, B5.5.39, were intended as supplemental guidance to reinforce those concepts and not as required characteristics. ITG members appeared to agree on both of these points.

### Illustration 2 - Characteristics of revolving facilities set out in paragraph B5.5.39

The general characteristics of revolving facilities within the scope of paragraph 5.5.20 are:

1. They do not have affixed term or repayment structure and usually have a short contractual cancellation period (for example, one day).
2. The contractual ability to cancel the facility is not enforced in normal day-to-day management and it may only be cancelled when the entity becomes aware of an increase in credit risk.
3. They are managed on a collective basis.

There was also discussion about the unit of account, as the different draw down options of multi-purpose revolving facilities may have very different natures. While these different potential products may be documented in a single contract, they are usually managed separately. There was general agreement that although all components fall under the same contract, this does not necessarily imply they constitute a single unit of account.

ITG members appeared to reach a consensus that one of the criteria that must be met for a facility to be within the scope of paragraph 5.5.20 of IFRS 9 is that the entity must have the contractual ability to demand repayment of the loan component and cancel the undrawn component. ITG members appeared to agree that if a facility can only convert into one or more fixed-term loans when drawn, then it is outside the scope of paragraph 5.5.20 of IFRS 9 and an entity should consider the contractual terms when measuring ECLs. It also appeared to be agreed that if the facility converts into a short-term revolving loan, such as a credit card or a line of credit, then it is within the scope of paragraph 5.5.20. ITG

<sup>5</sup> The maximum period to consider when measuring expected credit losses is set out in IFRS 9.5.5.19.



members noted that interpreting 'short-term' in this context might involve judgement, taking into account whether drawn and undrawn amounts are managed on a combined basis.

There appeared to be consensus that it is possible to treat a multi-purpose facility that includes the possibility of drawdown as a term loan within the scope of the revolving facilities exception.

There were mixed views on the application of paragraph 5.5.20 to the specific facts and circumstances of the submission. Towards the conclusion of the discussion, there appeared to be agreement that a multi-purpose facility with an option to draw down as either a fixed term loan or a revolving facility, while undrawn, would be in the scope of paragraph 5.5.20. However, once it is partially drawn down as a fixed-term loan, this component would be outside the scope of the paragraph going forward, although the remaining portion of the original revolving facility would remain within its scope. In effect, once the borrower elects to draw down a fixed-term loan, this becomes a separate unit of account, as it would not be managed on a combined basis together with undrawn and demandable drawn amounts.

### How we see it

- ▶ The discussion clarified that all components that fall under the same contract do **not** necessarily constitute a single unit of account. Entities should exercise judgement in determining the unit of account and carefully consider the contractual terms and conditions of these kinds of agreements, as well as how the different components of the facility are managed.
- ▶ If one or more of the characteristics described in B5.5.39 is not present, the entity will need to consider carefully whether an instrument could still meet the conditions set out in paragraph 5.5.20.

## Paper 3 - Measurement of ECLs for charge cards

The question raised by the submitter concerned specific credit facilities issued by banks or financial institutions that do not have a defined or documented credit limit, such as certain charge cards. The bank approves customer transactions at the time of sale, based on the customer's perceived spending capacity using statistical models, and can cancel the card account at its discretion. However, all balances for charges previously approved are not due until the end of the month, even if the card is cancelled during the month.

If there is no contractual amount specified and approval is given at point of sale, then the commitment is nil and the product is not in the scope of the revolving facilities exception.

The IASB board members emphasised that the paragraph 5.5.20 exception that requires entities to look beyond contractual terms for certain types of revolving facilities,<sup>6</sup> does not address the contractual credit limit.

The IASB staff analysis suggested that unless the limit is explicitly stated as zero, there is an expectation that there is an implied limit and that an entity should assess what this limit is, based on all relevant facts and circumstances, including how the charge cards are managed in practice. However, ITG members expressed their concern with the concept of 'implied limits', in particular, if it means applying or using internal limits, as they are not representative of a contractual commitment. How these products are managed in practice should not trump the absence of a legal obligation.

<sup>6</sup> Set out in paragraph 5.5.20 of IFRS 9.

Many ITG members therefore expressed their view that the charge card did not belong within the scope of paragraph 5.5.20 of IFRS 9. It merely represented a facility for a one-month term loan and no future loan commitment existed beyond that one-month period.

Members of the IASB clarified that the use of the term 'implied limit' was meant to be consistent with the contractual terms, insofar as it should reflect a general understanding of the customers that would be enforceable in law, even if not explicitly stated in the contractual terms.

Some ITG members also stressed that the one-month term of drawn amounts remains unchanged if the charge card is cancelled. Consistent with the previous discussion (paper 2), the Board members highlighted that an entity would be required to focus on whether drawn and undrawn amounts are managed on a combined basis in order to assess whether the product is in the scope of the exception.

### How we see it

- Application of the standard to charge cards requires an analysis of the specific facts and circumstances, with a particular focus on the bank's contractual commitment and its rights to demand immediate repayment and whether a loan commitment exists beyond the next payment due date.
- The implications of this paper reach further than just charge cards, but may also cover credit cards and overdraft facilities if the credit limit is not contractually specified.

## Paper 4 - Period over which to measure the ECLs for revolving credit facilities

ITG members discussed the application of the impairment requirements of IFRS 9 to a portfolio of revolving credit card exposures. Specifically, the discussions focused on the determination of the appropriate period to consider when measuring ECLs and the impact of expected credit risk mitigating actions on this period.

The ITG members appeared to agree that the starting point of the period when measuring ECLs for all financial instruments should look forward from the reporting date.<sup>7</sup>

ITG members also appeared to reach consensus that 'credit risk mitigating actions' contemplated in paragraph B5.5.40(c) of IFRS 9 should be limited to actions that reduce an entity's exposure to credit risk, such as reducing the credit limit or withdrawing the commitment, whichever ever happens first.<sup>8</sup> Other actions such as enhanced or more frequent internal monitoring, or reminder collection phone calls would not qualify as mitigating actions for the purposes of B5.5.40(c).

Only credit risk-mitigating actions that reduce the outstanding credit limit are relevant in determining the period over which an entity is exposed of credit risk when applying paragraph 5.5.20 of IFRS 9. Future reinstatements of previously withdrawn limits should be ignored.

<sup>7</sup> In accordance with the requirements to calculate either 12-month or lifetime expected losses at each reporting date set out in paragraphs 5.5.3 and 5.5.5 of IFRS 9. IFRS 9.5.5.20 extends the maximum period to consider when measuring the ECL for certain revolving credit facilities. However, it does not modify the starting point.

<sup>8</sup> IFRS 9.B5.5.40(c).

It was also generally agreed that it is necessary to recognise, in assessing 'the period' for Stage 2 loans, that some may subsequently revert to Stage 1. However, the possible future reinstatement of previously withdrawn credit limits should not be considered.

In summary, to determine the period of credit risk exposure for revolving credit facilities, ITG members appeared to agree that:

- ▶ For financial assets that are in Stage 1, the maximum period to consider would be 12 months. It is unlikely that it would be a shorter, although it is theoretically possible.
- ▶ For financial assets in Stage 2:
  - ▶ For the proportion where the facility has neither been withdrawn nor is expected to be withdrawn (including those facilities that are expected to stay in Stage 2 or revert to Stage 1), the maximum period to consider would be their remaining behavioural life (that is the expected period until the borrower ceases to use the card or the lender withdraws the facility).
  - ▶ For the proportion that is expected to move to Stage 3 - the period until the facility is expected to be withdrawn plus the recovery period for any amounts expected to have been drawn down at that date.

The period to measure ECLs may be limited to the next date that the entity will carry out a review as thorough as on origination, if this is likely to lead to the withdrawal of some facilities.

ITG members also appeared to agree that the period could be limited to the next date that the entity expects to carry out a review process that is at least as thorough as that which took place on origination. However, this would only be appropriate if the entity is likely to withdraw some facilities as a result of the review and has actually done so in the past.

There was also further input from ITG members that the determination of measurement periods will require appropriate segmentation of the portfolio and, in some cases, an entity may determine different measurement periods in respect of different segments in different stages.

Finally, ITG members emphasised the significance of disclosure<sup>9</sup> of areas of judgement (inputs, assumptions, portfolio segmentations and estimation techniques), that will assist the users of financial statements in understanding how management have formed their assessment.

### How we see it

- ▶ The IASB staff papers and the ITG discussion appear to have given a conclusive answer as to the required approach to determine the period over which to estimate the ECL for revolving credit facilities. Entities now have a basis on which to implement these provisions of the standard.
- ▶ Until now, banks may not have intended to measure the ECL over the expected lifetime for the stage 2 facilities that are not expected to default. This clarification may result in a period for measurement of the ECL for such facilities that is potentially a number of years.

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<sup>9</sup> In accordance with IFRS 7

## Paper 5 - Collateral and other credit enhancements and the measurement of the ECL

Most ITG members agreed that the concept of 'integral to the contractual terms' in the definition of credit loss is a broader than 'part of the contractual terms'. This allows more collateral to be included in the ECL calculation.

The ITG members discussed the inclusion of cash flows from collateral and other credit enhancements in the measurement of the ECL. Specifically, the ITG discussed what is meant by credit enhancements that are 'integral to the contractual terms' in the definition of credit loss in Appendix A of IFRS 9.<sup>10</sup>

Most ITG members agreed that the concept of 'integral to the contractual terms' is a broader and more inclusive concept than 'part of the contractual terms' introduced in paragraph B5.5.55 of IFRS 9.

The IASB members at the meeting favoured the broader interpretation contained in the definition of credit loss<sup>11</sup> rather than in paragraph B5.5.55 of IFRS 9, as it was felt that the inclusion in the expected cash shortfalls of these 'integral' credit enhancements rather than just those that are 'part of the contractual terms' would better model the ultimate economic losses of an entity.

Whilst there was no consensus on how to evaluate whether an enhancement is integral to the contractual terms, ITG members agreed that it would require an assessment on a case-by-case basis, evaluating specific facts and circumstances. One ITG member suggested that the discussion would imply that the only enhancements likely to be excluded would be those that are recognised separately.<sup>12</sup> For instance, cash flows from a credit default swap that is accounted for as a derivative would not be included in the measurement of ECLs of the underlying financial asset.

It was noted that the assessment of 'integral' requires judgement. One ITG member noted that this should consider relevant factors, including :

**Inseparability:** if the exposure were to be transferred, does the enhancement go with it?

**Market convention:** whether the exposure and the credit enhancement are traded as a package in the market.

**Separate payment to a third party:** separate streams of payments may suggest separate accounting.

**Timing:** does the enhancement exist at the beginning of the arrangement or is it added later? Does it matter with respect to an assessment of whether it is integral or not?

The IASB members highlighted that similar assessments of (i) 'integral' features and (ii) separate recognition for credit enhancements are required under IAS 39 *Financial Instruments: Recognition and Measurement* and that there was no intention to alter the treatment when drafting IFRS 9 (although some guidance from IAS 39<sup>13</sup> was not specifically copied into IFRS 9). They also emphasised that paragraph B5.5.55 was drafted only with the intention to caution against double counting those credit enhancements that are already recognised separately, and was not intended to limit the inclusion of credit enhancements that were previously included in IAS 39 allowances for loan losses.

<sup>10</sup> IFRS 9 Appendix A definition of credit loss.

<sup>11</sup> Appendix A IFRS 9.

<sup>12</sup> IFRS 9.B5.5.55

<sup>13</sup> E.4.1 "Objective evidence of impairment" and E.4.8 "Recognition of collateral" of IAS 39.

## How we see it

The ITG appears to have confirmed that the scope of credit enhancements that can be included in the measurement of expected credit losses is broad and largely unchanged from IAS 39.

Some examples of credit enhancements that should probably be included would be:

- ▶ Guarantees of debt instruments in a subsidiary company given by a related party, including its parent or a sister company
- ▶ Government guarantees of retail mortgages required by laws and regulations

## Paper 6 - Inclusion of cash flows expected from the sale on default of a loan in the measurement of ECLs

An entity may include cash flows expected from the sale of a defaulted loan in measuring losses given default, if it has the intention and ability to sell.

ITG members discussed the inclusion of cash flows from the sale on default of a loan in the measurement of ECLs.

ITG members appeared to agree that whilst the consideration of sale proceeds is relevant to the measurement of ECLs in all three stages of the IFRS 9 impairment model, it is only relevant to the loss given default (LGD) element of the ECL model.

In addition, there appeared to be consensus that the inclusion of cash flows from sale on default would only be appropriate when an entity can demonstrate the ability and intention to sell, as follows:

- ▶ ITG members agreed that ability would include a legal right, albeit there is no expectation that this right has to be explicitly stated in the contractual terms
- ▶ Intention may be supported by past practice, although this is not strictly necessary

ITG members agreed that reasonable and supportable sources of information must be used to determine the proceeds from sales, and acknowledged that the secondary market may be used as a reasonable proxy for substantiating the likely sale proceeds.

Finally, ITG members appeared to agree that costs to sell should also be considered. These should be netted against sale proceeds to obtain the expected cash flows to include in the LGD for recovery scenarios.

## Paper 7 - Meaning of 'current effective interest rate (EIR)'

The issue discussed by the ITG concerned the appropriate discount rate to apply when measuring ECLs for a floating-rate financial asset.

IFRS 9 mandates that the time value of money be taken into account when measuring ECLs, and for floating-rate financial instruments it requires using the 'current effective interest rate'.<sup>14</sup>

ITG members first noted that the definition of EIR in IFRS 9 remained unchanged from that contained in IAS 39 and thus did not require the attention of the group.<sup>15</sup>

ITG members agreed that there should be consistency between the interest rate used to project future cash flows and the interest rate used to discount ECLs. It was clarified that the term 'current'<sup>16</sup> does not necessarily mean the spot rate at the reporting date but, instead, 'current' should be intended as the EIR that will apply over the period when the respective shortfalls arise.

## Paper 8 - Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months

The ITG discussed the requirement for the assessment of a significant increase in credit risk in respect of financial assets originated with a maturity of less than 12 months. The submitter challenged the application where the maturity of financial assets is less than 12 months on the basis that the 12-month ECLs would always equal the lifetime ECLs.<sup>16</sup>

ITG members emphasised that the assessment of significant deterioration and the measurement of ECLs are distinct concepts. They agreed that the standard is clear that even for short-term maturity financial assets, the assessment for significant increases in credit risk is required, without exception.

It was observed that there are scenarios where the life of a financial asset might increase as a result of a significant increase in credit risk.

It was also acknowledged, and further reinforced by the BASEL Committee observer, that the regular assessment of credit quality is expected as part of good credit risk management practice.

Furthermore, ITG members highlighted the need to conduct an assessment for significant increases in credit risk to satisfy the IFRS 7 disclosure requirements.<sup>17</sup>

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<sup>14</sup> IFRS 9.B5.5.44.

<sup>15</sup> The definition of EIR is contained in Appendix A to IFRS 9.

<sup>16</sup> Under IFRS 9, the loss allowance for a financial instrument that has seen a significant increase in credit risk should be of an amount equal to the lifetime ECL. IFRS 9.5.5.3.

<sup>17</sup> IFRS 7.35H and IFRS 7.35M require the presentation of financial instruments distinguishing between those that have suffered a significant increase in credit risk and those that have not.

## Paper 9 - Measurement of the loss allowance for credit-impaired financial assets

The ITG members discussed the measurement of the gross carrying amount and the loss allowance for credit-impaired financial instruments carried at amortised cost (excluding those that are purchased or originated credit-impaired).

Interest revenue for credit-impaired financial assets is required to be reported in profit or loss based on the original effective interest rate multiplied by the net amortised cost (i.e., the gross carrying amount less the loss allowance). The submitter asked how the disclosed figures for the gross carrying amount and loss allowance should each be calculated.

The submitter provided the example of a credit-impaired asset with an amortised cost of 100 and an EIR of 10% per annum. On December 31, 20X1, an impairment allowance was recognised of CU 60. During 20X2, no cash is received, and on December 31, 20X2 there is no change in the expected cash flows. Accordingly, the amortised cost becomes 44 (being  $40 + (40 \times 10\%)$ ).

Method	A	B	C
Gross carrying amount	110	104	100
Loss allowance	(66)	(60)	(56)
Amortised cost	44	44	44

For assets in stage 3, it is necessary to 'gross up' accrued interest income, to increase both the disclosed gross carrying amount and loss allowance in the notes to the financial statements.

It was acknowledged by the ITG members that IAS 39 provides no specific guidance on this matter and that there is diversity in current practice.

The ITG members appeared to agree that only Approach A among those presented by the submitter is IFRS 9-compliant.<sup>18</sup> This is because IFRS 9, unlike IAS 39, defines the gross carrying amount. Approach A requires the entity to calculate:

- (a) The gross carrying amount by discounting the estimated contractual cash flows using the original effective interest rate<sup>19</sup>
- And
- (b) The loss allowance by discounting the expected cash shortfalls using the original effective interest rate

<sup>18</sup> Based on the definition ECLs set out in Appendix A of IFRS 9.

<sup>19</sup> The effective interest method applies the effective interest rate to the estimated contractual cash flow before considering ECLs.

## Paper 10 - Presentation of the loss allowance for financial assets measured at amortised cost

The ITG members discussed whether there is a requirement to present the loss allowance separately in the statement of financial position for financial assets measured at amortised cost.

It was confirmed that there have not been any consequential amendments to IAS 1 in regards to the presentation of loss allowances in the statement of financial position following the introduction of IFRS 9; as such, there remains no specific requirement.<sup>20</sup>

It was generally agreed that there is no expectation that entities should present the loss allowance on the face of the statement of financial position, although one ITG member suggested that they would have no objection should an entity wish to present the loss allowance separately.

ITG members emphasised that the submission was focused only on presentation issues in the statement of financial position and that separate disclosure of the loss allowance in the notes to the financial statements continues to be a disclosure requirement of IFRS 7.

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<sup>20</sup> IAS 1.54.



## Appendix: Issues Discussed by the ITG to Date

### ITG meeting - 22 April 2015

Agenda reference	Issues discussed
1	The maximum period to consider when measuring ECLs
2	Forecasts of future economic conditions
3	Loan commitments - scope
4	Revolving credit facilities <ul style="list-style-type: none"><li>▶ Determining the appropriate period to consider when estimating ECLs</li><li>▶ Determining the date of initial recognition for the purposes of assessing significant increase in credit risk</li></ul>
5	Assessment of significant increases in credit risk for guaranteed debt instruments
6	Measurement of ECLs for an issued financial guarantee contract
7	Measurement of ECLs in respect of a modified financial asset

### ITG meeting - 16 September 2015

Agenda reference	Issues discussed
1	Significant increases in credit risk <ul style="list-style-type: none"><li>▶ Assessing increases in credit risk for portfolios of loans with broad credit quality bands and use of behavioural life indicators</li></ul>
2	Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increase in credit risk
3	Measurement of ECLs for revolving credit facilities
4	Forward looking information <ul style="list-style-type: none"><li>▶ Determining the appropriate period to consider when estimating ECLs</li><li>▶ Determining the date of initial recognition for the purposes of assessing significant increase in credit risk</li></ul>

### ITG meeting - 11 December 2015

Agenda reference	Issues discussed
1	Incorporation of forward looking information
2	Scope of paragraph 5.5.20
3	Measurement of ECLs for charge cards
4	Period over which to measure ECLs for revolving credit facilities
5	Collateral and other credit enhancements and the measurement of expected credit losses
6	Inclusion of cash flows from the sale on default of a loan in the measurement of expected credit losses
7	Meaning of current effective interest rate
8	Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months
9	Measurement of the loss allowance for credit-impaired financial assets
10	Presentation of the loss allowance for financial assets measured at amortised cost

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