Tel: +44 20 7893 3300
Fax: +44 20 7487 3686
@: abuchanan@bdoifra.com
www.bdointernational.com

BDO IFR Advisory Limited
Contact: Andrew Buchanan
55 Baker Street
London W1U 7EU
United Kingdom

International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

27 September 2023

Dear Sir

Post-implementation Review Request for Information - IFRS 9 *Financial Instruments* - Impairment

We are pleased to comment on the above Request for Information (the RFI). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the RFI.

Our responses to the questions in the RFI are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)7875 311782 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

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Appendix

Impairment

Question 1: Do the impairment requirements in IFRS 9 result in:

(a) more timely recognition of credit losses compared to IAS 39 and address the complexity caused by having multiple impairment models for financial instruments? Why or why not?

(b) an entity providing useful information to users of financial statements about the effect of credit risk on the amount, timing and uncertainty of future cash flows? Why or why not?

In our experience, IFRS 9 overall has resulted in more timely recognition of credit losses than IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39') and has resulted in entities providing more useful information to users and analysts about the effect of credit risk on the amount, timing and uncertainty of future cash flows.

The general approach to recognising expected credit losses

Question 2(a) - Are there fundamental questions (fatal flaws) about the general approach? If yes, what are those fundamental questions?

Question 2(b) - Are the costs of applying the general approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?

We do not believe there are fatal flaws in the fundamental approach to recognising expected credit losses ('ECL').

We have observed some diversity in practice about what are considered to be 'all cash shortfalls' in accordance with the defined terms in Appendix A of IFRS 9.

Appendix A of IFRS 9 defines –

- Expected credit losses as 'the weighted average of credit losses with the respective risks of a default occurring as the weights'.
- Credit loss as 'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)'.

The diversity arises from circumstances in which lender voluntarily forgives contractual cash flows due from the borrower. In some cases, entities have sought to identify which of the forgiven cash flows are linked to the increase in credit risk; in others, all cash shortfalls are

attributed to the change in credit risk and are included in the calculation of the ECL provision.

The IFRS Interpretations Committee Agenda Decision approved in October 2022 *Lessor Forgiveness of Lease Payments (IFRS 9 and IFRS 16)* indicates that it is appropriate to reflect all cash shortfalls in the calculation of the ECL provision. It would be helpful for an amendment to be made to IFRS 9 explicitly to include the clarification in the agenda decision.

<u>Determining significant increases in credit risk</u>

Question 3(a) - Are there fundamental questions (fatal flaws) about the assessment of significant increases in credit risk? If yes, what are those fundamental questions?

Question 3(b) - Can the assessment of significant increases in credit risk be applied consistently? Why or why not?

We do not believe that there are fatal flaws regarding the assessment of significant increases in credit risk (SICR).

Although there is a degree of flexibility for entities in their application of the ECL model, we consider that the principles-based approach results in the appropriate recognition of significant increases in credit risk and, consequently, an appropriate input to the calculation of ECL provisions. We believe that the rebuttable presumption that the credit risk on a financial instrument has increased significantly, and that lifetime expected credit losses be recognised, when a financial asset is more than 30 days past due, is useful in increasing consistency amongst entities/industries.

<u>Measuring expected credit losses</u>

Question 4(a) - Are there fundamental questions (fatal flaws) about requirements for measuring expected credit losses? If yes, what are those fundamental questions?

Question 4(b) - Can the measurement requirements be applied consistently? Why or why not?

We do not believe there are fatal flaws in the measuring ECL.

Although an element of diversity is unavoidable given the varying level of complexity in entities we believe that the principles in IFRS 9 have overall resulted in consistency in its application. In recent years, we have seen increasing use of 'overlays' (or 'post model adjustments) during periods of economic stress, such as the COVID-19 pandemic. However, we understand that many entities have developed robust methodologies for these adjustments, which are necessary as there is no practical way for certain types of events to be built into a model that is primarily based on historical information.

We have observed some uncertainty with regard to determining the behavioural life of revolving facilities and would welcome additional illustrative examples. We note that this issue was discussed by the ITG, and it may be helpful to incorporate this (and other issues discussed by the ITG) into additional application guidance.

We note the IASB's project on Climate-related Risks in the Financial Statements, and suggest that part of this project could include consideration of how climate-related risks can and should be incorporated into the assessment of ECL.

Simplified approach for trade receivables, contract assets and lease receivables

Question 5(a) - Are there fundamental questions (fatal flaws) about the simplified approach? If yes, what are those fundamental questions?

Question 5(b) - Are the costs of applying the simplified approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?

We do not believe there are fatal flaws in the simplified approach.

We consider that the disclosure requirements added to IFRS 7 regarding the aging of trade receivables and the associated ECL for each band of aging provides useful information.

Purchased or originated credit-impaired financial assets

Question 6 -Can the requirements in IFRS 9 for purchased or originated credit-impaired financial assets be applied consistently? Why or why not?

In general, we have found that the requirements in IFRS 9 for purchased or originated credit-impaired financial assets are applied consistently. An exception arises in respect of the appropriate approach to be followed when there has been a modification to contractual cash flows which gives rise to a derecognition event, in particular whether the newly originated financial asset should be considered to be originated credit impaired. Please see our response to question 7 below.

Application of the impairment requirements in IFRS 9 with other requirements

Question 7: Is it clear how to apply the impairment requirements in IFRS 9 with other requirements in IFRS 9 or with the requirements in other IFRS Accounting Standards? If not, why not?

When lending arrangements are modified or renegotiated, there are significant implications for the application of the ECL model depending on whether the existing financial asset recorded by the lender is accounted for as having been modified (and is therefore not derecognised), or is derecognised with a new financial asset being recognised. This is because the modified existing financial asset will typically continue to be classified in the same ECL stage as previously (which may be stage 2 or 3, both of which require lifetime ECL to be

recognised with interest income being restricted for stage 3 assets). In contrast, when a new financial asset is recognised, it will normally be included in stage 1 for ECL purposes with 12 month expected credit losses being recognised.

Although IFRS 9 contains requirements for modified financial liabilities, it does not contain specific requirements for whether a modified financial asset continues to be recognised, or is derecognised with a new financial asset being recognised. This lack of specific requirements has given rise to diversity in practice, with a consequential effect on ECL calculations. We encourage the IASB to add requirements to IFRS 9 for this issue, and welcome the inclusion of modifications of financial assets and liabilities in the pipeline project for Amortised Cost Measurement.

Issues also arise for financial assets which have been subject to a significant increase in credit risk and are credit impaired, and are then modified to the extent that the existing financial asset is derecognised and a new financial asset is recognised. Applying the requirements of IFRS 9.B5.5.26, although typically the new financial asset would be included in stage 1 for ECL purposes with 12 month expected credit losses being recognised, in some cases they will be recognised as originated credit impaired (albeit in unusual circumstances). The determination of whether the newly recognised asset is originated credit impaired can be very difficult in practice (for example, a borrower may be in financial difficulty, but the terms of the modified loan make it significantly more affordable). We suggest additional illustrative examples and/or application guidance is developed.

In our response to question 2 we noted the October 2022 Interpretations Committee agenda decision *Lessor Forgiveness of Lease Payments*. The conclusion reached by the Committee differed from how some entities had previously accounted for those transactions. It would be helpful for an amendment to be made to IFRS 9 explicitly to include the clarification in the agenda decision.

Transition

Question 8: Were the costs of applying the transition requirements and auditing and enforcing their application significantly greater than expected? Were the benefits to users significantly lower than expected?

In our experience, the banks and financial institutions were the most affected by impairment provisions of IFRS 9 and therefore, as expected, incurred extensive costs and faced significant implementation challenges upon transition to IFRS 9. However, the ECL model has brought significant improvements to the quality of information included in financial statements.

Outside the financial sector, for some entities with larger portfolios of trade receivables, significant work was required on transition to the ECL model. In some cases, the effect of recognising an ECL provision in accordance with IFRS 9 was ultimately not materially different from the provision recognised in accordance with the incurred loss approach under IAS 39.

However, overall, we believe that the impairment requirements of IFRS 9 represent a significant improvement in comparison with the previous requirements of IAS 39 and that they give rise to more timely recognition of credit losses.

Credit risk disclosures

Question 9(a) - Are there fundamental questions (fatal flaws) about the disclosure requirements in IFRS 7 for credit risk? If yes, what are those fundamental questions?

Question 9(b) - Are the costs of applying these disclosure requirements and auditing and enforcing their application significantly greater than expected? Are the benefits to users significantly lower than expected?

We do not believe there are fatal flaws in the disclosure requirements in IFRS 7 for credit risk.

IFRS 7.35D provides entities with a degree of flexibility when deciding on the level of detail of the disclosures, the emphasis placed on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

However, despite this, in some cases, entities using the simplified approach have found the extent of disclosures to be greater than they would consider necessary. We suggest that illustrative examples are developed to demonstrate how disclosures can be simplified for entities with less complex financial assets, such as trade receivables. For example, the fact that in some cases, information about write-off policies and how the entity manages any collateral may not be material.

We also observe that IFRS 7 does not contain explicit requirements for credit risk sensitivity disclosures, and suggest that consideration is given to how these could be incorporated.

Other matters

Question 10(a) - Are there any further matters that you think the IASB should examine as part of the post-implementation review of the impairment requirements in IFRS 9? If yes, what are those matters and why should they be examined?

Question 10(b) - Do you have any feedback on the understandability and accessibility of the impairment requirements in IFRS 9 that the IASB could consider in developing its future IFRS Accounting Standards?

We have no further comments.