

Get ready for FRS 109

The impairment requirements





FRS 109 'Financial Instruments' fundamentally rewrites the accounting rules for financial instruments. It introduces a new approach for financial asset classification; a more forward-looking expected loss model; and major new requirements on hedge accounting.

With FRS 109 becoming mandatorily effective in Singapore from 1 January 2018, companies now really need to evaluate the impact of the new Standard. As well as compiling the information necessary to implement the Standard, companies will need to review loan covenants and other agreements that could be affected by the impact on reported results.

This is the second in a series of publications designed to get you ready for FRS 109. In this issue, we bring you up to speed with the Standard's new impairment requirements.

Contents

1	Introduction	4
2	Scope of the new impairment requirements	6
3	The general (or three-stage) impairment approach	9
3.1	Overview	10
3.2	Impact of a significant increase in credit risk	12
3.2.1	Identifying a significant increase in credit risk	14
3.2.1.1	Definition of default	14
3.2.1.2	Interaction with the level of credit risk on initial recognition	16
3.2.1.3	Interaction with the length to maturity of an instrument	17
3.2.1.4	Reasonable and supportable information	17
3.2.1.5	Rebuttable presumption for payments more than 30 days past due	17
3.2.1.6	Multi-factor analysis	18
3.2.1.7	Individual or collective assessment	18
3.3	Measuring expected credit losses	20
3.3.1	General principles	20
3.3.2	Probability-weighted amount	21
3.3.3	Time value of money	21
3.3.4	Reasonable and supportable information	22
3.3.5	Measurement of expected credit losses for different types of asset/exposure	23
3.4	Application issues	23
3.4.1	Period to consider when measuring expected credit losses	23
3.4.2	Collateral	24
3.5	Practical expedients	24
3.5.1	'Low credit risk' exception	24
3.5.2	Other practical expedients	25
4	Simplified model for trade receivables, contract assets and lease receivables	26
4.1	Overview	27
4.2	Applying the simplified model	28
5	Purchased or originated credit-impaired financial assets	31
6	Presenting credit losses	34
6.1	Financial assets measured at amortised cost	35
6.2	Financial assets measured at fair value through other comprehensive income	35
7	Disclosures	37
8	Practical insight – next steps	39

1. Introduction

Under FRS 109, recognition of impairment no longer depends on a reporting entity first identifying a credit loss event. This is a major change from the previous Standard, FRS 39.

FRS 109 instead uses more forward-looking information to recognise expected credit losses for all debt-type financial assets that are not measured at fair value through profit or loss.

This section gives a high level overview of the changes and explains why they were necessary.



In July 2014, the IASB issued IFRS 9's impairment requirements. These fundamentally rewrite the accounting rules for impairment of financial assets.

The IASB's aim was to rectify a major perceived weakness in accounting that became evident during the financial crisis of 2007/8, namely that IAS 39 'Financial Instruments: Recognition and Measurement' resulted in 'too little, too late' – too few credit losses being recognised at too late a stage. IAS 39's 'incurred loss' model delayed the recognition of impairment until objective evidence of a credit loss event had been identified. In addition, IAS 39 was criticised for requiring different measures of impairment for similar assets depending on their classification.

IFRS 9's impairment requirements use more forward-looking information to recognise expected credit losses for all debt-type financial assets that are not measured at fair value through profit or loss (and for some other credit exposures – see 'practical insight' box on loan commitments and financial guarantees in section 2). One consequence is that a credit loss arises as soon as a company buys or originates a loan or receivable – a so-called 'day one loss'. Unlike IAS 39, the amount of the recognised loss is the same irrespective of whether the asset is measured at amortised cost or at fair value through other comprehensive income.

Recognition of impairment therefore no longer depends on the company first identifying a credit loss event. Instead an entity always estimates an 'expected loss' considering a broader range of information, including:

- past events, such as experience of historical losses for similar financial instruments
- current conditions
- reasonable and supportable forecasts that affect the expected collectability of the future cash flows of the financial instrument.

In December 2014 The Singapore Accounting Standards Council (ASC) completed its deliberation on the adoption of International Financial Reporting Standard (IFRS) 9 Financial Instruments and issued the new standard as Singapore Financial Reporting Standard (FRS) 109 Financial Instruments which is mandatorily effective for annual periods beginning on or after 1 January 2018.

In the following sections we help you evaluate FRS 109's requirements, and the challenges that it will bring.

Recognition of impairment no longer depends on first identifying a credit loss event. Instead all entities will recognise expected credit losses.

2. Scope of the new impairment requirements

FRS 109's impairment requirements apply to all debt-type assets that are not measured at fair value through profit or loss.

Certain other credit exposures that were outside the scope of FRS 39 are also within the scope of the Standard.

Investments in equity instruments are outside the scope of the impairment requirements as they are measured at fair value.

This section explains the scope of the impairment requirements in more detail and comments on some of the practical implications.



FRS 109 requires an entity to recognise a loss allowance for expected credit losses on:

- debt instruments measured at amortised cost
- debt instruments measured at fair value through other comprehensive income
- lease receivables
- contract assets (as defined in FRS 115 ‘Revenue from Contracts with Customers’)
- loan commitments that are not measured at fair value through profit or loss
- financial guarantee contracts (except those accounted for as insurance contracts).

FRS 109 requires an expected loss allowance to be estimated for each of these types of asset or exposure. However, the Standard specifies three different approaches depending on the type of asset or exposure:

Three approaches

Type of asset/ exposure	Applicable model	Described in
Trade receivables and contract assets without a significant financing component*	Simplified (lifetime expected loss approach)	Section 4
Assets that are credit-impaired at purchase or origination	Change of lifetime expected loss approach	Section 5
Other assets/ exposures	General (or three-stage) approach	Section 3

The Standard specifies three different approaches depending on the type of asset or exposure.

Practical insight – loan commitments and financial guarantees

Loan commitments

Similar to FRS 39, FRS 109 requires some loan commitments to be measured at fair value through profit or loss (those that can be net cash-settled or which oblige the issuer to lend at a below-market rate). Unlike, FRS 39, however, other loan commitments are subject to FRS 109's impairment model. This is an important change compared to FRS 39.

Financial guarantees

Financial guarantee contracts are also within the scope of FRS 109's expected loss requirements for the issuer, unless they have previously been accounted for as insurance contracts under FRS 104 'Insurance Contracts' and the entity elects to continue to account for them as such. This election is irrevocable and cannot be applied to an embedded derivative where the derivative is not itself a contract within the scope of FRS 104.

Implications

For financial institutions that manage off-balance sheet loan commitments and financial guarantee contracts using the same credit risk management approach and information systems as loans and other on-balance sheet items, this might prove to be a simplification. For other institutions that issue these types of instruments, the new requirements could be a significant change, necessitating adjustments to systems and monitoring processes for financial reporting purposes.

Practical insight – equity instruments

Under FRS 109, investments in equity instruments are measured either at fair value through profit or loss or at fair value through other comprehensive income. Impairment of such assets is unnecessary as they are measured at fair value, and they are therefore outside the scope of FRS 109's impairment requirements.

Unlike FRS 39, it is not possible under FRS 109 to measure investments in equity instruments at cost where they do not have a quoted market price and their fair value cannot be reliably measured.

Investments in equity instruments are measured either at fair value through profit or loss or at fair value through other comprehensive income. Impairment of such assets is therefore unnecessary.

3. The general (or three-stage) impairment approach

FRS 109's general approach to recognising impairment is based on a three-stage process which is intended to reflect the deterioration in credit quality of a financial instrument.

- Stage 1 covers instruments that have not deteriorated significantly in credit quality since initial recognition or (where the optional low credit risk simplification is applied) that have low credit risk
- Stage 2 covers financial instruments that have deteriorated significantly in credit quality since initial recognition (unless the low credit risk simplification has been applied and is relevant) but that do not have objective evidence of a credit loss event
- Stage 3 covers financial assets that have objective evidence of impairment at the reporting date.

12-month expected credit losses are recognised in stage 1, while lifetime expected credit losses are recognised in stages 2 and 3.

This section starts with an overview of the general (or three-stage) model discussed on the previous page before looking in detail at how to identify a significant increase in credit risk; the measurement of expected credit losses; application issues that are likely to be encountered; and practical expedients that are available.

3.1 Overview of the general approach

FRS 109 draws a distinction between financial instruments that have not deteriorated significantly in credit quality since initial recognition and those that have.

'12-month expected credit losses' are recognised for the first of these two categories. 'Lifetime expected credit losses' are recognised for the second category. Measurement of the expected credit losses is determined by a probability-weighted estimate of credit losses over the expected life of the financial instrument.

An asset moves from 12-month expected credit losses to lifetime expected credit losses when there has been a significant deterioration in credit quality since initial recognition. Hence the 'boundary' between 12-month and lifetime losses is based on the change in credit risk not the absolute level of risk at the reporting date.

There is also an important operational simplification (one of several in the new Standard) that permits companies to stay in '12-month expected credit losses' if the absolute level of credit risk is 'low'. This applies even if the level of credit risk has increased significantly. See Section 3.5.1.

What are 'credit losses'?

Credit losses are defined as the difference between all the contractual cash flows that are due to an entity and the cash flows that it actually expects to receive ('cash shortfalls'). This difference is discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

What are '12-month expected credit losses'?

- 12-month expected credit losses are a portion of the lifetime expected credit losses
- they are calculated by multiplying the probability of a default occurring on the instrument in the next 12 months by the total (lifetime) expected credit losses that would result from that default
- they are not the expected cash shortfalls over the next 12 months.

What are 'lifetime expected credit losses'?

Lifetime expected credit losses are the expected shortfalls in contractual cash flows, taking into account the potential for default at any point during the life of the financial instrument.

There is also a third stage. This applies to assets for which there is objective evidence of impairment (essentially the same as objective evidence of an incurred loss in FRS 39). In Stage 3 the credit loss allowance is still based on lifetime expected losses but the calculation of interest income is different. In the periods subsequent to initial recognition, interest is calculated based on the amortised cost net of the loss provision, whereas the calculation is based on the gross carrying value in Stages 1 and 2.

Finally, it is possible for an instrument for which lifetime expected credit losses have been recognised to revert to 12-month expected credit losses should the credit risk of the instrument subsequently improve so that the requirement for recognising lifetime expected credit losses is no longer met.

We refer to the model described above as the 'general approach'. As noted in the diagramme in section 2, there are two exceptions to this general approach:

- a simplified approach for trade receivables, contract assets and lease receivables – see Section 4
- an approach for purchased or originated credit-impaired financial assets – see Section 5.

Three approaches

Deterioration in credit quality			
	Stage 1 (performing)	Stage 2 (under-performing)	Stage 3 (non-performing)
Credit quality	Financial instruments that have not deteriorated significantly in credit quality since initial recognition or (where the optional simplification is applied) that have low credit risk at the reporting date	Financial instruments that have deteriorated significantly in credit quality since initial recognition (unless the optional simplification is applied and they have low credit risk at the reporting date) but that do not have objective evidence of a credit loss event	Financial assets that have objective evidence of impairment at the reporting date
Recognition of expected credit losses	12-month expected credit losses are recognised	Lifetime expected credit losses are recognised	Lifetime expected credit losses are recognised
Recognition of interest	Interest revenue is calculated on the gross carrying amount of the asset	Interest revenue is still calculated on the asset's gross carrying amount	Interest revenue is calculated on the net carrying amount (ie reduced for expected credit losses)
Practical expedient	Low credit risk	Credit risk > low	Credit risk > low

3.2 Impact of a significant increase in credit risk

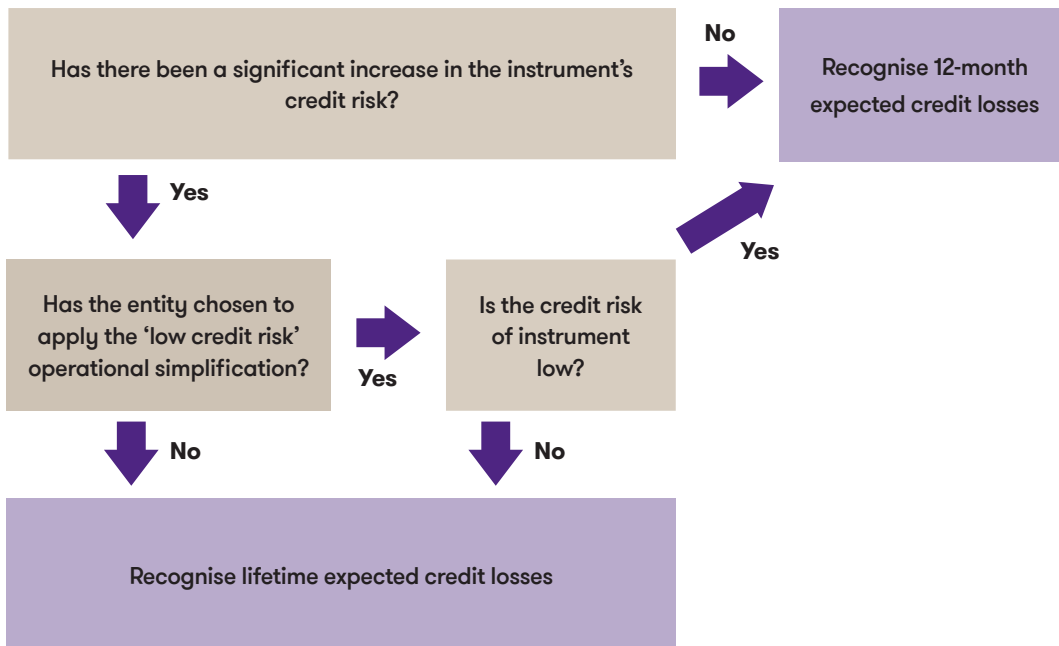
Under FRS 109's general impairment model, the way in which the allowance for expected credit losses is calculated changes as the credit risk of a financial instrument deteriorates significantly.

As noted above, the loss allowance is generally measured at 12-month expected credit losses if, at the reporting date, its credit risk has not increased significantly since initial recognition. This also applies if credit risk has increased significantly but:

- the company has chosen to apply the 'low credit risk' operational simplification (see section 3.5.1); and
- the absolute level of credit risk is low.

Otherwise, if credit risk has increased significantly since initial recognition, the credit loss allowance is measured at lifetime expected credit losses.

Impact of a significant increase in credit risk



It is possible for an instrument for which lifetime expected credit losses have been recognised to revert to 12-month expected credit losses should the credit risk of the instrument subsequently improve.

Example – 12 month versus lifetime expected credit losses

Entity B has a reporting date of 31 December. On 1 July 20X1 Entity B advanced a 3-year interest-bearing loan of S\$2,000,000 to Entity A. Management estimates the following risks of defaults and losses that would result from default at 1 July 20X1 and at 31 December 20X1 and 20X2:

	A Risk of default in next 12 months	B Risk of default in months 13-36	C Loss that would result from default	(A+B)*C Lifetime expected credit losses
At 1 July 20X1	2.5%	5.0%	800,000	60,000
At 31 Dec 20X1	3.0%	10.0%	700,000	91,000
At 31 Dec 20X2	1.0%	2.0%	500,000	15,000

Note that the probability that there will be no default is implicit in the percentages above. Note also that the loss that will transpire should a loss occur in the event of default in the next 12 months does not correspond to the expected cash shortfalls in the next 12 months.

What credit loss provision should Entity B book at:

- (i) 1 July 20X1
- (ii) 31 December 20X1
- (iii) 31 December 20X2

Solution

At 1 July 20X1:

On initial recognition Entity B should recognise a credit loss provision equivalent to 12-month expected losses.

$$\text{12-month expected loss} = (2.5\% * \$800,000) = \$20,000$$

At 31 December 20X1:

Entity B first evaluates whether credit risk has increased significantly since the loan was initially recognised (on 1 July 20X1). If Entity B has chosen to use the practical expedient for low credit risk, it also evaluates whether the absolute level of credit risk is low. The evaluations are as follows:

- credit risk relative to initial recognition? The total risk of default has increased from 7.5% to 13.0% which is clearly significant
- is absolute level of credit risk 'low'? Although 'low' is not quantified, a 13.0% risk of default certainly appears to not be low. FRS 109 refers to an example of low credit risk being an external rating of 'investment grade'. The lowest rating generally considered investment grade is 'BBB' meaning adequate capacity to meet financial commitments.

The credit loss provision should therefore be based on lifetime expected losses.

$$\text{Lifetime expected loss} = (3.0\%+10\%) * \$700,000 = \mathbf{\$91,000}$$

At 31 December 20X2:

Entity B again evaluates whether credit risk has increased significantly since 1 July 20X1. If Entity A has chosen to use the practical expedient for low credit risk, it also evaluates whether the absolute level of credit risk is low. The evaluations are as follows

- credit risk relative to initial recognition? The total risk of default has now decreased to 3.0% and is therefore lower than the risk at initial recognition of 7.5%
- is absolute level of credit risk 'low'? This evaluation is not relevant given there has not been a significant increase in the instrument's credit risk compared to the level at initial recognition.

The credit loss provision should therefore return to being based on 12-month expected losses.

12-month expected loss = $(1.0\% * S\$500,000) = S\$5,000$

Determining whether there has been a significant increase in the credit risk of a financial instrument is therefore key to applying the Standard's impairment requirements. We discuss this below.

3.2.1 Identifying a significant increase in credit risk

Subject to the 'low credit risk' operational simplification, FRS 109 requires that the credit losses estimate switches from 12-month expected credit losses to lifetime expected credit losses when credit risk has increased significantly since initial recognition. If the level of credit risk reduces in a later period, such that the level of credit risk is no longer significantly higher, the credit losses estimate switches back to 12-month expected credit losses. The assessment of whether there has been a significant deterioration in the credit risk of a financial instrument is therefore key.

To make this assessment an entity compares the risk of a default occurring on the financial instrument as at the reporting date with the same risk as at the date of initial recognition, considering reasonable and supportable information that is indicative of significant increases in credit risk since initial recognition.

3.2.1.1 Definition of default

FRS 109 explains that changes in credit risk are assessed based on changes in the risk of a default occurring over the expected life of the financial instrument (the assessment is not based on the amount of expected losses). 'Default' is not itself actually defined in FRS 109 however. Companies must instead reach their own definition and FRS 109 provides guidance on how to do this.

The Standard states that when defining default, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a 'rebuttable presumption' that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

Practical insight – Defining default

Not every entity needs to define ‘default’. For example, an entity whose credit exposures are limited to trade receivables and contract assets (with no significant financing component) would apply the simplified model described in section 4.

However, ‘default’ is a key building block when applying the general (three-stage) model because:

- movement between the three stages is driven by changes in the risk of default
- some entities estimate credit losses as the product of the probabilities of various defaults (PDs) and the losses that would arise if those defaults occur (‘loss given default’ or LGD)

Definitions of default used in practice fall into two very broad categories:

- definitions based on contractual breaches such as failure to make a payment when due or breaches of a covenant
- more judgemental definitions based on qualitative factors.

The most important point is that the definition should be appropriate to the instrument. This is best explained by examples:

Example 1 – instalment loan

Lender A makes a 5 year amortising loan with payments of principal and interest payable in regular monthly instalments. The borrower is also subject to six-month financial covenants.

For this loan a definition of default based on missed payments and covenant breaches could be suitable.

Example 2 – term loan

Lender B makes a 5 year loan with interest payable monthly and principal all due on maturity.

In this case it is unlikely that a definition of default that is based solely on missed payments will be sufficient. This is because the main repayment is not due until maturity and hence a definition based on late payment would not capture the possibility that events take place before maturity that result in the borrower becoming unlikely to repay.

Once determined, the definition shall be applied consistently to all financial instruments unless information becomes available that shows another definition is more appropriate for a particular financial instrument.

Practical insight – interaction with regulatory definitions of default

Some entities such as financial institutions may be the subject of regulation which is designed to gauge their solvency. The regulations affecting such entities will often contain a definition of default. This leads to the question of whether the regulatory definition can be used for FRS 109 purposes.

The simple answer to this question is that regulatory definitions of default can be used in so far as they do not conflict with the principles set out in FRS 109.

Example

An entity might wish to use a local regulator's definition of 'non-performing loans' for determining when it needs to transfer assets into and out of Stage 3 of FRS 109's impairment model. Under the local regulator's rules, a loan cannot be transferred back to the portfolio of performing loans until at least 12 months have elapsed from the point it was categorised as non-performing. Can the regulator's definition of non-performing loans be used as the basis for making transfers into and out of Stage 3 of FRS 109's impairment model?

The regulator's definition of non-performing loans may not be appropriate for FRS 109 purposes. FRS 109 would require the asset to be transferred out of stage 3 if the credit risk on the financial instrument improves so that the financial asset is no longer credit-impaired. There is nothing in FRS 109 to prohibit the transfer out of stage 3 occurring sooner than 12 months after the transfer into stage 3. The regulatory definition of non-performing loans may be a useful starting point in arriving at a definition of default, but will probably need to be amended to comply with FRS 109.

3.2.1.2 Interaction with the level of credit risk on initial recognition

Applying the three-stage model requires calibrating the level of credit risk of financial assets at initial recognition. This becomes the reference point at each future reporting date. If the credit risk has increased, the next key assessment is to determine whether or not the increase is significant.

A given increase in credit risk is more likely to be significant for a financial instrument with a lower credit risk at initial recognition.

Practical insight – effect of business combinations

When financial assets are acquired in a business combination, the reference point for measuring the initial level of credit risk of those assets is reset to the date of the business combination.

Example

Entity C acquired Entity D in a business combination in June 2014. Entity D holds a loan from an associate that was considered low credit risk when first advanced in 2012. In June 2014, the risk of default on this loan was considered to be significant. At the reporting date of December 2014, the risk of default remains the same as at June 2014. Has there been a significant increase in credit risk at the reporting date of December 2014?

No. The date of the business combination is the reference date for the acquirer's financial statements, not the acquiree's date of initial recognition.

3.2.1.3 Interaction with the length to maturity of an instrument

The risk of a default occurring on financial instruments that have comparable credit risk is higher the longer the expected life of the instrument. For example, the risk of a default occurring on an asset with an expected life of 20 years is higher than that on an otherwise identical asset that has an expected life of 10 years.

The change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 20 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring generally decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. This may not be the case however for financial assets that only have significant payment obligations close to the maturity of the asset. For such assets, the risk of a default occurring may not necessarily decrease as time passes.

3.2.1.4 Reasonable and supportable information

An entity should use 'reasonable and supportable information that is available without undue cost or effort' to determine whether credit risk has increased significantly. This should typically include forward-looking information as well as historical data such as past due status.

This reflects the fact that typically, credit risk increases significantly before a financial instrument becomes past due (NB this holds true for other borrower-specific factors such as modifications or restructurings).

However when forward-looking information is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition.

3.2.1.5 Rebuttable presumption for payments more than 30 days past due

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk of a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

The presumption can be rebutted only when the reporting entity has reasonable and supportable information available that demonstrates that 30 days past due does not represent a significant increase in the credit risk of a financial instrument. For example historical evidence might demonstrate that there is no significant correlation between the risk of a default occurring and financial assets becoming more than 30 days past due. Instead, a correlation might be observable only once payments are say more than 45 days past due.

The presumption does not apply when an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due.

An entity should use 'reasonable and supportable information that is available without undue cost or effort' to determine whether credit risk has increased significantly. This should typically include forward-looking information as well as historical data.

3.2.1.6 Multi-factor analysis

FRS 109 states that the analysis of credit risk is a multi-factor and holistic analysis. This means that determining whether a specific factor is relevant, and the weight it should be given compared to other factors in the overall assessment, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region.

3.2.1.7 Individual or collective assessment

Depending on the nature of the financial instrument and the information available about its credit risk, it may not be possible (without undue cost or effort) to identify significant changes in credit risk at individual instrument level before the financial instrument becomes past due. It may therefore be necessary to assess significant increases in credit risk on a collective or portfolio basis.

This is particularly relevant to financial institutions with a large number of relatively small exposures such as retail loans. In practice, the lender may not obtain or monitor forward-looking credit information about each customer. In such cases the lender would assess changes in credit risk for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments. Any instruments that are assessed collectively must possess shared credit risk characteristics. This is to prevent significant increases in credit risk being obscured by aggregating instruments that have different risks.

Practical insight – shared credit risk characteristics

The Standard gives the following, non-exhaustive list of examples of possible shared credit risk characteristics:

- instrument type
- credit risk ratings
- collateral type
- date of initial recognition
- remaining term to maturity
- industry
- geographical location of the borrower
- the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring.

There is a rebuttable presumption that the credit risk of a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

When instruments are assessed collectively, it is important to remember that the aggregation may need to change over time as new information becomes available.

Practical insight – information that may be relevant in assessing changes in credit risk

You may wish to consider the following in assessing changes in credit risk. The list is not intended to be exhaustive.

- significant changes in internal price indicators of credit risk
- changes in the terms of an instrument that reflect changes in credit risk (eg more stringent covenants)
- significant changes in external market indicators of credit risk (eg the length of time or extent to which a financial asset has been below amortised cost)
- existing or expected adverse changes in the regulatory, economic, or technological environment that significantly affect, or are expected to affect, the borrower's ability to meet its debt obligations
- an actual or expected significant change in the operating results of the borrower
- significant changes in the value of the collateral supporting the obligation or in the quality of guarantees or credit enhancements
- reductions in financial support from a parent entity that are expected to reduce the borrower's incentive to make scheduled contractual payments
- expected breaches of contract that may, for example, lead to covenant waivers or amendments, or interest payment holidays
- significant changes in the expected performance and behaviour of the borrower
- past due information.

The analysis of credit risk is a multi-factor and holistic analysis. Determining whether a specific factor is relevant and the weight it should be given will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region.

Practical insight – shared credit risk characteristics

Internal data

- significant changes in
 - internal price indicators
 - changes in other rates or terms
- actual or expected downgrade to internal credit rating or behaviour score
- expected changes in loan documentation or expected breach of covenant
- past due information (see discussion above).

Borrower-specific external data

- significant changes in
 - credit spread
 - credit default swap (CDS) prices
 - length of time fair value below cost
 - other market information
- actual or expected downgrade to external credit rating
- increases in credit risk of borrower's other instruments
- actual or expected deterioration in borrower's financial performance.

Broader external data

- adverse changes (actual or expected) in borrower's
 - financial performance
 - business, financial or economic conditions
 - regulatory, economic or technological environment
- adverse changes in value or quality of any
 - supporting collateral
 - shareholder guarantee or financial support.

3.3 Measuring expected credit losses

FRS 109 defines expected credit losses as “the weighted average of credit losses with the respective risks of a default occurring as the weights”. In other words, expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument.

3.3.1 General principles

FRS 109 does not prescribe a particular method of measuring expected credit losses. The Standard instead acknowledges that measurement might vary based on the type of instrument in concern and the information that is available. It does however require that any method that an entity uses to measure credit losses should take into account three ‘building blocks’.

Three key building blocks:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes
- the time value of money
- reasonable and supportable information about past events, current conditions and forecasts of future economic conditions.

We discuss each building block in turn below.

3.3.2 Probability-weighted amount

FRS 109 requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.

In doing this, the purpose is neither to estimate a worst-case scenario nor to estimate the best-case scenario. An estimate of expected credit losses shall however always reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

The Standard notes that in practice, a complex analysis may not be needed in order to arrive at the probability-weighted outcome. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. If this is the case, then the analysis must reflect at least the possibility that a credit loss occurs and the possibility that no credit loss occurs.

3.3.3 Time value of money

FRS 109 requires expected credit losses to be discounted to the reporting date using the effective interest rate determined at initial recognition or an approximation of it.

The table sets out the discount rates to be used for different types of financial instrument.

Discount rates to be used for different types of financial instrument

Instrument	Discount rate to be used
Fixed rate assets	<ul style="list-style-type: none"> effective interest rate determined at initial recognition
Variable rate assets	<ul style="list-style-type: none"> current effective interest rate
Purchased or originated credit-impaired financial assets	<ul style="list-style-type: none"> credit-adjusted effective interest rate determined at initial recognition
Lease receivables	<ul style="list-style-type: none"> same discount rate as used in the measurement of the lease receivable
Loan commitments	<ul style="list-style-type: none"> effective interest rate, or an approximation of it, that will be applied when recognising the financial asset resulting from the loan commitment
Loan commitments for which the effective interest rate cannot be determined	<ul style="list-style-type: none"> a rate that reflects the current market assessment of the time value of money and the risks specific to the cash flows (unless adjustment has instead been made to the cash shortfalls)
Financial guarantee contracts	<ul style="list-style-type: none"> a rate that reflects the current market assessment of the time value of money and the risks specific to the cash flows (unless adjustment has instead been made to the cash shortfalls)

3.3.4 Reasonable and supportable information

Reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions.

The information used is required to reflect factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. Information that is available for financial reporting purposes is always considered to be available without undue cost or effort.

An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. Neither is a detailed estimate of expected credit losses needed for periods that are far in the future. Instead an entity may extrapolate projections from available, detailed information for such periods.

Possible data sources

- internal historical credit loss experience
- internal ratings
- credit loss experience of other entities
- external ratings, reports and statistics.

Where an entity does not have sufficient sources of entity-specific data of its own, it may use peer group experience for comparable financial instruments.

Historical information is a useful base from which to measure expected credit losses but may need to be adjusted to reflect current conditions. For example, estimates of changes in expected credit losses should reflect and be directionally consistent with changes in related observable data from period to period and in the magnitude of those changes. Examples include changes in:

- unemployment rates
- property prices
- commodity prices
- payment status or
- other factors indicative of credit losses on the instrument.

As discussed in earlier sections, an entity is required to recognise either lifetime expected credit losses or 12-month expected credit losses depending on the particular circumstances of the instrument in concern.

An entity may use practical expedients when measuring expected credit losses if they are consistent with FRS 109's principles. An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix (see section 4.2).

FRS 109 explains that a credit loss arises even if the entity expects to be paid in full but at a later time than when contractually due. This follows from the fact that expected credit losses consider the timing of payments as well as the cash shortfalls.

FRS 109 requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.

3.3.5 Measurement of expected credit losses for different types of asset/exposure

The table opposite illustrates how the principles for the measurement of credit losses apply to various different types of asset/exposure.

3.4 Application issues

3.4.1 Period to consider when measuring expected credit losses

Entities are required to estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument.

There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

For the purpose of measuring expected credit losses, FRS 109 states that the maximum period to consider is the maximum contractual period (including borrower extension options) over which the entity is exposed to credit risk. In some cases an entity might expect to be exposed to credit risk over a longer period than the contractual period – for example if it expects to extend the loan term even though it has no obligation to do so. However, subject to the limited exception for credit card and similar facilities (see practical insight box below), the measurement period is limited to the contractual period even though a longer period may be consistent with business practice.

Principles for the measurement of credit losses

Type of instrument	Measurement of credit losses
Financial assets (that are not credit-impaired)	Present value of the difference between <ul style="list-style-type: none"> the contractual cash flows due under the contract the cash flows expected to be received
Credit-impaired financial assets (that are not purchased or originated credit-impaired financial assets*)	Expected credit losses are the difference between <ul style="list-style-type: none"> the asset's gross carrying amount the present value of estimated cash flows discounted at the financial asset's original effective interest rate
Undrawn loan commitments	Present value of the difference between <ul style="list-style-type: none"> the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan the cash flows that the entity expects to receive if the loan is drawn down
Financial guarantee contracts	Cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party.

* purchased or originated credit-impaired financial assets are excluded as the general approach to impairment is not applied to them (impairment is always based on lifetime expected credit losses and the estimate of such losses on initial recognition is reflected in a credit-adjusted effective interest rate).

Example – Measurement period

Entity E makes a 12-month loan to Entity F. The contract states that the loan can be extended for a further 6 months at the sole option of Entity E (the lender). Entity E's management considers that it is probable that the loan will be extended. It is assumed that the loan meets FRS 109's 'solely payments of principal and interest' condition to be measured at amortised cost.

In this example, the expected losses would be measured based on the 12-month contractual term. The measurement would not take into account possible future losses arising from management's decision to extend the loan for the additional 6 month period, unless or until the extension option is actually exercised. This is because the extension is at the sole option of the lender, so 12 months is the maximum contractual period over which the lender is exposed to credit risk.

If Entity F (the borrower) has the right to extend the loan however, the maximum contractual credit risk period would be 18 months.

For loan commitments and financial guarantee contracts, the maximum contractual period is the period over which an entity has a present contractual obligation to extend credit.

3.4.2 Collateral

While the existence of collateral plays a limited role in the assessment of whether there has been a significant increase in credit risk, it is very relevant to the measurement of expected credit losses.

FRS 109 states that the estimate of expected cash shortfalls reflects the cash flows expected from collateral and other credit enhancements that are integral to the instrument's contractual terms.

The estimate of expected cash shortfalls on a collateralised financial instrument reflects

- the amount and timing of cash flows that are expected from foreclosure on the collateral
- less the costs of obtaining and selling the collateral.

This is irrespective of whether or not foreclosure is probable. In other words, the estimate of expected cash flows considers both the probability of a foreclosure and the cash flows that would result from it. A consequence of this is that any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract are included in the analysis. This is not to say that the entity is required to assume that recovery will be through foreclosure only however. Instead the entity should calculate the cash flows arising from the various ways in which the asset might be recovered and assign probability-weightings to those outcomes (see also section 3.3.2).

Practical insight – credit card and similar facilities

Some financial instruments include both a loan and an undrawn commitment component, with the effect that the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. Examples are revolving credit facilities, such as credit cards and overdraft facilities, which can be contractually withdrawn by the lender with as little as one day's notice.

In practice lenders continue to extend credit for a longer period in such situations. The consequence of this is that the lender may frequently withdraw the facility only after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. FRS 109 contains specific guidance for such arrangements stating that the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even though the period may extend beyond the maximum contractual period.

The Standard notes that when determining the period over which the entity is exposed to credit risk, the entity should consider factors such as relevant historical information and experience on similar financial instruments. This guidance, which is narrowly scoped, should not be applied by analogy to other instruments.

3.5 Practical expedients

3.5.1 'Low credit risk' exception

As a practical measure, FRS 109 states that an entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. This is an optional simplification. It is designed to relieve entities from tracking changes in the credit risk of high quality assets. This election can be made on an instrument by instrument basis.

Practical insight – what is 'low' credit risk?

FRS 109 does not define 'low' credit risk. It does state that the credit risk on a financial instrument is considered low for the purpose of FRS 109, if:

- the financial instrument has a low risk of default
- the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and
- adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.

To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of ‘investment grade’ is an example of a financial instrument that may be considered as having low credit risk.

An asset is not considered to have low credit risk simply because it has

- a low risk of loss
- a lower risk of default than other assets that the entity holds
- a lower risk of default relative to the credit risk of the jurisdiction in which the entity operates.

Where an entity opts to use the simplification and an instrument is deemed to have low credit risk, a loss allowance is

recognised based on 12-month expected credit losses. When an instrument is no longer considered to have low credit risk then the general requirements for assessing whether there has been a significant increase in credit risk apply.

3.5.2 Other practical expedients

In addition to the low credit risk exception described above, FRS 109 contains a number of other practical expedients and simplifications:

Practical insight – impact on corporates

Corporate entities that hold externally rated debt instruments are likely to rely on external rating agencies data when using the low credit risk simplification. It is important to realise however that in some situations adjustments may be needed to these ratings. For example during the financial crisis, it was evident that some ratings were lagging behind the times and did not reflect current market conditions.

In order to conclude that an instrument with an external rating equivalent to ‘investment grade’ has low credit risk, FRS 109 therefore requires an entity to consider whether an external rating is determined using methodologies that are consistent with a globally understood definition of low credit risk and whether there is evidence of an increase in credit risk that is not yet reflected in the rating.

FRS 109 expedients and simplifications

Practical expedient or simplification	Reference within this guide
Rebuttable presumption that default does not occur later than when a financial asset is 90 days past due	See section 3.2.1.1
Rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due	See section 3.2.1.5
Simplified approach for trade receivables and contract assets of one year or less or ones that do not contain a significant financing component	See section 4.1
Option of applying the simplified approach for trade receivables and contract assets which do contain a financing component	See section 4.1
Option of applying the simplified approach for lease receivables	See section 4.1
Use of provision matrices when applying the simplified model for trade receivables	See section 4.2

4. Simplified model for trade receivables, contract assets and lease receivables

In developing FRS 109's impairment requirements, there was concern that the process of determining whether to recognise 12-month or lifetime expected credit losses was not justifiable for instruments such as trade receivables and lease receivables.

FRS 109 therefore includes a number of simplifications which are explained in this section.



As discussed on the previous page, it was decided that the three-stage approach described in section 3 was too complex for certain types of assets. Set out below is an overview of the simplifications made in finalising the Standard.

4.1 Overview

FRS 109 includes the following simplifications:

Situation	Simplification
Trade receivables and contract assets of one year or less or ones which do not contain a significant financing component	Always recognise a loss allowance at an amount equal to lifetime expected credit losses
Trade receivables and contract assets which do contain a significant financing component (in accordance with FRS 115)	Entities are allowed to choose to always recognise a loss allowance at an amount equal to lifetime expected credit losses
Lease receivables within the scope of FRS 17 / FRS 116	An entity is similarly allowed to choose as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses.

The accounting policy choice applies independently for trade receivables with a significant financing component, lease receivables and contract assets with a significant financing component.

A key advantage of the simplified approach is that an entity is not required to determine whether credit risk has increased significantly since initial recognition. Instead a loss allowance is recognised based on lifetime expected credit losses at each reporting date.

Using the simplified approach means an entity is not required to determine whether credit risk has increased significantly since initial recognition.

Practical insight – determining whether there is a significant financing component under FRS 115

To determine whether a financing component is significant under FRS 115, an entity considers several factors, including, but not limited to, the following:

- the difference, if any, between the promised consideration and the cash price
- the combined effect of:
 - the expected length of time between delivery of the goods or services and receipt of payment
 - the prevailing interest rates in the relevant market.

A contract may not have a significant financing component if:

- advance payments have been made but the transfer of the good or service is at the customer's discretion
- the consideration is variable based on factors outside the vendor's and customer's control (eg a sales-based royalty)
- a difference between the promised consideration and the cash price relates to something other than financing such as protecting one of the parties from non-performance by the other.

As a practical expedient, an entity can ignore the impact of the time value of money on a contract if it expects, at contract inception, that the period between the delivery of goods or services and customer payment will be one year or less.

Practical insight – contract assets

'Contract asset' is a term introduced by the new revenue recognition standard (FRS 115 'Revenue from Contracts with Customers'). FRS 115 provides a detailed definition but contract assets are broadly equivalent to unbilled revenue.

Even though contract assets are not financial assets, and are accounted for mainly under FRS 115, FRS 109's impairment requirements apply to them. This means that when entities recognise revenue in advance of being paid or recording a receivable, they also need to recognise an expected credit loss.

4.2 Applying the simplified model

FRS 109 does not prescribe how an entity should estimate lifetime expected credit losses when applying the simplified model. The Standard does however permit the use of practical expedients and refers to the example of a 'provision matrix'. We anticipate that this approach will be widely applied.

In devising such a provision matrix, an entity would use its historical credit loss experience (adjusted as necessary to reflect current conditions) for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. This might be done, for example, by specifying provision rates depending on the number of days that a trade receivable is past due.

Depending on the diversity of its customer base, it might also be necessary for the entity to segregate the trade receivables. This would be the case for example if the entity's historical credit loss experience shows significantly different loss patterns for different customer segments.

Segregating trade receivables

The following are some examples of criteria that might be used to group assets:

- geographical region
- product type
- customer rating
- collateral or trade credit insurance
- type of customer.

Example

Company E, a manufacturer, has trade receivables of S\$100 million in 20X1 representing balances from a large number of small clients.

The trade receivables do not have a significant financing component and are accordingly measured for impairment purposes at an amount equal to lifetime expected credit losses. Company E operates in only one geographical region.

Company E uses a provision matrix to determine expected credit losses on the receivables. The provision matrix is based on historical observed default rates over the expected life of the trade receivables, adjusted for forward-looking estimates such as the deterioration in economic conditions expected by Company E in the coming year. This process results in the following provision rates which are based on the number of days that a trade receivable is past due:

	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due
Lifetime expected credit loss rate	0.2%	1.1%	3.9%	7.5%	9.2%

These percentages are then applied in the provision matrix as follows:

	Lifetime expected credit loss rate	Gross carrying amount of trade receivables	Lifetime expected credit losses (gross carrying amount of trade receivables x lifetime expected credit loss rate)
	%	SGD\$	SGD\$
Current balances	0.2%	40,000,000	80,000
Balances 1-30 days past due	1.1%	28,000,000	308,000
Balances 31-60 days past due	3.9%	19,000,000	741,000
Balances 61-90 days past due	7.5%	10,000,000	750,000
Balances more than 90 days past due	9.2%	3,000,000	276,000
		100,000,000	2,155,000

With reference to the disclosure requirements added by FRS 109 to FRS 107 'Financial Instruments: Disclosures' (see section 7), such a provision matrix could also form the basis of a risk profile disclosure.

Practical insight – building a provision matrix

As noted, FRS 109 permits entities to use ‘practical expedients’. A provision matrix is one example. However, there is no further guidance on other possible expedients or on how to implement a provision matrix in practice.

There is no ‘one size fits all’ approach to this: each entity will need to consider its own circumstances, including the materiality of expected losses and the data available (without undue cost or effort).

Single loss-rate approach

Fortunately, many businesses experience low levels of bad debts. In practice, however, few companies will be able to demonstrate that ECLs are so immaterial that no calculations or loss reserves are required at all. Nonetheless, for some companies applying a single loss-rate to receivables or groups of receivables might be appropriate. For example, an entity might determine an average historical loss rate by comparing the total balance of trade receivables at various past dates and determining the amounts collected/not collected. This would then be adjusted as necessary to reflect changes in circumstances.

Provision matrix

In other cases a provision matrix or other more sophisticated approach will be necessary. The idea behind a provision matrix is to estimate expected credit losses (ECLs) based on the ‘age’ of receivables. Accordingly, the operational challenge is to determine the relationship between the age of your receivables and the risk of non-payment. In order to ‘build’ a provision matrix the typical steps will be:

1. segregate receivables into appropriate groups
2. within each group, determine:
 - a) age-bands
 - b) historical back-testing dates (data points)
3. for each age-band, at each back-testing date determine:
 - a) the gross receivables
 - b) the amounts ultimately collected/written-off/provided. If material, adjustments should be made to exclude the effect of non-collections for reasons other than credit loss (eg credit notes issued for returns, short-deliveries or as a commercial price concession)
4. compute average historical loss rate by age-band
5. adjust historical loss rates if necessary, eg to take account of changes in:
 - a) economic conditions
 - b) types of customer
 - c) credit management practices
6. consider whether ECLs should be estimated individually for any period-end receivables, eg because specific information is available about those debtors
7. apply loss rate estimates to each age-band for the other receivables in this group.

5. Purchased or originated credit-impaired financial assets

FRS 109 contains a specific approach for assets that are credit impaired at the date of initial recognition. Under this approach, which differs from FRS 109's general model for impairment, entities:

- apply the credit-adjusted effective interest rate to the asset's amortised cost from initial recognition
- subsequently recognise the cumulative changes in lifetime expected credit losses
- gains are not limited to the reversal of previously recognised losses as they are for other assets.

This section explains the requirements in more depth. It ends with a diagramme summarising how the approach for credit impaired assets and the simplified model for trade and lease receivables described in section 4, interact with the general model described in section 3.

FRS 109 contains a specific approach for purchased or originated credit-impaired financial assets (assets that are credit impaired at the date of initial recognition) which differs from the general model for financial assets.

Under this specific approach, an entity is required to apply the credit-adjusted effective interest rate to the amortised cost of the financial asset from initial recognition. Thereafter it only recognises the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance. The amount of the change in lifetime expected credit losses is recognised in profit or loss as an impairment gain or loss.

Unlike other financial assets, gains on purchased or originated credit-impaired assets are not limited to the reversal of previously recognised impairment losses. Instead an improvement in credit quality beyond that which was estimated at the time of initial recognition, results in impairment gains being recognised in profit or loss.

Definition of a credit-impaired financial asset

FRS 109 states that a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.

Evidence that a financial asset is credit-impaired include observable data about the following events:

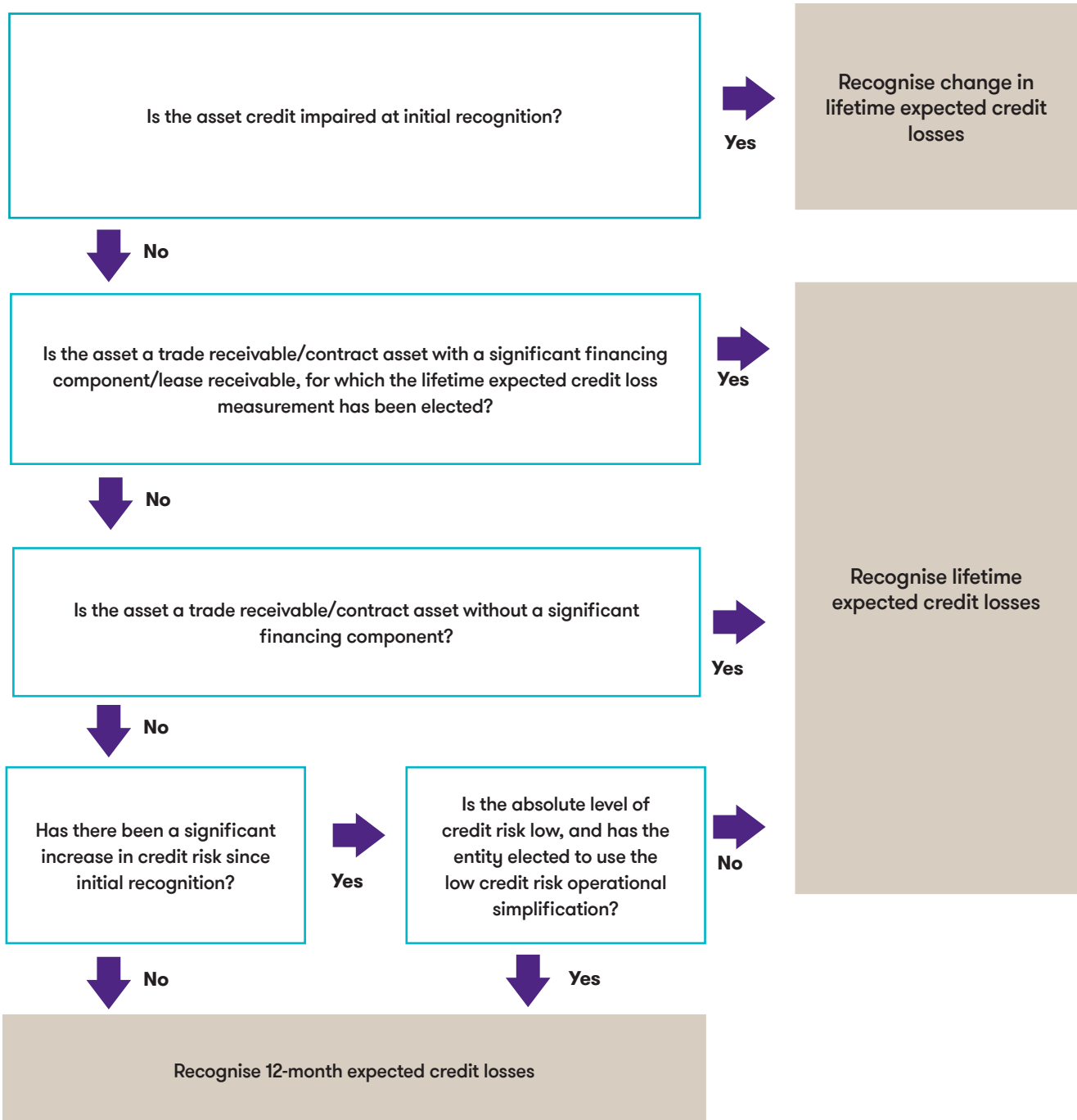
- significant financial difficulty of the issuer or the borrower
- a breach of contract, such as a default or past due event
- the lender(s), for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation
- the disappearance of an active market for the financial asset because of financial difficulties
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

The Standard notes that it may not be possible to identify a single discrete event – instead, the combined effect of several events may have caused financial assets to become credit-impaired.

Unlike other financial assets, gains on purchased or originated credit-impaired assets are not limited to the reversal of previously recognised impairment losses.

The following diagramme summarises the interaction of the exceptions discussed in sections 4 and 5 with the general model discussed in section 3.

Decision tree for expected credit loss



The specific approach for purchased or originated credit-impaired financial assets, and the simplified model for trade receivables, contract assets and lease receivables, differ from FRS 109's general model.

6. Presenting credit losses

The classification of a financial asset does not impact on the presentation of the loss allowance in profit or loss but it does impact on the presentation in the statement of financial position.

This section explains the requirements and provides guidance on fulfilling them.



Measurement of impairment losses is the same whether a financial asset is measured at amortised cost or is a debt-type instrument measured at fair value through other comprehensive income. In both cases, the amount of expected credit losses (or reversal) required to adjust the 'loss allowance' at the reporting date to the amount required under the Standard is recognised in profit or loss. The classification of the financial asset does however have an impact on the presentation of expected credit losses in the statement of financial position.

6.1 Financial assets measured at amortised cost

For financial assets measured at amortised cost in the statement of financial position, the loss allowance reduces the net carrying amount of the asset.

In the event of a 'write-off', the entity should directly reduce the asset's gross carrying amount. If the amount of loss on write-off is greater than the accumulated loss allowance, the difference represents an additional impairment loss.

6.2 Financial assets measured at fair value through other comprehensive income

The measurement of debt-type financial assets classified at fair value through other comprehensive income (FVOCI) is a combination of both amortised cost and fair value measurement. As a result, impairment gains and losses are determined using the same methodology that is applied to assets measured at amortised cost.

Practical insight – write-offs

FRS 109 does not specify exactly when an asset is written off (ie derecognised). The principle is however that a write-off occurs when there is 'no reasonable expectation' of recovering either the entirety or a portion of an asset's contractual cash flows. Write-offs can relate to an entire asset or to part of it.

In practice many entities will need to develop a write-off policy that is appropriate to their circumstances and to the different types of assets they hold. Entities with relatively few financial assets might determine write-offs on a case-by-case basis.

An appropriate write-off policy is important in order to avoid 'grossing-up' financial assets and related loss reserves when the assets are uncollectible. Write-offs will also be important when analysing historical credit losses. This is because entities need to determine the point at which assets become uncollectible in order to determine past loss rates.

Because such assets are measured in the statement of financial position at fair value, the expected credit losses recognised under FRS 109 do not reduce the carrying amount of the financial assets in the statement of financial position. Instead an accumulated impairment amount is recognised in other comprehensive income.

This amount is the same as the amount that would be recognised if the asset had been measured at amortised cost. In contrast to assets measured at amortised cost however, there is not a separate loss allowance. Rather impairment gains or losses are accounted for as an adjustment of the revaluation reserve relating to the asset that has been accumulated in other comprehensive income, with a corresponding charge to profit or loss.

Example

Entity Y purchases a debt instrument on 1 July 20X0. The debt instrument has a fair value of S\$5,000 on initial recognition and is measured at fair value through other comprehensive income. The instrument has a contractual term of 10 years, and has both a nominal and an effective interest rate of 5 per cent (for simplicity, journal entries for interest revenue have not been given below). The instrument is determined as not being credit-impaired on initial recognition.

**Accounting entries on
31 December 20X0**

	Debit (CU)	Credit (CU)
--	------------	-------------

Financial asset measured at FVOCI	5,000	
Cash		5,000

Being recognition of the debt instrument at its fair value.

At the reporting date of 31 December 20X0, the fair value of the debt instrument has declined to CU4,750 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition. Expected credit losses are therefore measured at an amount equal to 12-month expected credit losses, which amounts to CU150.

**Accounting entries on
31 December 20X0**

	Debit (CU)	Credit (CU)
--	------------	-------------

Impairment loss (profit or loss)	150	
Other comprehensive income	100	
Financial asset – FVOCI		250

Being recognition of 12-month expected credit losses and other fair value changes on the debt instrument. Note that the cumulative loss in OCI of CU100 consists of the total fair value change of CU250 (CU5,000 - CU4,750) offset by the accumulated impairment amount recognised of CU150.

On 1 January 20X1, the entity decides to sell the debt instrument for CU4,750, which is its fair value at that date.

**Accounting entries on
31 December 20X0**

	Debit (CU)	Credit (CU)
--	------------	-------------

Cash	4,750	
Financial asset – FVOCI		4,750
Loss (profit or loss)	100	
Other comprehensive income		100

To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss.

Practical insight – presentation of the loss allowance in the primary statements

IFRS 9 introduced a consequential amendment to IAS 1 ‘Presentation of Financial Statements’ which requires impairment losses to be shown as a separate line item in the statement of profit or loss, however no similar amendment was made in respect of the statement of financial position.

While IFRS 9 explicitly states that the loss allowance for financial assets measured at fair value through other comprehensive income shall not reduce the carrying amount of the financial asset in the statement of financial position, the position is not clear for financial assets measured at amortised cost. The question of how an entity should present the loss allowance for financial assets measured at amortised cost was therefore referred to the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG), a discussion forum set up by the IASB to provide support for stakeholders on implementation issues following the issue of IFRS 9.

The issue was discussed at the ITG’s December 2015 meeting. The view at this meeting was that an entity is not required to present the loss allowance in respect of financial assets measured at amortised cost separately in the statement of financial position. An entity should however give consideration to IAS 1’s general requirement to present additional line items when this is relevant to an understanding of the entity’s financial position. Judgement will therefore be needed in coming to a decision.

7. Disclosures

Given the significance of determining whether there has been an increase in credit risk under FRS 109's new expected credit loss model, and the importance of impairment itself, FRS 109 has amended FRS 107 extensively.

This section outlines the main areas of change.



The disclosures added to FRS 107 are intended to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

To achieve this objective, credit risk disclosures shall provide:

- information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses
- quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes
- information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

Where information is presented elsewhere, for example in a management commentary that does not form part of the financial statements, it is acceptable to cross-reference to such documents in order to avoid duplication.

In making their disclosures, entities should consider factors such as:

- how much detail to disclose
- how much emphasis to place on different aspects of the disclosure requirements

Key disclosures

FRS 107 has been amended to include both extensive qualitative and quantitative disclosure requirements. Some of the more important disclosures include:

Qualitative disclosures

- inputs, assumptions and techniques used to:
 - estimate expected credit losses (and changes in techniques or assumptions)
 - determine 'significant increase in credit risk' and the reporting entity's definition of 'default'
 - determine 'credit-impaired' assets
- write-off policies
- policies regarding the modification of contractual cash flows of financial assets
- a narrative description of collateral held as security and other credit enhancements.

Quantitative disclosures

- reconciliation of loss allowance accounts showing key drivers for change
- explanation of gross carrying amounts showing key drivers for change
- gross carrying amount per credit risk grade or delinquency
- write-offs, recoveries and modifications
- quantitative information about the collateral held as security and other credit enhancements for credit-impaired assets.

- the appropriate level of aggregation or disaggregation
- whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

8. Practical insight – next steps

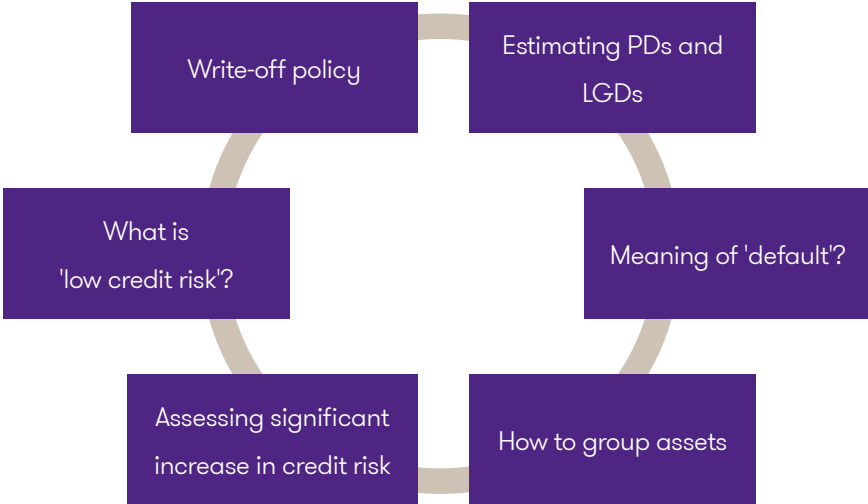
FRS 109 comes into mandatory effect for accounting periods beginning on or after 1 January 2018, there are a number of actions you should consider to prepare for implementing the requirements.

This section sets out our recommendations. In particular we suggest you engage with your auditors and business advisers now.

Set out below are the actions we recommend you undertake in order to get up to speed with the new Standard’s impairment requirements:

- study the impairment requirements and evaluate how the information will be accumulated
- create and maintain buy-in from senior management within your organisation for the project
- compile information about existing contracts in order to gauge the Standard’s impact and decide whether and how to group them together
- review loan covenants and other agreements that incorporate financial ratios and metrics, such as compensation arrangements, that could be affected by the new Standard
- communicate what is happening and how it affects the entity, for example by:
 - explaining how default will be defined
 - explaining how the entity will determine what is a significant increase in credit risk
 - providing enough information to allow for comparisons over time
- consider how you will approach the calculation of the ‘probability of default’ (PDs) and ‘loss given defaults’ (LGDs)
- decide whether to use practical expedients
- monitor progress towards interim and final milestones and intervene where required.

Key Implementation challenge



About Financial Reporting Advisory Services (FRAS)

In today's competitive business environment and fast changing regulatory & reporting landscape, dynamic organisations face several challenges with respect to financial reporting which could potentially impact the value of the businesses.

There is a greater need for accurate and timely financial information now. As a part of our Audit and Assurance practice, Financial Reporting Advisory Services (FRAS) has developed innovative solutions to make financial reporting process smooth, time-bound and auditable.

The FRAS team at Grant Thornton is a multi-disciplinary team that designs and implements creative solutions to address these complexities. Most of our team members are former auditors and assist Companies design 'auditor ready' solutions such as whitepaper, reporting packages, reconciliations supporting financial report disclosures.

What differentiates us

- We pre-empt problems and draft solutions to them
- Most of our professionals have auditing experience, which helps them appreciate practical complexities in financial reporting
- Our team combines accounting knowledge with technological skills to deliver efficient and sustainable financial reporting solutions
- Our senior professionals are chosen experts with deep technical accounting knowledge and vast experience of advising clients on accounting matters
- Our size and structure create advantages for you. We adopt a flatter structure, with shorter decision making chains, empowered teams and no complex chains of command. Our teams are more responsive
- Access to wide pool of IFRS experts from our offices in the region as well as our office in US, UK, India and Ireland.

About Grant Thornton Singapore

Grant Thornton Singapore is a member of Grant Thornton International Ltd. We aim to unlock the potential for growth in dynamic organisations and this aim underpins everything we do. We apply strong technical guidance and breadth of experience to ensure that clients receive a truly unique experience. Our proactive teams, led by accessible and approachable partners, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients, and help them find growth solutions.

More than 50,000 Grant Thornton people, across over 135 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work. Through this membership, we access global resources and methodologies that enable us to deliver consistently high quality outcomes for owners and key executives in our clients.



Teams and solutions built around your needs not our structures



Large international client base



Fully integrated Assurance, Tax & Advisory firm.



“Our competitive advantage includes our use of software technology, experience in working with international clients and commitment to value and excellence.”

Rodger Flynn,
CEO, Grant Thornton Singapore Pte Ltd

To find out more, please visit www.grantthornton.sg or contact any of our offices as mentioned below:



Timothy Braun
Partner
Grant Thornton Singapore
T +65 6805 4130
E Timothy.Braun@sg.gt.com



Chetan Hans
Director
Grant Thornton Singapore
T +65 6805 4110
E Chetan.hans@sg.gt.com

GRANT THORNTON SINGAPORE PTE LTD

39 Robinson Road
#14-01 Robinson Point
Singapore 068911

+65 6805 4110
enquiries@sg.gt.com

For more information or for any queries, write to us at enquiries@sg.gt.com

© 2018 Grant Thornton Singapore Pte Ltd. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton Singapore Pte Ltd is a member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. This publication has been prepared only as a guide. No responsibility can be accepted by us for loss occasioned to any person acting or refraining from acting as a result of any material in this publication.

This document contains general information only and Grant Thornton is not, by means of this document, rendering any professional advice or services. This document is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a professional advisor. Whilst every care has been taken in compiling this document, Grant Thornton makes no representations or warranty (expressed or implied) about the accuracy, suitability, reliability or completeness of the information for any purpose. Grant Thornton, their employees or agents accept no liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.