

STAFF PAPER

27 February–29 February 2012

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Application of the 'three-bucket' model to trade receivables without a significant financing component		
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Purpose of the paper

1. This IASB-only paper addresses whether trade receivables without a significant financing component¹ should follow the general 'three-bucket' model. The equivalent FASB question on this issue is covered in Agenda Paper 4B/Memo 137. This issue is being addressed separately because the initial measurement of trade receivables differs between IFRSs and US GAAP (see Appendix B of Agenda Paper 4B/Memo 137).

Assumptions

2. The basis of this paper is the following proposals in the revised revenue ED 2011/6 *Revenue from Contracts with Customers* (the 'revenue ED'):
 - (a) Trade receivables with an expected maturity of one year or less at contract inception need not be evaluated for the effects of time value of money (ie it is assumed that the financing component is insignificant).

¹ Trade receivables without a significant financing component include those with either (i) a maturity of 12 months or less, or (ii) a maturity of greater than 12 months but with an insignificant financing component, and in accordance with the revenue ED an entity need not adjust for the time value of money in determining the measurement of revenue.

- (b) For trade receivables without a significant financing component, revenue would be measured and presented at the ‘transaction price’ as defined in the revenue ED (in many cases, the transaction price will be the invoice amount).
 - (c) Initial and subsequent credit losses on trade receivables without a significant financing component would be presented in a line item that is adjacent to the revenue line item. As a consequence, impairment losses on those trade receivables would be *presented* differently from all other financial assets that are subject to impairment.
 - (d) Upon initial recognition of trade receivables, any difference between the amount recognised for the receivable and the corresponding amount recognised as revenue would be presented in profit or loss as a separate line item adjacent to the revenue line item.
3. The staff note that changes to those proposals during redeliberations might have implications on the impairment model for trade receivables proposed in this paper. If knock-on effects arise, the boards may have to revisit the impairment model for trade receivables.

Impairment model for trade receivables without a significant financing component

4. IFRS 9 *Financial Instruments* (consistently with IAS 39 *Financial Instruments: Recognition and Measurement*) currently requires that all financial assets, including short-term trade receivables, must be measured at fair value on initial recognition. In practice, we understand that many recognise such short-term trade receivables at the invoice amount. In contrast, US GAAP requires that financial assets must be measured at initial recognition at the transaction price. The revenue ED requires the credit losses line item that is presented adjacent to revenue to be calculated based on the initial measurement of the receivable.
5. This means that the credit loss amount varies depending on the initial measurement of the receivable. This can be illustrated using a simple example.

6. Assume that an entity sells a good to Company A. The invoice amount is CU1000 payable in 3 months' time. The financing component is assumed to be insignificant, but given the credit quality of Company A, there are expected losses and the fair value of the entity's receivable is CU995. Before applying the 'three-bucket' impairment model, application of the revenue ED would be as follows at the point of recognition of the revenue:

	Receivable at fair value (Consistently with IFRS 9)	Receivable at transaction price (Consistently with US GAAP)
Revenue	CU1000	CU1000
Expected credit losses (adjacent line item)	CU(5)	CU(-)
<hr/>		
Receivable recognised	CU995	CU1000

7. As the table above shows, because IFRS 9 requires recognition of all financial assets at fair value, an amount that represents the expected credit losses on the receivable (implicit in its fair value) is recognised *even before the 'three-bucket' impairment model is applied*. In contrast, no expected credit losses would be recognised in the adjacent line item if the initial measurement of the receivable was at the transaction price (eg at the invoice amount).

Alternative A

8. Alternative A would provide an exception from the 'three-bucket' impairment model for trade receivables treated as not having a significant financing component, by:
- (a) *NOT* requiring an allowance balance to be established for initial estimates of expected losses; and
 - (b) requiring that changes in lifetime expected losses must always be recognised (eg categorising trade receivables outside Bucket 1 throughout their life).
9. As illustrated above, because of the interaction of the revenue ED and IFRS 9 (if strictly applied), an impairment amount for trade receivables without a significant financing component should be recognised in profit or loss through the application of

the revenue ED. Thus, without application of the normal ‘three-bucket’ model, expected credit losses have already been accounted for in profit or loss. However, an impairment allowance is not recognised—instead, the expected losses are implicit in the fair value of the receivable.

10. To prevent a further impairment expense being recognised for the same initial estimate of credit losses, the Board may decide to provide an exception from the general ‘three-bucket’ model. That is, an impairment allowance should *not* be recognised on initial recognition of trade receivables without a significant financing component that arise from contracts with customers within the scope of the final revenue standard. If an allowance were to be established, as is usual for assets subject to impairment accounting under the proposed model, a further charge for the same expected losses would have to be recognised in profit or loss.
11. Because the revenue ED already results in the recognition of initial expected losses, it seems most appropriate only to recognise an impairment allowance based on a change in expected lifetime losses that adjust the initial loss estimates. In accordance with the revenue ED, an amount reflecting initial credit loss estimates would be presented as a separate line item adjacent to the revenue line item in the statement of profit or loss. Because of the short-term nature of many of these receivables, the amount recognised initially by applying the revenue ED is often a lifetime loss, so it is suggested that the asset should be directly placed into Bucket 2 or 3 (as applicable). To the extent that there are subsequent favourable or unfavourable changes in expected lifetime losses, the trade receivable would remain in Bucket 2 or 3 and the impairment allowance would be updated accordingly.
12. To achieve the outcome above, trade receivables without a significant financing component would need to be exempt from application of the usual impairment model.

Advantages

13. Many entities that have contracts with customers within the scope of the revenue ED would have significant operational difficulty in calculating a 12-month expected loss if the maturity of the contract is greater than 12 months. An exception to the Bucket 1 measurement would provide operational relief for those entities.

14. This approach does not require the complexity of looking for deterioration in credit quality to track bucket allocation. This is appropriate, because as a practical matter, there is no distinction between ‘lifetime’ and ‘12 months’ for many of these receivables, so the complexity of the bucket concept is arguably unnecessary given that any allowance balance established will often reflect lifetime expected losses.
15. Alternative A enables the carrying amount of the trade receivables without a significant financing component to be fair value, rather than reducing the fair value by an allowance balance, as applies in the broader model. The desirability of this is increased because the effect of expected losses at initial recognition would be particularly pronounced for such short-term assets.
16. In the revenue ED, a practical expedient was proposed for trade receivables without a significant financing component—revenue can be recognised based on the invoice amount and ignoring the effect of the time value of money. Arguably, allowing the impairment model to be applied in a more simple form is consistent with such an expedient.

Disadvantages

17. The accounting for trade receivables subject to the exception in Alternative A will be different to the accounting for all other financial assets subject to impairment. Unlike other financial assets subject to impairment accounting, on initial recognition these assets would have a carrying amount equal to fair value. In particular, even if assets are identical economically, the presentation and carrying amount in the statement of financial position of trade receivables without a significant financing component would not be the same as for other assets. This can be illustrated by comparing the accounting for the receivable from the revenue transaction set out in paragraph 6 with a comparable instrument. Assume that the entity also lends Company A money for 3 months. The amount due in 3 months is CU1000 and no interest is due during the 3 months. The amount that the entity lends today is CU995, which is fair value. Assuming that the expected losses on the bond are CU5 (because financing costs are ignored, for simplicity) the balance sheet on initial recognition for the two cases under IFRS would be as follows, applying the ‘three-bucket’ model as proposed in Alternative A:

	Trade receivable	Short-term bond
Receivable/financial asset	CU995	CU995
Impairment allowance		CU(5)
Carrying amount	CU995	CU990
Impairment charge in profit or loss	CU5 ²	CU5 ³

18. Within the context of the decisions reached around the ‘three-bucket’ model, some may be concerned that starting trade receivables in Bucket 2 or 3 would compromise the ‘three-bucket’ model.
19. A counter view to this concern is that, because no impairment allowance is recognised upon initial recognition, Alternative A follows a deterioration model. An impairment *allowance* is only recognised once an unfavourable change in expectations occurs from the expectations at initial recognition. In addition, applying the measurement objective for Buckets 1, 2 or 3 should generally result in similar outcomes for these assets because of their short-term nature. So arguably there is no practical difference or reason to initially classify these receivables in Bucket 1 aside from consistency in optics with the general model.
20. However, initially classifying those trade receivables in Bucket 2 or 3 would increase the diversity in credit quality in those buckets. In addition, information about deterioration in credit quality would be lost, because those trade receivables are not tracked through the buckets. However, some believe that the disclosure information obtained by tracking such deterioration is not as relevant for receivables without a significant financing component, because they are generally of short maturity and consequently the cost and complexity of such tracking does not outweigh the benefits.

Alternative B

21. This alternative would be twofold (affecting both initial measurement of the receivable and also the impairment accounting):

² Recognised next to revenue.

³ Recognised as a (general) impairment expense.

- (a) if a receivable is accounted for as not having a significant financing component in accordance with the revenue ED, the receivable shall be measured at the invoice amount on initial recognition in IFRS 9; and
 - (b) allocate those receivables directly to Bucket 2 or 3 on initial recognition and recognise lifetime expected losses throughout the asset's life.
22. IAS 39 already notes that when the effect of financing is immaterial it can be ignored in establishing the fair value of a financial asset. Anecdotal feedback also tells us that in practice today, despite the requirements of IAS 18 *Revenue* and IAS 39, both of which are based on fair value measurement, entities are recognising revenue on short-term trade receivables and the associated receivable at invoice amounts. The revenue ED intended to provide a practical expedient by ignoring the financing amount in the revenue calculation if the transaction price is not adjusted for the effects of the time value of money. Some may argue that unless we reflect this expedient in IFRS 9 we risk overriding the relief intended in the revenue ED.
23. The IASB could introduce a similar practical expedient into IFRS 9 to required that trade receivables with no significant financing component, for which the practical expedient in the revenue ED has been used, to be measured at the invoice amount rather than at fair value. This would have a further advantage of aligning the initial measurement of such receivables with US GAAP. It also addresses the risk that while we already require short-term trade receivables to be measured at fair value, we understand that practice is that many recognise such receivables at the invoice amount. If we have an impairment model as outlined in Alternative A that relies on impairment being recognised as a result of the fair value measurement of the receivable, it could result in no impairment being recognised on initial recognition in practice even where there are expected losses.
24. Under Alternative B no expense amount for the expected credit losses would arise through the application of the revenue ED because the initial measurement of the receivable is at the invoice amount. Consequently, in order to reflect expected losses from initial recognition, as proposed more generally in the impairment model being developed, an allowance balance would need to be established in order for there to be a corresponding expense for the amount of the expected credit losses. For the reasons

given in Alternative A it is proposed that such receivables should initially be allocated to Bucket 2 or 3 as applicable—but in Alternative B from initial recognition a (lifetime) allowance balance would be established.

25. Although the approach is slightly different to Alternative A, the resulting carrying amount of the trade receivables without the significant financing element would be similar under both proposals. The overall effect on profit or loss would also be similar. However, the allowance balance would be different (because no allowance balance is established on initial recognition under Alternative A—an allowance balance would only arise as a result of changes in credit loss expectations after initial recognition) and the presentation of impairment in profit or loss would be on different line items (adjacent to revenue for Alternative A and in the ‘general impairment’ line item for Alternative B). The effects are ‘similar to’ rather than the same as Alternative A, because the impairment calculation on initial recognition for Alternative A reflects the initial measurement of the receivable at fair value. That measurement would include the effect of expected credit losses and also the effect of the time value of money if material.

Advantages

26. Alternative B, like Alternative A, provides operational relief from having to calculate a 12-month expected loss using the concepts in Bucket 1, which is arguably appropriate for the reasons set out for Alternative A. Another advantage of this approach is that it would be more closely converged with US GAAP, because on initial recognition US GAAP requires the receivable to be measured at its transaction price rather than at fair value.

Disadvantages

27. Alternative B, like Alternative A, results in the carrying amount of trade receivables without a significant financing component not equating to that of other short-term financial assets. In this case it is because the trade receivable would be measured initially at its transaction price rather than at its fair value. Using the same example as referred to above, and contrasting the sale of goods with the short-term bond, the effect on initial recognition would be as follows:

	Trade receivable	Short-term bond
Receivable/financial asset	CU1000	CU995
Impairment allowance	CU(5)	CU(5)
Carrying amount	CU995	CU990
Amount of expected credit losses recognised in profit or loss	CU5 ⁴	CU5 ⁵

28. Within the context of the decisions reached on the ‘three-bucket’ model, some may be concerned that starting trade receivables in Buckets 2 or 3 would compromise the ‘three-bucket’ credit deterioration model. Information about deterioration in credit quality would be lost because those trade receivables are not tracked throughout the buckets if they deteriorate from the initial credit quality.
29. In addition, initially classifying those trade receivables in Bucket 2 or 3 would increase the diversity in credit quality in those buckets.

Alternative C

30. Alternatively, the IASB may decide to require the Bucket 1 measurement to be recognised on initial recognition of trade receivables without a significant financing component. This would be consistent with the approach followed for all other financial assets that are initially classified in Bucket 1 (including all other short-term financial assets).
31. However, Alternative C would not address the operational challenges of tracking trade receivables without a significant financing element through the buckets (see paragraph 20 above). There is arguably little benefit obtained in exchange for the costs that that tracking would give rise to (see paragraph 14). Given the probable preparer population to which these requirements will apply (ie corporates rather than financial institutions), and thus the credit systems likely to currently be in place, the staff think that this issue deserves special attention.

⁴ Arising from the application of Bucket 2.

⁵ Arising from the application of Bucket 1.

32. Under Alternative C, the carrying amount of the assets would be consistent with other short-term financial assets subject to impairment accounting (ie fair value). However, as noted in paragraph 15, the effect of that model, which adjusts the carrying amount away from fair value, would be particularly pronounced for trade receivables without a significant financing component, because they are generally short-term in nature.
33. In addition, it would result in two charges being made to profit or loss for the same initial expected losses when the receivable is measured at fair value in accordance with IFRS 9—once through application of the revenue ED and then through application of the impairment model.

Further interaction with Revenue ED

34. The staff note that the revenue ED is built on the premise that credit losses associated with revenue transactions (apart from those incorporated into the revenue amount) should be reflected in a line item next to the revenue line in the statement of profit or loss. In order to implement this, we note that it will be necessary to ensure that the impairment amounts that relate to trade receivables for which the entity does not adjust the transaction price for the time value of money (in accordance with the revenue ED) are reflected in this line item, instead of in the ‘general’ impairment line item.
35. The staff would like confirmation of whether that is indeed the intention of the Board (subject of course to the outcome of the redeliberation of the revenue ED), because if it is, then this will need to be reflected in the impairment model (ie the nature of the underlying transaction that resulted in the recognition of a financial asset can affect the presentation of expected credit loss amounts).

Question 1

For trade receivables without a significant financing component, does the Board want the expected credit loss amounts to be presented:

- (a) in a line item adjacent to revenue (similar to the revenue ED); or
- (b) in the impairment loss line item (similar to the treatment of all other financial assets subject to impairment accounting)?

Staff analysis and recommendation

36. Alternative B creates a separate model from the one that is being developed for all other financial assets subject to impairment. Nevertheless, the staff recommend Alternative B because it addresses the entity's operational concerns, is more closely converged with US GAAP, and the overall effect on profit or loss and the resulting carrying amount is similar to Alternative A. In addition, the staff recommend Alternative B because Alternative A carries the risk that no expected credit losses are recognised on day 1 and that the net carrying value at initial recognition will not equal fair value. This is because in practice today, entities are recognising revenue and the associated receivable at invoice amounts despite the current requirements in IFRS.
37. Limiting the scope of the exception to those trade receivables that are subject to the practical expedient in the final revenue standard eliminates the need to further define the population to which the exception applies. It therefore reduces pressure on the scope of the exception.

Question 2

Does the Board agree with the staff recommendations in paragraphs 36 and 37 that a separate model should be created for trade receivables without a significant financing component so that:

they are initially measured at the invoice amount?

they are initially classified in Buckets 2 or 3 rather than Bucket 1? and

the scope of the requirements in (a) and (b) above would be limited to those trade receivables without a significant financing element subject to the final revenue standard?

If not, what would the Board like to do, and why?