IFRS 9 and IAS 37: Credit Enhancement on Trade Receivables

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Entities may enter into financial guarantee contracts and insurance contracts (commonly called "credit enhancements") over loan assets or trade accounts receivable. This is done so that when a counterparty defaults on some or all of its obligations, the entity can recover all or some of its losses through the credit enhancement.

In measuring expected credit losses, paragraph B5.5.55 of IFRS 9 *Financial Instruments* requires entities to include the cash flows from the realization of the collateral and other credit enhancements that are:

(a) part of the contractual terms; and

(b) are not recognized separately by the entity.

In December 2015, the IASB's Transition Resource Group for Impairment of Financial Instruments (ITG) discussed what was meant by credit enhancements that are "part of the contractual terms." The ITG observed that credit enhancements included in the measurement of expected credit losses should not be limited to those that are explicitly part of the contractual terms, but rather those that are integral to the contractual terms. All facts and circumstances should be considered in making this judgment. However, the ITG did not address a situation when the financial guarantee is not mentioned in the loan's contractual terms. It also did not address how to account for the credit enhancement if the financial guarantee is determined to be not integral and not otherwise required to be recognized separately.

Fact Pattern

- Entity X is a manufacturer of specialty gear and sells its products to large retailers (i.e., customers).
- Entity X offers credit to its customers so that they have net 90 days to pay for the products sold. Entity X records trade receivables that are accounted for at amortized cost and subject to impairment. The time value of money on these trade receivables is insignificant and, hence, no interest is recorded.
- Entity X enters into a blanket group insurance policy (group insurance policy) with an unrelated third-party to cover its trade receivables. The group insurance policy covers Entity X for up to a maximum exposure of $30 million. Entity X does not need to name each individual trade receivable separately to be covered but rather the third-party insures all trade receivables up to a maximum exposure of $30 million at any point in time.
- Entity X pays a monthly fee to the third-party as premium for the group insurance policy. Premium payments are expensed when incurred.

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Issue 1: Is the group insurance policy integral to the contractual terms of each individual trade receivable?

View 1A – Yes, the group insurance policy is integral and should be factored into the measurement of expected credit losses.

Proponents of this view consider that the group insurance policy will compensate Entity X for any losses it suffers on each of the individual trade receivables up to a maximum of $30 million. Also, the individual trade receivables are covered as they are originated because the group insurance policy applies to the whole portfolio at any point in time.

Therefore, the group insurance policy is integral to the contractual terms of each individual trade receivable.

View 1B – No, the group insurance policy is not integral and should not be factored into the measurement of expected credit losses.

Proponents of this view consider that the group insurance policy is not entered into at the same time as each individual trade receivable. Also, the group insurance policy does not name any of the individual trade receivables as assets being insured, nor does each individual trade receivable's contractual terms refer to the insurance contract.

Therefore, the group insurance policy is not integral to the contractual terms of each individual trade receivable.

The Group's Discussion

Group members supported the view that the group insurance policy is not integral to each individual trade receivable and, therefore, should not be factored into the measurement of expected credit losses (View 1B). Their rationale is that Entity X has discretion in deciding whether to enter into the group insurance policy. Therefore, this group insurance policy is a separate risk mitigation strategy. Also, the $30 million coverage is a notional amount that is not specifically linked to specific trade receivables, and therefore, not considered integral to the trade receivable's contractual terms.

One Group member thought that since the group insurance policy would cover in substance at least $30 million of losses, it should be considered in the expected credit loss calculation. However, several Group members noted that the group insurance policy covers incurred losses, whereas the IFRS 9 model considers both whether a loss has occurred and whether a loss might occur in the future. These Group members thought that, the expected credit loss calculation should not consider the existence of the group insurance policy given it is not integral to the contractual terms of the individual trade receivables.

Issue 2: If the group insurance policy is determined not to be integral and not otherwise required to be separately recognized, how should it be accounted for?

View 2A – The group insurance policy should be accounted for as a compensation right by analogy to the guidance for reimbursements in IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.*

Under this view, the group insurance policy likely satisfies the definition of an insurance contract in IFRS 4 *Insurance Contracts*. However, it is excluded from the scope of IFRS 4 because it is a direct insurance contract held by a policyholder. Since the group insurance policy is outside the scope of IFRS 9 and IFRS 4, no specific IFRS Standard applies. As such, the entity should develop its accounting policy in accordance with the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to account for the group insurance policy (i.e., financial guarantee).

Proponents of this view note that since the expected credit loss on the trade receivables has been recognized under IFRS 9, the entity should recognize a compensation right provided it is virtually certain that the compensation will be received if the credit loss is suffered. The compensation right should be accounted for by analogy to IAS 37.

View 2B – The group insurance policy should be accounted for as an indemnification asset by analogy to the guidance for reimbursements in IFRS 3 Business Combinations*.*

This view is similar to View 2A in that the entity should develop its accounting policy in accordance with IAS 8. However, proponents of this view would analogize to IFRS 3's indemnification asset requirement for recognizing the financial guarantee because the recognition threshold for contingent liabilities in IFRS 3 is closer to that of the expected credit loss model in IFRS 9.

Further, IFRS 3 allows an indemnification asset to be recognized and measured on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount. Measurement is based on management's assessment of whether the indemnification asset is collectible, provided the indemnification asset is not subsequently measured at fair value.

Applying this indemnification asset approach, the guarantor's credit risk becomes a measurement issue rather than a recognition issue. The virtually certain criterion under IAS 37 does not apply to indemnification assets arising from a business combination.

The Group's Discussion

Group members supported that an asset should be recognized for the group insurance policy but expressed diverse views in terms of which IFRS Standard an entity should consider when developing its accounting policy in accordance with IAS 8. One Group member highlighted that if the asset is considered a receivable from the insurer, an expected credit loss would need to be recognized against that receivable for the potential collection risk from the insurer.

Some Group members thought analogizing to IAS 37 (View 2A) in developing an accounting policy may be appropriate but shared several challenges with this approach. For example, one hurdle is overcoming the virtual certainty threshold in IAS 37. One Group member thought that since the

entity has a contractual right from the insurer to be reimbursed for losses, virtual certainty is established because the right is enforceable.

Other Group members thought that applying the indemnification asset approach in IFRS 3 (View 2B) can help with overcoming the challenges raised in analogizing to IAS 37. For example, a past event must have taken place for a reimbursement right to be recognized under IAS 37. However, IFRS 3 contemplates recognizing a contingent liability whether or not it is probable an outflow of economic resources will occur. This threshold for recognition of the reimbursement right is closer to that of the expected credit loss model in IFRS 9. Since the entity is insured by the group insurance policy, the contingent liability is like an indemnified liability. As such, an indemnification asset is recognized at the same time the entity recognizes the indemnified item. Under IFRS 3, credit risk associated with the indemnification asset does not affect recognition of the asset but is factored into its measurement. One Group member also thought that the group insurance policy gives the entity certain contractual rights that may have value, and therefore, the indemnification asset approach is more appropriate.

The Group also talked about whether netting the asset against the expected credit loss of the trade receivables is an option. However, several Group members noted that the contract with the insurer is a separate transaction not integral to the trade receivables. Therefore, they thought the amounts should not be offset in the statement of financial position.

Issue 3: If the group insurance policy is determined to be integral and not otherwise required to be separately recognized, how should it be accounted for?

Analysis

- Since the group insurance policy is integral to the trade receivables, it should not be accounted for separately. As such, Entity X needs to consider the effect of the group insurance policy when:
    - measuring the fair value of the trade receivables;
    - estimating the expected cash receipts from the trade receivables; and
    - assessing impairment of the trade receivables.

The Group's Discussion

Since the Group supported the view that the group insurance policy is not integral to each individual trade receivable under Issue 1, the following is a theoretical discussion.

Group members who expressed a view agreed with the analysis. A few Group members noted that if the group insurance policy is integral to the trade receivables, it is collateral that should be considered as part of the loss given default in the expected credit loss calculation. Furthermore, since the expected credit loss may be computed on a portfolio basis, the amount should be lowered by the group insurance policy because it will compensate the entity for the identified cash shortfall. For disclosure purposes, entities would still need to determine at what stage the financial asset is in under the expected credit loss model in IFRS 9 even if a group insurance policy exists.

Overall, the Group discussed these issues to raise awareness about this item. The Group noted that determining whether a credit enhancement is considered integral or not to the contractual terms is dependent on facts and circumstances. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

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