November 2009

Exposure Draft

Snapshot: Financial Instruments: Amortised Cost and Impairment

This snapshot is a brief introduction to a proposed IFRS on amortised cost and the impairment of financial assets. It provides an overview of the proposals published for public comment by the International Accounting Standards Board (IASB) on 5 November 2009.

The proposals form part of the IASB's response to the global financial crisis and are consistent with recommendations made by the G20, the Financial Stability Board, the Financial Crisis Advisory Group and others.

Project objectives:

- To improve the usefulness of financial statements by improving the transparency of provisions for losses on loans and the credit quality of financial assets.
- To improve the accounting for provisions for losses on loans by taking into consideration expected losses, resulting in more timely recognition of losses.
- To reflect the economic reality of lending by recognising interest revenue as a credit cost adjusted return, which eliminates the front-loading of interest revenue.

Project stage:

This is the second part of a three-part project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The project has three main parts – (1) classification and measurement, (2) amortised cost and impairment (loan loss provisions) and (3) hedge accounting.

This snapshot summarises proposals contained in the exposure draft (ED) that deals with the second part of this project – amortised cost and impairment.

Publication of the ED was preceded by a Request for Information that was published in June 2009 to invite comments on the feasibility of applying an expected cash flow amortised cost and impairment method.

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Comment deadline:

The ED is open for public comment until 30 June 2010.

There will be extensive outreach activities throughout the comment period to ensure that views are obtained from a broad range of interested parties.

Next steps:

The IASB is establishing an expert advisory panel (EAP) comprising experts with relevant practical experience in risk management and related systems that will:

- address how the proposals might be applied operationally;
- advise the IASB on the guidance that should be included in any final requirements; and
- facilitate field testing of the proposals.

Project part	Exposure draft	Finalisation
1. Classification and measurement	July 2009	For financial assets, November 2009 to permit use for 2009 year-end financial statements. For financial liabilities, during 2010. No mandatory application before 2013
2. Impairment	November 2009	In 2010. No mandatory application before 2013 or later
3. Hedge accounting	December 2009	In 2010

Mandatory effective date not before 1/1/2013

Why is the IASB proposing these changes?

Problems with incurred loss impairment

The impairment model under IFRSs is an incurred loss model.

Under the incurred loss model, loans may be written down (impaired) only when evidence is available that a loan or portfolio of loans will not be repaid in full.

Such evidence (known as a trigger event) may be specific to an individual loan (eg a bankruptcy) or an event that is likely to lead to defaults across a portfolio of loans (eg an increase in unemployment and a downturn in the property market may lead to an increase in mortgage defaults).

Expected future credit losses are not permitted to be recognised until a trigger (loss) event has occurred. This has resulted in the incurred loss model being criticised during the global financial crisis for recognising expected losses too late.

When a loan is made, the risk of default is included in calculating the interest on the loan. However, at present the accounting assumes that the loan will be repaid in full unless, at some point during the loan's life, evidence is provided to the contrary.

Therefore, under an incurred loss model, until a trigger event occurs the full contractual interest is recognised as revenue. When a trigger event occurs the impairment is recorded, resulting in an abrupt adjustment in the income statement (P&L). This pattern occurs even if the amount of that loss had always been expected (eg reflects historical experience).

The high recognition of interest revenue until actual evidence of a trigger event occurs has been criticised for not reflecting that future credit losses are expected across a portfolio of loans.

Additionally, in practice entities have used different trigger events or have assessed the same trigger events differently. This has resulted in inconsistent impairment accounting for similar financial assets between different entities.

What is the IASB proposing?

Expected loss impairment method

The IASB is proposing to move from the current incurred loss impairment method to one based on expected losses.

The proposed expected loss model requires an entity:

- to determine the expected credit losses on a financial asset when that asset is first obtained
- to recognise contractual interest revenue, less the initial expected credit losses, over the life of the instrument[1]
- to build up a provision over the life of the instrument for the expected credit losses
- to reassess the expected credit loss each period
- to recognise immediately the effects of any changes in credit loss expectations.

How the proposed impairment method would be applied

The proposed method would be applied on a portfolio basis in many cases, especially for low value, high volume assets such as retail loans. This is similar to the way that the existing impairment requirements are applied.

Financial instruments this would apply to

The proposed IFRS would apply to all financial assets measured at amortised cost.

The proposed impairment method would apply to non-interest bearing assets, such as trade receivables. A simplified approach to such assets is proposed in the ED whereby the anticipated recoveries on the receivable would be estimated and an interest component need not be identified.

Presentation and disclosure

Investors are interested in both the contractual interest on financial assets and the effect of expected credit losses on the return (ie economic or credit cost adjusted interest revenue). Therefore, the ED proposes separate presentation of:

- contractual interest
- allocation of initial expected credit losses
- economic interest income after allocation of initial expected credit losses.

In addition, the effect of changes in loss expectations would be presented separately in P&L.

The ED proposes additional disclosures about:

- the expected credit losses
- the general credit quality of an entity's financial assets.

1 See later comment regarding financial assets with no explicit interest. For example, some trade receivables.

continued

Transition

The ED proposes a transition method that would adjust the effective interest rate to approximate the rate that would have been determined at inception using an expected cash flow method. The ED does not propose fully retrospective or prospective transition because of:

- impracticability and cost concerns
- the effect on comparability between financial assets recognised before and after adoption of the proposed approach.

Effective date

The IASB will set the effective date once it finalises the IFRS.

The responses to the Request for Information and the consultations undertaken indicate that the proposed impairment method would require a lengthy implementation period.

As a result, the IASB expects that the (mandatory) effective date for any final requirements would be around three years after publication of those requirements. However, it is expected that early (voluntary) adoption would be permitted.

What are the benefits of this approach?

The proposed impairment method is intended to improve the ability of users of financial statements to understand and use financial information presented about impairment and the credit quality of an entity's financial assets.

Today's incurred loss impairment method has been criticised for recognising expected losses too late, and requiring high interest revenue to be recognised until an incurred loss is recognised.

Users have also expressed dissatisfaction with the information currently provided about the credit quality of financial assets.

The major impacts that the proposed change would have are:

Expected losses recognised earlier

Expected losses would be recognised earlier in the life of an asset, and any changes in expected losses would be recognised immediately.

A comparison of the effect on P&L of an incurred loss model with that of the proposed expected cash flow model when losses are expected is shown to the right.

Interest revenue reflects initial loss expectations

Interest revenue that is recognised will reflect the allocation of expected credit losses over the life of the instrument. This is a better reflection of the 'economic' interest that the lender expects to earn from an asset over its life than today's approach. Hence, it avoids inappropriate front-loading of interest revenue.

Update of expected credit losses

Using the proposed impairment method, credit loss expectations are updated each period. Any changes to initial expectations of credit losses will be recognised immediately in P&L. This change could be an increase in expected losses, or a reduction (reversal) of past expected losses (including the initial expected loss estimate).

continued

Transparency

The proposals would enhance transparency regarding interest revenue and credit losses as well as for the credit quality of financial assets.

The ED proposes disclosures that compare the development of the credit loss allowance over time with cumulative write-offs. These disclosures would enhance transparency of the estimates of expected credit losses.

No loss recognition triggers

The proposed impairment method does not require loss recognition triggers because expected losses are applied to all loans within the portfolio.

This would eliminate the diversity that exists in the application of such triggers. It also means that expected losses would be recognised earlier.

Proposed impairment method better reflects economic reality

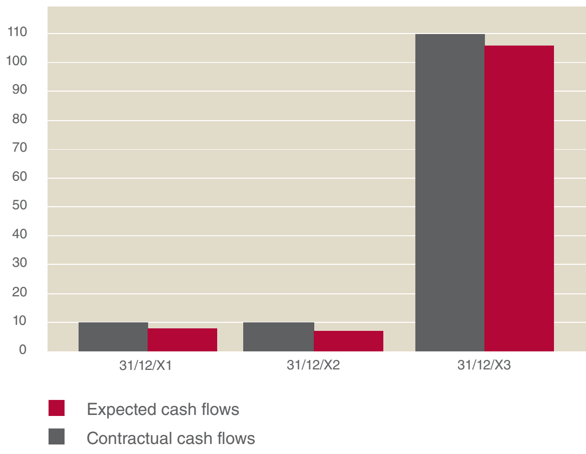
The proposed impairment method better reflects the economic position of a lender. When a loan is granted a lender has loss expectations and a portion of the lender's return is compensation for those expected losses. The proposed impairment method separates out the return for that credit risk and builds up a provision for expected losses over time. This reflects the economic situation behind the original lending decision and reflects the way that many lenders manage credit risk. An example is illustrated below for a very simple case where the lender has charged a total interest rate of 10 per cent over the portfolio. Of this, 3 per cent is in effect compensation for the credit loss expected when the loans were made.

Improved information about credit quality of assets

In developing the ED, the IASB has undertaken extensive consultations with investors and other users of financial statements. They said that the information currently provided about the credit quality of financial assets is insufficient.

Therefore, the ED proposes that additional information should be provided to help investors understand the credit quality of an entity's financial assets. The information will also enable users of financial statements to compare different entities' financial asset portfolios.

Loan advanced of 100 in 20X0 cash flows



Example: A portfolio of loans totalling 100 are advanced in 20X0 with a contractual interest rate of 10%. The graph shows the contractual and expected cash flows from the loans.

Expected interest rate from the loan portfolio is 7% using the effective interest rate method. The proposed impairment method builds up a provision each year to cover the expected losses. Under the current incurred loss model interest would be recognised at 10% as expected credit losses are ignored.

What are the considerations of moving to an expected loss model?

Operational complexity

To determine expected losses an entity must forecast expected credit losses and the timing of such losses over the life of financial assets (either on an individual or on a portfolio basis). Depending on the size and complexity of an entity's financial asset portfolio this can be operationally challenging.

The ED includes guidance on practical expedients. The expert advisory panel is expected to identify further practical expedients that would mitigate operational complexity.

Systems changes

In most cases changing from an incurred loss to an expected loss impairment model will require systems changes to be made. This has been confirmed during the consultations that have been undertaken and in responses to the Request for Information on the feasibility of an expected loss impairment model.

Expert advisory panel

Before the IASB decided to propose an expected loss model it published a Request for Information on the feasibility of an expected loss model. In addition, extensive consultations have been conducted with financial and non-financial companies, auditors, regulators and others. These covered different geographical areas, including emerging economies.

Responses to the Request for Information and the consultations confirmed the IASB's view that in some circumstances applying an expected loss impairment model would entail operational challenges. As a result the IASB is setting up an expert advisory panel to advise on how such practical challenges might be addressed and to field test the proposals.

Frequently asked questions

Does this method mean that more financial assets will be marked to market?

No. The proposed impairment method is based on estimates of the future contractual cash flows that will be recovered on the instrument. The discount rate excludes changes in liquidity and risk premiums.

What does this mean for IASB plans to converge with US GAAP?

Both IFRSs and US GAAP use an incurred loss impairment model. As part of its own comprehensive review of the accounting for financial instruments the US Financial Accounting Standards Board (FASB) will also consider changes to impairment accounting. The FASB has started exploring an impairment model that includes some loss expectations.

Further information

The ED includes questions on the proposals. Respondents are invited to comment on any or all of those questions and to comment on any other issue that the Board should consider in finalising the proposals. The IASB's redeliberations of the proposals will take place in public meetings as announced on the IASB website.

The deadline for comments on the ED is 30 June 2010. To view the ED and submit your comments, visit www.iasb.org.

The Request for Information on the feasibility of an expected loss model is available on the IASB website. Numerical examples of the calculation mechanics of an expected loss impairment model are also available on the IASB website. To view these items, visit www.iasb.org.

More information about measures undertaken by the IASB in response to the G20 conclusions and the recommendations of the Financial Stability Board is available on www.iasb.org/financial+crisis.

To stay up to date with the latest developments of the project to replace IAS 39 sign up for email alerts via the project homepage on www.iasb.org.

Notes

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