

International Accounting Standards Board

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Request for Information

Responses to be received by 1 September 2009

Request for Information ('Expected Loss Model')

Impairment of Financial Assets: Expected Cash Flow Approach

Background

- 1 After considering the comments it received on the discussion paper *Reducing Complexity in Reporting Financial Instruments*, the International Accounting Standards Board added to its active agenda a project to improve the reporting requirements for financial instruments. The project will ultimately result in the replacement of IAS 39 *Financial Instruments: Recognition and Measurement*. The Board aims to complete the project during 2010.
- 2 The project deals with the following matters:
 - derecognition of financial instruments (exposure draft published in March 2009).
 - classification and measurement of financial instruments (exposure draft expected to be published in July 2009).
 - impairment of financial assets (exposure draft expected to be published in October 2009).
 - hedge accounting (exposure draft expected to be published in December 2009).
- 3 This *Request for Information* seeks input for the Board's work on the impairment of financial assets.

Reason for this *Request for Information*

- 4 IAS 39 requires an incurred loss impairment approach for financial assets measured at amortised cost. Under that approach, an impairment loss is required to be recognised if an impairment loss has been incurred. If losses are expected to arise from future events, those losses are not recognised.
- 5 The incurred loss impairment approach has been criticised for many reasons, including:
 - interest revenue is overstated in the periods before a loss event occurs.
 - if a loss has been incurred it is not always clear when the loss event took place.
 - the approach is internally inconsistent because expected losses are implicit in the initial measurement of the asset, but not taken into account in determining the effective interest rate used for subsequent measurement.
 - incurred losses lag probable losses, which creates an information deficiency.
 - in some cases, a loss is recognised in profit or loss even though the original expectations have not changed.
 - changes in credit risk are not recognised because of the thresholds required to be crossed before recognising any impairment loss.
 - it is not clear when to reverse a previously recognised impairment loss.
- 6 The financial crisis brought many of these criticisms to the forefront. As a result, the Board has discussed possible alternative impairment approaches, with particular emphasis being given to an expected cash flow approach.
- 7 This *Request for Information* does not seek views on the relative advantages and disadvantages of alternative impairment approaches. Rather, it asks for information on the feasibility of an expected cash flow approach. The Board will consider that input when developing its proposals for the impairment of financial assets, for which it plans to publish an exposure draft in October 2009.

This paper has been prepared by the technical staff of the International Accounting Standards Board (IASB).

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB Update. Official pronouncements of the IASB, including discussion papers, exposure drafts, IFRSs and Interpretations, are published only after the IASB has completed its full due process, including appropriate public consultation and formal voting procedures.

Main features of an expected cash flow approach

- 8 In this request, the Board invites input on the expected cash flow approach as discussed at its meeting in May 2009. The main features of the approach are set out and discussed in IASB Agenda Papers 5A and 5D for that meeting. Those papers are available at the following links:

<http://go.iasb.org/6-09-Paper5A>

<http://go.iasb.org/6-09-Paper5D>

- 9 In summary, the main features of the expected cash flow approach include:
- (a) interest revenue is recognised on the basis of expected cash flows (including expected credit losses) upon the initial recognition of an instrument.

[**Note:** This differs from the approach in IAS 39 whereby an entity considers some expected cash flows (eg expected prepayments) but not others (eg expected credit losses). Because the treatment of expected credit losses constitutes an important difference between the current approach and the expected cash flow approach, emphasis is given below to the effect of expected credit losses.]
 - (b) impairment results from an *adverse change* in credit loss expectations (ie expectations of credit losses are higher than those previously expected).
 - (c) an impairment loss is recognised in profit or loss and is measured as the difference between the carrying amount of the financial asset and the present value of the revised expected cash flows of that asset.
 - (d) when determining the present value of expected cash flows, fixed rate instruments are discounted using the effective interest rate calculated upon the initial recognition of the instrument and variable rate instruments are discounted using the current effective interest rate.
 - (e) subsequent or additional impairment loss is recognised through continuous re-estimation of credit loss expectations.
 - (f) reversal of impairment loss is recognised in profit or loss when there is a *favourable change* in credit loss expectations (ie expectations of credit losses are less than those previously expected).
- 10 An expected cash flow impairment approach is likely to present the following application challenges, some of which are shared by an incurred loss impairment approach:
- (a) the need to formulate expected cash flow data for individual assets and/or portfolios of assets.
 - (b) the need to estimate initially and subsequently re-estimate credit loss expectations for individual assets and portfolios of assets (which is not a requirement of the incurred loss impairment approach).
 - (c) the interaction between individual and collective impairment assessments in the event of a loss incurred on specific assets in the portfolio (which also affects the incurred loss impairment approach to some degree).

Paragraphs 39 and 40 of Agenda Paper 5A describe the application challenges of accounting for losses identified on specific assets in a portfolio.

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- 11 The Board seeks information on the following matters pertaining to the feasibility of an expected cash flow approach:
- 1 Is the approach defined clearly? If not, what additional guidance is needed, and why?
 - 2 Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?
 - 3 What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?
 - 4 How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

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- 5 How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:
- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?
 - (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?
- 6 What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?
- 12 The Board would like to receive information by **1 September 2009**. Respondents should send their comments by email to: iasb@iasb.org. All comments received will be treated as public documents and made available on the IASB website.

Appendix

Application of the expected cash flow approach to variable rate instruments

- A1 This appendix presents alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments. It is not intended to be prescriptive, nor is it an indication of current requirements or practice from applying current IFRSs.
- A2 Variable rate instruments present unique challenges when applying the expected cash flow approach. These challenges relate, in part, to the need to update the effective interest rate to reflect movements in market rates of interest (see paragraph AG7 of IAS 39) and the resulting amortisation pattern for fees, points, transaction costs and other premiums or discounts ('upfront costs'). In effect, this results in a combination of a variable rate interest component (the portion indexed to a benchmark interest rate) and a fixed rate interest component (the upfront costs that are amortised). These challenges are further complicated when impairment losses reduce the carrying amount significantly below the nominal amount of an instrument.

Amortisation of upfront costs

- A3 IAS 39 requires upfront costs to be amortised over the expected life of the instrument, unless a shorter period is deemed more appropriate in the circumstances (see paragraph AG6). For this discussion, it is assumed that those costs are not amortised over a shorter period.
- A4 There are two main approaches for amortising upfront costs:
- Approach A:** Amortise upfront costs using the original effective interest rate calculated upon initial recognition of the instrument. Under this approach, the initially determined amortisation pattern would remain constant (ie there would be no revisions in response to changes to the variable interest rate for that amortisation pattern). This approach results in the variable interest receipts being recognised period by period as the actual amount that was set for that respective period while the amortisation of upfront costs remains unaffected (following a pattern similar to that for a fixed rate instrument).
- Approach B:** Recalculating the amortisation pattern for the upfront costs on the basis of an updated estimate for the remaining variable interest receipts to maturity. Under this approach, the amortisation pattern for the upfront costs would change each period in response to changes in the variable benchmark interest rate.

Impairment of variable rate instruments

- A5 IAS 39 requires an impairment loss to be recognised if the carrying amount of a variable rate instrument exceeds the present value of its expected cash flows, discounted at the current effective interest rate (see paragraph AG84 of IAS 39). This would be the case when an entity expects a shortfall in contractual interest and/or principal receipts. When an impairment loss is recognised, a portion of future contractual interest receipts that are still expected to be received partially become in substance repayments of principal because the contractual interest cash flow exceeds the effective interest accrual. In those situations, these portions reduce the carrying amount of the instrument rather than being recognised as interest revenue. For variable rate instruments, this repayment of principal might in part be effected through the variable benchmark interest component of the interest receipts. The economic effect is similar to a benchmark interest rate indexed principal repayment.
- A6 There are at least two possible approaches that could be considered for treating the 'repayment of principal' in those situations:
- Approach A:** Recalculate the effective interest rate so that the still expected future interest receipts (based on the forward curve as updated from time to time) and the still expected principal receipts are discounted to the carrying amount, consistently with paragraph AG7 of IAS 39. This would require continuous resetting of the effective interest rate post-impairment. It also raises the issue of sequencing two steps:

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- 1 recalculating the current effective interest rate at each measurement date (which requires a carrying amount as a starting point); and
- 2 revisions of the cash flow estimates regarding the expected shortfalls of contractual receipts (which requires the current effective interest rate in order to be converted into a present value—ie the carrying amount).

Approach B: Keep the effective interest rate constant after an impairment and treat changes in the carrying amount resulting from changes in the variable benchmark interest rate as a ‘catch up’ adjustment in accordance with paragraph AG8 of IAS 39. A ‘catch up’ adjustment is used because the changes in the cash flows no longer relate solely to interest receipts but also (often predominantly) relate to an in substance principal repayment.