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Project	<b>Financial Instruments – Recognition and Measurement</b>
Topic	<b>Amortised cost – an expected cash flow approach</b>

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134. DSR-Sitzung, 17.08.09

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## Introduction

### *Background*

1. At the March 2009 joint board meeting the boards discussed possible approaches to impairment/loss provisioning. They explored and compared the incurred loss model and an expected loss model. Both models use amortised cost conventions rather than fair value.
2. At that meeting the boards decided that impairment should be a separate work stream within the financial instruments project.
3. At the April 2009 meeting the IASB discussed the amortised cost measurement method<sup>1</sup>, including three possible impairment approaches for financial assets – incurred loss method, an expected loss method and a method based on fair value.
4. At that meeting the Board asked the staff to provide more information about the impairment approaches.

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<sup>1</sup> Agenda paper 14 of the April 2009 IASB meeting.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the 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 it has completed its full due process, including appropriate public consultation and formal voting procedures.

***Purpose of this paper***

5. This paper provides more information about the expected loss approach.
  
6. This paper does not ask the boards for any decisions. However, this series of papers aims to put board members in a position to take a decision on the impairment model that would be proposed should amortised cost be used as the measurement method for any financial asset. Therefore it is important that board members specify whether they need additional information or analysis on the subject being discussed (and if so, what). Given the timetable for this project, board members must ensure that such requests are focussed as well as necessary.

**Expected cash flow approach**

***Overview***

7. An observation. Current effective interest method (EIM) requirements are already based on an expected cash flow approach. It is only the ‘trigger’ or ‘threshold’ of the incurred loss model that is the exception (ie that future credit losses for which there is no objective evidence of impairment yet must not be taken into account in estimating future cash flows).<sup>2</sup>
  
8. So let us consider the triggers. The expected cash flow approach described in this paper uses a continuous re-estimate of (all) expected cash flows. Thus, it would not involve any trigger or threshold with regard to impairment testing (nor otherwise). Therefore, the requirement to continuously re-estimate (all) the expected cash flows would include any revisions of cash flow estimates that

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<sup>2</sup> As explained in the paper on amortised cost for the April 2009 IASB meeting (agenda paper 14 for that meeting, paragraph 27), this threshold results in the impairment loss reversing that part of the contractual interest that reflects compensation for credit losses expected at the outset but that was recognised as interest revenue in previous periods because the loss event had not yet occurred.

currently occur under the incurred loss model. In other words, an ‘impairment test’ is integral within the expected cash flow approach described in this paper. Eliminating ‘triggers’ or ‘thresholds’ with respect to assessing credit losses results in a consistent approach to revisions of cash flow estimates, whether for effective interest rate (EIR) purposes or assessing credit losses.

9. Thus, in summary, the key difference between the currently used amortised cost with an incurred loss model and the expected cash flow approach is that the estimates of future cash flows are not limited by the ‘incurred’ threshold. This also has a knock-on effect on the EIR (see paragraph 14 below) as well as on the issue of collective versus individual impairment assessments (see the section ‘Application to portfolios and individual financial assets’ below). Otherwise, the approaches are the same (especially regarding the financial mathematical mechanics).

#### ***Initial measurement***

10. As explained in the paper on amortised cost for the April 2009 meeting,<sup>3</sup> the initial measurement is the starting point for an amortised cost approach but not determined by that approach.<sup>4</sup> This starting point would not change as a result of using an expected cash flow approach. In particular, there would generally<sup>5</sup> be no credit loss recognised in profit or loss on initial recognition (as is the case under some approaches described as ‘expected loss’ approaches).

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<sup>3</sup> See agenda paper 14 of the April 2009 IASB meeting.

<sup>4</sup> Fair value plus (less) transaction costs of an asset (liability) is the starting point currently used in IAS 39.

<sup>5</sup> If there is a change in estimated cash flows between the time the conditions of an instrument (such as contractual interest) are set and initial recognition (eg during a commitment phase for which the loan commitment is not recognised) a credit loss is recognised in profit or loss (in accordance with IFRSs by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). The Board may consider changing the scoping so that the expected cash flow approach in the new financial instruments standard would apply in such circumstances rather than IAS 37.

11. Therefore, any decisions on the starting point are independent of a decision to use the expected cash flow approach.<sup>6</sup>

***Subsequent measurement – expected cash flows and the EIR***

12. The expected cash flow approach uses from the outset the best estimate of expected future cash flows. This estimate includes any expected reductions in cash flows owing to credit risk (ie there are no triggers or thresholds—see paragraph 8 above).
  
13. An aside. *If* (and that depends upon any criteria the boards use to determine measurement methods used for different instruments) an expected cash flow approach were applied to debt instruments acquired at a deep discount that reflects credit losses (deep discount bonds) the approach would work in the same way as for all other financial assets. It would result in the EIR being determined on the basis of the expected cash flows of the deep discount bond, which takes into account the expected shortfalls of contractual cash flows. Under the existing incurred loss model<sup>7</sup> for deep discount bonds, incurred losses are included in the cash flow estimate that is used in determining the EIR (although actual practice is unclear). The rate based on incurred losses will be different than the implicit fair value rate at which the bond is purchased and initially recognised. That means that the accretion from the fair value (at initial recognition) to redemption will not achieve full unwinding of the difference between fair value and the forecast expected cash flows (without further adjustments). However, because of the difficulty of differentiating incurred from expected but not yet incurred credit losses for such instruments, and the frequent revisions of the estimate, this effect is unlikely to be observable in practice (but rather dissolve in later revisions of estimates).

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<sup>6</sup> Obviously, changes in the starting point would affect the EIR that is determined under the EIM.

<sup>7</sup> See IAS 39.AG5.

14. Back to subsequent measurement. Once the expected cash flows have been determined, the next step is to determine the EIR. The expected cash flow approach uses the same financial mathematical mechanics of the EIM as the currently existing model (ie amortised cost with an incurred loss model). That means that with the initial carrying amount (starting point) and the expected cash flows as inputs, the EIR is calculated by iteration.
  
15. The financial mathematical mechanics for unwinding the initial carrying amount to the subsequent cash flows are also the same as under the currently existing model. For example, if all the future cash flows occur as originally expected the interest revenue recognised under the EIM is the only profit or loss impact. Any differences between coupon interest payments and the effective interest for the period directly adjust the carrying amount (akin to a repayment or an additional advance). If actual cash flows deviate from their estimates it gives rise to the same kind of 'catch-up' adjustments that the EIM uses today for other changes in estimates of cash flows (eg prepayment patterns).

***Illustration of the expected cash flow approach***

16. The following examples illustrate how the expected cash flow approach works. They start with a simple example and then step up the complexity using different scenarios. All examples use fixed rate financial assets. For variable rate financial assets the calculation of amortised cost in the context of impairment is not as straightforward (an existing practice problem).

*Example 1*

17. Example 1 illustrates a simple scenario in which the cash flows occur exactly according to the original expectations. Thus, no subsequent adjustment to profit or loss is required in periods 3–5, despite the shortfall in contractual cash flows. This is because those shortfalls (credit losses) were taken into account in determining the original EIR.

**IASB Staff paper**

10,000.00	Nominal amount
10%	Coupon interest rate
100	# loans
1,000,000.00	Lending volume
10.00%	EIR (excluding future losses)
8.84%	EIR (expected cash flow approach)

Period	Contractual CF	Default rate		Interest	Carrying amt	Adjustment
		Per annum	Expected CF			
0	-1,000,000.00		-1,000,000.00		1,000,000.00	
1	100,000.00	0.0%	100,000.00	88,396.06	988,396.06	0.00
2	100,000.00	0.0%	100,000.00	87,370.32	975,766.38	0.00
3	100,000.00	1.0%	99,000.00	86,253.90	963,020.28	0.00
4	100,000.00	2.0%	97,020.00	85,127.20	951,127.48	0.00
5	1,100,000.00	3.0%	1,035,203.40	84,075.92	0.00	0.00

*Example 2*

18. Example 2 uses as the starting point the same fact pattern as Example 1 (ie *initially* per annum defaults of 1%, 2% and 3% over periods 3–5 are expected). However, in this example the originally expected cash flows are revised at the end of period 2 in order to reflect *higher* per annum defaults than originally expected. The new estimate is 2%, 4% and 8% over periods 3–5.
  
19. As a consequence, the carrying amount is adjusted against profit or loss at the end of period 2 in order to reflect the revised cash flow estimate. The amount of the adjustment is the difference between
  - (a) the carrying amount at the end of period 2 that would have resulted without a revision of cash flow estimates; and
  - (b) the present value of the expected cash flows (after revising the estimate) over periods 3–5 discounted at the originally expected EIR.
  
20. No further adjustments are made unless there is a further revision of estimates (ie if the estimate as of the end of period 2 would be revised).

**IASB Staff paper**

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10%	Coupon interest rate
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Period	Contractual CF	Default rate		Interest	Carrying amt	Adjustment
		Per annum	Expected CF			
0	-1,000,000.00		-1,000,000.00		1,000,000.00	
1	100,000.00	0.0%	100,000.00	88,396.06	988,396.06	0.00
2	100,000.00	0.0%	100,000.00	87,370.32	907,902.50	-67,863.88
3	100,000.00	2.0%	98,000.00	80,255.00	890,157.50	0.00
4	100,000.00	4.0%	94,080.00	78,686.42	874,763.92	0.00
5	1,100,000.00	8.0%	952,089.60	77,325.68	0.00	0.00

*Example 3*

21. Example 3 also uses as the starting point the same fact pattern as Example 1 (ie *initially* per annum defaults of 1%, 2% and 3% over periods 3–5 are expected). Again, like in Example 2, in this example the originally expected cash flows are revised at the end of period 2 but this time in order to reflect *lower* per annum defaults than originally expected. The new estimate is 0.5% each period over periods 3–5.
  
22. As in Example 2, the carrying amount is adjusted against profit or loss at the end of period 2 in order to reflect the revised cash flow estimate. Because the cash flow estimate is revised upwards the adjustment is a gain. The amount of the adjustment is determined in the same way as for Example 2. Note that this results in a carrying amount in period 2 and 3 that is greater than the original proceeds. This is because of the upward revision of the cash flow estimates owing to lower expected credit losses than initially expected. Economically, this represents a gain from an improvement in the quality of the financial assets. The premium for default risk implicitly included in the contractual interest rate reflected the estimate of credit risk on origination of the financial assets. The current estimate of credit risk in period 2 is lower so that the holder of the asset receives a higher premium under the contractual terms than what the holder would require in period 2 for similar financial assets.

23. Again, as in Example 2, no further adjustments are made unless there is a further revision of estimates (ie if the estimate as of the end of period 2 would be revised).

	10,000.00	Nominal amount				
	10%	Coupon interest rate				
	100	# loans				
	1,000,000.00	Lending volume				
	10.00%	EIR (excluding future losses)				
	8.84%	EIR (expected cash flow approach)				
		Default rate				
		Per annum				
Period	Contractual CF	Expected CF	Interest	Carrying amt	Adjustment	
0	-1,000,000.00	-1,000,000.00		1,000,000.00		
1	100,000.00	100,000.00	88,396.06	988,396.06	0.00	
2	100,000.00	100,000.00	87,370.32	1,015,422.16	39,655.78	
3	100,000.00	99,500.00	89,759.32	1,005,681.48	0.00	
4	100,000.00	99,002.50	88,898.28	995,577.26	0.00	
5	1,100,000.00	1,083,582.36	88,005.11	0.00	0.00	

*Example 4*

24. Example 4 uses a different fact pattern than the previous examples (one that might be less probable to occur). In this example credit losses are expected to occur over the first three periods in a declining pattern. Initially, per annum defaults of 3%, 2% and 1% over periods 1–3 are expected. In this example the cash flows occur exactly according to the original expectations. Thus, similarly to Example 1, there is no adjustment to profit or loss in periods 1–3 despite the shortfall in contractual cash flows (credit losses) because they were taken into account in determining the original EIR.
25. The mechanics work no differently than in the scenarios of the previous examples, which had a default pattern that expected losses to occur in the later stages of the loans (periods 3–5).



IASB Staff paper

10,000.00	Nominal amount
10%	Coupon interest rate
100	# loans
1,000,000.00	Lending volume
10.00%	EIR (excluding future losses)
8.51%	EIR (expected cash flow approach)

Period	Contractual CF	Default rate		Expected CF	Interest	Carrying amt	Adjustment
		Per annum					
0	-1,000,000.00			-1,000,000.00		1,000,000.00	
1	100,000.00	3.0%		97,000.00	85,050.13	988,050.13	0.00
2	100,000.00	2.0%		95,060.00	84,033.79	977,023.91	0.00
3	100,000.00	1.0%		94,109.40	83,096.01	966,010.52	0.00
4	100,000.00	0.0%		94,109.40	82,159.32	954,060.44	0.00
5	1,100,000.00	0.0%		1,035,203.40	81,142.96	0.00	0.00

26. Let us consider the effects of the default pattern.
27. Some interpret the outcome in this scenario (that the losses are expected in the early stages) as giving rise to a ‘deferral’ of credit losses.
28. The interpretation of the revenue and carrying amounts as a deferral of credit losses is a misperception. The carrying amount is the present value of the expected cash flows—including reductions for all future credit losses whether or not ‘incurred’—discounted at the EIR determined initially (ie reflecting originally expected credit losses).
29. Thus, the view of a ‘deferral’ is implicitly based on regarding the EIR that is determined *ignoring* originally expected credit losses as the *correct* discount rate.
30. In every scenario in which the originally expected losses are more than zero, ignoring originally expected credit losses in determining the EIR results in a

higher EIR than the EIR that is determined under an expected cash flow approach (including originally expected credit losses).

31. Therefore, the carrying amount of a financial asset under an expected cash flow approach would be higher than under an incurred loss approach in every scenario in which:
  - (a) the incurred loss 'threshold' was reached so that the carrying amount of the financial asset is written down; and
  - (b) no further credit losses are expected thereafter.
  
32. Thus, the issue is not one of 'deferral' of credit losses (in fact, the expected cash flows could not be higher but only lower under an expected cash flow approach compared to an incurred loss approach). It is rather about a fundamental difference about the appropriate way of determining the effective yield of a financial instrument. Namely, whether to:
  - (a) factor in expected future credit losses; or
  - (b) ignore expected future credit losses until incurred.
  
33. Those who believe that the original EIR should be based on expected cash flows (ie factor in expected credit losses) consider that the incurred loss approach in a scenario of early losses results in a type of 'big bath' accounting. This is because an inappropriately high yield is used to determine the impairment loss once incurred, resulting in an overstated one-time hit to profit or loss, and then that high yield is used to unwind the carrying amount, which overstates interest revenue in the remaining period.
  
34. Those who are concerned about a 'deferral' effect for credit losses under an expected cash flow approach also appear to implicitly call into question the estimate of future cash flows. Because if that estimate is correct, the expected

cash flow approach does not involve any adjustments for credit losses unless and until the estimate is revised. But the reliability of the cash flow estimate affects any measurement approach, irrespective of the discount rate used to convert the estimate into a present value. Those who support an expected cash flow approach see no merit in using a discount rate that is higher only because it results—for purely mechanical reasons of financial mathematics—in a lower present value (which some consider ‘more conservative’ irrespective of the reason for the lower carrying amount). That rationale would justify any discount rate provided it is higher.

***Application to portfolios and individual financial assets***

35. Existing IFRS requirements relating to application of impairment requirements to portfolios and individual financial assets<sup>8</sup> (which the IASB deliberated at great length during the 2003 Improvements project) are based on:

- (a) an individual assessment of a financial asset for impairment; and
- (b) a collective assessment of a group of financial assets, which:
  - (i) is eligible in lieu of an individual assessment if:
    - the financial assets in the group are not individually significant;
    - the financial assets in the group have similar credit risk characteristics; and
    - there is no information yet that specifically identifies losses for an individually impaired asset (as soon as such information is available, the asset is moved from the collective to an individual assessment);
  - (ii) accompanies the individual assessment if:
    - no objective evidence of impairment exists for an individually assessed financial asset; and

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<sup>8</sup> See IAS 39.64 and IAS 39.AG87–AG88.

- the entity has a group of assets with similar risk characteristics.

36. The complexity of this interplay between individual and collective assessments results from the threshold used by the incurred loss model for recognising impairment losses (ie ‘objective evidence of impairment’ or ‘loss event’). It is this ‘incurred’ threshold that requires much of the differentiation regarding the collective assessment.<sup>9</sup> Not only does it result in complexity but also in arbitrary outcomes.

37. For example, requiring the accompanying collective assessment (see paragraph 35(b)(ii) above) if an entity has a group of assets with similar risk characteristics, but prohibiting it if the entity does not have such a group, is obviously not directionally consistent with an objective of identifying impairment losses, which do not depend on whether or not an entity has other financial assets with similar risk characteristics. Instead, it reflects the difficulty of applying the notion of a loss event, which results in a systematic bias because the application to groups results in a different (earlier) timing of identifying loss events than on an individual basis. This is for example the case of ‘incurred but not reported’ losses (IBNR).

38. An expected cash flow approach would eliminate the complexity and arbitrariness of the existing requirements. Because the expected cash flow approach does not involve a threshold for impairment testing (see paragraph 8 above) the interplay between a collective and an individual assessment would be principle-driven: the type of assessment that better facilitates the cash flow estimate would be used.

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<sup>9</sup> The differentiation between paragraph 35(b)(i) and 35(b)(ii) as well as the restriction for paragraph 35(b)(i) that there is no information yet that specifically identifies losses for an individually impaired asset.

39. Let us illustrate that. For financial assets that have similar characteristics estimating future cash flows on a group basis essentially allows making use of the law of large numbers, which improves the accuracy of the overall estimate. However, as the performance of an individual financial asset becomes increasingly doubtful it becomes less likely that it still shares the characteristics of the group it was included in before. Thus, that financial asset would either be included in another group that now offers a good fit of characteristics (eg a type of non-performing loan portfolio or cascade down a provision matrix) or it may have developed such individual characteristics making it so dissimilar that an individual assessment gives the better estimate.
40. Switching from a group- to an individual instrument-based cash flow estimate would not cause an automatic profit or loss impact just because of changing the approach. The financial instrument's carrying amount at the time of switching the approach already reflects the expected cash flows as most recently revised (ie the last time the estimate for the group was revised). Thus, if for example an entity uses a 'portfolio allowance' for the purpose of recording the adjustments for a group of financial assets resulting from revisions of cash flow estimates, the portion of that portfolio allowance that is attributable to the individual financial asset that is switched to an individual assessment would be taken out of that portfolio allowance and be attributed to that individual financial asset.<sup>10</sup> That is not to say that the new cash flow estimate on an individual financial asset level might not result in a revision of the previous (group level based) estimate.

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<sup>10</sup> In terms of bookkeeping this can be effected in different ways. For example, one way of achieving this is to remove the nominal amount of the financial asset from the total of nominal amounts that feed into the portfolio assessment, which ceteris paribus reduces the portfolio allowance (against profit or loss). The carrying amount of the financial asset would then be adjusted for the entire effect of the latest cash flow estimate made at the level of the individual financial asset (against profit or loss). Thus, the adjustment made at the level of the individual level would be offset to the extent of the adjustment that was already made previously at the portfolio level. (For disclosure purposes that link between the portfolio level adjustment and the individual level adjustment when switching the approach might need to be tracked, though. This is because, to the extent of the offset, a gross presentation as a reduction and an increase in the different adjustments might be misleading).

41. Another feature of the expected cash flow approach is that the same principle for estimates using a collective or individual approach would also apply to other aspects of cash flow estimates than credit risk related ones. As noted previously in this paper<sup>11</sup>, for example, an estimate of prepayment patterns for prepayable instruments is already required as part of the EIM under currently existing requirements.<sup>12</sup> That estimate may be based on an individual financial instrument or a group of financial instruments. However, this estimate is not subject to a threshold like the one for credit losses under the incurred loss model. Thus, an expected cash flow model would use the same principle for choosing between group- or individual instrument-based cash flow estimates irrespective of the type of uncertainty (ie whether or not credit loss related). However, for disclosure purposes, different types of uncertainties and how they affect the estimates may have to be disaggregated (eg to allow a reconciliation of changes related to credit risk).

***Challenges of an expected cash flow approach***

42. As set out earlier in this paper (see paragraph 9 above), the key difference between the currently used amortised cost with an incurred loss model and the expected cash flow approach is that the estimates of future cash flows are not limited by the ‘incurred’ threshold. This means that implementing an expected cash flow approach would require changing existing guidance regarding:
- (a) cash flow estimates;
  - (b) applying the EIM; and
  - (c) collective versus individual impairment assessments.

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<sup>11</sup> See paragraph 15.

<sup>12</sup> See IAS 39.9 (definition of EIM) and IAS 39.AG8.

*Cash flow estimates and their effect on the EIR*

43. The initial estimate of expected cash flows, including that for credit losses, drives the EIR and, thus, the revenue recognition. This is also likely to be the ‘pressure point’ of the expected cash flow approach. For example, if the initial estimate of credit losses were deliberately:
- (a) *overstated* it would result in an upside potential for gains in the future as the estimate is revised to a realistic expectation as well as provide a ‘cushion’ against surprise credit losses;
  - (b) *understated* it would inflate revenue at the expense of a downside potential for losses in the future as the estimate is revised to a realistic expectation.
44. Any temptation to overstate initial estimates of credit losses is mitigated by the detrimental consequences such behaviour would have. The flip side of overstating initially expected credit losses is that the EIR is understated (ie lower compared to an unbiased cash flow estimate). This reduces the interest revenue over the entire life of the instrument, which for example impacts the interest margin (a key performance measure for financial institutions to which a valuation multiple is typically applied directly or indirectly). Any gains recognised later as a result of revising the cash flow estimate to a realistic level are more volatile and hence typically considered less sustainable by users compared to interest revenue (and hence typically a lower valuation multiple is applied to such figures).
45. Therefore, compared to another similar entity that uses an unbiased estimate it is doubtful that tactics of overstating the initial estimate of credit losses would be beneficial. In addition, a track record of revising cash flow estimates in the same direction would call into question management’s ability to estimate cash flows, undermining users’ confidence. Thus, market discipline would mitigate what might appear to be a tempting prospect to some.

46. Similarly, market discipline would also mitigate a tendency to deliberately understate initial estimates of credit losses. The higher revenue would be undermined by a track record of consistently negative surprises. Such a scenario would result in devaluing the interest revenue figure in the users' view and raise their suspicion that initial credit loss estimates are biased to unrealistically low levels. That would defeat the purpose of using such biased estimates.
47. Disclosures could also address some of these issues.

*Guidance about cash flow estimates*

48. There is limited existing IFRS guidance on estimating cash flows for the purpose of the impairment test of financial assets.<sup>13</sup> Most of what there is relates to differentiating incurred losses from losses that are not yet incurred.
49. For the impairment test of non-financial<sup>14</sup> assets IFRSs include much more comprehensive guidance on estimating cash flows.<sup>15</sup> The extent of the guidance in IAS 36 reflects the higher complexity of estimating cash flows for non-financial assets. The complexity results from dealing with mainly non-contractual cash flows and the interaction of different assets. Thus, cash flow estimates are much more difficult compared to financial instruments as they include aspects such as budget information, growth rates assumptions, terminal values, and the effects of future capital expenditure and restructurings.

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<sup>13</sup> The guidance is mainly in IAS 39.AG85–92.

<sup>14</sup> IAS 36 applies to a limited number of types of financial assets (see IAS 36.4) but its main application is to non-financial assets.

<sup>15</sup> See IAS 36.33–54.



50. For the measurement of provisions IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* includes some guidance on estimating cash flows.<sup>16</sup> Similar to the IAS 36 guidance, it reflects that the estimates required for provisions often relate to non-contractual cash flows or cash flows that represent expenditure on measures an entity is obliged to take (eg regarding decommissioning or restoration obligations, repairs under warranty obligations). However, some aspects of the guidance on estimating cash flows are currently incorporated by reference into the incurred loss model of IAS 39. This is the guidance on how to deal with uncertainties of amounts.<sup>17</sup> It requires using the expected value for determining the best estimate within a range.
51. The comparison to the guidance on estimating cash flows in IAS 36 and IAS 37 argues that for financial instruments with contractually specified cash flows there is less of a need for similarly extensive guidance. The guidance on estimating cash flows that would be needed to be developed for an expected cash flow approach is mainly about:
- (a) a clear explanation (definition) of what is meant by expected cash flows for the purpose of the expected cash flow approach; and
  - (b) implementation guidance, especially for some low value, high volume items.
52. The explanation of expected cash flows would be required to avoid confusion with cash flow estimates for other purposes such as estimates required by financial institutions for regulatory purposes in accordance with Basel II. That guidance would set out aspects such as that the cash flow estimate has a time horizon over the entire life of the financial asset, and that no ‘thresholds’ or ‘cut-offs’ apply.

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<sup>16</sup> See IAS 37.38–43 and 48–50.

<sup>17</sup> See reference to IAS 37.39 in IAS 39.AG86.

53. The implementation guidance for low value, high volume items would illustrate how cash flows are estimated within a portfolio context. That guidance should include items such as trade receivables (keeping in mind this is not a financial services industry but a financial instruments project).

*Application of the EIM*

54. Guidance on applying the EIM would largely be a consequential amendment of the currently existing guidance. As set out earlier in this paper (see paragraphs 14–15 above), the financial mathematical mechanics do not change. The main challenge in transitioning from an incurred loss model to an expected cash flow approach will be sourcing the expected cash flow data and making the IT-system changes that requires.

55. Banks in particular have made significant investments in systems to comply both with accounting and with Basel II requirements (in jurisdictions that Basel II has been implemented). The staff has had, and will continue to have, exploratory discussions with some of these institutions about the extent of investment that might be required. However, before any specific proposals are made, assessing the possible impact on banks or any other types of entity is difficult.

*Collective versus individual impairment assessments*

56. Guidance on using a group- or an individual instrument-based cash flow estimate would be about establishing a clear principle that determines which approach is more appropriate in what circumstance. Such guidance would reflect the discussion about the application to portfolios and individual financial assets earlier in this paper (see the section ‘Application to portfolios and individual financial assets’ above).