Project **Financial Instruments – Recognition and Measurement**

Topic **Comparison between possible impairment approaches**

134. DSR-Sitzung, 17.08.09

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Introduction

Background

1. If any type of asset is measured using a cost-based method, an impairment test is required.

2. Paper 5C describes the implications for impairment approaches that are created as a result of the different characteristics of financial assets and non-financial assets.

3. Three possible impairment approaches have been identified for financial assets measured at amortised cost:

   (a) incurred loss;

   (b) expected cash flow approach; and

   (c) a fair value-based approach.

4. All of the approaches have been extensively described and discussed in previous agenda papers and board sessions.

Purpose of this paper

5. To further deepen the boards' understanding of the possible impairment approaches, and to move the boards towards a decision (should amortised cost

be used for any financial assets), this paper compares and contrasts the approaches.

6. We intend to use the table below to structure the discussion as follows:

   (a) The left-hand column lists the factors (topics) that the staff considers important in

      (i) understanding and

      (ii) considering the accounting effects

   of each impairment approach.

   (b) We will ask the Board to discuss one topic at a time.

7. The paper concludes with the important factors the staff believes that the boards should take into consideration in reaching any decision. However, this paper does not ask the boards for any decisions.

8. The staff will bring back a paper at a future meeting that will ask for a decision on the impairment model should amortised cost be used to measure some financial assets.

Approach / Topic	Incurred loss approach	Expected cash flow approach	Fair value-based approach
Initial determination of EIR	• based on initial measurement and expected cash flows (but ignoring future credit losses)	• based on initial measurement and expected cash flows	• based on initial measurement and expected cash flows
Trigger for impairment test	• required; indicator-based	• no trigger	• both indicator-based and value-based possible • trigger is likely to be required because an approach solely based on value seems to be inconsistent with the notion of impairment for financial assets measured at amortised cost
Measurement of revised carrying amount	• expected cash flows reflecting incurred losses discounted at original EIR (for fixed rate instruments) • no market adjustments • no future credit losses	• continuously updated expected cash flows reflecting expected losses discounted at the original EIR (for fixed rate instruments) • no market adjustments • includes future credit losses	• fair value (if less than carrying amount) • including credit related and non-credit related changes (eg liquidity) in fair value
Recognising impairment , disclosures and disaggregation	• profit or loss • disclosures	• profit or loss • disclosures	• profit or loss • splits possible (within P+L or P+L/OCI) • disaggregation (in presentation or disclosures) necessary to provide useful information

Approach / Topic	Incurred loss approach	Expected cash flow approach	Fair value-based approach
Subsequent or additional impairments	• if further losses have been incurred	• recognised automatically through continuous re-estimation of cash flows	• recognised automatically through determination of fair value • triggers could be used as threshold for recognition
Revenue recognition after impairment	• based on original EIR (for fixed rate instruments) • compatible with cost-based measurement objective	• based on original EIR (for fixed rate instruments) • compatible with cost-based measurement objective	• could be based on original or revised EIR • original EIR more compatible with cost-based measurement objective, but generally does not unwind to the expected cash flows • revised EIR unwinds to the expected cash flows, but impairs relationship between interest revenue recognition and (original) measurement basis • if portions are recognised in OCI a release mechanism must be determined

Approach / Topic	Incurred loss approach	Expected cash flow approach	Fair value-based approach
Reversals	• reversals required if triggered by event after recognition of impairment loss • up to amortised cost	• automatically by adjusting the expected cash flows (no trigger required) • upper limit is the full contractual cash flows discounted at the EIR	• reversals possible (generally up to amortised cost) • could be based on triggers or value recovery only
Other considerations			
Requirement for additional accounting guidance	• none/few, if Board wants to address issues that have arisen in practice	• principle could be implemented with limited changes to existing guidance • guidance would be required how to estimate expected cash flows, especially in context of portfolios of high volume, low value items	• depending on the characteristics of the model significant additional guidance could be required (e.g. interest accretion, disaggregation)

Approach / Topic	Incurred loss approach	Expected cash flow approach	Fair value-based approach

Costs to stakeholders	• no incremental complexity
	• no incremental costs
		• change inevitably results in cost for all stakeholders – preparers, auditors, users and others.
		• significant increase in complexity for preparers:
		  o generating raw data (which may not be available in all situations)
		  o forecast of expected cash flows (rather than current focus on identification of loss event)
		  o estimating expected losses
		• interaction with regulatory requirements if relevant (this may be limited)
		• implementation cost involved depending on data availability, data quality and system readiness
		• different type of complexities for financial institutions and non-financial institutions
		• reduced comparability with historical trend data for users
			• significant increase in complexity due to the monitoring and tracking requirements for impairments, reversals, additional impairments and interest accretion (depending on model chosen)
			• fair values should already be available (IFRS 7 disclosures) - however, the effort put into such measurements would inevitably increase, especially given that many such measurements with be Level 3 for which data might be scarce, and valuation techniques underdeveloped
			• subsequent accounting could require significant system changes

Approach / Topic	Incurred loss approach	Expected cash flow approach	Fair value-based approach
Applicability to portfolios	• permitted on a 'similar credit characteristics' basis (drives the precision of the estimate and can affect the timing of loss recognition) • complexity in monitoring migration of items (ie, what items have to be taken out of the portfolio as separately impaired or not the same characteristics anymore?) • incurred but not reported concept	• possible, but would require guidance to make approach operational (drives the precision of the estimate) • complexity in monitoring migration of items (ie, what items have to be taken out of the portfolio as separately impaired or not the same characteristics anymore?)	• possible, but would require guidance to make approach operational • complexity in monitoring migration of items (ie, what items have to be taken out of the portfolio as separately impaired or not the same characteristics anymore?)

Factors for consideration

9. We believe the important factors the boards should take into consideration in reaching any decision as to a preferred impairment approach for any financial assets measured at amortised cost include (in no particular order) the:

   (a) necessity to have, and complexity associated with, indicator-based impairment triggers;

   (b) measurement of impairment, particularly in the context of a amortised cost measurement;

   (c) link between interest revenue recognition and impairment measurement; and

   (d) ability of users to understand and use impairment information (including trade-off between amounts recognised vs required disaggregation).

10. The staff also notes that any change to existing requirements inevitably results in additional costs for all stakeholders. The staff already had (and will continue to have) discussions with some stakeholders about such costs. However, the staff believes that the boards will only receive a complete understanding of such costs after the articulation and exposure of any proposed impairment model.