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Financial Instruments: Amortised Cost and Impairment

On 5 November 2009, the International Accounting Standards Board (IASB) issued ED/2009/12, *Financial Instruments: Amortised Cost and Impairment*. This exposure draft (ED) represents the next part of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The ED proposes principles for the measurement of financial instruments at amortised cost including a new impairment methodology based on expected losses.

The ED is part of the wider project to replace IAS 39 with an entirely new Standard (IFRS 9) for which the date of mandatory adoption is not expected to be before January 2013.

Summary of the proposed model

The ED applies to all financial instruments that are measured at amortised cost and describes the objective of amortised cost measurement, underpinned by new measurement principles for financial assets, based on an expected cash flow methodology.

Under the proposed measurement principles, an entity would determine the initial carrying amount of a financial asset (or portfolio of financial assets) measured at amortised cost, on the basis of the present value of the future expected cash flows from the asset, taking into consideration expectations about future credit losses (referred to as the 'expected loss' approach[1]).

Subsequent to initial recognition an entity would be required to revise its estimates of expected cash flows at each measurement date. Any resulting adjustment to the carrying amount of the financial instrument would be recognised in profit or loss.

The proposed 'expected loss' approach is designed to result in earlier loss recognition compared to the 'incurred loss' approach currently in IAS 39 by taking into account future credit losses expected over the life of the financial asset measured at amortised cost. Under this approach the initial estimate of expected future losses is gradually recognised over the life of the instrument as it is incorporated into the effective interest rate.

The ED also proposes comprehensive presentation and disclosure requirements that would enable users of the financial statements to evaluate the financial effects of interest revenue and interest expense as well as the quality of financial assets including credit risk.

If adopted, the expected loss model would involve significant costs and an extended period of implementation given the expected significant changes required to financial systems, particularly in the financial services industry.

The IASB is establishing an Expert Advisory Panel (EAP) on the expected loss approach which will make recommendations on the nature and extent of any additional guidance required, explore possible simplifications and practical expedients of the model and facilitate field testing of the proposals.

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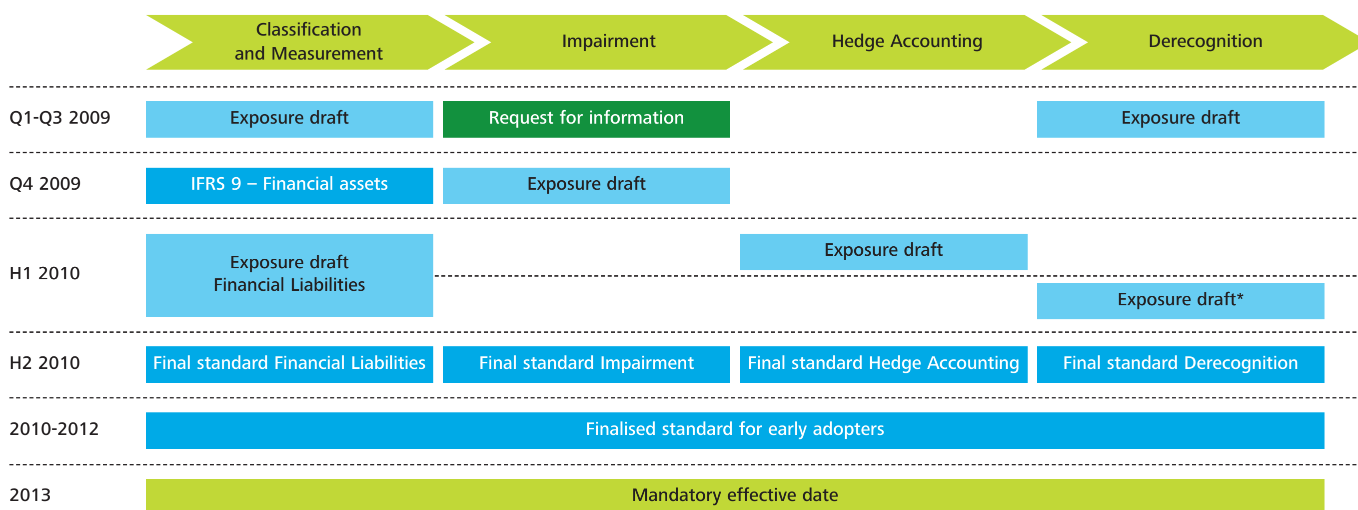
1 A detailed comparison of the incurred-loss model in IAS 39 and the proposed expected-loss approach is included in Appendix 2 to this newsletter

IAS 39 Replacement project timeline



*Due to significant changes from the original exposure draft, a revised exposure draft of the proposals for derecognition is expected to be issued

Objective of amortised cost measurement

The ED proposes to define the objective of amortised cost measurement and to clarify and/or simplify related definitions from IAS 39.

Under the proposals the objective of amortised cost measurement is to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument. Effective return reflects an allocation of instruments fees, points paid or received, transaction costs and other premiums or discounts as well as the initial estimate of expected credit losses on a financial asset.

Measurement

Amortised cost is calculated, using the effective interest rate (EIR) method, as the present value of the expected cash flows over the remaining life of the financial instrument, discounted at the EIR. Expected cash flows are estimated values based on the probability-weighted possible outcomes (i.e., even if the most likely outcome is full repayment, the likelihood of a debtor not repaying all contractual principal and interest amounts, is also factored into the estimate). The ED further clarifies that own non-performance risk, i.e. an entity's own credit risk, should not be included in the expected cash flows for financial liabilities.

Estimates of expected credit losses may be made on an individual or collective basis, depending on which approach provides the best estimate and ensuring that the selected approach does not result in double-counting of credit losses. In certain circumstances, the basis for estimates may be changed during the life of financial asset.

For the purpose of estimating the effect of credit losses on expected cash flows on a collective basis, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtor's ability to repay all contractual amounts according to the original terms.

The ED includes guidance on possible sources of data for estimating the effect of expected credit losses. In particular the ED specifies that historical data (such as credit loss experience) are adjusted on the basis of currently observable data in order to reflect the effects of current conditions that did not affect the historical data and to remove the effects of conditions in the historical period that no longer exist ('point-in-time estimate'). The ED also allows the use of peer group experiences for entities with no or insufficient entity-specific credit loss experience.

Effective interest rate

The measurement principles apply to both fixed rate and variable rate instruments. For a fixed rate financial instrument, the EIR is determined as a single constant rate over the life of the financial instrument and does not change as market interest rates change. For a floating-rate financial instrument (e.g. a financial asset that pays LIBOR plus a fixed credit spread), the EIR is not a single constant interest rate, but is instead calculated through a combination of the spot curve for the benchmark interest rate (e.g. LIBOR) and an initial effective spread.[2]

An example of applying the expected loss approach for a fixed rate loan is contained in Appendix 1 of this newsletter.

2 The IASB has also published on its website some numerical examples accompanying the ED illustrating the application of the expected-loss approach to a fixed and a floating rate loan

Practical expedients

Given the complexity of the approach proposed, the ED allows the use of practical expedients in calculating amortised cost if their overall effect is immaterial. This alternative calculation should:

- include all expected cash flows for the remaining life of the financial instrument;
- incorporate the effect of the time value for money (unless the effect is immaterial, e.g. for short-term trade receivables); and
- result in a present value that equals the initial measurement of the financial instrument.

The ED provides as an example guidance on the calculation of the amortised cost of trade receivables using a provision matrix. The entity would use its historical loss experience on trade receivables to estimate the expected credit losses (e.g. based on the number of days past due). Accordingly, on initial recognition, trade receivables without a stated interest rate which are so short term that the effect of discounting is immaterial would be measured at their invoice amount less the initial estimate of undiscounted expected credit losses. The initial estimate of undiscounted expected credit losses would be treated as a reduction of the invoice amount in determining the amount of revenue to be recognised.

Presentation and disclosures

The ED proposes comprehensive presentation and disclosure requirements. In particular, it proposes that the following line-items be presented separately in the statement of comprehensive income:

- gross interest revenue (calculated using the EIR method before taking into account the allocation of the initial estimate of expected credit losses);
- the portion of initial expected credit losses allocated to the period;
- net interest revenue (the subtotal of items above);
- gains and losses resulting from changes in cash flow estimates; and
- interest expense (calculated using the EIR).

The ED would further require the credit losses to be accounted for using an allowance account, and a reconciliation of changes during the period along with disclosure of the entity's write-off policy.

Entities would also be required to disclose:

- for each class of financial assets a comparison between the development of the credit loss allowance over time and cumulative write-offs and if significant, a qualitative analysis of the effect of changes in credit loss estimates on this comparison; and
- information on and changes to estimates used to determine amortised cost (e.g. basis of inputs, estimation techniques used, etc.) as well as a high level sensitivity analysis of the effects of using reasonable alternative assumptions in the calculation of expected credit losses.

In addition, the line item *'gains and losses resulting from changes in estimates'* would be disaggregated further into the effects of changes in the estimates of credit losses and other factors (e.g. prepayment rates).

Additional proposed disclosures include information on the assumptions and results of any stress testing (if such testing was performed for internal risk management purposes), information on the credit quality of financial assets (including an analysis of the changes in non-performing financial assets[3]) and vintage information (information showing the date of origination and date of maturity) for each class of financial assets at amortised cost.

Transition

The objective of the transitional requirements for financial instruments measured at amortised cost that were recognised before the date of initial application of the proposed IFRS, is to approximate the effective interest rate that would have been determined under the new guidance if it had been applied on initial recognition of the financial instrument. Any transition adjustment would be recognised against the opening balance of each affected component of equity for the earliest period presented and comparative information would be restated.

Effective date

The effective date of the proposed Standard has not yet been determined but the IASB indicated that a sufficient lead-time of 3 years after the finalisation of the Standard would be provided to implement the changes.

Comment deadline

Given the complexity of the issue and the time needed for the EAP to develop any additional guidance or simplification of the requirements, the comment period for the ED has been extended to eight months. Comments on the ED are due by 30 June 2010.

3 Non-performing financial assets are defined as being more than 90 days past due or considered uncollectible

Operational issues

The IASB has acknowledged that implementation of its proposed expected loss approach may prove operationally challenging and costly and may require significant lead-time to implement. Operational issues include:

- the need for management to create models and develop systems to compute estimates of future cash flows and credit losses over the life of a financial asset or group of financial assets;
- the need for management to consider whether impairment should be assessed and measured at an individual or portfolio level;
- the need for management to collect or obtain historical loss data or ratings information for assets with similar credit risk characteristics in estimating future cash flows;
- estimation uncertainty and the need for management to make difficult, subjective, and complex judgements in estimating future cash flows;
- the need for management to create systems that incorporate initially expected credit losses in the application of the EIR method (or other allocation mechanisms for credit losses) over the life of the financial asset;
- the need for management to update credit loss and other cash flow estimates on a periodic basis and;
- interaction with regulatory requirements (especially Basel II capital requirements).

The FASB's tentative approach

The US Financial Accounting Standards Board (FASB) is currently deliberating changes to its impairment model. Nonetheless, the FASB has tentatively decided to retain the incurred-loss approach. Under the FASB's tentative approach, the impairment criteria would apply to those financial assets whose changes in fair value are recognised in other comprehensive income.

The proposed model will be included in the comprehensive exposure draft that the FASB expects to publish in the first quarter of 2010. The IASB will publish a request for views on the FASB's model at the same time that the FASB publishes its proposals. The boards will consider the comments received on the FASB's model and the IASB's model together.

Appendix 1

The table below includes a numerical example of the calculation mechanics of the expected-loss approach for fixed rate financial instruments.

This example illustrates a pool of 100 loans with principal amount of CU 10,000 per loan, a contractual interest rate of 5% and a maturity of 5 years. At the end of year 2, the originally expected cash flows were revised in order to reflect higher per annum defaults than originally expected.

As a consequence, the net carrying amount is adjusted against profit or loss at the end of year 2 in order to reflect the revised cash flow estimate. The amount of the adjustment is the difference between (1) the net carrying amount at the end of year 2 before the revision of the cash flow estimate; and (2) the present value of the expected future cash flows (after revising the estimate) over year 3 to 5 discounted at the originally expected effective interest rate (EIR).

No further adjustments are made in years 3 to 5 as there are no further revisions of estimates.

Example: Fixed-rate loans

10,000	Nominal Amount (CU)
5%	Contractual Interest Rate (payable annually)
100	Number of loans
1,000,000	Lending volume (CU)
5.00%	Original EIR (excluding future losses)
4.20%	Original EIR (expected-loss approach)

Initially expected cash flows

Year	Contractual Cash Flows	Expected Loss Rate	Recoverable	Expected Cash Flows
20X0 CU	(1,000,000)			(1,000,000)
20X1 CU	50,000	0.0%	100.0%	50,000
20X2 CU	50,000	0.0%	100.0%	50,000
20X3 CU	50,000	1.0%	99.0%	49,500
20X4 CU	50,000	2.0%	98.0%	49,000
20X5 CU	1,050,000	4.0%	96.0%	1,008,000

Updated expected cash flows

Year	Contractual Cash Flows	Expected Loss Rate	Recoverable	Expected Cash Flows
20X3 CU	50,000	3.0%	97.0%	48,500
20X4 CU	50,000	4.0%	96.0%	48,000
20X5 CU	1,050,000	5.0%	95.0%	997,500

Amortised cost, Net Interest Revenue and Gain/Loss from Revision of Estimates

Year	Beginning Amortised Cost	Net Interest Revenue (a)	Actual Cash Flows	Amortised Cost before Reestimate (b)	Impairment Loss (c)	Ending Amortised Cost (d)
20X1 CU	1,000,000	41,985	(50,000)	991,985	0	991,985
20X2 CU	991,985	41,648	(50,000)	983,633	(11,162)	972,471
20X3 CU	972,471	40,829	(48,500)	964,800	0	964,800
20X4 CU	964,800	40,507	(48,000)	957,308	0	957,308
20X5 CU	957,308	40,192	(997,500)	0	0	0

(a) beginning amortised cost times original EIR under expected-loss approach
(b) beginning amortised cost adjusted for difference between actual cash flows and net interest revenue
(c) difference between present value of expected cash flows before and after reestimate
(d) (b) minus (c)

Note: The contractual effective interest rate is calculated as the internal rate of return for the series of contractual cash flows, whereas the expected-loss adjusted effective interest rate is calculated as the internal rate of return for the series of expected cash flows. Net interest revenue in each period is calculated as the product of the beginning amortised cost multiplied by the expected-loss adjusted effective interest rate. The amortised cost at the end of each period is the beginning amortised cost plus net interest revenue during the period less actual cash flows received during the period and less any impairment loss recognized during the period. The impairment loss in year 20X2 is the difference between the amortised cost basis and the present value of the updated estimate of expected future cash flows discounted using the expected loss-adjusted effective interest rate.

Appendix 2

The table below provides a detailed comparison of IAS 39's incurred-loss approach and the proposed expected-loss approach.

Approach	Incurred-loss approach	Expected-loss approach
Initial determination of the EIR	Based on the initial net carrying amount and expected future cash flows ignoring expected future credit losses.	Based on the initial net carrying amount and expected cash flows that are adjusted for expected future credit losses.
Trigger for impairment	Required; indicator-based (objective evidence of impairment).	No trigger.
Measurement of revised carrying amount	Expected cash flows reflecting incurred losses discounted at original EIR (for fixed rate instruments. No fair value adjustments. No reflection of expected future credit losses that have not yet been incurred.	Continuously updated expected cash flows reflecting expected losses discounted at the original EIR (for fixed rate instruments). No fair value adjustments. Reflects expected future credit losses.
Recognising impairment	Profit or loss.	Profit or loss.
Subsequent impairments	If further losses have been incurred.	Recognised automatically through continuous re-estimation of cash flows.
Revenue recognition after impairment	Based on original EIR (for fixed rate instruments).	Based on EIR.
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.

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