

## IASB's ED "Financial Instruments: Amortised Cost and Impairment"

### 1 Introduction

1.1 This paper is provided as background reading for the discussions at the ASB constituent roundtable meeting to be held on 6<sup>th</sup> May 2010. It provides details on:

- (a) The main requirements currently in IAS 39 "Financial Instruments: Recognition and Measurement"; and the IASB's ED in relation to amortised cost and impairment including the key differences between the existing and proposed models;
- (b) Concerns raised with the requirements in the IASB's ED by constituents; and
- (c) The other potential models being proposed by various stakeholders.

### 2 Key IAS 39 requirements and the ED proposals

#### Current requirements under IAS 39

2.1 The current requirements under IAS 39 for amortised cost accounting and impairment can be summarised as follows:

- (a) After initial recognition, IAS 39 requires financial assets held in the loans and receivables categories to be held at amortised cost and impairment of such assets to be recognised as and when it occurs. Financial assets in the available-for-sale and held to maturity categories are also subject to the impairment requirements in IAS 39.
- (b) The amortised cost is calculated by discounting all estimated cash flows (excluding future credit losses) resulting from the contractual terms of the financial asset using the effective interest rate.
- (c) Treatment of the impaired financial assets depends on its IAS 39 category:
  - Available-for-sale – cumulative losses recognised in **profit or loss**; reversals are only permitted for debt instrument categorised as available-for-sale

- Loans and receivables or Held-to-maturity financial assets carried at amortised cost – reduce the carrying amount of the assets either directly or through a loan allowance and recognise the amount in profit or loss; reversal of impairment loss permitted but must not exceed amortised cost prior to impairment
  - Financial assets carried at cost<sup>1</sup> – required to recognise an impairment loss; no reversal permitted
- (d) IAS 39 requires entities to look for objective evidence when assessing whether a financial asset or group of financial assets is impaired. (paragraph 58)
- (e) Under IAS 39, loss events that signify impairment must be observable and include: a breach of contract, such as a default or delinquency in interest or principal payments; it becoming probable that the borrower will enter bankruptcy or other financial reorganisation; the disappearance of an active market for that financial asset because of financial difficulties; and observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with any individual financial assets in the group

### **Requirements proposed in the ED**

2.2 The key requirements of the IASB's ED on amortised cost and impairment were summarised by the IASB in the Snapshot of the project it published in November 2009 alongside the ED. This is attached as paper 7B.

2.3 In brief, the model applies to all financial assets held at amortised cost but permits some practical expedients for those with no explicit interest rate (e.g. trade receivables). It requires an entity to:

- determine the expected credit losses on a financial asset when that asset is first obtained;
- recognise contractual interest revenue, less the initial expected credit losses, over the life of the instrument;

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<sup>1</sup> Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are permitted to be measured at cost.

- build up a provision over the life of the instrument for the expected credit losses;
- reassess the expected credit loss at the end of each period; and
- recognise immediately the effects of any changes in credit loss expectations.

2.4 A practical expedient is offered where the overall effect is immaterial. For non-interest bearing financial assets (e.g. trade receivables) the model applies a simplified approach whereby the expected credit losses on the receivables (e.g. by using a provision matrix) would be estimated and an interest component need not be identified.

2.5 The model also permits use of practical expedients for allocation of the initial estimate of expected credit losses on a financial asset over its expected life if the difference in outcome using this method is immaterial compared to the alternative allocation mechanism.

2.6 The ED does not deal with the operational aspects of the expected loss model. Further guidance on how the requirements of the ED may be applied is being considered by the Expert Advisory Panel (EAP) set up by the IASB. The EAP is not expected to produce a public report on its conclusions. Instead, it is understood that it will advise the IASB on the key problems with applying the ED requirements in practice; potential resolution of such problems; and the type of guidance that might be useful.

**Differences between IAS 39 and proposed model**

2.7 Table 1 sets out the key differences between the IAS 39 recognition and measurement requirements and those proposed in the ED.

Table 1

	Incurred Loss Approach	Expected Loss Approach
Initial determination of the EIR	Based on initial net carrying amount and expected future cash flows <u>ignoring</u> future credit losses	Based on initial net carrying amount and expected future cash flows that are adjusted for future credit losses
Impairment trigger	Indicator based (objective evidence of impairment)	No trigger
Measurement of revised carrying amount	Expected cash flows reflecting incurred losses discounted at original EIR  Future credit losses are not reflected	Cash flows updated for changes in expectations of future credit losses discounted at original EIR (for fixed rate instruments) or spot benchmark rate plus spread (for floating rate instruments)
Subsequent impairments	If losses incurred	Automatic recognition through re-estimation at measurement date of expected future cash flows
Reversals	Reversals up to amortised cost required if trigger event after recognition of impairment loss	Automatic adjustment to expected cash flows up to the full contractual cash flows discounted at EIR

### **3 Concerns raised by constituents with the requirements in the ED**

3.1 The ASB conducted some outreach with constituents on the IASB's proposals. The concerns raised by these constituents with the requirements in the ED can be categorised as follows:

- (a) Concerns with the model;
- (b) Implementation issues; and
- (c) Cost vs. benefit issues.

#### **Concerns with the IASB's model**

3.2 An internal inconsistency in the model is that initial estimates of credit losses are spread over the life of the instrument but the subsequent changes are booked as immediate catch up adjustments.

3.3 Actual losses may occur before sufficient expected loss provisions have been built up leading to negative impairment. On an open portfolio basis this should even itself out but there will always be exposure to unexpected loss.

3.4 The model results in volatility (similar to fair value adjustments) and subjective adjustments to the provisions which convey information on the management's assessment of the future rather than conditions at the balance sheet date.

3.5 For variable rate instruments the adjustment would be tantamount to fair valuing the interest component as entities would need to take the spot/forward interest rates into account to calculate the EIR and this would change at each reset date. It is questionable whether these fair value like adjustments are compatible with amortised cost measurement.

#### **Implementation issues**

##### *Issues Relevant for preparers*

3.6 Currently banks only *use expected cash flows in exceptional cases* i.e. for loans already identified as being impaired, to ascertain the extent of the impairment. The proposal will require this methodology to be applied to all financial assets held at amortised cost (which will include investment securities classified as

such under IFRS 9). As a means of arriving at the loss number the methodology was categorised by one bank as like “boiling down the ocean”.

3.7 *Pricing for products is driven by competition* in the market, of which credit risk is only one element. However, it is not a stable or explicit element. So a methodology needs to be developed for this purpose.

3.8 *Availability of historical data* is an issue. A possible source may be the data used for Basel II calculations. A number of bank consumer lending portfolios for Basel II calculations follow the standardised approach. This entails simple estimations rather than the detailed information required under the advanced approach.

3.9 No current *methodology on how to determine expected losses* over the life of instruments/ portfolios, although EAP working on this aspect ie. timing. But a read across to Basel II is difficult as it defines a period of default, resulting in a prudent estimate. Basel numbers include expectations for one year after the balance sheet date whereas the IASB proposals would include expectations over the life of the loan. Here all such assessments are left to management of the entity, including whether or not to use the Basel II probability of default as a baseline for these calculations.

3.10 *Unit of account issues* have not been resolved. So although it is feasible to calculate a loss expectation for a closed portfolio of a large number of similar loans, it is not so feasible where there are expected losses for large individual loans but no indications of impairment.

3.11 *Treatment of open portfolios*, portfolios with revolving credits or pre-payable instruments is not certain under this model.

3.12 *Disclosures (e.g. loss triangle) more focused on methodology* than on the actual credit quality of the portfolios. Difficult to implement for long dated and open ended portfolios.

3.13 *The amount of disclosures at a meaningful level (e.g. by product, geography and/or vintage) will be extensive.* One regional building society in the UK identified at least 300 portfolios in its vintage mortgage book. Larger banks that operate in many geographical markets across a number of different products will have significantly more. A trade-off between meaningful disclosures and volume of disclosures will have to be made. One large UK bank stated that

they would need almost one hundred extra pages in their Annual Report to provide the loan triangles at a meaningful level of analysis.

3.14 *Currently the accounting and credit systems* in most banks are not interlinked. For most banks the implementation of this requirement will incur significant systems costs. Most banks when asked quote costs that are comparable to the Basel implementation projects as a minimum.

#### ***Issues relevant for auditors***

3.15 The nature of the calculation makes the *loan impairment model akin to Level 3 calculations* for the fair value hierarchy. However, the level of unobservable data will be significant to the measurement making it harder to audit.

3.16 *Level of judgement* required will make the impairment charge a subjective number. Although, judgement is currently applied in this area (e.g. around trigger identification for potentially impaired securities), the IASB proposals have significantly expanded the population subject to judgemental measurement. Auditors are concerned that it might be difficult to audit management expectation on such a large scale.

3.17 *Impenetrable changes in estimates* – Due to the nature of the model proposed by the IASB changes in more than one assumption can lead to results that will make it harder to ascribe the effect of a single assumption.

#### ***Issues for investors***

3.18 Investors, in principle, are in favour of a switch from incurred to expected losses. They do not like artificially high profits being booked upfront or delays in reporting losses. They are clear that the credit crisis has shown that the incurred loss model in IAS 39 has both these shortcomings and so needs to be improved. They do, however, have some concerns with the IASB's proposed model.

3.19 *Whether the level of management judgement inherent in the amortised cost calculations is acceptable in the financial statements.* A large majority of bank assets will be at amortised cost. Some insurers also retain certain assets at amortised cost which will need to be accounted for in accordance with this methodology. Receivables held by companies which fall under the scope of IFRS 9 will also be accounted for in accordance with this methodology. If this methodology is adopted into IFRS, it is possible that these balances will entail more

management judgement (in the guise of management expectations of both extent and timing of credit losses) than that currently applied to financial assets at level 3 fair value. Users are concerned about the scope for earnings manipulation when so much is left to management's judgement. Frequent, and sometimes debatable, value changes that may not convey any information about the changing operational performance or risk (e.g. arising from changes in expectations based on moves in market prices) are seen as unhelpful in a stable amortised cost approach.

3.20 *Frequent re-estimation of credit losses will lead to volatility and pro-cyclicality* akin to that for financial assets held at fair value now. This will be an issue whether or not economic conditions are factored into the calculations. Economic conditions are incorporated into that model by the Bank's economist who have access to systemic risk information. The IASB's model is similar in some ways to the Bank of Spain's Dynamic Provisioning Model. If economic conditions are factored into the IASB model, the question remains whether bank management will have sufficient information to make calls about all the markets they operate in, to ensure comparability of assumptions. As a minimum, some disclosure of the management's assumption of the economic conditions would be required for users to ascertain comparability across the market.

3.21 *Interaction between accounting and regulatory capital.* Some banks have indicated that if this methodology had been in place at the outset of the credit crisis the adjustment to their balance sheets would have been equivalent to half of their regulatory capital. From a users' perspective the key issue is the interaction between an increase in cyclical losses (due to the accelerated timing of loss recognition in the loan book) and regulatory capital requirements, especially those that affect distribution to shareholders. Regulators would need to ensure that regulatory capital (which was deemed too low at the outset of the credit crisis) was at an adequate level to take such a change into account.

3.22 *What information does this extra disclosure provide?* It is unclear whether quantitative disclosure on the operation of the methodology (i.e. loan loss triangles) would be the best way to provide information on the credit quality of the portfolios held. Users are most interested in how changes in loss expectations relate to the quality of the underlying portfolio.

## **Cost v Benefit concerns**

3.23 Implementation costs for this model are particularly high for banks due to the nature of their current systems and the portfolios they hold. They also assert that the proposals also do not appear to meet the objective of reducing complexity. A number of these institutions are concerned that no real benefits have been identified of implementing this methodology.

3.24 It is important to consider the preparers' concerns against the benefits for the users. From a user's point of view, the key benefit, as highlighted in 3.18, is that entities will not be booking high upfront interest charges or delaying reporting losses.

3.25 It may be worth investigating whether the benefits can be provided to the users through other less complex mechanisms or via a phased implementation of the final requirements on amortised cost and impairment for financial assets.

## **4 Other potential models**

4.1 Due to the inherent complexity of the IASB's proposals in the ED the EAP as well as other constituents are currently looking at other models of amortised cost and impairment accounting that permit earlier recognition of credit losses than is currently feasible under the incurred loss model. These include the EBF model, the Basel model and the FASB model. Most of these models are in the early stages of development and are likely to have their own peculiarities that have yet to be identified. The key components of these models, as currently understood, are set out below.

### **EBF Model**

4.2 Developed by the European Banking Federation the EBF model keeps the calculation of the EIR separate from the recognition of expected losses. This model aims to address the complexity of the IASB proposals which arises from incorporating the expected losses into the amortised cost calculations. Under this model:

- (a) The unit of account can be a portfolio, an open or closed portfolio (as determined by the business model of the entity);
- (b) The amortised cost will be calculated as under current IAS 39;

- (c) The expected losses over the life of the loan or portfolio<sup>2</sup> are estimated and spread through profit or loss through this average life.
- (d) The expected losses are reviewed and recalculated at each reporting date and any changes to the estimates are also spread over the average life;
- (e) Incurred credit losses are booked against the existing expected loss impairment allowance. If the allowance is not sufficient, the incurred losses are booked directly to the income statement. Subsequent changes in incurred losses are booked against the expected loss impairment allowance account;
- (f) Non-performing loans and the relevant expected loss allowance are isolated from the rest of the portfolio and treated as in current IAS 39;
- (g) Future expectations about credit losses not incorporated;
- (h) No negative impairment.

### **Basel Model**

4.3 The Basel Committee is working with the IASB's EAP to come up with an alternative model based on the Basel II provisioning approach. The aim is to address the deficiencies in the incurred loss approach and promote a forward looking provisioning approach that is more transparent but also appropriate for validation by auditors.

4.4 This model uses a building block approach and incorporates data currently being accumulated for the Basel II calculations in the computation of the loss rate as follows:

- (a) A loss rate is calculated for use over the life of the loan or loan portfolio. This loss rate is derived by reference to average loss rates over the past years, incorporating a complete economic cycle (the quantitative block), to which management judgement is applied to change the credit loss estimate (the qualitative block). The qualitative block will relate to changes for the nature of the loan, significant changes in economic conditions or structural changes in lending policy.

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<sup>2</sup> Life of the portfolio is defined as the average maturity of the loans in the portfolio weighed by the outstanding balance.

- (b) The loss rate is applied evenly to all contractual cash flows to determine the expected cash flows. The EIR is then calculated using this series of expected cash flows.
- (c) Interest income is recognised on the basis of the EIR.
- (d) If there are material changes to the estimates of expected cash flows the EIR is revised and any catch-up adjustment is made to the provision account (as under the IASB model).

4.5 The timing and phasing in of the Basel model would need to be carefully thought through to take the economic cycle into account.

### **FASB Model**

4.6 The FASB is due to publish its proposals for changes to financial instruments requirements under US GAAP later this year. As part of this the FASB published a document "Accounting for Financial Instruments: Summary of Decisions Reached to Date at of March 31, 2010" on its website<sup>3</sup>. The FASB model is predicated on accounting for all financial assets at fair value. However, the changes in fair value may be reported in the Income Statement or Other Comprehensive Income (OCI) depending on the entity's business strategy. This document includes a section on the FASB's proposals on accounting for credit impairment for financial assets whose changes in fair value are recognised in OCI. The recognition and measurement of such credit impairments would be determined at the end of each reporting period as follows:

- (a) An entity should recognise credit impairments when it does not expect to collect all amounts due according to the contractual terms of the financial asset. In making this assessment, an entity should consider all past and current factors that impact the current and future collectability of the financial asset.
- (b) Entities have latitude to develop measurement methods that are practical in their circumstances and are not prevented from evaluating credit losses on a pool or portfolio basis.

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<sup>3</sup> The FASB decision summary can be accessed on the FASB website or by clicking the following link: [http://www.fasb.org/cs/ContentServer?c=FASBContent\\_C&pagename=FASB%2FFASBContent\\_C%2FProjectUpdatePage&cid=1175801889654](http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1175801889654)

- (c) The entity would use a net present value technique to determine the amount of credit impairment.
- (d) An entity may also be able to recognise credit impairment equal to the amount by which the amortised cost for a financial asset exceeds the present value of its expected cash flows. However, in this case the entity may not recognise any additional credit impairments.
- (e) Credit impairment may also be calculated by reference to financial assets having similar risk characteristics.
- (f) For pools of homogeneous financial assets the amount of credit impairment to be recognised should be determined by applying an aggregate loss rate to the pool balance.