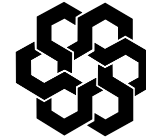

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement***

Subject: **Differentiation between credit-related impairment losses and other fair value changes of available-for-sale debt instruments (Agenda Paper 6A1)**

Introduction

1. This paper presents and analyses suggestions that participants raised at the round tables held in November and December 2008 in response to the credit crisis with regard to differentiating different components of fair value changes of available-for-sale (AFS) debt instruments. The accounting issues relating to equity AFS investments re discussed in paper 6A2.

2. This paper focuses on whether any of the accounting issues raised by participants require the urgent and immediate attention of the boards to improve financial reporting and help enhance investor confidence in financial markets. The paper addresses this objective by using the following structure:

   (a) participant's suggestion:

      (i) concern

      (ii) proposed solution

(b) staff summary analysis

(c) staff recommendation

Issue

Participant's concern

3. Some participants raised the issue that impairment is measured differently in IAS 39 for debt instruments classified as:

   (a) AFS; and

   (b) loans and receivables (LAR) or held-to-maturity (HTM).

   (It is important to note that – in summary – US GAAP applies the same impairment model for securities in AFS and HTM, and a different impairment model for loans in Held for Investment).

4. AFS debt instruments are carried at fair value and impairment losses are measured as the difference between amortised cost and the lower fair value.

5. LAR and HTM debt instruments are carried at amortised cost and impairment losses are measured as the difference between amortised cost and the present value of estimated future cash flows, calculated using the original effective interest rate or – for variable interest rate instruments – the current effective interest rate ('incurred loss model'). (Some also noted that, however, the impairment recognition triggers are the same for debt instruments in LAR, HTM and AFS).

6. Participants were concerned that the same or similar instruments are subject to different measurements of impairment depending on its classification (the staff notes that this issue is not unique to impairment; the same or similar instruments are also measured differently today, depending upon classification).

7. The view expressed is based on the incurred loss model's notion of impairment as a credit-related decline in value rather than a fair value decline

in its entirety. (See discussion in paper 6A regarding the meaning of 'impairment').

8. The credit crisis has resulted in significant declines in fair value for many AFS debt instruments that according to some participants often exceed the impairment loss that would arise under the incurred loss model.

Proposed solution

9. Most participants agreed that it would be useful to provide information that disaggregates the impairment loss recognised for AFS debt instruments into:

   (a) its incurred loss portion – determined in the same way as for debt instruments measured at amortised cost using the incurred loss model; and

   (b) the remainder – the fair value change other than (a) above.

10. However, participants proposed different solutions for how that disaggregated information should be provided:

   (a) Users advocated providing the disaggregation as a disclosure in the notes or, alternatively, by separate presentation in the statement of comprehensive income within profit or loss. Most users were clear that recognition of the fair value impairment loss in profit or loss provided more relevant information, and historically had provided a better indication of ultimate realised losses – and that any other approach would damage their confidence in reported earnings

   (b) Preparers preferred disaggregation by recognising only the incurred loss part of the fair value change in profit or loss while the remainder should be recognised in other comprehensive income (OCI) [1].

[1] The submission to the US SEC study of Mark-to-Market accounting by the Center for Audit Quality (CAQ) included a proposal to consider disaggregating a fair value impairment and report probable credit losses in income and all other changes in OCI. The proposal also suggested the inclusion of OCI on the face of the income statement. This proposal was advocated by a number of participants at the round table meetings held in the US, and participants at other round tables suggested variations on that approach.

Staff summary analysis

Disaggregation approach – factors to consider

11. The users' proposed solution would not change existing recognition or measurement requirements of IAS 39 but rather add a disclosure or presentation requirement.

12. In contrast, the preparers' proposed solution would change the recognition and measurement requirements. The measurement of an impairment loss would be aligned with the incurred loss model used for HTM and LAR in IAS 39. The rest of the fair value change would remain in OCI (and, as noted, some might advocate one performance statement).

13. Disaggregation of a fair value decline on AFS debt instruments has the following advantages:

    (a) Disaggregation of the fair value decline into its incurred loss portion could use the already existing guidance on impairment regarding financial instruments carried at amortised cost.

    (b) Disaggregation would facilitate comparability between instruments irrespective of whether they are classified as AFS, HTM or LAR.

    (c) Disaggregation of the fair value decline of AFS instruments would not affect the measurement in the statement of financial position or total equity so that no information that was previously available would be lost. Instead, it would provide additional information that currently does not exist, ie increase transparency, regarding losses that for debt instruments

        (i) automatically recover (eg a fair value decline attributable to an increase in the risk-free interest rate that automatically recovers by maturity); and

        (ii) only recover if there is a favourable change in circumstances (ie a reversal of impairment).

(d) There could be scenarios where an increase in fair value attributable to a decrease in the risk-free interest rate partially or totally offsets an impairment loss on the basis of the incurred loss model. An entity would not recognise a part or all of that impairment loss in accordance with the impairment approach for AFS instruments because a decline in fair value is a prerequisite in addition to objective evidence for impairment. Disaggregation would reveal such impairment losses that are currently not transparent.

14. Disaggregation of a fair value decline on AFS debt instruments has the following disadvantages:

(a) Disaggregation of losses adds complexity – the staff notes that many who believe fair value measurement will not reduce the complexity of today's requirements have this view.

(b) The approach is inconsistent with the long-term objective of having fair value through profit or loss as the only category.

(c) The calculation of an impairment loss in accordance with the requirements for HTM and LAR can only be described in terms of a calculation, rather than being any measurement attribute.

15. The approach advocated by some preparers of disaggregating in terms of presentation (and possibly to require a single statement of comprehensive income) was not widely supported by users who participated in the round tables, as noted in paragraph 10.

16. This approach involving a single statement would eliminate a presentation option for the statement of financial performance thereby reducing complexity.

17. However, the disadvantages of this approach include:

(a) Information about impairment in profit or loss that is available under the current AFS impairment approach would be lost (ie transparency in that respect would be reduced).

(b) Other items in OCI receive the same increase in prominence as fair value losses on AFS instruments. This would affect for example actuarial gains and losses in accordance with IAS 19 *Employee Benefits*, cash flow hedging results and changes in the cumulative translation adjustment in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

(c) This approach would create an overlap with the Board's current project on financial statement presentation.

(d) There are potential knock-on effects, for example regarding interim reporting because the condensed format may obscure the impact of fair value losses on AFS instruments on OCI.

Staff recommendation

18. The focus of this paper is whether any of the accounting issues raised by participants require the urgent and immediate attention of the boards to improve financial reporting and help enhance investor confidence in financial markets.

19. Given the position of most of the investors who participated in the round table regarding the suggestion by some preparers that only the incurred loss part of the fair value change be recognised in profit or loss while the remainder should be recognised in other comprehensive income (OCI), the staff do not recommend that that Board pursue this in the very short-term. Instead, the staff recommends that the Board consider this, along with other possibilities, as part of the broader reconsideration of impairment requirements.

20. However, the staff notes there is widespread support from participants for providing disaggregated information. This is consistent with the previous extensive work the IASB and FASB staff has done with users of financial statements regarding the disaggregation of fair value changes of financial instruments.

21. As noted in paper 6A, the staff thinks that the disagreement how that information should be provided reflects two different notions of what an impairment loss is:

(a) Depending on the circumstances the (entire) fair value decline of an asset is the impairment loss. Implicitly, this includes future expected losses as market participants take them into account. This is the basis of the current impairment requirements for AFS instrument in IAS 39.

(b) The impairment loss is a loss that has been incurred. It focuses on defaults of debtors on their obligations without taking into account expected future loss events. Thus, an impairment loss is only a component of the entire fair value change. (For equity instruments this approach is elusive.) This notion of an impairment loss is the basis of the current impairment requirements for HTM and LAR instruments in IAS 39.

22. It follows from paragraph 18 of IAS 1 *Presentation of Financial Statements* that providing information by note disclosure cannot avoid the question of what should be included in profit or loss. Thus, the decision of whether to provide disaggregated information as a disclosure or by allocation to profit or loss and OCI (refer to paragraph 10 of this paper) depends on what notion of impairment loss someone has (refer to the previous paragraph).

23. The staff believes each view has its own merits and that in the context of a mixed measurement model it is ultimately a question of personal opinion and preference. This is because each view can be logically derived from one of the elements of the mixed measurement model.

24. In accordance with its technical analysis (refer to the previous section of this paper) the staff thinks that additional disaggregated disclosure would improve the transparency of fair value declines and allow a comparison with the impairment losses recognised on debt instruments classified as LAR and HTM.

25. Moreover, the additional disclosure would be generated using existing IAS 39 requirements, which allows a quick implementation. The staff notes that

entities need to maintain the amortised cost of AFS debt instruments for the purpose of interest revenue recognition anyway.

26. The staff recommends not extending this additional disaggregated disclosure to debt instruments designated as at fair value through profit or loss under the fair value option.[2] This is because:

(a) no such request was made by round table participants; and

(b) paragraph 20(b) of IFRS 7 *Financial Instruments: Disclosures* only requires disclosure of interest income on the basis of the effective interest method for financial instruments that are not at fair value through profit or loss; therefore, in contrast to AFS debt instruments, extending the disclosure to debt instruments designated as at fair value through profit or loss under the fair value option would require entities to set up a 'shadow' amortised cost accounting for these items, which would involve significant cost and effort and is not practical in the context of a short-term amendment.

27. However, the staff proposes including a question in the invitation to comment that asks constituents for their views on whether the additional disaggregated disclosure should be also applied to debt instruments designated as at fair value through profit or loss under the fair value option.

28. In summary, the staff believes that additional disclosure of disaggregated fair value declines for AFS debt instruments strikes the best balance between:

(a) the urgent need for additional information that round table participants (especially users) requested as a short-term improvement of transparency and comparability; and

[2] Paragraph 9(c) of IFRS 7 requires disclosure of the amount of change in the fair value that is attributable to changes in the credit risk. However, that is a different amount than the impairment loss that would be recognised under the incurred loss model. In addition, the scope of that disclosure requirement only includes instruments that would have met the definition of LAR.

(b) the extent of change to financial reporting that such additional information entails, which should be kept to a minimum given the short lead-time that would be available.

Questions to the Board:

(a) Do you believe that the IASB should propose additional disaggregated fair value information for AFS debt instruments to enhance investor confidence?

(b) If not, why not and what would you propose doing instead?

29. The following section assumes that the Board agrees to propose additional disaggregated fair value information for AFS debt instruments to enhance investor confidence.

Possible approaches to providing disaggregated fair value information for AFS debt instruments

30. Additional disclosure could be proposed by amending paragraph 20 of IFRS 7 *Financial Instruments: Disclosures* as follows (inserted text is underlined):

‘An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

…

(e) the amount of any impairment loss for each class of financial asset; for debt instruments classified as available for sale an entity shall also disclose the following components:

(i) the amount that would have been determined as an impairment loss in accordance with paragraphs 63–64 of IAS 39 had the debt instrument been carried at amortised cost; and the cumulative balance of these amounts at the beginning and end of the period and a reconciliation of changes in that balance; and

(ii) the remainder of the impairment loss.’

31. The staff believes that a reconciliation of the cumulative balances (a ‘roll forward’) would improve the quality of financial reporting because it facilitates users’ analyses of how the incurred loss portion of the fair value

change correlates with the entire fair value changes over time. It would provide equivalent information to the reconciliation required by paragraph 16 of IFRS 7 for allowance accounts for credit losses and, thus, further align the proposed disaggregated disclosure with disclosure requirements in relation to the incurred loss model.

32. The impairment requirements of SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* apply to financial instruments (that are securities) in the AFS and HTM categories. That impairment model is a fair value measurement model (similar to that impairment measurement model used in IAS 39 for AFS instruments only). IFRSs do not distinguish between securities and other financial assets. In addition, IFRS 7 is an integrated disclosure model for all financial instruments. In other words, the IASB is in a different place than the FASB.

33. The FASB staff has suggested two ways to provide disaggregated fair value information more broadly than the approach suggested in the preceding paragraphs. The two approaches are:

    (a) to provide pro forma type information about the effect on earnings and shareholders' equity as if <u>all debt securities</u> were accounted for (i) at fair value and (ii) using the incurred loss model.

    (b) in addition to disclosures under (a), to provide a summary of the valuation of debt securities that sets out (i) the valuation underlying the measurement in the statement of financial position, (ii) fair value and (iii) the amount determined under the incurred loss model.

34. These approaches aggregate information, and that may in itself be useful to investors. In addition, either of these two approaches could be accommodated within IFRS 7, although much of the information required is already required by IFRS 7 (the exception being that proposed in paragraph 30(b) of this paper regarding the amount determined under the incurred loss model for debt securities classified as at fair value through profit or loss).

35. There are obvious benefits in the IASB and FASB proposing exactly the same requirements. However, as noted previously, IFRSs do not distinguish between debt securities and other financial assets, and that means that we would never achieve exactly the same scope of disclosure, unless the IASB did make a distinction between securities and other financial assets.

36. The approach set out in paragraph 30:

    (a) limits changes to existing IFRSs to respond to the concerns raised by round table participants; this also takes into consideration that any amendment may take effect at rather short-notice, which is burdensome for preparers;

    (b) avoids duplication of information that is already required in accordance with existing IFRSs (such as the fair value of financial instruments that are not carried at fair value); and

    (c) blends into the structure of existing IFRSs, ie it offers the 'best fit'.

37. The staff recommends proposing amending paragraph 20 of IFRS 7 (as set out in paragraph 30 of this paper) for the reasons given in the preceding paragraph.

38. The staff recommends proposing that transition should be prospective application. This is because for comparative periods the amount that would have been determined as an impairment loss under the incurred loss model had the debt instrument been carried at amortised cost would inevitably be susceptible to hindsight.

39. The staff recommends that the exposure draft have a comment period that ends on 12 January 2009 (with a target publication date of 18 December, that would be a comment period of around 25 days). This would allow the draft amendment to be finalised at the January 2008 Board meeting and an amendment issued shortly thereafter. The minimum permitted by paragraph 42 of the *IASB Due Process Handbook* is 30 days. The staff believes that a period of around 25 days is appropriate because of:

(a) the urgent nature of the proposed amendments and the current environment that we are operating in;

(b) the very limited extent of the proposed amendment; and

(c) the FASB using a fast-tracked approach for their corresponding project (the FASB staff draft timetable has a possible target issue date for any FASB Staff Position of early January 2009).

40. Because the proposed comment period is less than 30 days, this timetable is subject to approval by the Trustees.

41. The FASB staff has suggested to encourage but not require comparative information for periods prior to initial adoption of the proposed disclosure requirements. The staff's recommendation would not preclude comparative information for periods prior to initial adoption but not encourage it either in accordance with IFRS custom.

42. **Questions to the Board:**

(a) Do you agree with the staff recommendation to propose amending paragraph 20 of IFRS 7?

(b) If you do not agree with the staff recommendation to propose amending paragraph 20 of IFRS 7, how else do you wish to implement the disclosure requirement, and why?