Project	**Financial Instruments: Recognition and Measurement**
Topic	**Measurement Methods: Amortised Cost**

Introduction

Background

1.   In November and December 2008, the two boards added to their active agendas a joint project to develop a comprehensive standard for the recognition and measurement of financial instruments. At the March 2009 joint meeting the boards discussed:

     (a)   the objectives of the project;

     (b)   potential measurement methods for financial instruments; and

     (c)   potential characteristics for categorising financial instruments.

2.   The boards decided tentatively to consider at a future meeting three potential measurement methods:

     (a)   fair value (defined as an exit price);

     (b)   another remeasurement method based on discounted cash flows; and

     (c)   amortised cost.

3.   In the March 2009 joint meeting the boards also discussed accounting for loan losses, exploring and comparing the incurred loss model and an expected loss model. The boards noted that loan loss provisioning is relevant to this project if amortised cost is used to measure any financial assets.

Purpose of this paper

4.   The purpose of this paper is to describe the 'amortised cost' method. This paper also:

    (a)   outlines some aspects of an amortised cost model that could be improved.

    (b)   further analyses impairment models that could be used as part of an amortised cost model.

5.   This paper does not ask for a decision. The boards will be asked to decide about which measurement method(s) to pursue further following discussion about the remeasurement method that is not fair value through profit or loss.

6.   While not asking for a decision there is a question at the end of the paper asking whether board members require any further information or analysis about an amortised cost approach.

Summary of relevant comments from the discussion paper - Reducing Complexity in Reporting Financial Instruments

7.   The discussion paper *Reducing Complexity in Reporting Financial Instruments* (DP) published in March 2008 proposed an approach to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions (approach 2). The DP further asked respondents how instruments that are not measured at fair value should be measured, when impairment losses should be recognised and how the amount of impairment losses should be measured. Respondents had varied views suggesting some of the following:

- An expected loss model (but where impairment losses are reversible).

- An incurred loss model or the existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement*–because the DP suggests approach 2 as an intermediate approach, some respondents believe that the changes to the current approach might introduce complexity in the short-run.

- A combined incurred and expected loss model, ie an incurred loss approach when an impairment loss is observed and an expected loss approach when no impairment loss observed and expected loss would better reflect the true economics of the instrument.

Another issue several respondents raised related to the inconsistent treatment of impairment reversals on debt and equity instruments classified as available for sale.]

Amortised cost–scope

8. Amortised cost only deals with the subsequent measurement of financial instruments (ie after initial recognition). The initial measurement is the starting point for an amortised cost approach but not determined by that approach.[1]

9. This paper is about <u>amortised</u> cost. Thus, it does not deal with the measurement of an asset at cost, ie a cost approach that simply carries forward a cost amount (unless and until the asset is impaired). The latter approach is currently used for some investments in equity instruments.

10. The two main elements of an amortised cost model are:

   (a) the amortisation method; and

   (b) the impairment test.

Amortisation method

11. Amortisation in a financial instrument measurement context is about allocating interest revenue or interest expense over a relevant period. There are various

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[1] Fair value plus (less) transaction costs of an asset (liability) is the starting point currently used in IAS 39.

amortisation methods (eg straight-line, (coupon-)interest proportional[2], effective yield).

12. For the purpose of this paper the effective interest method (EIM) is used for amortisation. The EIM is a form of effective yield. Commercial decisions about investing/lending and borrowing are typically made on an effective yield basis. In addition, the other amortisation methods are simpler methods but provide a less 'consistent link'[3] between the carrying amount and the related interest revenue or interest expense. Consequently, they result in a less relevant allocation pattern. Therefore, other amortisation methods are not further considered in this paper because they would not be an improvement compared to the EIM.

13. The EIM results in allocating interest revenue or interest expense over the relevant period such that the interest rate exactly discounts the estimated future cash flows to the carrying amount of the financial asset or financial liability. The EIM works differently for fixed and variable rate instruments:

  (a) Fixed rate instruments: the EIM results in a constant periodic interest rate on the carrying amount (from time to time) of the instrument.

  (b) Variable rate instruments: the EIM results in a periodic interest rate that changes in response to changes in the variable rate.

14. The main effect of the EIM is equalising distortions of the interest rate when (i) either there are transaction features that in economic substance are interest or (ii) contractual interest cash flows are not aligned with the related funding volume[4], for example:

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[2] This method differs from straight-line allocation for loans with amortising balances (ie loans that are not repaid with one bullet payment on maturity); it achieves an allocation that is more proportionate to the loan balance because the interest coupons decrease with every repayment of principal.

[3] For example, for a fixed rate loan a consistent link would be a constant percentage.

[4] Funding volume refers to the amount advanced (including any interest capitalised into the loan balance) less repayments. This term is used rather than principal or notional amount because it is not affected by

(a)   premiums or discounts (which are similar to zero-coupon type interest and are often used to fine tune coupon interest or issuance proceeds, for cash flow timing purposes or for reasons of coupon interest taxation);

(b)   fees and points paid or received between parties to the contract that have interest character (eg origination fees);

(c)   transaction costs (which are economically similar to some amounts under (b) above and often the result of arbitrary transaction structures; for example the lender could agree to pay some amounts that otherwise would arise for the borrower and roll them into the interest or fees charged on the loan);

(d)   stepped interest payments or similar interest cash flow designs (which are structured for cash flow timing purposes rather than reflecting the return on or the cost for the funding volume of each respective period).

15.   Thus, the EIM provides useful information for 'cash' instruments. That is to say, instruments that are funded. That is not the case for unfunded instruments, such as derivatives. This paper does not explore this issue further, because what financial instrument might qualify for which measurement method will be addressed at a later stage in this project.

16.   Both IFRSs and US GAAP use the EIM to determine interest revenue and interest expense for some financial instruments. As a result of applying the EIM issues have arisen in practice. Some of the major ones that may constitute challenges to be addressed in using EIM for the measurement of financial instruments in a future standard are:

(a)   applying the EIM to variable rate instruments and distinguishing between variable and fixed rate instruments;

(b)   the effect of so called 'catch-up adjustments' resulting from revising estimates of cash flows[5]; the decision on what financial instruments

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product design features (such as discounts or premiums). For a simple loan originated and repayable at par with uniform fixed interest coupons the funding volume would be the nominal amount.
[5] A catch-up adjustment arises for example when the expected timing of principal payments for prepayable instruments is revised (if no embedded derivative was separated for the prepayment feature).

might qualify for amortised cost measurement (see paragraph 15 above) affects what type of estimates give rise to catch-up adjustments;

(c)   applying the EIM to groups of financial instruments (eg portfolios);

(d)   recognising interest revenue after recognition of impairments;

(e)   determining the effective interest rate (EIR) for instruments acquired at a discount that reflects expected credit losses.

17.   If the boards decide to further pursue the amortised cost method they will have to decide which of these issues to address. This paper does not discuss possible solutions for them.

18.   Even if amortised cost is not used as a measurement method, guidance on the EIM might still be required in order to determine interest revenue or interest expense for disclosure or disaggregation purposes.

Impairment test for financial assets

19.   An amortised cost model requires an impairment test for financial assets. There are different impairment models that could be used:

(a)   Incurred loss model.

(b)   Expected loss model.

(c)   Fair value based model.

20.   The impairment models listed above do not include what has been discussed more recently using the term 'dynamic provisioning'. This is because the boards have a separate work stream that specifically deals with such a type of provisioning. Following the March 2009 joint meeting the staff had a meeting with the Bank of Spain and expects to come back with a paper in May or June.

21.   If a cost-based approach is chosen as a remeasurement method, at the March 2009 joint meeting the boards expressed a clear preference for a single

impairment method, if possible. Some board members think such an objective may not be possible if particular types of financial instruments are measured using a cost-based approach. One example is if any equity instruments are measured at cost. This paper, however, only addresses interest bearing or similar types of financial instruments.

Incurred loss model

Characteristics

22. An incurred loss model has typically the following main features:

(a) recognising interest revenue on the basis of the full contractual interest (with adjustments as required by the EIM);

(b) monitoring financial assets for evidence of impairment, which is based on a notion of a credit loss (ie credit deterioration that indicates the obligor may default on contractual cash flows);

(c) recognising an impairment loss in profit or loss at the point in time when evidence of impairment exists (ie a loss has been 'incurred');

(d) measuring an impairment loss as the difference between:

- the carrying amount of the financial asset (before impairment); and

- the present value of the estimated future cash flows using the EIR as a discount rate[6];

(e) the estimate of the future cash flows takes into account the loss estimate based on incurred credit losses but excludes future credit losses that have not yet been incurred;

(f) reversal of an impairment loss through profit or loss if the reversal relates to an event occurring after recognition of the impairment loss (which may be required or prohibited).

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[6] For fixed rate financial instruments the original EIR is used whereas for variable interest rate instruments the current EIR is applied.

Discussion

23. Under an incurred loss model, impairment losses are only recognised when a threshold (or 'trigger') is reached. For example, evidence of impairment (the result of a 'loss event') is such a threshold. In that case an impairment loss is only recognised after a loss event has occurred. Using such a threshold provides some discipline over possible earnings management (ie an arbitrary build up of loan loss reserves in good times that can be used to mask increasing loan losses in bad times).

24. However, the incurred loss model has given rise to problems in applying the threshold. The differentiation between incurred and other losses (future credit losses that have not yet been incurred) has proven troublesome in practice. For example, incurred losses include losses commonly known in the financial services sector as 'incurred but not reported' (IBNR). Essentially, finding a non-arbitrary, operational threshold for the 'incurred' notion has been elusive. This difficulty is well illustrated by consideration of an investment in a Collateralised Debt Obligation. There is widespread divergence in practice about the point in time and the type of evidence that results in an IBNR impairment loss. In particular, collective assessments using correlation of defaults with economic data have been subject to diverging application in practice. Thus, the requirement to determine when the loss event occurs creates itself opportunities for earnings management because of the subjectivity involved.

25. Outside the financial services sector the application of the incurred loss model to financial instruments such as trade receivables has caused problems as well. For example, determining impairment losses using a provision matrix is a common practice but there is uncertainty when such a matrix complies with an incurred loss model and its threshold.

26.   An incurred loss model does not reflect lending decisions. When making a lending decision, every lender expects some credit losses from its lending activities (unless the lending was entirely to 'risk free' borrowers). However, on origination lenders could typically sell a loan issued at par for at least the nominal amount. Thus, in a market where defaults are expected from the outset and the pricing of the loans reflects that expectation, originating a loan does not give rise to a loss despite an expectation from the outset that not all contractual cash flows will be collected. This is because the pricing includes a component that compensates the lender for expected losses.[7]

27.   To the extent that expected losses are priced into the contractual interest the recognition of interest revenue using the EIM results in a revenue recognition pattern that does not reflect the lending decision; unless and until a loss event occurs the interest revenue recognised using the EIM includes the compensation for expected credit losses as profit. Thus, if credit losses crystallise as expected the incurred loss model has a 'cliff effect' because once the loss event occurs an impairment loss is recognised (see Appendix A for a graphic illustration of the cliff effect). This impairment loss reverses 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.

28.   Over time many users have also criticised the incurred loss model. Many have stated that they believe that recognition of impairment losses is delayed because of management bias in the judgements required to identify loss events, that the incurred loss model does not reflect the way that lending decisions are made, and that the significant judgements required result in lack of comparability about impairment levels between similar entities.

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[7] This assumes a market in which the lenders can pass on expected losses as a component of the pricing for their lending activities. For competitive or other reasons market conditions may be not always allow lenders to pass on expected losses so that they are not fully compensated. In a long-term equilibrium financial intermediaries would on average be able to pass on the risk.

Expected loss model

Characteristics

29. In discussions about impairment models stakeholders have not used the term 'expected loss model' consistently. For the purpose of this paper the expected loss model is the one that staff presented to the boards in their joint meeting in March 2009 (see agenda papers 7A and 7B of the March 2009 joint IASB/FASB meeting). This expected loss model has the following main features:

    (a) credit losses are viewed as an integral part of lending; interest revenue is recognised on a basis that factors in expected credit losses from the outset (thus, this does not give rise to a credit loss recognised in profit or loss [nor elsewhere] on initial recognition of the financial asset);

    (b) monitoring financial assets for impairment, which is based on a notion of an adverse change in credit loss expectations (ie the revised expectations of credit losses on the subsequent measurement date have increased compared to the credit losses previously expected);

    (c) recognising an impairment loss in profit or loss at the point in time when there is an adverse change in the expectation of credit losses (ie when the estimate increases);

    (d) measuring an impairment loss as the difference between:

    - the carrying amount of the financial asset (which includes the effect of previously expected credit losses but before taking into account the revised estimate); and

    - the present value of the revised estimate of future cash flows using the EIR determined under item (a) above as a discount rate (ie reflected an expected return rather than the contractual return);

    (e) the estimate of the future cash flows takes into account the loss estimate based on expected credit losses irrespective of whether or not they have yet been incurred;

    (f) reversal of an impairment loss through profit or loss at the point in time when there is a favourable change in the expectation of credit losses (ie when the estimate decreases).

Discussion

30.   The expected loss model is underpinned by the way that a lending decision is made. In making such a lending decision, in effect the contractual interest rate is broken into different components reflecting:

(a)   the time value of money ('risk free rate');

(b)   compensation for expected credit losses on the basis of the expectation at the outset, ie when the contractual interest is agreed (originally expected credit losses);

(c)   compensation for accepting risk (eg that actual credit losses may be higher than the originally expected credit losses, liquidity risk, etc.);

(d)   a profit margin (that also compensates for aspects such as the various transformations provided by intermediaries)

The compensation for originally expected credit losses (component (b) above) does not give rise to income if the cash flows occur as expected (ie to the degree originally expected cash flows are not collected). This will only be income if and to the extent that credit losses turn out to be lower than originally expected. Thus, the expected loss model does not factor in this component of the contractual interest into the expected return (determined at the outset). Economically, this component is not revenue but an amount that could become a gain from a future change in estimate (which could be at maturity of the loan). The other three components of contractual interest (components (a),(c) and (d) above) do not have to be differentiated for the purpose of determining interest revenue. Nevertheless, identifying the component that reflects the compensation for originally expected credit losses (component (b) above) may be challenging because it is often an implicit part of the lending decision rather than a separate, explicit consideration (for further discussion of complexity see paragraph 38 below). Thus, application guidance would have to be developed about the method(s) an entity should use if the boards decide to use this approach.

31. There are some alternatives[8] that could be used in accounting for interest revenue under an expected loss model (see paragraph 29(a) above):

    (a) **Gross presentation approach**:

        (i) in a first step, interest revenue is measured excluding the effect of the expected credit losses (ie on the basis of contractual interest);

        (ii) in a second step, an adjustment for the effect of originally expected credit losses on the net EIR is recognised as an expense (with a credit to an allowance that reduces the asset).

    (b) **Net presentation approach**: the interest revenue is measured including the effect of originally expected credit losses as a reduction (ie interest revenue is lower than the EIR based on contractual interest because the part of the contractual interest cash flows that economically covers originally expected credit losses is not treated as interest revenue). However, the net presentation approach could be combined with disaggregated disclosure of its two components (whether in the notes or on the face of the statement of comprehensive income).

    The net presentation approach seems to better reflect the way lending decisions are made (see paragraph 30 above) because it avoids presenting the effect of originally expected credit losses as an expense. However, as noted, disaggregation of the components is important to be able to isolate the effects of any change in expected losses (also see comments on disclosures in paragraph 34 below). The measurement of the asset in the statement of financial position is unaffected by the presentation of interest revenue.

32. The key advantage of the expected loss model is that it reflects the lending decision. On the one hand, the way it recognises interest revenue takes into account that lenders expect some credit losses from their lending activities already when making a lending decision (unless the lending was entirely to 'risk free' borrowers). Thus, it avoids the 'cliff effect' that occurs under the incurred

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[8] See paragraphs 18–19 of agenda paper 7A of the March 2009 joint IASB/FASB meeting.

loss model when the originally expected losses crystallise.[9] On the other hand, the expected loss model considered in this paper does not give rise to a loss on origination of a loan. This avoids the drawback of an impairment model that involves including a new loan in a general provisioning approach, which results in a loss on initial recognition of a loan (which some stakeholders also refer to as an 'expected loss model' - but that is not what is meant by that label in this paper). As explained earlier, recognising a loss on initial recognition of a loan is usually inconsistent with any rational lending decision (see paragraph 26 above).

33. An expected loss model also seems to provide a better basis for analyses of credit losses and the associated risk. It isolates the effect of changes in estimates of credit losses thereby providing information about how loss expectations change over time. In contrast, recognition of impairment losses under the incurred loss model does not provide a meaningful insight into such changes in expectations because that trend is distorted by the 'cliff effect' of loss events, which results in recognising impairment losses even without a change in the originally expected credit losses. Thus, the incurred loss model results in an interference of changes in estimates (upward revision of originally expected credit losses) with crystallisation of estimates (the originally expected credit losses 'occur', ie there is a loss event), which distorts the information (eg if used for trend analysis when the cliff effect implies a deterioration of the credit risk while it actually remained unchanged or even slightly improved).

34. The information set that could accompany an expected loss model seems to the staff to facilitate enhanced analyses of credit risk (compared to an incurred loss model). Possible types of information that could be included in such an approach are for example:

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[9] See paragraph 27 of this paper.

(a)   the component reflecting compensation for originally expected credit losses (see paragraph 30(b) above), as a percentage number, stratified in time bands by time of initial recognition and type of asset/product;

(b)   originally expected credit losses and the corresponding gross lending volume (both on origination), as absolute amounts, stratifying financial assets in time bands by time of their initial recognition and type of asset/product; this would allow a ratio analysis and could be considered alternatively to item (a) above;

(c)   changes in expected credit losses in the current period and cumulatively (using the same stratification as contemplated under item (b) above); this could be provided using for example a reconciliation of the allowance account for credit losses analysing the changes by type of change, for example:

- additions resulting from originally expected credit losses (as amounts build up over time);

- increases in estimated credit losses;

- decreases in estimated credit losses that are reversals of previous increases in estimates;

- decreases in estimated credit losses that are realised gains resulting from originally expected credit losses that have not crystallised;

- realised credit losses (write-offs on actual defaults).

35.   Such information would facilitate trend analyses, back testing of estimates, comparisons between different entities of their credit loss expectations and their ability to pass on costs of credit losses.

36.   There are also some concerns about using an expected loss model. For example, the Basis for Conclusions on IAS 39 (paragraph BC109) notes in the context of a discussion of an incurred loss versus an expected loss model that the IASB had reasoned that recognising impairment on the basis of expected future

transactions and events would be inconsistent with an amortised cost model.[10]
However, this is an assertion rather than a rationale. As set out in agenda
paper 7B of the March 2009 joint IASB/FASB meeting, ignoring expected
losses until they occur for the subsequent measurement of a financial asset is
inconsistent with the fact that the initial measurement of the financial asset
implicitly includes expected losses. Thus, it is the incurred loss model rather
than the expected loss model that is inconsistent with amortised cost
measurement.

37. As already mentioned in the discussion of the incurred loss model (see
paragraph 23 above), the potential for 'earnings management' is one of the key
concerns about an expected loss model. However, the estimate of credit losses
inevitably involves judgement irrespective of the measurement model chosen.
The incurred loss model also requires judgement in determining whether and
when a loss event has occurred and regarding the differentiation of incurred and
expected but not yet incurred credit losses (see paragraph 24 above). Thus, the
aspect of 'earnings management' potential is no rational criterion for choosing
between the two models. At best, using this criterion is tantamount to choosing
which type of 'cookie jar' is less preferable rather than having one or not.
Moreover, in the light of how the weighting of relevance versus reliability has
developed over the years (eg as it is reflected in the current framework project of
the boards), the staff believes that the focus should be on what information is
more relevant. By contrast, concerns about 'earnings management' potential
relate to reliability in terms of verifiability (or even deliberate bias, which
violates neutrality).

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[10] In June 2002, as part of its comprehensive Improvements project, the IASB published an exposure
draft that proposed improvements to IAS 39. Constituents responding to the exposure draft were
confused about whether the proposed impairment approach for financial assets measured at amortised
cost reflected an expected loss model or an incurred loss model. Paragraph BC109 of the Basis for
Conclusions reflects the outcome of the IASB's related deliberations.

38.   Another concern is the possible complexity of an expected loss model, especially if compared to an incurred loss model. It is important to differentiate different types of complexity:

(a)   Complexity arises from the *financial mathematics* that the EIM involves (including the estimates that are related to the EIM rather than impairment, such as expected prepayments), in particular the fact that it requires iterative computations. However, this type of complexity is independent of the impairment model used in connection with amortised cost.

(b)   Complexity also arises from the *estimates that are required* for the impairment test, which can involve substantial efforts in sourcing and analysing data. The question is how this effort differs depending on the impairment model used. The estimate of credit losses is not any simpler if it is restricted to 'incurred losses'. Because of the difficulty in differentiating estimates of incurred credit losses from estimates of expected but not yet incurred credit losses the incurred loss model arguably entails the more complex estimate as it requires a further differentiation. While the incurred loss model does not involve an estimate until and unless a loss event has occurred it would be naïve to conclude that this reduces complexity compared to the expected loss model. This is because the incurred loss model requires monitoring all the financial assets (within its scope) for evidence of impairment. Together with the requirements of the collective assessment this means essentially that even before a loss event occurs a substantial effort is required regarding data sourcing and analysis under the incurred loss model.

(c)   Another type of complexity arises from *bookkeeping and financial reporting requirements*, in particular *presentation and disclosure*. This complexity is about the granularity and extent of information that must be maintained (particularly in IT-systems) to allow tracking and extracting the information needed to meet financial reporting requirements (eg disaggregated financial information or inputs used for calculations). In this respect it is important to keep in mind that any enhancement of the status quo disclosure requirements (eg further disaggregation of amounts) that would also be required in case the incurred loss model were retained does not constitute an increase in complexity attributable to using an expected loss model. Instead, the main difference arising from using an expected loss model is that the

use of an allowance account would always be required and include different amounts.

(d) One-off complexity results from a *change of the status quo*. It relates to the adoption of a new way of processing information (eg switch-over of IT-systems, training of staff). This type of complexity arises on any change of requirements and is not unique to adopting an expected loss model.

In summary, applying the expected loss model seems no more complex in terms of financial mathematics than accounting for other scenarios that entail splitting interest coupons between interest revenue and adjustments of the carrying amount (eg an annuity type loan or a loan with a significant discount or transaction costs). The only difference is that the EIR is different, but it is still determined on the basis of the same type of iterative calculation.

39. In evaluating accounting complexity the complexity of a financial instrument should also be considered. As noted earlier (see paragraph 25 above), using a provision matrix is a common practice particularly for trade receivables but the threshold for recognising impairment losses used in an incurred loss model has created problems. For such relatively simple financial instruments applying an expected loss model does not have to be overly complex. For example, it could involve using a provision matrix based on expected losses (which has been done in large parts of practice before the incurred loss model became mandatory) and charging the initial amount determined in accordance with the matrix against revenue.

40. Note that for non-coupon interest bearing trade receivables the expected loss is not compensated in the same way as for example for many coupon interest bearing loans that have a credit spread included in the interest coupons. The fact that there may be a 'loss' on recognising a trade receivable from the approach described above is a (mis)perception issue. It is not about a 'loss' on recognition but rather reflects that under widespread practice trade receivables

that are short-term are not discounted but recognised at their invoice amount.[11] This approach does not only ignore the time value of money but it ignores the credit risk in form of expected losses as well (until they become 'incurred'). Arguably, the combination of not discounting short-term receivables and not recognising credit losses unless and until they have been incurred has a dangerous potential to systematically understate credit risk for this type of financial instrument and thus overstate the asset for a period just after initial recognition.

41.   Thus, measuring trade receivables not at their invoice amount but at a lower amount that reflects credit losses expected from the outset is not about recognising a 'loss' on initial recognition of the trade receivable but rather reflecting that the invoice amount is the *redemption* amount on a zero-coupon bond type instrument (albeit with a short-term life). Just as zero-coupon bonds are not measured at their redemption amount when acquired there is no more conceptual reason to look differently at trade receivables only because they are acquired as consideration for non-financial items (goods or services). Thus, considering the initial measurement of trade receivables at less than their invoice amount as giving rise to an inappropriate 'loss' is based on a view that implicitly accepts the invoice amount as the conceptually correct initial measurement. However, the latter measurement is only a practical expedient under materiality considerations.

Fair value based model

42.   There are many possible variations of a fair value based impairment model, but such a model typically has the following main features:

(a)   recognising interest revenue on the basis of the full contractual interest (with adjustments as required by the EIM);

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[11] For example, IAS 39.AG79 says 'Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.'

(b) monitoring financial assets for impairment, which could be based on different criteria:

   (i) a decline of fair value below the amortised cost of the financial asset, which would result in accounting at fair value through profit or loss from that point in time;

   (ii) a decline of fair value below the amortised cost of the financial asset combined with management's intent and ability to hold the financial asset until recovery of its amortised cost;

   (iii) evidence of impairment based on a notion of a credit loss (ie credit deterioration that indicates the obligor may default on contractual cash flows);

(c) recognising an impairment loss in profit or loss at the point in time when the impairment criterion or criteria (see item (b) above) are met;

(d) measuring an impairment loss as the difference between:

   • the carrying amount of the financial asset (before impairment); and

   • fair value;

(e) the loss estimate implicitly included in the fair value reflects the assumptions that market participants would use in pricing the asset (or management's best estimate as to what those would be in case this is unobservable input);

(f) reversal of an impairment loss through profit or loss using a mechanism that reflects the criteria used for determining impairment (see item (b) above); such reversal may be required or prohibited (eg using amortisation through other comprehensive income instead of recognition in profit or loss).

43. Using a fair value based impairment test essentially requires fair value accounting on a contingent basis (ie once the criterion or criteria for impairment have been met). Thus, this impairment model is a mix of an amortised cost model and a fair value model. This has created significant complexity arising from combining two conceptually very different models, which has created serious application problems under existing requirements (eg for financial instruments classified as available for sale).

44. However, a fair value based impairment model might address some of the significant concerns that users have expressed about the effects of management bias on the timing and amounts of recognised impairments. Of course, to the extent that markets are not active, some still have concerns about the effect of management estimates. However, almost all preparers who are financial institutions strongly believe that fair values significantly overstate the amount of losses that will ultimately be incurred.

45. The impairment discussion about the incurred and expected loss models in this paper has been about recognition and measurement of credit losses. The incurred loss model is a mix of approaches – the recognition is triggered by evidence of a loss in cash flows, but the measurement of estimated recoverable cash flows requires expectations of losses arising from the loss event. The expected loss model only updates the cost measure for changes in expected losses if and when expectations change. A fair value model not only updates the impairment measure for changes in expected losses, but also updates the measure for every other input (notably the impact of liquidity). All of these different approaches (and the strong views about them from stakeholders as well as board members) reflect the fact that there is no common understanding of what impairment is meant to represent. Should it simply be the effect of actual or expected changes in credit losses, or should it be something else (and what should that be)?

Question for the boards

Need for further information

What further information or analysis do you require about an amortised cost method (including impairment), and how will that information or analysis be useful to you?

Appendix A

A1.   The following graph illustrates the 'cliff-effect' of an incurred loss model (taken
       from agenda paper 7A of the March 2009 joint IASB/FASB meeting – see
       paragraph 22 of that paper):