Project **Financial Instruments – Recognition and Measurement**

Topic **Fair value-based impairment models**

Introduction

Background

1. At the March 2009 joint board meeting the boards discussed possible approaches to impairment/loss provisioning. They explored and compared the incurred loss model and an expected loss model. Both models:

   (a) use amortised cost conventions rather than fair value; and

   (b) attempt to identify losses on existing loans.

2. At that meeting the boards decided that impairment should be a separate work stream within the financial instruments project.

3. At the April 2009 meeting the IASB discussed the amortised cost measurement method, including three possible impairment approaches for financial assets – an incurred loss method, an expected loss method and a method based on fair value. It was clear from that discussion that different board members were discussing different varieties of an impairment method based on fair value.

4. Before the boards are able to decide upon a preferred impairment method if an amortised cost measurement method is chosen for any financial assets, the boards need to compare and contrast the different impairment methods. In order to do that compare and contrast exercise, all board members need to be talking

about the same version of each possible impairment method (this especially applies to a fair value impairment method).

Purpose of this paper

5. The objective of this paper is to describe the mechanics of a fair value-based impairment model in connection with the amortised cost method. Thus, this paper does not address the impairment of any equity instruments that may be carried at cost.

6. This paper does not ask the boards for any decisions. However, this series of papers aims to put board members in a position to make a decision on the impairment model that would be proposed should amortised cost be used as the measurement method for any financial asset. Therefore it is important that board members specify whether they need additional information or analysis on the subject being discussed (and if so, what). Given the timetable for this project, board members must ensure that such requests are focussed as well as necessary.

Defining characteristics of a fair value-based impairment model

7. A fair value-based impairment model for financial assets essentially means that the measurement method used for determining an impairment loss is the fair value of a financial asset at the impairment date. That is, there is a switch from an amortised cost measurement method to a fair value measurement method at some point after initial recognition. That point (the 'impairment trigger') can be determined in a variety of ways. Subsequent to that switch to fair value measurement, the instrument may be measured using fair value, amortised cost (with possibly a reset of the cost base), or some hybrid measurement basis.

8. A switch between measurement methods is a source of complexity. Switching between amortised cost and fair value typically causes a range of problems, particularly for subsequent interest revenue recognition.

9. In summary, the fundamental components[1] of a fair value-based impairment method are:

   (a) the impairment trigger;

   (b) the amount of (impairment) loss;

   (c) the presentation of (impairment) losses in the primary financial statements;

   (d) the subsequent interest revenue recognition; and

   (e) reversals of previously recognised impairment losses.

10. These components (and their variations), and the impact on the numbers reported in the financial statements of a reporting entity, are discussed below.

Impairment trigger

11. Various approaches exist to determine when to require a numerical calculation of a potential impairment loss. A distinction can be made between indicator-based approaches and value-based approaches. The type of impairment trigger has an impact on the timing of recognition of any impairment losses.

Indicator-based approach

12. Under an indicator-based approach, a reporting entity monitors for occurrence of particular events or circumstances indicating a credit loss has been incurred (i.e., actual cash flows to the entity are expected to be lower and/or occur later than contractually specified). This is commonly referred to as a loss event. Such indicators can be one or a combination of instrument-specific factors, the entity's intention/financial position and other factors (such as the impact of possible actions that a prudential regulator may take).

[1] Some or all of these components are common to other impairment approaches.

13. Both IFRSs and US GAAP currently use some form of an indicator-based approach to identify loss events and trigger a quantitative impairment test for financial assets.

14. Under US GAAP the following indicators are applied that are supplemented by additional authoritative and non-authoritative accounting literature:[2]

    (a) It is more likely than not that the creditor will be unable to collect all amounts due under the contract (loans accounted for under Statement 114 *Accounting by Creditors for Impairment of a Loan*).

    (b) Other-than-temporary impairment (OTTI) concept evaluating management intent/ability to hold the instrument and other facts and circumstances (securities within the scope of Statement 115 *Accounting for Certain Investments in debt and Equity Securities* that are not measured at fair value through profit or loss).[3]

    (c) Loss is probable and reasonably estimable (receivables accounted for under Statement 5 *Accounting for Contingencies*).

15. Under IFRSs, IAS 39.59 contains a list of indicators (e.g. significant financial difficulty of the debtor, probable bankruptcy of the debtor, etc.) that alone or in combination trigger a quantitative impairment test.

16. The indicators mentioned above are not intended to be comprehensive. Other indicators could be identified or some indicators could be removed.

17. Any indicator-based approach involves judgement in application (unless brightline rules are provided). Many respondents to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* highlighted the difficulties in applying the IFRS indicators.

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[2] Agenda paper 11C of the November 2008 IASB meeting contains a detailed analysis of the impairment models currently applied under IFRS and US GAAP.

[3] US GAAP uses an indicator-based approach for financial assets in security form. However, that is applied in situations in which there has been a fair value decline below carrying amount.

Value-based approach

18. Under a value-based approach to impairment the reporting entity only looks at changes in the fair value of a financial asset. There is no separate impairment test trigger based on indicators other than fair value. Generally, if fair value is below carrying amount an (impairment) loss is considered to have occurred and the difference is recognised as an (impairment) loss.

19. A value-based approach using fair value as the reference point fundamentally changes the measurement method being used from amortised cost at initial recognition to a lower of cost or fair value approach (LOCFV). Should the boards choose a LOCFV approach, this will impact the rationale behind any criteria used to decide how instruments are measured at initial recognition.

Amount of (impairment) loss

20. Once it has been determined that a financial asset is impaired, an impairment calculation has to be performed to determine the amount of loss to be recognised.

21. Under a fair value-based impairment model, the amount of loss is determined as the difference between the carrying amount and the fair value of the financial asset at the impairment (reporting) date. As mentioned above, this amount reflects changes in all the valuation variables of the instrument.

22. This paper has so far discussed impairment in the context of fair value - an exit value would reflect market participants' expectations about the cash flows that the financial asset will generate. Existing models generally apply an exit notion as it reflects the market's assessment about the amount, timing and uncertainty of those future cash flows.

23. However, another approach is to use a value in use notion reflecting management's (rather than the markets) estimate of future cash flows, discounted by current market rates[4].

24. Like in other IFRSs, a combination of an exit notion and a value in use notion (higher of-test) can be used to reflect that management is aiming to maximise the value it can recover from the asset. (Also see discussion in paper 5C about the impact of the different characteristics of financial and non-financial assets have on impairment approaches).

Presentation of (impairment) losses in the primary financial statements

25. There are basically two ways of presenting the difference between carrying amount and fair value in financial statements:

    (a) in profit or loss; or

    (b) partly in profit or loss and partly in other comprehensive income.

26. Recognising the full impairment loss in the income statement is the most straightforward way of presenting a loss as a result of the impairment calculation. Many users have argued for this approach.

27. However, other stakeholders argue that the difference between carrying amount and the fair value of the financial asset is not the most useful information to present in profit or loss. They argue that some of the fair value decline reflects unrealised gains or losses due to the changes in the *non-credit* related variables underlying the instrument (e.g. risk free interest rates, foreign exchange).[5]

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[4] A rate that reflects current market assessments of the time value of money and the risks specific to the asset that investors could require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those the entity expects to derive from the asset (IAS 36.56).

[5] It is debatable whether a change in the spread for a certain credit risk class (credit sector spread) can be considered part of impairment loss that is mainly driven by the contractual cash flows, not by changes in the assessment of the risks that arises from the cash flows and the counterparty.

28. To distinguish between a credit-related loss and other changes in fair value, the amount of loss determined can be split up between a *credit-related* portion (recognised in profit or loss) and a *non-credit related* portion (recognised separately in profit or loss or recognised in other comprehensive income). Such a split also can be done in the notes.

29. However, such an approach inevitably raises the question how the *credit-related* portion is determined, as well as the meaning of the calculated numbers in the context of a fair value measurement.

30. One possible solution to disaggregate the fair value change could be by determining the present value of the expected future cash flows discounted at the original effective interest rate of the financial asset – similar to measurement using an expected or incurred loss approach. The latter would ignore future credit losses that have not been incurred and be largely consistent with the current impairment model in IAS 39. A disadvantage of such an approach is that it mixes a current value measurement approach used for the overall impairment loss with a method of disaggregation of that loss that uses a cost based measurement approach (ie not a current value measurement). This also creates knock-on effects in subsequent periods (see below).

31. Another possible approach would be to fair value the credit risk component of the financial asset, which would more consistent with the overall approach to a fair value-based impairment model. However, there is no straightforward answer as to how that would be determined. This would also be difficult to apply in practice, for both financial and non-financial entities.

32. If the non-credit related portion of the loss was to be recognised in other comprehensive income the loss split in profit or loss can be presented gross or net.

33. When using a gross presentation the full difference between carrying amount and fair value would be included in profit or loss and the non-credit related portion transferred to OCI by a credit[6] to the income statement.

34. Under a net approach, the credit-related portion of the difference would be recognised in profit or loss and the non-credit related portion would be recognised directly in OCI.

Subsequent interest revenue recognition

35. Once an impairment has been determined to exist and a loss has been recognised, there are several approaches to recognising interest revenue subsequently. Let us first consider the approaches assuming that the entire fair value impairment is recognised in profit and loss.

36. **One approach uses the fair value at the date the financial asset has been impaired as the new cost basis.** This would result in the effective interest rate (EIR) being updated, i.e. the entity would determine the discount rate that discounts the expected future cash flows to arrive at the fair value of the financial asset. This discount rate then is used to accrete the instrument to ultimately arrive at the expected value on maturity. This approach is tantamount to a deemed sale and buy back of the instrument at the measurement date.[7] As the impaired financial asset pulls to the expected value on maturity, a component of interest revenue does not represent the contractual (effective) interest from the instrument, but rather reflects a 'recovery' of the previously recognised fair value loss[8]. Furthermore, any further subsequent reset of the cost basis (i.e., the amortised cost using the new EIR for accretion) due to further impairments requires resetting the EIR again.

[6] Potentially, it could also be a debit depending on the direction of the non-credit related change in fair value.
[7] Depending on the approach chosen to recognise the difference between fair value and carrying amount this might not reflect a deemed sale (if not all of the unrealised loss ends up in profit or loss).
[8] The amortised costs often accrete rapidly because the EIRs determined after impairment are relatively high. This will be aggravated when the negative fair value change is largely caused by non-credit related factors.

37. A problem with this approach is that the link between revenue recognition and the measurement of the asset is likely to break. The amortised cost measurement basis for interest revenue recognition loses its predictive value and the interest revenue reported for the impaired financial asset becomes meaningless. (See discussion in agenda paper 5C regarding the integrated approach between revenue recognition and impairment in the amortised cost model for contractual financial assets.)

38. **Another approach would be to keep the original EIR.** This would preserve the link between interest revenue recognition and the original measurement basis of the asset, but lead to interest accretion based on the expected cash flows with any change in fair value that does not impact the expected cash flows in the fair value-based impairment loss not being included in this calculation. As a result, any change in fair value that was not caused by changes in the expected cash flows will not be amortised through profit or loss using the effective interest method but would require some other unwinding mechanism. The effect of this is a disconnection between the measurement of the financial asset and the interest revenue recognition.

39. Some may argue that the significant increase in credit risk triggering impairment makes **a continuous measurement based on fair value** more relevant. However, once it is expected that the actual cash flows will equal the contractual cash flows this logic contradicts any original conclusion that amortised cost is the most relevant measurement basis, because of the expectation that actual cash flows will equal contractual cash flows. As a logical consequence, the basis would have to be switch back again to amortised cost at that point. When the financial asset is continuously remeasured using fair value accreting interest based on the latest determined fair value does not result in information that is useful.

40. Let us now consider the possible effects of splitting the fair value impairment loss into different components.

41. If a method of splitting an impairment loss into a credit related portion (P+L) and a non-credit related portion (OCI) is used, there will be a further complication. Under such an approach, a method of releasing the OCI component would have to be specified – preferably one that provides useful/meaningful information to users of financial statements.

42. One possible solution, a recycling approach, could be the following:

    (a) determine the EIR assuming fair value as the new cost basis;

    (b) determine the EIR for the cost basis including the credit related loss; and

    (c) use the difference between (a) and (b) to amortise the amount in OCI to profit or loss.

43. However, such an approach would result in the part of the loss that is recognised in OCI effectively being reversed through profit or loss. The effect on profit or loss would be the same as updating the EIR on impairment.

44. Alternatively, the amount recognised in OCI could be "amortised" by increasing the carrying value of the impaired financial asset based on the future cash flows (e.g. by using an EIR determined as under the previous paragraph) instead of being recognised in profit or loss. This is the approach taken for held-to-maturity securities that are impaired under the recently issued FSP 115-2 on other-than-temporary impairments.

45. A further alternative would be to account for the non-credit related portion like current accounting for AFS financial assets and let this portion unwind directly in OCI. All other things being equal and actual cash flows occurring as expected, the non-credit related portion should be zero at maturity. This would require the instrument to be carried at fair value continuously and also involves the same issues as for AFS today.

Reversals

46. Before addressing accounting for reversals a fundamental decision would have to be made: Are reversals through profit or loss required or not permitted at all? Under US GAAP reversals are not permitted for particular securities. Likewise, IFRS does not permit reversals through profit or loss for equity instruments classified as available for sale. However, reversals of impairment losses on available-for-sale debt instruments are recognised in profit or loss.

47. The assessment as to whether a reversal of an impairment loss has occurred can be done using similar approaches to those used for identifying that an impairment has occurred in the first place, i.e. using an indicator-based or a value-based approach. As mentioned above, using indicators inevitably involves applying judgement. It could be required that the same indicator that caused the impairment must be met to allow a reversal (although note that for debt instruments IFRSs currently do not require the indicator for reversals to be the same (but inverse) as the one that triggered the impairment).

48. Under an indicator-based approach an entity would have to assess whether an event subsequent to the recognition of an impairment has resulted in an increase in the recoverability of the cash flows. Once it is determined that an indicator for a reversal exists, the second step would be to determine whether the fair value has increased.

49. Under a value-based approach increases in the fair value above the carrying amount would be considered a reversal. This would mean continuously remeasuring the financial asset until it eventually recovers up to its amortised cost. This (LOCFV) approach would add complexity to the impairment model.

50. The question can be asked whether all increases in fair value qualify for recognition as a reversal or whether only increases in fair value due to changes in credit risk do. It is not the intent of this paper to discuss this issue in detail. However, any such assessment adds to the complexity of the impairment model.

51. Furthermore, a series of impairments and reversals over the life of the financial asset create practical difficulties (e.g. tracking impact of reversals, additional impairments, etc.).

52. The cap for reversals would be the amortised cost of the instruments assuming no impairment had occurred. It seems counterintuitive that reversals would be permitted above a basis that was considered useful to users before the impairment occurred.

A starting point for a potential fair value-based impairment model

53. This paper demonstrates that there are many options, and complications, with a fair value-based impairment model.

54. Any impairment model must meet the objective of providing useful information to users – and that includes the complexity of understanding the results and effects of an impairment model and comparability of the numbers reported.

55. This paper started out by stating that it is important that board members talk about one version of a fair value impairment model.

56. Described below is one version of such a model. It does not represent a staff recommendation.

Trigger

57. Any change in fair value below its amortised cost.

Measurement and presentation of impairment loss

58. Difference between amortised cost (i.e., carrying amount) and fair value recognised in profit or loss.

Subsequent measurement

59. As long as the fair value is below the amortised cost (which would have to be carried forward), the financial asset is measured at fair value through profit or loss. Hence reversals are required. No effective interest is accreted in profit or loss.

60. Once fair value equals or is above the amortised cost, the financial asset is carried at amortised cost again. Interest would be accreted on the basis of the original effective interest rate.

Appendix

Fair value-based impairment models used in current accounting literature

Variations of a fair value-based impairment models are currently applied in both IFRS and US GAAP:

Type of instrument/characteristic	Impairment trigger	Amount of (impairment) loss	Presentation of (impairment) losses in the primary financial statements	Interest revenue recognition	Reversals to P+L
US GAAP					
Pre FSP 115-2					
HTM debt securities (SFAS 115)	Combination	CA - FV	P+L - no split	Updated EIR (FV new cost basis)	Prohibited
AFS debt securities (SFAS 115)	Combination	CA - FV	P+L - no split	Updated EIR (FV new cost basis)	Prohibited
AFS equity securities (SFAS 115)	Combination	CA - FV	P+L - no split	n/a	Prohibited
Post FSP 115-2					
HTM debt securities (SFAS 115)	Combination	CA - FV	P+L / OCI - split - gross	Original EIR[1]	Prohibited
AFS debt securities (SFAS 115)	Combination	CA - FV	P+L / OCI - split - gross	Updated EIR[4]	Prohibited
AFS equity securities (SFAS 115)	Combination	CA - FV	P+L	n/a	Prohibited
IFRS					
AFS debt instruments	Indicator-based	CA - FV	P+L - no split	Original EIR	Required
AFS equity instruments @FV	Indicator-based	CA - FV	P+L - no split	n/a	Prohibited
LAR debt instruments[2]	Indicator-based	CA - FV	P+L - no split	Original EIR	Required

1 = depending on method for determining credit-related portion

2 = as a practical expedient if observable market price available

3 = if no intent to sell/be forced to sell and no expectation to recover the amortised cost basis

4 = updated for the credit-related fair value change recognised in P+L