



Project	<b>Financial Instruments – Recognition and Measurement</b>
Topic	<b>Amortised cost – objective of an impairment test and implications for financial assets</b>

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## Introduction

### *Background*

1. At the April 2009 meeting the IASB discussed the amortised cost measurement method<sup>1</sup>, including three possible impairment approaches for financial assets – an incurred loss method, an expected loss method and a method based on fair value.
2. At that meeting the Board asked the staff to provide more information about two of the impairment approaches. In response to that request there are two agenda papers that provide more information about:
  - (a) an expected cash flow approach (agenda paper 5A); and
  - (b) a fair value based impairment approach (agenda paper 5B).
3. At the April 2009 meeting the Board also requested more information about the objective of an impairment test and how the impairment test for financial assets relates to the impairment tests for non-financial assets.

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<sup>1</sup> Agenda paper 14 of the April 2009 IASB meeting.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

***Purpose of this paper***

4. This paper provides a brief discussion about, and contrasts between, the impairment approaches for financial and non-financial assets. This paper also summarises the implications for the impairment test of financial assets under an amortised cost model that were discussed in detail in paper 5B (fair value-based impairment models).
5. This paper does not provide an in depth analysis of accounting for impairments in general as this project is about financial instruments (with an ambitious timetable). If the Board would like to consider impairment on broader basis (ie including non-financial assets) this should be a separate project. The staff also notes that the impairment project was only recently removed from the agenda.<sup>2</sup>
6. This paper does not ask the boards for any decisions. This paper is intended to help the boards in comparing the different impairment approaches for financial assets (see paper 5D), and reaching a decision as to the preferred impairment approach if any financial assets are measured at amortised cost.

**Objective of an impairment test**

7. IAS 36 *Impairment of Assets* states that the objective of an impairment test is to ensure that an asset is not carried at an amount that exceeds the asset's recoverable amount.<sup>3</sup> Doing so would overstate the entity's financial position. Thus, in order to avoid such a situation, an impairment loss is recognised that writes down the asset from its carrying amount to its lower recoverable amount.

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<sup>2</sup> Impairment was included in the Memorandum of Understanding (MoU) in 2006 but for the 2008 MoU the boards chose to defer completing the projects on impairment until other work is complete.

<sup>3</sup> See IAS 36.1.

8. Impairment test approaches are a part of the accounting model for assets that are not accounted for at fair value through profit or loss. For all such assets accounting standards need to address when and how to recognised changes in the value of an asset. In cost-based accounting models there are two ways for departure from the initial cost because of value changes:
- (a) revenue recognition (for recognising a value increase in the financial statements); and
  - (b) impairment testing (for recognising a value decrease in the financial statements).

***Financial assets at amortised cost***

9. For financial assets measured at amortised cost all three aspects (cost basis, impairment and revenue recognition) are included in a single standard, IAS 39 *Financial Instruments: Recognition and Measurement*. While the scope of IAS 18 *Revenue* includes revenue recognition for interest IAS 18.30(a) refers to the effective interest method (EIM) as set out in IAS 39, ie IAS 18 includes the revenue recognition requirements of IAS 39 by reference.
10. That amortised cost model uses an integrated approach for dealing with the three aspects—the cost basis, revenue recognition and impairment. By definition the EIM determines the carrying amount and revenue recognition as part of the same calculation.<sup>4</sup> Also, the effective interest rate (EIR) used for revenue recognition purposes is used in measuring an impairment loss. In contrast to the approach for other assets that presents revenue gross (see paragraph 18 below), in the integrated model for financial instruments only the margin (interest) is revenue and repayments are accounted for as a direct asset recovery.

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<sup>4</sup> See IAS 39.9 – this is an iterative computation.

11. Such an integrated model works for financial instruments at (amortised) cost because by definition the cash flows associated with the instrument are contractual, and hence have an integral contractual return over the contractual life of the instrument. The ability to determine a contractually based return in turn results in a link of this return to both the measurement of the asset as well as its impairment test.

***Non-financial assets***

12. In contrast, there is no integral rate of return for non-financial assets as there is for financial instruments that are measured at (amortised) cost. This is because most returns on non-financial assets are not contractually pre-set over the life of the asset(s). Therefore determining a return is subject to many more assumptions. This is reflected in aspects of estimating cash flows for non-financial assets such as:

- budget information;
- growth rates assumptions;
- terminal values;
- effects of future capital expenditure; and
- effects of restructurings.

13. Thus, for the impairment test of non-financial<sup>5</sup> assets IFRSs include much more comprehensive guidance on estimating cash flows.<sup>6</sup> The extent of the guidance in IAS 36 reflects the higher complexity of estimating cash flows for non-financial assets. The complexity results from dealing with mainly non-contractual cash flows and the interaction of different assets. Thus, cash flow estimates are much more difficult compared to financial instruments.

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<sup>5</sup> IAS 36 applies to a limited number of types of financial assets (see IAS 36.4) but its main application is to non-financial assets.

<sup>6</sup> See IAS 36.33–54.

14. As a consequence, revenue recognition for these non-financial assets does not allow pre-setting the associated revenue over the life of the asset but every revenue transaction is subject to verification whether it meets the requirements for recognition if and when it happens. Hence, for these assets there is a dichotomy regarding the design of the approach to deal with value increases (ie revenue recognition) and with value decreases (ie impairment testing). This dichotomy is also reflected in the use of cash generating units<sup>7</sup> for impairment testing, which is different from the unit of account for revenue recognition purposes. The revenue recognition and the impairment testing for these assets are thus not integrated as is the case for financial assets that are measured at (amortised) cost.
15. This is also the reason why impairment tests for non-financial assets cannot use the same rate that is inextricably linked to revenue recognition, unlike financial assets at (amortised) cost.
16. As a consequence (and by necessity), a current value measurement is used for the impairment test of these non-financial assets (despite using a cost model as the general measurement approach).
17. A further consequence is that for non-financial assets the aspects of cost basis, impairment and revenue recognition of a cost-based method are scattered throughout several IFRSs (in essence, reflecting the inability to have an integrated approach for all the aspects of any cost-based accounting approach).  
Notably, in standards that deal with:

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<sup>7</sup> Cash generating units are used by IAS 36 in order to avoid an arbitrary allocation of cash flows to individual assets. This is different from a portfolio based impairment test for financial instruments, which is about using the law of large numbers in order to improve the accuracy of estimates (as well as a practical expedient for bookkeeping purposes, which does not mean you could not identify the cash flows attributable to a financial instrument).

- (a) the cost basis (eg IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, and IAS 38 *Intangible Assets*);
- (b) impairment (eg IAS 2, and IAS 36); and
- (c) revenue recognition (eg IAS 18).

18. As previously noted, for these non-financial assets measurement of revenue is based on the gross amount of the consideration and the assets result in a related expense on a gross basis. The difference between the revenue and the associated expense is the profit margin.

***Implications for a mixed measurement approach***

19. The difference between
- (a) the integral approach to establishing the cost basis, revenue recognition and impairment for financial assets; and
  - (b) the fragmented approach with a dichotomy of revenue recognition and impairment for non-financial assets

shows why mixing two different measurement models creates problems. For example, combining amortised cost with a fair value based impairment test. Using a current value measurement such as fair value breaks the integral cost-based approach used for financial instruments, which means that the measurement of the asset, revenue recognition and impairment no longer have the intertwined linkage that they have under an amortised cost model with an incurred or expected loss approach.

20. A switch between measurement methods is a source of complexity. Switching between amortised cost and fair value typically causes problems regarding:
- (a) recognising interest revenue after an impairment has been recognised:
    - (i) if the measurement switches back to amortised cost after a one-off write down to fair value, this often results in

yields that to many appear unreasonable or need to be reset too frequently; or

- (ii) if the measurement remains at fair value following an impairment test, revenue recognition using the effective interest method is no longer feasible; and
- (b) for approaches using a one-off write down to fair value on impairment, finding a way to switch back to an amortised cost basis after an impairment has been recognised (often there are further fair value declines requiring further resets of the carrying amount to a lower fair value, which in turn requires the rate used for revenue recognition to be reset again).

- 21. Agenda paper 5B on fair value-based impairment models discusses the combination of amortised cost with fair value in more detail.