IASB Meeting Agenda reference **8**

Staff Paper Date **15-16 October 2009**

Project **Financial Instruments – Replacement of IAS 39**

Topic **Classification and measurement: financial assets acquired at a discount that reflects incurred credit losses**

Purpose of this paper

1. The exposure draft *Financial Instruments: Classification and Measurement* (ED) proposed two classification conditions. On 29 September the Board tentatively confirmed those two conditions and agreed that they should be carried forward to the IFRS—that is, classification and measurement should be determined on the basis of:

   (a) the entity's business model for managing its instruments; and

   (b) the contractual cash flow characteristics of the instrument.

2. **The purpose of this paper is to discuss how those two conditions should be applied to a financial asset that is acquired at a discount that reflects incurred credit losses.**

Proposals in the ED

3. The ED states that a financial asset that is acquired at a discount that reflects incurred credit losses **cannot** be subsequently measured at amortized cost because:

   (a) an entity does not hold such instruments to collect the cash flows arising from the instruments' contractual terms; (paragraph B10(b)) and

   (b) the investor believes that the actual losses will be less than the losses that are reflects in the purchase price; thus, the instrument creates

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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.

exposure to significant variability in actual cash flows and such variability is not interest. (paragraph BC29)

Feedback received

4. Although the ED did not ask a question specifically related to a financial asset that is acquired at a discount that reflects incurred credit losses, many respondents discussed that particular instrument in their letters. Almost all **disagreed** with paragraphs B10 and BC29 that such assets would never meet the proposed conditions to be measured at amortized cost.

The entity's business model for managing its instruments

5. Most respondents focused on paragraph B10 and disagreed with the ED's conclusion that these assets cannot be held with an objective of collecting the contractual cash flows. Almost all respondents saw paragraph B10 as an **exception** from the approach proposed in the ED.

6. They stated that paragraph B10 did not reflect the approach taken by some entities, especially when the assets were acquired as part of an otherwise performing portfolio. These respondents said that the portfolio, including the assets with incurred credit losses, could indeed be part of a business model that has the objective of holding to collect contractual cash flows.

7. Respondents also highlighted that the proposed approach was not operational in the context of the acquisition of a portfolio. Such a portfolio inevitably includes individual loans with "incurred" losses. However, identifying individual incurred loans is not operational or perhaps impossible. As a result, the ED proposal would mean that any acquired loan portfolios would, by default, be required to be measured at fair value. Moreover, some respondents noted that when an entity acquires a portfolio, it is difficult to determine whether a discount relates to incurred credit losses, changes in interest rates, or the shape of the yield curve.

8. Furthermore, a few respondents noted that their business model is to purchase portfolios of debt (this may or may not include portfolios of debt in which some debtors are non-performing or close to non-performing) and attempt to extract the contract cash flows through various means, initiating contact with the debtor via mail, telephone, and legal avenues. Those respondents noted that they do not purchase such portfolios with a view to make a profit by selling them—in fact, they typically hold the assets until maturity. The profitability of their business is driven by the efficiency of their collection operations and processes—not by taking advantage of market risks.

9. Some respondents acknowledged that the acquirer might purchase such assets with a speculative view—for example, for subsequent resale of the assets or in anticipation of favorable changes in market conditions. In those cases, the respondents agreed that the business model would not be consistent with holding the assets to collect contractual cash flows —and, thus, the assets should be measured at fair value.

10. In summary, respondents said that preparers will have to use judgment in deciding whether financial assets acquired at a discount that reflects incurred credit losses are held with an objective to collect contractual cash flows. But respondents said that such judgment is **the same as** is necessary for any other instrument being classified under this approach —and disagreed that these assets should be automatically disqualified from being measured at amortized cost simply because they were acquired with incurred credit losses.

The contractual cash flow characteristics of the instrument

11. Some respondents also commented on paragraph BC29. Those respondents said the fact that the investor **believes** that the actual losses will be less than the losses reflected in the purchase price is irrelevant to the analysis of the **contractual** cash flow characteristics of the instrument.

12. In other words, the respondents said that contractual terms of the instrument are established at inception of the instrument and do not change based on the timing of acquisition.

Staff analysis and recommendations

13. Consistent with the majority of respondents, we agree that the fact that an asset is acquired at a discount that reflects incurred credit losses does not in itself disqualify it from being measured at amortized cost. That is, we agree that such assets can:

(a) be held for the objective of collecting the contractual cash flows; and

(b) have contractual cash flow characteristics that represent payments of principal and interest on that principal.

Question 1 – Financial assets acquired at a discount that reflects incurred credit losses
Does the Board agree that the fact that an asset is acquired at a discount that reflects incurred credit losses does not in itself disqualify it from being measured at amortized cost? If not, why?