



Project	<b>Financial Instruments – Recognition and Measurement</b>
Topic	<b>Impairment – Presentation and Disclosures</b>

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## Introduction

### *Background*

1. In June 2009, a Request for Information (RFI) on the *feasibility* of the expected cash flow (ECF) approach was posted on the IASB website with responses requested by 1 September 2009.
2. At its 17 September 2009 meeting, the IASB tentatively decided to issue an exposure draft (ED) in October 2009 proposing the ECF approach as the impairment method for financial assets measured at amortised cost.
3. In seeking input to the possible presentation and disclosure requirements to accompany the proposed ECF approach in the ED, the staff has held a number of outreach discussions and meetings with financial statement users to seek views as to what they regard as useful information on impairment and credit quality of financial assets.
4. The staff notes that some respondents to the RFI also commented on possible presentation and disclosure requirements (notwithstanding they were not the subject of the RFI).

### *Purpose*

5. The purpose of this paper is to propose presentation and disclosure requirements to accompany the proposed ECF approach in the ED on impairment of financial

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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.

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assets. This paper set out staff recommendations, and asks the Board for decisions.

**Structure**

6. The rest of this paper is structured as follows:
  - (a) overall objective for presentation and disclosure;
  - (b) presentation and disclosures for the ECF approach:
    - (i) on the face of the financial statements; and
    - (ii) note disclosures explaining further the amount reported on the face;
  - (c) additional disclosures on the quality of financial assets; and
  - (d) transition.

**Overall objective**

7. The staff believes that the overall objective of presentation and disclosure for impairment of financial assets is to provide useful and transparent information to enable users to decipher what happened—and *why*—in relation to:
  - (a) the ECF approach; and
  - (b) credit quality of financial assets.
8. The proposals are designed to facilitate a thorough understanding of the impairment of financial instruments using the ECF approach and enhance the disclosures on credit quality of financial assets. As such, these proposals do not replace the credit risk related disclosure currently required in IFRS 7 Financial Instruments: Disclosures.

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**Presentation on the face of the primary financial statements*****Statement of comprehensive income – interest revenue***

9. Under the ECF approach, interest revenue is recognised based on the expected cash flows (including expected credit losses). Respondents to the RFI and outreach activities emphasised that contractual-based interest revenue is important information. For example, it is used to compute the interest margin on a comparable basis for revenue and expense (a key performance indicator). There was a concern that contractual-based interest revenue would no longer be available under the ECF approach.
10. The staff agrees that interest revenue based on contractual cash flows is valuable information and therefore proposes the following presentation on the face of the statement of comprehensive income:

$$\begin{array}{r}
 \text{Interest revenue based on contractual cash flows} \\
 \text{Less: } \underline{\text{Adjustment for allocation of initial expected losses}} \\
 = \text{Interest revenue based on ECF}
 \end{array}$$

11. This gross presentation provides transparency and allows users to distinguish the amount of adjustment from contractual revenue for the period that will contribute to the build up of the provision account.

***Statement of comprehensive income – changes in expectations***

12. Under the ECF approach changes in expectation will result in additional impairment charges or reversals. The staff believes that this amount should be presented as a separate line item on the face of statement of comprehensive income to provide useful information to users. The staff recommends this line item be further disaggregated in the notes (see paragraphs 33-35).

***Staff recommendation***

13. The staff recommends that the Board proposes that on the face of the statement of comprehensive income:
- (a) interest revenue is presented as follows:

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	Interest revenue based on contractual cash flows
Less:	<u>Adjustment for allocation of initial expected losses</u>
=	Interest revenue based on ECF

- (b) changes in expectations are presented as a separate line item.

**Question 1 – Presentation on the face of the primary financial statements**

Does the Board agree with the staff recommendation as set out in paragraph 13?

If not, why and what other presentation would the Board like and why?

**Disclosures in the notes to the financial statements**

14. Most analysts the staff has spoken to indicated that they would like to see more disaggregated/detailed breakdown of quantitative disclosures. The staff notes that mandating a specific level of detail may overburden financial statements with unnecessary excessive detail. However, on the other hand entities should not aggregate information that would obscure important information.
15. On balance, the staff believes that the proposed note disclosures should be provided, at a minimum, by class of instrument. Application guidance in IFRS 7<sup>1</sup> currently provides discussion on classes of financial instruments and level of disclosure. Management should use judgement to provide the appropriate level of disaggregation (whether by class or at a more disaggregated level) that would result in decision-useful information to users.

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<sup>1</sup> The relevant extract of IFRS 7 is provided in Appendix A.

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**Provision account for expected credit losses**

16. Under the ECF approach, the carrying amount of the provision account is a crucial number as it provides users with information on how much provision the entity has set aside for expected credit losses. The staff therefore believes that the use of a provision account for expected credit losses should be *mandated*.
17. Feedback from analysts indicates (and the staff is also of the opinion) that direct write-offs against the contractual amount of financial assets without use of a provision account would conceal useful information about the credit quality of the financial asset. The staff is of the opinion that these direct write-offs should be prohibited. Write-offs of losses should (always) be made against the provision account (ie be presented as both an addition and a use—a flow through—in the reconciliation even if an asset becomes impaired and is then already written off within one period).
18. Some respondents to the RFI commented on the importance of the reconciliation of the provision account to enhance user understandability of the ECF approach. Consider the following quote:

To improve the quality of information surrounding the expected cash flow approach, we recommend the IASB should require companies to distinguish between information about the built-up of provisions for expected credit losses and the use of provisions for actual credit losses (eg loan write-downs/charge-offs or increase in specific provisions). This information should be disclosed in a manner that enhances the understanding of the quality of the financial assets and how expected loss provisions are being reduced when actual losses occur. A reconciliation of the provision and a gross presentation of total loans and the provision account (contra asset account) could be a considerable and useful improvement.  
[CL#71]

19. The staff strongly believes that the reconciliation is crucial in explaining the movement of the provision account and is vital in providing transparency to the ECF approach.

**Staff recommendation**

20. The staff recommends that the Board proposes:
  - (a) mandatory use of a provision account for expected credit losses;

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- (b) prohibiting *direct* write-offs (ie require using the provision account even when an asset becomes impaired and is written-off in the same period);
- (c) requiring reconciliation of the provision account for credit losses by class of financial asset. At a minimum the reconciliation should consist of the following line items:

TABLE 1

<p>Opening balance of provision account for credit losses</p> <p><i>Additions:</i></p> <ul style="list-style-type: none"> <li>• Allocation of initial expected credit losses in the current period</li> <li>• Increase in expected credit losses for the current period</li> </ul> <p><i>Subtractions:</i></p> <ul style="list-style-type: none"> <li>• Decrease in expected credit losses for the current period</li> <li>• Write-offs</li> </ul> <p>Closing balance of provision account for credit losses.</p>
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- 21. The staff recommends disclosure of the entity’s write-off policies should be required. However, the staff notes that ‘write-off’ is not currently defined in the IFRS literature. The staff therefore recommends the Board propose to define “write-off” as where *the entity has no reasonable expectations of recovery and has ceased any further recovery enforcement activities*. The expected loss would be 100% in these cases.<sup>2</sup>

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<sup>2</sup> Note that using this definition will not necessarily mean that all 100% expected loss scenarios are write-offs (yet).

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**Question 2 – Reconciliation of provision account for credit losses**

Does the Board agree with the staff recommendation to propose:

- a) mandatory use of a provision account for expected credit losses?
- b) prohibiting direct write-offs?
- c) requiring a reconciliation of the provision account for credit losses by class of financial assets held at amortised cost?
- d) that the reconciliation should comprise at a minimum the following line items:

Opening balance of provision account for credit losses

*Additions:*

- Allocation of initial expected credit losses in the current period
- Increase in expected credit losses for the current period

*Subtractions:*

- Decrease in expected credit losses for the current period
- Write-offs

Closing balance of provision account for credit losses

- e) a definition of 'write-off' require disclosure of the entity's write-off policies?

If not, why and what other disclosures would the Board like and why?

***Vintage information and loss triangle****Vintage information*

22. Feedback from users indicates that disclosing financial assets by year of origination and maturity would provide useful information. This disclosure can be presented in a table format such as below on the basis of *nominal* amounts (this disclosure would be by class of financial instruments):

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TABLE 2

		YEAR OF ORIGINATION				
		20X7	20X8	20X9	20X0	Total
MATURITY	20X7					
	20X8					
	20X9					
	20X0					
	Total					

23. The staff believes that such information is useful because:
- (a) it allows users to assess credit risk that is associated with particular vintages; and
  - (b) facilitates users’ analysis of the quality of the lending business.<sup>3</sup>
24. This vintage information would be provided on the basis of *nominal* amounts because:
- (a) the nominal basis is more useful for the purpose of the analysis of the quality of the lending business;<sup>4</sup> and
  - (b) using the carrying amount of the basis would create significant practicability issues regarding impairment assessments performed on a portfolio level (if the portfolio includes different vintages).
25. For example, consider two entities, Entity A and Entity B. The majority of Entity A’s loans originated at the height of the liquidity bubble whilst the majority of Entity B’s loans originated prior to the height of the liquidity bubble. The vintage information would reveal the difference in the quality of the loan books.

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<sup>3</sup> For example, it would assist in deriving assumptions about what funding costs for financing with matching maturities would amount to.

<sup>4</sup> See paragraph 23(b).



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*Loss triangle*

- 26. A ‘loss triangle’ is a disclosure format that tracks the development of losses over time. The information provided by a loss triangle is a comparison of actual outcomes with previous estimates. A prominent use of this disclosure format is the disclosure about claims development by insurers.
- 27. Feedback from users and outreach activities indicates that loss triangle disclosures would be useful. The staff is of the view that a loss triangle provides transparency to the ECF approach as it offers useful back testing information regarding how loss estimates develop over time.
- 28. A loss triangle disclosure by class of financial instruments can be presented in a table format such as below:

**TABLE 3**

		YEAR OF ORIGINATION				
		20X7	20X8	20X9	20X0	Total
Credit loss provision (cumulative)						
	At the end of the origination year	xx	xx	xx	yy	
	One year later	xx	xx	yy		
	Two years later	xx	yy			
	Three years later	yy				
Gross provision for credit losses (before write-offs)		yy	yy	yy	yy	zz
Cumulative write-offs as a result of delinquencies		xx	xx	xx	xx	zz
Cumulative write-offs as a result of foreclosures		xx	xx	xx	xx	zz
Total cumulative write offs		zz	zz	zz	zz	zz
Net provision for credit losses (gross provision for credit losses less cumulative write-offs)		zz	zz	zz	zz	zz

- 29. This table will show a steady build up of provisions from the origination year if management expectations do not change. However, the table would not show a steady build up pattern if there are many significant changes in management expectations. The table therefore provides transparency as to the frequency and extent management revises its estimates throughout the life of the instrument.

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30. The last line ‘net provision for credit losses’ would tie back to the carrying amount of the provision account. At the end of the life of an instrument, the cumulative write offs and the cumulative provisions should equal.
31. If there are significant changes in the build up pattern of the provisions (ie changes in loss estimates) users need (additional) explanation of the cause(s) of that development. Under these circumstances a qualitative analysis (narrative explanation) should be required.

**Staff recommendation**

32. The staff recommends the following disclosures in the notes to the financial statements by class of financial assets:
  - (a) vintage information of financial assets held at amortised cost (contractual amounts) by year of origination and maturity in table format; and
  - (b) loss triangle disclosures in table format and qualitative analysis where there are significant changes in loss estimates.

**Question 3 – Vintage information and loss triangle disclosures**

Does the Board agree with the staff as proposed in paragraph 32?

If not, why and what other disclosures would the Board like and why?

**Changes in expectations**

33. Some respondents to the RFI raised concerns that additional charges or reversals in the statement of comprehensive income may relate to changes in expectations that are non credit loss related (eg changes in prepayment rates). The staff believes that it is important to isolate the changes in expectations that are credit related and the changes that are not.
34. Furthermore, the staff believes that:

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- (a) if the adjustment to profit or loss as a result of changes in expectations is significant; or
- (b) where there are material positive or negative adjustments from a particular portfolio, vintage or geographical area,

the entity should provide further quantitative and qualitative analysis as appropriate in order for users to understand the nature of the adjustment and why.

**Staff recommendation**

35. The staff therefore recommends entities disclose *separately* in the notes to the financial statements:
- (a) the amount recognised in profit or loss resulting from changes in credit loss expectations;
  - (b) the amount recognised in profit or loss resulting from changes that are *not* related to credit (eg changes of expected prepayment rates); and
  - (c) further quantitative and qualitative analysis:
    - (i) if there is a significant effect on profit or loss as a result of changes in expectations; and
    - (ii) where there are significant positive or negative effects from a particular portfolio, vintage or geographical area.

**Question 4 – Changes in expectations disclosures**

Does the Board agree with the staff recommendation as set out in paragraph 35?

If not, why and what other disclosures would the Board like and why?

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**Management's assumptions and methodology**

- 36. Some respondents to the RFI and outreach activities commented that the basis of inputs/assumptions used in determining expected loss should be disclosed given the broad range of information that may be used and the significant judgement involved in the ECF approach.
- 37. The staff agrees with these comments and believes disclosure on the techniques, inputs and management judgement used in determining expected loss is vital information that needs to be communicated to user to allow users to understand the entity's application of the ECF approach.

**Staff recommendation**

- 38. The staff therefore recommends the following disclosures:
  - (a) the basis of inputs (eg historical information or rating reports) and the estimation technique used to determine initial expected losses;
  - (b) for changes in expectations, an explanation of what expectations have changed, the cause of the change and disclosure of new inputs and assumptions used; and
  - (c) if there has been a change in estimation technique, disclosure of that change and the reason for the change.

**Question 5 – Disclosures on management's assumptions and methodology**

Does the Board agree with the staff recommendation as set out in paragraph 38?

If not, why and what other disclosures would the Board like and why?

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***Sensitivity analysis and stress testing***

*Sensitivity analysis*

39. Given the broad range of information that may be used and the significant judgement involved in the ECF approach, some respondents and feedback from users suggest that sensitivity analysis would be useful.
40. The staff agrees that this information would be useful but also acknowledges that providing this particular type of disclosure is very challenging. The staff believes that a high-level narrative explanation about key assumptions and the effect of using reasonably possible alternative assumptions would strike a good balance.
41. For example, if the underlying assumption for loss estimates is a severe deterioration of the real estate market in a geographical area an entity would disclose what effect would result in two alternative scenarios if the property market performance was a less severe downturn experienced in previous cycles or flat.

*Stress testing*

42. The staff notes that stress testing information would be useful and could enhance the sensitivity disclosures (provide a worst case scenario). However, the staff acknowledges that not all entities perform stress testing for their financial assets held at amortised costs and that mandating stress testing would be too onerous (at least for most non-financial services entities).

*Staff recommendation*

43. The staff recommends that the following disclosure be required regarding sensitivity of assumptions:
  - (a) if changing one or more of the inputs to reasonably possible alternative assumptions would change the initial expected loss or subsequent changes in credit loss significantly, the entity should state the fact and the effect of those changes; and

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- (b) the entity shall disclose how the effect of a change to a reasonable possible alternative assumption was derived.
44. The staff recommends that stress testing information be disclosed *if* management performs stress testing for their internal risk management purposes. An entity should note that such stress testing occurs and provide information that allows users to understand the implications for the financial position and performance of the entity as well as its ability to withstand the stress scenario. For example, that information would include how such stress tests are conducted, a description of the ‘stress’ scenario and the related assumptions, and the outcome of the stress testing (including any significant conclusions drawn).

Question 6 – Sensitivity analysis and stress testing disclosures
<p>Does the Board agree with the staff recommendation as set out in:</p> <p>(i) paragraph 43 in relation to sensitivity analysis?</p> <p>(ii) paragraph 44 in relation to stress testing?</p> <p>If not, why and what other disclosures would the Board like and why?</p>

### Credit quality of financial asset disclosures

45. The discussions and staff recommendation in this section consider ways to enhance decision-usefulness for users of financial statements on the credit quality of financial assets. Feedback from analysts indicates that *additional*<sup>5</sup> disclosures regarding the following subjects would assist users in forming their view about the adequacy of provisions for credit losses:
- (a) non-performing financial assets; and
- (b) collateral held for non-performing loans.

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<sup>5</sup> The suggested disclosures are *not* a replacement of the current credit risk disclosures in IFRS 7, rather these are additional disclosures.

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**Non-performing financial assets held at amortised cost**

46. There is currently no definition of a non-performing financial asset in the IFRS literature. However, based on regulatory requirements there has been increasing general acceptance of using a threshold of 90 days overdue for delineating non-performing loans.
47. Feedback from analysts indicates that an explanation of the movements in the non-performing loan portfolio would be useful. This could be achieved by a reconciliation as follows:

**TABLE 4**

<p>Opening balance (contractual amount) of non performing financial assets held at amortised cost</p> <p><i>Additions:</i></p> <ul style="list-style-type: none"> <li>• Increases in non performing financial assets held at amortised cost for the current period</li> </ul> <p><i>Subtractions:</i></p> <ul style="list-style-type: none"> <li>• Recoveries by way of cash from enforcing securities over the asset</li> <li>• Recoveries by way of cash as result of payment from the debtor</li> <li>• Renegotiations</li> </ul> <p>Closing balance (contractual amount) of non performing financial assets held at amortised cost</p>
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48. The information presented in the above table will allow users to understand the extent of the entity’s non-performing financial assets and how management deals with them. The above information should be disclosed by class of financial asset.
49. The rationale for using *contractual* amounts (rather than carrying amounts) as the basis for this disclosure is that for financial assets that are accounted for on a portfolio level where the portfolio includes both performing and non-performing loans (which the ECF approach would allow) determining the carrying amounts of the different parts of the portfolio would often be impracticable owing to

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portfolio level adjustments. However, the staff believes it would be useful to require a narrative explanation of the interaction between movements in the non-performing asset portfolio and the changes in the provision account (if significant).

50. The staff notes that the Board proposed in the ED on annual improvements eliminating the disclosure requirement regarding renegotiated loans in IFRS 7.36(d). The disclosure of renegotiations as part of the reconciliation in Table 4 above does not contradict the proposed annual improvement. The rationale that underpins the proposed annual improvement does not apply to the disclosures contemplated in this paper.<sup>6</sup>

***Collateral held against non-performing financial assets held at amortised cost***

51. Feedback from analysts indicates the following table disclosure would provide useful information on the quality of collateral held against non-performing financial assets.

**TABLE 5**

<p>Opening fair value of collateral held against non-performing financial assets held at amortised cost</p> <ul style="list-style-type: none"> <li>• Additions to collateral</li> <li>• Reductions in collateral (eg foreclosure, reclassification back to performing assets)</li> <li>• Net changes in fair value of existing collateral</li> </ul> <p>Closing fair value of collateral held against non-performing financial assets held at amortised cost.</p>
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<sup>6</sup> The concerns that resulted in the proposed annual improvement were that it is difficult to decide whether renegotiations were in response to impairment or other commercial reasons and whether the disclosure applies only to instruments renegotiated in the current reporting period or to other past negotiations as well. In this paper it is clear that the disclosure only affects loans that were renegotiated after they had become non-performing (90 days overdue) and that the disclosure only relates to the movement in the current reporting period.



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52. The staff notes that the Board proposed in the ED on annual improvements changes to the IFRS 7 disclosure requirements regarding collateral. The Board’s rationale was that this type of disclosure might result in misleading information because of the aggregation of assets that might be over-collateralised and other assets that might be under-collateralised. Instead, the Board decided to propose disclosures about the financial effect of collateral.
53. The staff believes that the rationale that resulted in these proposed annual improvements also applies to the disclosures outlined in Table 5.

**Staff recommendation**

54. The staff recommends that the Board proposes:
- (a) defining a financial asset is non-performing when a counterparty has failed to make a payment 90 days after it is contractually due;
  - (b) disclosing reconciliation in the movement for non-performing financial assets held at amortised cost (including—if significant—a narrative explanation of the interaction between movements in the non-performing asset portfolio and the changes in the provision account);  
*but*
  - (c) *not* to require disclosing reconciliation of the fair value movements of the collateral held against non-performing financial assets.

**Question 7 – Credit quality of financial assets disclosures**

Does the Board agree with the staff recommendation as set out in paragraph 54?

If not, why and what other disclosures would the Board like and why?

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**Transition disclosures**

55. Given the complexity of the transition of the ECF approach it is essential that entities provide information that enables users to understand the transitional effects of the ECF approach. The staff is of the view that, it is important to highlight to users how transition would impact equity and interest revenue line items.

**Staff recommendation**

56. The staff therefore recommends the following disclosures:
- (a) disclose the amount recognised in equity as a result of transition (ie the change in the amortised cost resulting from adopting the ECF approach); and
  - (b) qualitative analysis of the effect on profit or loss resulting from adoption of the ECF approach (ie the difference in the effective interest rate previously determined under the incurred loss approach and the expected effective interest rate determined under the ECF approach).

**Question 8 – Transition disclosures**

Question – Does the Board agree with the staff recommendation as set out in paragraph 56?

If not, why and what other disclosures would the Board like and why?

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## Appendix A

**Extract from Appendix B of IFRS 7**

Classes of financial instruments and level of disclosure (paragraph 6)

- B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IAS 39 (which determine how financial instruments are measured and where changes in fair value are recognised).
- B2 In determining classes of financial instrument, an entity shall, at a minimum:
- (a) distinguish instruments measured at amortised cost from those measured at fair value. □
  - (b) treat as a separate class or classes those financial instruments outside the scope of this IFRS.
- B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.