Project	**Financial Instrument – Recognition and Measurement**
Topic	**Impairment: possible issues to be addressed in the exposure draft by application guidance or clarification**

Introduction

Background

1. At its 17 September 2009 meeting, the IASB decided that the impairment exposure draft (ED) should use a design that articulates a clear objective and emphasises principles reinforced by *concise* application guidance.

2. Many respondents to the Request for Information (RFI) asked the Board to provide additional guidance on particular issues. Some also requested clarification or confirmation of some aspects. A summary of the responses in relation to what additional guidance is needed is reproduced in Appendix A.

Purpose

3. The purpose of this paper is to follow up on the issues set out in Appendix A as they relate to additional guidance (paragraph 13 of Appendix A) or clarification (paragraph 15 of Appendix A). This paper sets out staff recommendations, and the rationale for them, on what issues should be addressed by application guidance and clarification in the ED and asks the Board for decisions.

Summary of staff recommendations

4. This paper recommends that:

(a) the ED provides principles regarding cash flow estimates on a collective (portfolio) and an individual basis (including the interplay between those bases).

(b) the ED includes concise application guidance for

  (i) forecasting cash flows; and

  (ii) the treatment of trade receivables.

(c) the Board use the Expert Advisory Panel (EAP) as a forum to further explore the following issues:

  (i) determination of the initial expected spread;

  (ii) practical aspects of applying the effective interest method (including variable rate instruments); and

  (iii) interaction with Basel II requirements.

(d) the ED clarifies the following aspects:

  (i) point-in-time versus through-the-cycle-estimates;

  (ii) expected value versus most probable value; and

  (iii) use of entity specific versus market data.

5. The fact that half of the respondents to the RFI did not include a view on the possible alternatives of how the ECF approach might be applied to variable rate instruments demonstrates that this is a complex technical area. There were also conflicting views on their preferences for the two possible alternatives. Rationales for their preferences were also mixed. Thus, this issue is not addressed in this paper but the staff will bring a paper to the Board that provides an analysis of this issue.

Issues suggested for additional guidance

Changing loss estimates from a collective (portfolio) to an individual assessment

6. There was disagreement among respondents to the RFI on the issue of whether a switch to an individual assessment after identification of a loss for a specific asset should be required. Some respondents supported a mandatory switch while others advocated precluding a switch. Each view assumed its preferred solution would facility the better estimate of cash flows.

7. There were also conflicting views about whether a removal of an asset specifically identified as impaired would ensure that double-counting of losses is avoided or, conversely, create a risk of double counting.

8. The staff thinks that how double counting is avoided is a matter of consistency in applying the respective approach (ie removing an asset or not) rather than related to one approach or the other. For example, if an asset specifically identified as impaired is removed from a portfolio that changes the character of the remaining portfolio. Thus, in order to avoid double counting either assets that perform better than reflected in the underlying assumption for the portfolio need to be removed as well or the removal of only the 'bad' assets (but no 'good' assets) would have to be reflected in the estimates for the remaining portfolio (ie an increase in its quality).

9. Thus, guidance on avoiding double counting cannot be provided by mandating one approach (ie removing an asset or not) but can only be a guiding principle for the application of any approach an entity chooses. Thus, the question is rather whether it is necessary to point out at all that double counting must be avoided or whether it goes without saying anyway.

Staff recommendation

10. In light of the responses received, the staff recommends (and most respondents who commented also supported) that the ED not mandate a collective or individual basis for estimating cash flows and not require or preclude a switch between these two bases. Instead, the staff recommends that the ED provides principle-based guidance that focuses on two aspects:

    (a) using the approach that provides the best estimate; and

    (b) ensuring that if entities switch between approaches that does not result in double counting.

Question 1
Does the Board agree with the staff recommendation that the ED provides principle-based guidance that focuses on two aspects of portfolios based versus individual estimates: (i) using the approach that provides the best estimate; and (ii) ensuring that if entities switch between approaches that does not result in double counting? If the Board does not agree, what does the Board propose instead, and why?

Forecasting cash flows

11. Respondents to the RFI and outreach activities had significant concerns over forecasting cash flows. Suggestions for guidance relate to data sources, estimates for individual financial instruments, estimates on a portfolio and individual level, correlation in portfolios, implications of 'actual' losses, migration over time, penalty payments, and recovery costs.

12. The staff thinks that IAS 39.AG89 includes useful guidance that addresses the most frequently raised aspects:

    (a) how to deal with situations where there is lack of historical data; and

(b) whether to take into account any adjustments to historical data for changes in economic cycle and the outlook for the cycle.

13. The staff believes that some aspects of IAS 39.AG89 could be used as basis for providing application guidance for the ECF approach (the main difference being that the guidance would apply to estimates as from the recognition of the financial instruments rather than only after a loss even occurred). The key points are:

    (a) use of peer group experience if an entity has insufficient historical data;

    (b) adjusting historical data for changes in circumstances over time;

    (c) reviewing methodology and assumptions to reduce differences between estimates and actual outcomes.

14. The staff notes that the issue of how the changes in the economic cycle are factored in when estimating future cash flows are related to one of the suggested clarifications (point-in-time versus through-the-cycle estimates), which is addressed further below in this paper.[1] That clarification provides principle-based guidance on this question.

15. The issue of estimates on a portfolio versus on an individual level is addressed by the staff recommendation for Question 1 in the previous section.

16. The staff thinks that the remaining issues suggested for guidance, ie data sources (to the extent not covered by the discussion in the previous paragraphs), estimates for individual financial instruments, correlation in portfolios, implications of 'actual' losses, migration over time, penalty payments, and

[1] See paragraph 22(a)15(a).

recovery costs are more detailed questions for which the EAP could provide useful insights.

Staff recommendation

17. The staff recommends:

    (a) providing concise application guidance on how to source and adjust historical data drawing on existing guidance in IAS 39.AG89 as this is a critical, generic issue;

    (b) charging the EAP with analysing the remaining issues related to cash flow estimates that respondents to the RFI raised as these issues are more detailed and often process driven so that the EAP could provide useful insights.

Question 2
Does the Board agree with the staff recommendation regarding the estimation of cash flows: (i) that the ED provides concise application guidance on how to source and adjust historical data drawing on existing guidance in IAS 39.AG89? (ii) charging the EAP with analysing the remaining issues related to cash flow estimates that respondents to the RFI raised? If the Board does not agree, what does the Board propose instead, and why?

Treatment of trade receivables

18. As noted in a previous agenda paper,[2] some respondents to the RFI were concerned over the application of the ECF approach to trade receivables and the complexity it involves. More specifically their concern was that introducing the

[2] Agenda paper 12B of the 17 September 2009 IASB meeting (see paragraphs 12-13 and Appendix A of that paper).

ECF approach to trade receivables would automatically imply a requirement to discount trade receivables and then apply an effective interest rate (EIR) type interest revenue calculation for interest revenue regardless of materiality.

19. The staff believes that in order to avoid misunderstandings of the ECF approach the ED should providing application guidance for trade receivables as indicated in the previous agenda paper[3]. In particular, where the effect of discounting is immaterial:

    (a) the initial measurement of trade receivables reflects expected losses on their collection, ie they are measured at their invoice amount less the initially expected credit loss.[4]

    (b) the initially expected loss is updated for changes in estimates. For example, this means that the difference between the initial carrying amount and the invoice amount is recognised as a gain is when the loss expectation changes to that effect, which for short term receivables may be on collection.

Staff recommendation

20. Given the application of the ECF approach to trade receivables affects about all entities, in particular entities outside the financial services sector that often have less exposure to and sophistication in accounting for financial instruments, the staff recommends that the ED provides application guidance on trade receivables. The staff believes that the application guidance recommended would be sufficient guidance and that illustrative (numerical) examples in

[3] Agenda paper 12B of the 17 September 2009 IASB meeting (see paragraph 13 and Appendix A of that paper).

[4] The staff notes that this is also subject to the general materiality provisions of IFRSs (see IAS 8.8). Therefore, the guidance would only apply if the initially expected losses are not immaterial. If the entire difference between the initial fair value of a trade receivable and its invoice amount is immaterial then entities need not apply either discounting or the expected loss recognition guidance but could use the invoice amount.

addition to the application guidance are unnecessary. Thus, the staff recommends not providing illustrative examples.

Question 3
Does the Board agree with the staff recommendation that the ED
(i) provide application guidance for trade receivables?
(ii) <u>not</u> include illustrative (numerical) examples for trade receivables?
If the Board does not agree, what does the Board propose instead, and why?

Other issues

Staff recommendation

21. Given that implementing the ECF approach is typically very process driven, the staff recommends that the ED not provide any further application guidance but use the EAP as a forum to further explore the following issues:

    (a) determination of the initial expected spread;

    (b) practical aspects of applying the effective interest method (including variable rate instruments); and

    (c) interaction with Basel II requirements.

Question 4
Does the Board agree with the staff recommendation that rather than providing further application guidance in the ED, the EAP should be charged with addressing process driven implementation issues relating to the ECF approach?
If the Board does not agree, what does the Board propose instead, and why?

Issues suggested for clarification

22. Respondents to the RFI requested also that certain clarifications be made. The staff is of the view that in articulating clearly the objective of the ECF approach the following issues could be clarified:[5]

(a) point-in-time versus through-the-cycle-estimates;

(b) expected value versus most probable value;

(c) use of entity specific versus market data; and

(d) differences to fair value.

Staff recommendation

23. The staff believes that the first three items have a pervasive, significant effect and, hence, are crucial to a clear articulation of the objective of the ECF approach. Thus, the staff recommends including these clarifications in the ED.

24. The staff is of the view the differences to the fair value model could be addressed in the basis of conclusions in the context of the rationale for choosing the ECF approach rather than other alternatives (such as a fair value based impairment test).

[5] The aspect of interaction with Basel II requirements is addressed in paragraph 21(c) as the staff believes this aspect also has strong implications for how an ECF approach might be implemented in practice and, hence, should be within the remit of the EAP.

Question 3
Does the Board agree with the staff recommendation (i) to include in the ED clarifications regarding point-in-time versus through-the-cycle-estimates, expected value versus most probable value, and the use of entity specific versus market data? (ii) addressing differences to fair value in the basis for conclusions? If the Board does not agree, what does the Board propose instead, and why?

Appendix A

Extract from Agenda Paper 12 of the September 2009 IASB meeting (paragraphs 12–15)

12. A majority of respondents requested the Board to elaborate on the approach so as to provide additional guidance on particular issues. Some also requested clarification or confirmation of some aspects.

13. Issues that were suggested for additional guidance include:

    (a) for variable interest rate instruments refer to the section for Question 4 below;

    (b) for the issue of changing loss estimates from a collective (portfolio) to an individual assessment refer to the section for Question 5 below;

    (c) application by non-financial entities, in particular treatment of trade receivables;

    (d) forecasting cash flows (eg data sources, estimates for individual financial instruments, estimates on a portfolio and individual level, correlation in portfolios, implications of ‘actual’ losses, migration over time, penalty payments, recovery costs);

    (e) specific types of instruments (eg instalment loans, revolving facilities);

    (f) determination of the initial expected spread;

    (g) application of the effective interest method; and

    (h) more complex and detailed illustrative examples.

14. Some respondents also requested guidance on presentation, disclosure and transition (notwithstanding they were not the subject of the RFI).

15. Suggested clarifications include:

    (a) point-in-time versus through-the-cycle-estimates;

    (b) expected value (ie probability weighed) versus most probable value (ie the most likely outcome);

    (c) interaction with Basel II requirements;

    (d) use of entity specific versus market data; and

    (e) difference to fair value.

Appendix B

B1. IAS 39.AG89 provides the following guidance on cash flow estimates:

> Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.