Project **Financial Instruments – Recognition and Measurement**

Topic **Impairment: transition**

Introduction

Background

1. In June 2009 a request for information (RFI) on the feasibility of the expected cash flow (ECF) approach was posted to the IASB website with responses requested by 1 September 2009. While the RFI did not address transition some respondents commented on transition in their responses to questions 1 or 6 in the RFI. Those questions were about:
   (a) whether the approach is defined clearly; and
   (b) possible simplifications to the approach.

2. Respondents who touched on transition commented:
   (a) retrospective application would involve considerable hindsight because of the initial loss estimate that is allocated over time using an adjusted effective interest rate (EIR);
   (b) given their concerns about the overall complexity of the ECF approach retrospective application would amplify operational challenges;
   (c) prospective application has the disadvantage that the ECF and the incurred loss approach would have to be applied in parallel, which is complex.

Purpose of this paper

3. This paper sets out alternatives for the *basic design* of the transition approach regarding the ECF approach and the related staff recommendation and question to the Board. Thus, this paper does not address any transition related disclosures.

4. As this paper addresses the transition regarding the ECF approach it solely pertains to financial instruments that will be in the scope of the new financial instruments standard and will be measured at amortised cost. Thus, all references in this document to financial instruments shall be taken to refer to **only** those financial instruments.

Alternative approaches for transition

5. The staff believes there are the following possible alternatives for transition (each of which is discussed further below):

   (a) **retrospective application**, which means the ECF is applied to all financial instruments irrespective of when they were first recognised.

   (b) **prospective application**, which means the ECF approach is applied to only those financial instruments with initial recognition on or after adoption of the ECF approach.

   (c) a **customised transition** approach that combines prospective application (with an exception if using hindsight would not be involved) and a change for the measurement of financial instruments that were initially recognised before adoption of the ECF approach (rather than using the incurred loss model).

Retrospective application

6. While IFRSs use retrospective application as the default transition model the use of hindsight is precluded in applying a new accounting policy.[1] The ECF approach uses the initial expected loss as an important estimate that determines the EIR and, thus, interest revenue allocation over the life of the financial instrument.

7. It is clear from the responses to the RFI that few, if any, entities have determined and retained initial loss estimates for existing financial instruments that could be used for retrospective application of the ECF approach. Thus, retrospective application would involve a degree of hindsight in these circumstances that precludes retrospective application. This is consistent with some respondents' concern that retrospective application would involve considerable hindsight.[2]

8. However, there may be circumstances where an initial loss estimate can be derived without using hindsight. For example, if financial instruments at their date of initial recognition had ratings[3] available that correspond to default probabilities entities may be able to determine an initial expected loss without hindsight. The staff notes that not every rating corresponds to default probabilities and that in order to determine an expected loss in addition to default probabilities other parameters are required (eg the loss given default, exposure at default). For some financial instrument these other parameters may also be determinable without hindsight (eg financial instruments with a fixed exposure at default and a loss given default that is the entire balance or depends

[1] See IAS 8.19(b), 23 and 53.
[2] See paragraph 2(a).
[3] For the purpose of determining whether hindsight would be involved it does not matter whether these ratings are internal or external but rather whether they were concurrently available on initial recognition of the financial instrument or not.

on collateral values for which concurrent information at the time of initial recognition is available).

9. In summary, the staff expects that in the vast majority of circumstances hindsight would be involved in a retrospective application of the ECF approach but that there may be some circumstances where the required information would be available without hindsight.

10. The implications are that if the Board mandated retrospective application the rule would de facto become the exception. This means retrospective application would put an onus on entities to identify the circumstances where retrospective application would be possible despite a very low likelihood of occurrence, which the staff believes would be unduly onerous. However, the possibility of circumstances where retrospective application might be feasible without hindsight means that precluding retrospective application would affect entities in such scenarios.

Prospective application

11. Prospective application has the following main consequences:

    (a) financial instruments recognised before adoption of the ECF approach would continue to be accounting for using the incurred loss model; and

    (b) entities that could apply the ECF approach retrospectively without hindsight would nonetheless be precluded from doing so.

12. Using prospective application means that the ECF approach would be ‘phased in’ over a period that depends on the nature of the financial instruments of each entity. Thus, in the light of the long remaining maturities that some financial instruments have, using prospective application might grandfather the incurred

loss model for a significant volume of financial instruments for many years despite its criticisms that resulted in the decision to replace it.

13. ‘Phasing in’ the ECF approach would also decrease comparability both between entities as well as for an entity over time because the impact is highly dependent on individual circumstances of each entity (nature of existing financial instruments, changes in the asset composition through growth, changes in product mix, sales, business combinations, etc.)

14. In operational terms the ‘phasing approach’ means that entities have to operate two different impairment models in parallel for possible long periods. This creates operational challenges for the accounting systems, which would need to have a dual capability.

15. As discussed earlier in this paper,[4] entities that could apply the ECF approach retrospectively without hindsight would nonetheless be precluded from doing so if prospective application was mandated. This might render the transition to the ECF approach more onerous for some entities and also preclude the use of the better impairment model even though it could be applied.

Customised transition approach

16. As an alternative to entirely prospective or retrospective application a customised transition approach could be used. This customised approach aims at avoiding the most significant drawbacks of the other alternatives, which are:

[4] See paragraph 10.

(a) an onus on entities to identify the circumstances where retrospective application would be possible despite a very low likelihood of occurrence (which the staff believes would be unduly onerous);

(b) precluding retrospective application even though the required information is available without the use of hindsight;

(c) grandfathering the incurred loss model for potentially long periods with the adverse effect on systems (accommodating parallel running of models) and the quality of the impairment test for financial instruments recognised before transition.

17. The staff believes an approach that would address these issues could be as follows:

(a) generally, use prospective application for financial instruments with initial recognition on or after the adoption of the ECF approach;

(b) provide an exception to prospective application that *permits* entities to choose retrospective application if the required information is available without using hindsight; and

(c) change the measurement of financial instruments that were initially recognised before adoption of the ECF approach (and for which retrospective application is not applied) rather than grandfathering the incurred loss model.

18. The combination of features (a) and (b) is similar to retrospective application (which does not allow using hindsight)[5]. However, the staff believes the advantage of the customised approach is that it would not require each entity to determine whether impracticability applies but instead could *choose* to apply the

[5] See IAS 8.19(b), 23 and 53: even if retrospective application is required the use of hindsight would invoke the exception on the basis of impracticability (which includes hindsight).

ECF approach retrospectively to any financial instrument if the necessary information is available without involving hindsight.

19. The staff believes this will provide significant relief for entities on transition as the onus to determine for all types of instruments and all vintages what information from the past is available and then determine whether it involves a degree of hindsight that corresponds to ‘impracticability’ would be unduly onerous. However, the customised approach would not preclude entities from using information that is available without the use of hindsight as mandating prospective application would. Thus, the customised approach is more targeted and differentiating. The staff also believes that the accounting for the financial instruments that were initially recognised before adoption of the ECF approach[6] provides an incentive to entities to choose retrospective application and thus for a reasonable effort regarding the analysis of available data.

20. For those financial instruments initially recognised before adoption of the ECF approach and that are not subject to retrospective application the following measurement would be used instead of the incurred loss model:

(a) retaining the EIR determined under IAS 39 for these instruments as the discount rate for the amortised cost calculation (ie not modifying the EIR for loss expectations as would be required under the ECF approach);

(b) using cash flow estimates in accordance with the ECF approach (ie including all expected credit losses over the remaining life of the instrument irrespective of whether or not incurred).

[6] See paragraph 24(c).

21. This approach means that the <u>numerator</u> of the amortised cost present value calculation is the same for all financial instruments (irrespective of vintage). Thus, the measurement of all financial instruments would be based on the best estimate of future cash flows rather than continuing the use of the 'loss event' threshold of the incurred loss model.

22. The <u>denominator</u> for financial instruments with initial recognition before adoption of the ECF approach (and for which retrospective application is not chosen) would continue to use the EIR that results under the incurred loss model (ie determine it as under IAS 39 today).

23. The difference on transition between the carrying amount that was determined under the incurred loss model and the carrying amount that results from using the cash flow estimate under the ECF approach would be recognised directly against retained earnings because it reflects a cumulative adjustment from a change in accounting policy.

24. The effect of this customised approach for financial instruments with initial recognition before adoption of the ECF approach (and for which retrospective application is not chosen) is:

    (a) the credit losses included in the measurement of the financial instruments are based on the best estimate of the expected losses rather than grandfathering the incurred loss model for potentially long periods with the adverse effect on the quality of the impairment test; and

(b) it avoids the need to run parallel systems for loss estimates (ie retaining a legacy systems that tracks the incurred threshold);[7]

(c) it has a negative impact on equity as a higher discount rate (the EIR determined without factoring in initially expected losses) is applied to lower cash flow estimate that reflects expected losses.

Staff recommendation

25. The staff believes that both unmodified retrospective or prospective application are inappropriate transition approaches (refer to the respective sections in this paper for the drawbacks associated with the respective approach).

26. The customised transition approach avoids the most significant drawbacks of unmodified retrospective or prospective application. However, the staff acknowledges that it results in a negative impact on equity as a result of discounting expected cash flows using the original EIR determined under IAS 39's incurred loss model. Some aspects might mitigate that effect:

(a) an entity's option to apply the ECF approach retrospectively (if the needed information is available without using hindsight);

(b) for financial instruments that exist already for a long time (with a positive track record) or that are already impaired the difference to the amortised cost on the basis of the incurred loss model might not be so significant.

[7] This is based on the premise that there would be no requirement to disclose incurred losses. Note that this is not to say that no information about 'actual losses' would be available under the ECF approach. The staff is currently in the process of developing disclosures and they could be using other notions of 'actual' such as write-offs, losses on items in default (non performing items) or similar. The whole notion of what are 'actual' losses is not as straightforward as it might appear price facie and warrants a separate discussion in the context of disclosures. However, given the work undertaken by staff to date (in particular the outreach activities regarding the RFI) the staff believes that the 'incurred loss' under IAS 39 is no good measure of 'actual loss'.

27. In addition, while not avoiding the impact on equity, the recognition directly in retained earnings of the effect of changing from the incurred loss model to the new measurement basis avoids an impact on profit or loss.

28. Notwithstanding these potentially mitigating factors there would be a negative impact on equity. The magnitude depends on the individual circumstances of each entity.

29. Thus, there is an inevitable trade-off between:

    (a) the negative impact on equity on the one hand; and

    (b) the advantages of avoiding grandfathering the incurred loss model, ie not carry forward an inferior impairment model and not require systems to accommodate parallel running of models.

30. On balance, the staff recommends the customised transition approach.

ECF approach: transition
Does the Board agree with the staff recommendation to use the customised transition approach as set out in this paper? If the Board does not agree with the staff recommendation, what transition approach does the Board prefer, and why?