



Project	Financial Instruments – Recognition and Measurement
Topic	Impairment: summary feedback analysis for the Request for Information regarding the expected cash flow approach

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. The RFI solicited feedback on the following aspects:
 - (a) whether the approach is defined clearly;
 - (b) whether the approach is operational;
 - (c) switchover issues (costs of implementing the approach, ongoing costs thereafter, required lead-time);
 - (d) how to apply the approach to variable rate instruments;
 - (e) implications for the interplay between application on a portfolio and an individual instrument level; and
 - (f) possible simplifications to the approach.
2. In early August the IASB staff posted to the IASB website some numerical examples that illustrate possible ways of how the ECF approach might be applied to variable rate instruments.

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.

3. The staff has also conducted extensive outreach activities (involving 30 one-on-one and small group discussions with different financial and non-financial entities, auditors, regulators, and others). The discussions held often involved numerous follow-on discussions with the same party. These outreach activities covered different geographical areas, including emerging economies, and are still ongoing. Appendix A contains an analysis of responses by type of party and geographical region. The feedback from these outreach activities is consistent with the feedback included in the formal responses summarised below but allowed the staff to go into even more detail.

Purpose of this paper

4. This paper provides a summary analysis of the responses to the RFI. A separate paper (agenda paper 12B) sets out alternatives for how to proceed on an exposure draft and the related staff recommendations and questions to the Board.

Overview of the responses received on the RFI

5. The IASB received 59 responses by the comment deadline of 1 September 2009. In total, 79 responses have been received as of the date of the posting of this paper. Appendix A contains an analysis of responses by type of respondent and geographical region.
6. Owing to the focus of the RFI on **feasibility**, most respondents were preparers (and related representative bodies) with some responses from standard setters, regulators and auditors. The preparer responses were dominated by financial services sector related preparers and representative bodies.
7. Respondents raised a variety of issues for the Board to consider when deciding how to proceed on an exposure draft. These fall broadly into the following categories:

IASB Staff paper

- (a) Requests for additional guidance or clarification regarding the application of the ECF approach;
 - (b) Indications of costs and lead time regarding adoption; and
 - (c) Suggestions for simplification.
8. A large majority of respondents agreed that the ECF approach is a significant operational challenge and would entail substantial costs and lead time to implement.
9. In contrast, the issues flagged for additional guidance or clarification included some divergent, and sometimes conflicting, views among respondents. In particular, regarding the drafting of the exposure draft (and ultimately a final standard), there are conflicting views on the basic question whether including comprehensive, detailed guidance would have a beneficial or an adverse effect on the application, and costs of application, of the ECF approach.
10. Notwithstanding that the focus of the RFI and all its questions was the feasibility of the ECF approach, many respondents already included general comments on the conceptual merit of the ECF approach and whether it provides useful information (some including their view on the cost-benefit aspect). Views were mixed. In this regard the staff notes that these aspects are the type of feedback that will be solicited on the exposure draft, which has a much broader scope than the RFI. The respondents to the RFI do not represent a cross section of the IASB's audience (notably the RFI did not target investors), and respondents were – necessarily given the RFI focus – biased towards preparers. Thus, this paper does not include further analysis of the general comments on conceptual merit and possible benefits (in terms of better information to investors) aspects.
11. Some respondents commended the IASB's initiative of using the RFI to seek input on the feasibility of the ECF approach as part of its process to develop the

proposals.¹ The staff notes that some respondents also recommended that field testing be used for this part of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Another suggestion was to set up an expert advisory panel to discuss the operational challenges of the ECF approach, possibly alongside the issuance of an exposure draft. The staff thinks that such further initiatives regarding the operational aspects would be useful.

Analysis of responses to the questions in the RFI

Question 1

Is the approach defined clearly? If not, what additional guidance is needed, and why?

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,

¹ One respondent objected to considering the feasibility before considering whether the ECF approach is an improvement on existing practice (refer to CL 10 – Institute of Chartered Accounts in England and Wales).

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.

16. In developing an exposure draft the Board will need to consider how much additional guidance and clarification should be provided. As mentioned earlier,² there are conflicting views whether providing more comprehensive, detailed guidance would have a beneficial or an adverse effect on the application of any requirements. The views ranged from the approach as described in the RFI (including documents incorporated by reference) to be unclear due to lack of specific guidance to already being excessively detailed rules-based due to the

² See paragraph 9.

level of detail. Many respondents also argued that anything other than a principles-based approach would significantly increase the costs of application and reduce the ability of different entities to use different approaches relevant to different situations to best meet the objective of an ECF approach.

17. The staff notes that the debate about how much guidance should accompany principle-based standard setting is a fundamental one, which also reflects cultural differences in standard setting (and more generally in law making) in different environments. A similar divide already emerged on the classification and measurement phase of this project. The divide is particularly sharp for this kind of topic that is very process driven, involving estimates and calculations. In order to facilitate efficient drafting of the exposure draft it will be essential that the Board makes a *clear* decision about how it wants to strike the balance between principles, application guidance and illustrative examples.

Question 2

Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?
--

18. While a majority of respondents considered the approach operational most of those respondents considered that the ECF approach would give rise to significant operational challenges. Some other respondents believed it would be impossible to apply. The staff notes that the difference between ‘challenging’ and ‘impossible’ is not clear cut but depends on aspects such as the items to which an ECF approach is applied (eg receivables, significant individual assets or portfolios of similar items), lead time and the cost-benefit assessment of the particular respondent (note the ‘undue cost’ limitation in the question). Thus, changes or different views regarding these factors could result in a different delineation between ‘challenging’ and ‘impossible’.

19. The key reasons given why the ECF approach would be challenging were:
- (a) the difficulty of the cash flow estimate; and
 - (b) the complexity of effective interest method.
20. In relative terms the concern about cash flow estimates was greater than that about the complexity of the effective interest method. However, the concerns about the complexity of the effective interest method were still significant, given the approximations and their implementation in systems that many financial institutions use to calculate it today.
21. The key concerns about the difficulty of the cash flow estimate were:
- (a) Loss estimates would be required over **the life of the financial instrument**, which is a much longer outlook period than the forecasting horizon needed under the incurred loss model and also Basel II regulatory requirements. This raises the issue of the availability of sufficient historical data for deriving statistic loss parameters. Another issue are any adjustments to extrapolated historical data to take account of changes in the economic cycle and the outlook for the cycle.
 - (b) Estimates of the **timing** of losses in addition to the loss amount; a related issue is that the estimate has to include loss of interest in addition to loss of principal.
22. The staff notes that for understanding the responses it is important to be aware that not all respondents are IFRS users and that some responses clearly reflect regulatory requirements as a reference point of respondents. Thus, the staff emphasises that the summary of responses is without prejudice regarding existing IFRS requirements. IAS 39 requires already today that the measurement of impairment of financial instruments at amortised cost must

include interest cash flows and also the timing of losses over an outlook period of the entire remaining life of the financial instrument.³

23. In addition, in describing the challenges of cash flow estimates respondents also cited some aspects that were suggested for additional guidance or clarification in response to Question 1 (see previous section).
24. The key concern about the complexity of the effective interest method was about the IT systems implications. Systems data are typically based on the contractual terms of financial instruments. In order to transform the contractual interest data into effective interest rate based accruals for accounting purposes companies typically use a separate calculation in order to determine adjustments to the contractual data. In combination these approximate the outcome of applying the effective interest method. This 'profiling' of interest revenue would be more complex under the ECF approach as more adjustments would be needed given that initial loss expectations need to be factored in when determining the effective interest rate.
25. Another concern relates to variable rate instruments (see the section for Question 4 below).
26. Those who believe the ECF approach would be feasible cited the same kind of concerns as discussed above but considered them so significant that in their view (at least without undue cost) it made application of the ECF approach impossible. Others stated that consideration of the items to which the ECF approach should be applied (eg for some items the incurred loss method used

³ See IAS 39.63 and AG92. In fact, the effective interest method does not differentiate between interest and principal *cash flows* but transforms all cash flows of an instrument for accounting purposes into interest revenue and repayments using an internal rate of return methodology.

today may well be a good approximation of the ECF method) might be a way by which costs could be reduced.

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

27. Most respondents considered that implementation costs would be very significant. The staff agrees with respondents that a *quantification* is necessarily very difficult at this stage. Some respondents provided ranges of amounts, which are highly dependent on the size of an entity, existing systems and data as well the financial instruments held.⁴ Some respondents compared the *dimension* of the implementation effort to the efforts of adopting IFRSs or Basel II requirements. Those estimates ranged from 25% to 75% of the effort to switch to IFRSs (regarding financial instruments) to about the same as adopting Basel II.
28. Respondents also expected increased ongoing costs, mainly related to additional staff for cash flow forecasting (data capture and analysis) as well as an increased volume of data storage capacity that would be needed to store the additional data required as the basis for deriving statistical parameters. Other ongoing costs relate to systems maintenance for the expanded systems.

⁴ Estimates are therefore difficult to summarise and lack comparability but customary amounts were double-digit figures of millions in the respective currency. One banking association referred to costs in terms of equivalent to a 25 to 30 basis points spread on the affected instruments.

29. Respondents emphasised that implementing the ECF approach would require considerable lead time, mainly attributable to system changes and the conditioning and analysis of historical data in order to be able to derive statistical parameters for the new outlook period of the life of the instrument.
30. Among the respondents who quantified the required lead time most estimates were in a range of 2 to 3 years from the issue of a final standard. Some respondents expected shorter or longer lead times (ranging to a required minimum of 5 years).

Question 4

How would you apply the approach to variable rate instruments, and why? *[The Request for Information refers to an Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments, which is not reproduced here.]*

31. The staff provided a narrative description of possible alternatives how the ECF approach might be applied. Essentially, there are two mathematical mechanisms that can be used to ensure that the carrying amount of a variable rate instrument unwinds to the remaining expected cash flows:
- (a) resetting the effective interest rate (EIR), ie an iterative calculation that *changes the EIR* such that the carrying amount will unwind to changed cash flow estimates;
 - (b) a ‘catch-up’ adjustment to profit or loss, which *changes the carrying amount* so that the adjusted carrying amount will unwind to changed cash flow estimates.

32. As mentioned earlier,⁵ the staff also provided numerical examples regarding variable rate instruments. Those examples illustrate the two mathematical mechanisms (EIR resets and catch-up adjustments).
33. The fact that about half of the responses did not include a view on what is an appropriate approach confirms that this is a complex technical issue. This is also consistent with the feedback the staff received as part of its outreach activities, which revealed that this is already a difficult area under today's requirements of IAS 39.
34. Among the respondents who did indicate a preference there were conflicting views with about equal support for resetting the EIR and catch-up adjustments. Some respondents also preferred not resetting the EIR as long as the variable rate instrument is not impaired but switching to resetting the EIR after an impairment occurred.
35. The respondents' rationale for their preferences were mixed with some focusing on the simpler (more pragmatic) solution in terms of mathematics and systems requirements while others looked at the economics and how they would best be portrayed. There were also conflicting views among respondents whether resetting the EIR or catch-up adjustments are more difficult for systems to accommodate.
36. Some also suggested exploring whether there are other alternatives.
37. Some respondents suggested that the Board not specify a required methodology for floating rate instruments, but rather state the measurement objective

⁵ See paragraph 2.

(including impairment) and allow an entity to determine the most practical approach to meet that objective.

Question 5

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

- 38. Respondents had mixed and sometimes conflicting views on whether there should be a switch from a collective to an individual assessment if a loss is identified for a specific instrument (ie removing that asset from the portfolio).
- 39. Most respondents who commented on this question believed there should not be prescriptive guidance on this issue. Instead, there was support for principle-based guidance focusing on two aspects:
 - (a) using the approach that provides the best estimate; and
 - (b) ensuring that there is no double-counting of the loss.
- 40. There was disagreement among the other respondents with some supporting a mandatory switch to an individual assessment after identification of a loss for a specific asset while others advocated precluding such a switch. Each view assumed its preferred solution would facilitate the better estimate of cash flows.

41. 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.

Question 6

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

42. There was a variety of suggestions for simplification, which can be classified into two broad categories:
- (a) generic suggestions regarding the overall approach;
 - (b) detailed suggestions for specific issues.
43. The generic suggestions included:
- (a) modifying the incurred loss model to achieve a result that is more similar to the ECF approach outcome (eg removing or changing the ‘incurred threshold’ and the related loss events, keeping the effective interest method as is);
 - (b) exempt some type of instruments from the scope of the ECF approach (eg trade receivables, instruments quoted in active markets, significant individual assets);
 - (c) build on the Basel II model (eg reduce the outlook period to 12 months), or maximise the use of the Basel II parameters;
 - (d) use portfolio based estimates (probability of default and loss given default statistics, which are often available as part of the credit risk management and often used in determining the portfolio incurred but not reported (IBNR) impairment under today’s incurred loss method);

- (e) focus on an objectives-based approach.
44. The detailed suggestions for simplifications of specific issues included (there were a number of detailed suggestions that relate to the generic suggestions above—refer to the examples in brackets; these are not replicated in the list below):
- (a) simplifying the EIR calculation by using separate calculation modules for the losses and the interest, which can be achieved in different ways:
 - (i) using an ‘insurance premium’ approach to reflect the initially expected losses in profit or loss (this approach could use a separate present value calculation for the expected losses that is then either converted into annuities or the changes in the present value are used as the period charge); or
 - (ii) using average profiles for profiling⁶;
 - (b) using an adequacy test for the expected loss that is included in the EIR; and
 - (c) using a flat forward curve to simplify the cash flow inputs used for variable rate instruments.
45. The Board will need to determine what simplifications are acceptable in view of the overall objective of the approach that will be proposed in the exposure draft. Some of the generic suggestions might also be considered when contemplating what questions to include in the exposure draft. For the more detailed suggestions it depends on how the Board will strike the balance between principles, application guidance and illustrative examples whether (if considered appropriate) they might be explicitly included in the exposure draft.

⁶ See paragraph 24 for profiling.

Appendix A

Statistics

Comment letters

Geographic region	Number
Africa	2
Asia-Pacific	20
Europe	38
International	10
Middle East	0
North America	9
South America	0
TOTAL	79

Type	Number
Accountancy Bodies	7
Accounting Firms	3
Financial Institutions	
<i>Representative Bodies</i>	16
<i>Companies</i>	15
Individuals	3
International Bodies	2
Preparers:	
<i>Representative Bodies</i>	6
<i>Companies</i>	7
Public Sector	4
Regulators	3
Standard Setters	11
Miscellaneous	2
TOTAL	79

Outreach activities to date

Geographic region	Number
Africa	2
Asia-Pacific	8
Europe	12
International	4
Middle East	0
North America	1
South America	3
TOTAL	30

Type	Number
Accounting Firms	3
Financial Institutions	
<i>Representative Bodies</i>	2
<i>Companies</i>	12
Insurance	
<i>Companies</i>	9
Regulators	3
Standard Setters	1
TOTAL	30