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Project	<b>Financial Instruments – Recognition and Measurement</b>
Topic	<b>Impairment: Staff recommendations and questions to the Board</b>

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### **Purpose of this paper**

1. This paper sets out alternatives for how to proceed on an impairment exposure draft (ED), the related staff recommendations and questions to the Board.
2. This paper builds on the summary analysis of the responses to the Request for Information (RFI) regarding the feasibility of the expected cash flow (ECF) approach, as discussed in agenda paper 12A.

### **Alternatives for how to proceed**

#### ***Drafting design: emphasis of objectives and principles versus comprehensive guidance***

3. As discussed in agenda paper 12A,<sup>1</sup> in developing an ED the Board will need to consider how much additional guidance and clarification should be provided.
4. The responses to the RFI, as well as the staff's outreach activities, revealed that there are conflicting views whether providing more comprehensive, detailed guidance would have a beneficial or an adverse effect on the application of any requirements. Some strongly hold the view that a principles-based approach with a clearly articulated objective may be one way of significantly decreasing the

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<sup>1</sup> See paragraphs 16–17 of agenda paper 12A.

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.

costs of application and improving the ability of different entities to use different approaches relevant to different situations to best achieve the objective of an ECF approach. Others request the Board provide significant guidance.

5. In this context the staff notes that there is a widely held view that the *specific* guidance in IAS 39 *Financial Instruments: Recognition and Measurement* on what ‘incurred’ is and what circumstances constitute loss events has been a key cause of the problems associated with the incurred loss model (namely late recognition of losses). In particular, the list of examples of loss events in IAS 39.59-60 and the related application guidance in paragraphs AG89-90 has caused interpretation problems (rather than help avoiding them as intended), particularly in the context of the incurred but not reported (IBNR) requirements for portfolios of financial assets. This has also resulted in great diversity in practice regarding the recognition of impairment losses. This result is counter-intuitive for many because the ‘incurred threshold’ was designed and intended to prevent divergence in practice.
6. The staff notes that the topic of amortised cost, including determining effective interest and impairment, is very process driven because it involves difficult estimates and calculations.
7. Therefore, and in the light of the problems caused by the detailed guidance in IAS 39 today, the staff believes that the ED proposals should articulate a clear objective and emphasise principles, and not provide significant detailed guidance. For example, the staff does not recommend that detailed application guidance is provided regarding when an individual asset should be removed from a portfolio, beyond stating the impairment measurement objective and the requirement to avoid any double-counting of impairment.

*Staff recommendation*

8. The staff recommends that the ED uses a design that articulates a clear objective and emphasises principles reinforced by *concise* application guidance.
  
9. In order to facilitate efficient drafting of the ED it is essential that the Board makes a *clear* decision about the drafting design.

*Question to the Board*

**Question 1: drafting design of the ED**

Does the Board agree with the staff recommendation that the ED uses a design that articulates a clear objective and emphasises principles reinforced by *concise* application guidance?

If the Board does not agree, what does the Board propose instead, and why?

**Scope of the ED**

10. One of the generic suggestions for simplifying the ECF approach – and to reduce the difficulties and costs of application - is to exempt some type of instruments from the scope of the ECF approach<sup>2</sup>. For example:
  - (a) trade receivables,
  - (b) significant individual assets, and/or
  - (c) instruments quoted in active markets.
  
11. The staff thinks key arguments for and against this suggestion can be summarised as follows:
  - (a) pro: curtailing the scope would allow the ED to focus on items where the ECF approach has the biggest impact and the historical data basis is

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<sup>2</sup> See paragraph 43(b) of agenda paper 12A.

likely to be the best (ie for portfolios of *loans*<sup>3</sup> that are not individually significant). In some cases, there may be little difference between applying an incurred loss or an ECF methodology. Exempting some items from the scope could also reduce the costs and challenges of implementation of an ECF approach for many entities (for example, non-financial entities, although see comments below regarding trade receivables).

- (b) against: one of the key objectives of the project—reducing complexity of reporting for financial instruments by using a *single* impairment test for all financial instruments—would be undermined. Simplified guidance for those items not addressed in the ECF approach would still be required. Also, the possibility of delayed loss recognition because of the ‘incurred’ threshold for some items would remain.

12. **Trade receivables.** The staff notes that the RFI did not specifically address this type of instrument because the staff believes that application of the ECF approach to trade receivables would not be overly complex. In the outreach program, the staff did discuss this issue with non-financial entities. The staff also notes that this issue was already briefly addressed in an earlier agenda paper about impairment in April<sup>4</sup> (the relevant paragraph is reproduced in Appendix A for convenience).

13. The concern of respondents to the RFI might have resulted because that paper was not incorporated by reference (it was a paper covering other impairment approaches rather than focussing the mechanics of the ECF approach). In particular, the staff notes that (similar to the requirements of IAS 39) the application of the ECF approach would not necessarily require discounting (and determining an effective interest rate with a margin adjustment reflecting

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<sup>3</sup> For this purpose loans would exclude instruments quoted in active markets.

<sup>4</sup> Agenda paper 14 of the April 2009 IASB meeting, paragraph 39.

expected losses). Under the ECF approach changing the accounting for credit losses would not automatically require introducing discounting for receivables for which the effect of discounting is immaterial.

14. **Significant individual assets.** Some believe that the effect of applying the ECF approach instead of the incurred loss approach would not be significant. This is mainly because the loss pattern of these items is characterised by low probability of default (PD) but a significant exposure if there is a default (LGD). For these ‘high impact–low frequency’ default patterns expected loss estimates inevitably deviate more significantly from actual losses than for high volume low value items. This is because for large individual assets diversification of credit risk does not work as well as for high volume low value items.
15. On the other hand, the more ‘lumpy’ loss pattern on these items can be considered as a reflection of the concentration of credit risk resulting from these assets. In other words, *conceptually* the ECF approach applies equally to large individual items and portfolios of small items (only that in the latter case the law of large numbers works in favour of the estimate). However, in practice, for many such items the difference between the outcome of applying an incurred loss or an ECF approach may not be large because the probability of default may only jump at around or slightly before the incurred trigger is hit anyway.
16. **Instruments quoted in active markets.** These have similar issues as large individual investments where they give risk to large individual items. However, a particular difficulty for these instruments is that for secondary investors historical credit loss data are not as readily available as for originators of loans with a close relation to the borrower.

*Staff recommendation*

17. The staff thinks that clarification about the treatment of trade receivables could alleviate the concerns in the responses to the RFI. Therefore, the staff

recommends retaining trade receivables in the scope of the ED but clarifying their treatment in the ED and including in the ED a question whether that is an operational approach.

18. Regarding instruments quoted in active markets and significant individual assets the staff recommends retaining these in the scope of the ED but explaining the potential difficulties in the ED and ask explicit questions regarding whether including these instruments in the scope is operational, and whether the benefits of applying an ECF approach vs. the incurred loss approach outweigh the costs.

*Question to the Board*

**Question 2: scope of the ED**

Does the Board agree with the staff recommendations that the following instruments are included in the scope of the ED with specific questions in the ED asking whether the benefits of that scoping outweigh the operational difficulties and costs:

- 1) trade receivables
- 2) instruments quoted in active markets?
- 3) individually significant assets?

If the Board does not agree, what does the Board propose instead, and why?

***Allocation of initially expected losses***

19. One of the key operational challenges is the calculation of effective interest. This was discussed in paper 12A.
20. Possible alternatives for the allocation of the initially expected losses using the effective interest method (EIM) are:
  - (a) not allocating the initially expected loss at all, which means retaining the EIM as it is in IAS 39 today but would result in a credit loss on day one (ie an instant impairment charge on initial recognition); this would also create a conflict with the general requirement of initial measurement at fair value (adjusted for transaction costs), ie another exception.
  - (b) allowing a straight-line amortisation (or rather ‘accumulation’) profile. This means that the present value of the future cash flows discounted using the effective interest rate (EIR) no longer equates to the amortised cost carrying amount (although depending on the circumstances, those differences can often be expected to be small).
  - (c) allowing 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).

*Staff recommendation*

21. The staff believes that the alternatives (b) and (c) are often reasonable approximations and directionally consistent with the objective of the ECF approach. Thus the staff recommends that these alternatives be permitted as approximations. Allowing these approaches could significantly reduce some of the operational and systems costs that some (financial institutions, in particular) would otherwise face.
22. Alternative (a) is not directionally consistent with the ECF approach and would usually result in a non-faithful representation - there is no economic loss if the expected losses are reflected in (and covered by) the margin (pricing) on the instrument. Therefore, the staff recommends not allowing alternative (a).

*Question to the Board*

**Question 3: allocation of initially expected losses**

Does the Board agree with the staff recommendations to not permit a day one loss recognition but to simplify the EIM application by permitting:

- 1) straight-line amortisation profiles?
- 2) an 'insurance premium' approach?

If the Board does not agree, what does the Board propose instead, and why?

## Appendix A

Extract from agenda paper 14 of the April 2009 IASB meeting (paragraph 39):

In evaluating accounting complexity the complexity of a financial instrument should also be considered. As noted earlier, using a provision matrix is a common practice particularly for trade receivables but the threshold for recognising impairment losses used in an incurred loss model has created problems. For such relatively simple financial instruments applying an expected loss model does not have to be overly complex. For example, it could involve using a provision matrix based on expected losses (which has been done in large parts of practice before the incurred loss model became mandatory) and charging the initial amount determined in accordance with the matrix against revenue.