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Project	<b>Financial Instruments: Replacement of IAS 39 Amortised Cost and Impairment –</b>
Topic	<b>Objective and Approach</b>

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## Introduction

### *Background and purpose of this paper*

1. Agenda paper 1B presents the staff's approach to redeliberations of phase 2 (amortised cost and impairment) of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* over the forthcoming meetings. In that paper, the staff outlines that it intends to use Appendix A in agenda paper 1B as a 'roadmap' for the redeliberations. It also states that (and why) discussions and recommendations will first be presented to the Board in the context of **open portfolios**.

### *Purpose of this paper*

2. The purpose of this paper is to address the top layer of the 'roadmap' as set out in Appendix A of agenda paper 1B.
3. This paper asks the Board whether it wants to use an expected loss impairment approach based on expected losses. One model using such an approach was set out in the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED). Specifically, this paper asks the Board *what the impairment approach should be*.

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This paper has been prepared by the technical staff of the IFRS Foundation 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 IFRS Interpretations Committee 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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**Structure**

4. The rest of the paper is structured as follows:
  - (a) the objective of amortised cost measurement as set out in the ED;
  - (b) the various impairment approaches in the context of amortised cost measurement; and
  - (c) staff recommendation and question to the Board.
5. *If* the Board agrees with the staff recommendation to use an expected loss approach, agenda paper 1D then asks the Board for decisions on *what* that expected loss approach should be (ie outlook period and the conditions to consider when calculating expected losses).

**Objective of amortised cost**

6. Paragraph 4.2 of IFRS 9 *Financial Instruments* determines the type of assets that shall be measured at amortised cost. It states:

A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (i) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
- (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

7. The ED proposes:

The objective of amortised cost measurement is to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the *financial instrument*.

8. Most respondents agree that the objective is clear and appropriate, although some respondents also felt the objective should be modified to address impairment specifically.

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9. Many respondents also suggest that the allocation of the initial estimate of expected credit losses should remain separate from the effective interest method of calculating amortised cost. Respondents state their reasons are both conceptual and operational. This paper does not discuss *whether* credit losses should be separated from the effective interest method. *If* the Board decides to use an expected loss approach, this will be addressed in a separate paper at a future meeting when the Board discusses the allocation of initial estimated credit losses (fourth layer of the diagram).

**The impairment approach**

10. This section of the paper discusses the following impairment approaches:
- (a) expected loss approach;
  - (b) incurred loss approach;
  - (c) fair-value based approach; and
  - (d) impairment approach based on IAS 36 *Impairment of Assets*.
11. In the context of IFRS 9 the discussion of impairment approach relates only to the amortised cost measurement category.<sup>1</sup>

***Expected loss approaches***

12. The ED defines amortised cost as ‘[a] cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense.’ The ED proposes using the effective interest method for amortisation. Under the expected cash flow (ECF) approach in the ED, initial expected lifetime credit losses are included in the amortisation to provide information about the effective return of a portfolio. The proposal therefore provides a link between the overall profitability of the portfolio and *expected* credit losses estimated at the outset. The ECF approach is one particular form of an expected

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<sup>1</sup> IFRS 9 only uses one single impairment test.

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loss approach. Other expected loss approaches vary by when the expected loss is recognised and for what time horizon and how it is determined.

13. Most respondents support the Board's proposed move towards some form of an expected loss approach to impairment. However, some respondents disagreed. Their main concerns are discussed in the remainder of this section.

*Consistency with initial measurement*

14. Some respondents disagree that estimates of expected credit losses should initially be included in the calculation of amortised cost. They argue that by incorporating credit loss expectations in the effective interest method, the measurement moves away from the cost-based *initial* measurement of financial assets. Some are also concerned that at inception of a financial instrument, using an interest rate other than the contractual interest rate would be tantamount to moving away from the market view at that date.
15. Firstly, the staff note that all financial assets are *initially* measured at their *fair values* at inception<sup>2</sup> rather than at cost. Amortised cost is solely a *subsequent* measurement.
16. Secondly, the initial carrying amount (ie fair value plus transaction costs) of financial assets (at least) implicitly includes a deduction for expected losses. The initial carrying amount can be regarded as the present value of:
  - (a) the contractual cash flows discounted at the *contractual* effective interest rate; or alternatively
  - (b) the expected cash flows discounted at the expected effective interest rate *adjusted* for the effect of expected credit losses.

Both alternatives lead to the same present value.

17. Hence, including expected losses in amortised cost measurement results in a subsequent measurement that is consistent with the initial measurement at fair value plus transaction costs.

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<sup>2</sup> Plus transaction costs for assets not subsequently measured at fair value through profit or loss (see IFRS 9.5.1.1 and IAS 39.43).

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18. This also demonstrates that the use of an effective interest rate that is adjusted for the effect of expected credit losses is *not* tantamount to moving away from the market view (at inception of the instrument). Instead, the market view is inherent in the initial measurement (ie fair value plus transaction costs) and different discount rates<sup>3</sup> that can be derived from it, each reflecting the market view inherent in the fair value of the asset.

*Cost-based measurement*

19. Some respondents are concerned that using an expected loss approach is inconsistent with a cost-based measurement. The concerns relate to the possibility of gains resulting in a write-up of the carrying amount above the initial carrying amount, and more generally that management's expectations of future credit losses would affect the carrying amount.
20. The staff note that the notion of *amortised* cost measurement in IAS 39 can be described as a cost-based measurement but that it is not the same as 'cost' – or even a 'cost plus an amount or minus an amount that is subsequently amortised' approach.
21. Instead, amortised cost as defined in IAS 39 is a present value of *estimated* future cash flows (ignoring future credit losses) discounted at the effective interest rate.<sup>4</sup> Hence, for example, prepayments have to be estimated and changes in those estimates give rise to gains and losses, which can also result in write-ups of the carrying amount above the initial carrying amount. (Note, this is different than some of the approaches US GAAP uses for 'amortised cost' measurement).

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<sup>3</sup> The difference in the rates is due to the difference in the type of cash flow used as the numerator of the present value calculation. It is a matter of consistency, ie that there must not be double counting nor omission of any effect. For example, discounting certainty equivalents of the cash flows using the risk free rate would result in the same initial carrying amount (present value).

<sup>4</sup> See definition of 'amortised cost' and 'effective interest method' in IAS 39.9 and also AG8.

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22. The only aspect that makes amortised cost ‘cost-based’ is that the discount rate (the original effective interest rate<sup>5</sup>) is held constant and hence provides a link to the initial measurement of the asset.
23. Therefore, an expected loss approach is consistent with a cost-based measurement just like IAS 39 today. In fact, an expected loss approach would remove the exception in IAS 39 that excludes future credit losses from the estimated cash flows (owing to the incurred loss model) – but that includes all other types of expected cash flows.<sup>6</sup>

*Effective interest method – an allocation mechanism (not a measurement basis)*

24. A few respondents argue that by using the effective interest method to allocate expected losses (ie combining revenue and impairment recognition and measurement) the Board would in effect elevate the effective interest method to a measurement basis. These respondents do not consider the effective interest method as a measurement basis and are concerned that using an effective interest method that combines revenue recognition with impairment accounting is akin to a fair value based measurement approach (given that changes in fair value also include both revenue and impairment losses).
25. The staff note that *amortised cost* (as used today in IFRS) is the measurement basis.<sup>7</sup> The effective interest method is used in the ED as the *method* to calculate amortised cost – but is *not* the measurement basis. It determines the discount rate used for discounting the expected cash flows and it is a *mechanism* to allocate the initial expected losses. Hence, the staff agrees with the view that the effective interest method is not and should not be confused with a measurement basis.
26. Further, the staff consider that this concern also relates to whether amortised cost is considered as a ‘cost’ measurement or as a present value of estimated future cash flows (see paragraph 20). The ED is clear that amortised cost is a

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<sup>5</sup> For variable rate assets the effective interest rate is adjusted for movements in market interest rates. Hence, the link to the initial measurement constant spread that is not

<sup>6</sup> See the definition of ‘effective interest method’ in IAS 39.9.

<sup>7</sup> ED, Appendix A and paragraph 6.

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‘cost-based’ measurement that is a present value.<sup>8</sup> If *amortised* cost is mistaken as ‘cost’, the present value is not recognised as a measurement basis. The misconception that effective interest method has been elevated to a measurement basis might arise because some consider only ‘cost’ (and fair value) but not the present value as a measurement basis (ie *cost-based* is considered the same as ‘cost’).

*Consistency with the pricing of the financial asset*

27. Future expected credit losses form an implicit component of the pricing of a financial asset.<sup>9</sup> Based on history, lenders typically expect some credit losses when making lending decisions and this is reflected in the contractual interest rate charged by the lender. The expected loss approach therefore is a faithful representation of the economics of loan pricing.
28. Hence, many respondents agree that the spread<sup>10</sup> on a financial asset includes an amount that covers expected credit losses. Also, many financial institution respondents believe that the expected loss approach is more consistent with the way credit risk is managed, assessed and priced.
29. However, some respondents argue that because the spread covers a range of future expected losses it is not possible to identify a separate, single amount relating to future expected loss within the contractual interest rate. Hence, they are concerned that an expected loss model uses initial estimates that are not based on sufficiently robust information, which would result in the recognition of gains or losses from changes compared to the initial estimate.
30. The staff consider that this concern relates to how and when gains and losses from changes in expected loss estimates should be recognised in profit or loss. It reflects the trade-off between reliable and relevant information. An increase in the reliability of the loss estimate comes at the expense of later recognition of impairment losses (when the losses are more ‘observable’ and less uncertain,

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<sup>8</sup> ED, paragraph 6.

<sup>9</sup> See paragraphs 4 and 5 of agenda paper 4A of the 3 August 2010 meeting.

<sup>10</sup> This is the spread above the risk free rate (sometimes it is referred to as the ‘credit spread’ but it includes other elements as well, eg profit margin, liquidity, etc.)

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and hence loss estimates are less likely to change in amount or timing). In a wider sense, this relates to whether amortised cost is considered as a 'cost' measurement or as a present value of estimated future cash flows (see paragraph 20).

31. Under 'cost' measurement, one might take the view that losses must be reliably and accurately measured before they are recognised. In contrast, if amortised cost is viewed as a present value of estimated future cash flows one would take into account more forward looking information in estimating cash flows.
32. Hence, the 'cost'-view implies to take into account changes in estimates later (nearer their crystallisation) than under the 'present value'-view.
33. The staff note that to the extent the initial expected loss is excluded from accounting for the asset the economic phenomenon of a lending transaction is ignored. This is because the (entire) initial expected loss is included in the pricing of the asset.

*Interaction between financial reporting and management reporting*

34. Many respondents to the ED and feedback from outreach activities agree that the Board's proposed approach – by using lifetime expected loss – portrays the underlying economics of the financial assets.
35. However, a few respondents from financial institutions commented that they do not generally use an approach in managing their net interest margin and credit risk that is consistent with the ECF approach proposed in the ED.
36. The staff are aware that financial entities, in particular, have a very distinct credit risk function as it needs to have some independence in order to be effective. This also often entails an internal reporting structure that reports contractual interest revenue separately from credit loss information.
37. However, the staff note that the same economic transaction gives rise to both interest cash flows and future expected credit losses (albeit different risks are managed separately by different departments or functions).
38. The staff further note that information produced for financial reporting under IFRSs for external purposes could be different from financial information



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produced for internal purposes. IFRS 8 *Operating Segments* provides users of financial statements a view of an entity's operation from the same perspective as management.

39. External financial reporting aims to faithfully portray the economic effects of the transactions with parties external to the entity (see paragraphs 27 and 36). How management allocates the costs within different departments within in an entity is a matter of management cost accounting within the entity.
40. Instances where the accounting for financial and management reporting purposes could be different exists today under IFRSs. For example, IAS 23 *Borrowing Costs* requires borrowing costs that are directly attributable to the acquisition, construction or production of qualifying asset to be capitalised<sup>11</sup>, whereas many entities expense borrowing costs for internal reporting purposes (reflecting the management view).
41. Another example is that under IAS 16 *Property Plant and Equipment* costs of replacing a component of plant are capitalised<sup>12</sup> whereas the management view sometimes results in expensing these costs for internal reporting purposes.

*Consistency with other IFRSs and IASB projects*

42. Some respondents also argue that the proposed initial and subsequent measurement of financial assets by incorporating management's expectations of future credit losses would be inconsistent with other IFRSs and IASB projects.
43. Some are concerned that the early recognition of impairment under an expected loss approach is inconsistent with the recognition of a restructuring provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Recognising such a provision is subject to strict criteria, which implies a later recognition (compared to when losses are expected).
44. The staff note that restructuring provisions within IAS 37 are subject to *specific* guidance on the recognition criteria.<sup>13</sup> Hence, this type of provision is least

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<sup>11</sup> IAS23.8.

<sup>12</sup> IAS 16.13.

<sup>13</sup> See IAS 37.71-72.

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suitable for an assessment of whether a requirement is consistent with IAS 37 in *general*.

45. Moreover, in order to ascertain any inconsistency of IAS 37 with an expected loss approach a restructuring provision is less suitable than other types of provisions because it is unrelated to revenue recognition. In contrast, the concern raised by respondents is related to the link of the expected loss approach to revenue recognition. Hence, the staff consider warranty provisions more appropriate since they relate to revenue recognition (the most pertinent provision – for onerous loan commitments – is addressed in paragraph 61-65).
46. Illustrative example 1 of IAS 37<sup>14</sup> (based on the application of paragraph 24 of IAS 37) provides that warranties from manufacturers be recognised based on the best estimate of the warranty related cost if, based on past experiences, it is probable that there will be some claims under the warranties. Although the likelihood of outflow for any one item may be small it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole<sup>15</sup>.
47. Similarly, an expected loss approach that provides that initial expected credit losses are included in the amortisation because, within a portfolio of financial assets, management typically expects<sup>16</sup> that it will not be able to collect all the contractual cash flows even though the likelihood of a loss for any one individual financial asset may be small.
48. Hence, for portfolios of financial assets the expected loss approach is consistent with IAS 37 in that it also includes management's expectation of future losses (that equate to costs). However, for an individual item the probability threshold<sup>17</sup> in IAS 37 would often give a different answer (see paragraphs 63 and 65). The fact that the initial expected loss is recognised over the life of the financial instrument reflects that the interest revenue relates to that period.

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<sup>14</sup> See Appendix A.

<sup>15</sup> IAS 37.24

<sup>16</sup> Management's expectation is reflected in how the loan is priced, ie setting of the contractual interest rate (and premium or discount, if any).

<sup>17</sup> See IAS 37.14(b), 23 and 24.

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Hence, this achieves an equivalent result to the warranty cost, which are recognised in the period of the related sales revenue. (In other words, the staff believe the expected loss approach to be consistent with the accounting in IAS 37 for warranty costs).

49. In Exposure Draft ED/2010/6 *Revenue from Contracts with Customers* (Revenue ED), the Board proposes that an entity shall reduce the amount of promised consideration to reflect the customer's credit risk<sup>18</sup>. The measurement is consistent with the expected loss approach because that also considers initially expected credit losses.
50. From the above discussions, the staff notes that incorporating management's expectation of future losses in recognition and measurement is consistent with IAS 37 as well as the Board's current revenue recognition proposals.

*Accounting versus regulatory requirements*

51. Most respondents have commented that the expected loss approach proposed by the Board should be developed for the purposes of accounting rather than for regulatory purposes. However, some others felt that an impairment approach should closely align to the approaches used by various regulators.
52. The staff notes that the expected loss approach has been developed as an improvement to financial reporting – to address the shortcomings of the incurred loss approach (eg the overstatement of interest revenue in the early years of the financial assets) while ensuring that the economics of the lending transaction are faithfully presented. While these shortcomings were highlighted by the recent credit crisis, these required improvements apply irrespective of that crisis. The Board's project to replace IAS 39 originates from the 2008 Discussion Paper *Reducing Complexity in Reporting Financial Instruments*.

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<sup>18</sup> Paragraphs 43 and B79 of the Revenue ED.

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***Incurred loss approach****Enhancing incurred loss approaches*

53. In its deliberations the Board decided to move away from an incurred loss approach. The incurred loss approach ignores the expected credit losses until a loss event has occurred even though the expected credit losses are (at least implicitly) taken into account in the lending decision. Hence, the effective return is overstated until a loss event occurs and no link exists between the future expected credit losses and the overall profitability (ie the net effect on profit or loss) of the asset.
54. Most respondents agree with the criticisms of the incurred loss approach as set out in the ED's Basis for Conclusions. These criticisms include:
- (a) inconsistency with initial measurement;
  - (b) late recognition of credit losses, which creates information deficiency;
  - (c) inconsistency with pricing of the financial asset and risk management;
  - (d) it is impossible to clearly identify *when* the specific loss event occurred; and
  - (e) recognising a credit loss even though it has been expected at the outset (and priced into the loan) and therefore does not faithfully represent the underlying economics of the lending transaction.
55. A few respondents suggest that the incurred loss approach could be improved by additional application guidance or disclosures. For example, by providing greater clarification about a wider range of events that could be taken to have occurred and hence would give rise to incurred losses. In their view, general information about the economic environment, such as rates of unemployment, rates of employment participation, asset price inflation and rates of economic growth, being leading indicators, can be used to infer the occurrence of specific events that give rise to impairment losses.
56. The staff note that such an approach is consistent with the notion of 'incurred but not reported' (IBNR) credit losses. IAS 39 already includes the notion of

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IBNR in its incurred loss approach.<sup>19</sup> Hence, it has been applied in practice under IFRSs.

57. The weakness of using IBNR as a means to differentiate incurred and expected losses is that depending on the loss indicator used, a credit loss that is not yet incurred on the basis of one indicator can be incurred on the basis of another, more leading indicator. Different entities are likely to assess different loss events differently and use different indicators. Hence, IBNR is not selective. That is, it does not provide a consistent, sound differentiation of which losses have been ‘incurred’.
58. The Expert Advisory Panel (EAP) also discussed and concluded that it is almost impossible to differentiate what losses have been incurred based on a change in an indicator and what are future credit losses that have yet to be incurred. Part of the problem is that the loss indicators used for IBNR purposes are more continuous *developments* rather than discrete ‘events’ (eg the change in economic growth or the unemployment rate) while an incurred loss approach is based on identifying loss events.
59. The staff also note that the application of IBNR is a key factor that causes diversity in practice regarding the timing of loss recognition. Because of the weakness of IBNR as a differentiator (see paragraph 57) providing additional application guidance cannot avoid the in diversity in practice regarding what is treated as incurred versus not yet incurred. Because of the complexity of the issue and how it affects the recognition of impairment disclosures could not effectively address the issue. In fact, some have described IBNR as applying an impairment model that is closer to expected than incurred approaches while others have applied IBNR such that it hardly makes a difference because it is considered somewhat of a foreign object in an incurred loss approach (which explains the significant diversity in practice that exists today).
60. Furthermore, including additional application guidance does not resolve the conceptual flaws of an incurred loss model. In particular, it does not portray the

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<sup>19</sup> See IAS 39.59(f) and AG90.

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economic return and the economics of lending transactions based on pricing of financial assets. As noted in paragraph 53 above, the incurred loss approach still ignores credit losses until there is a loss event (albeit an inferred one). At best, an IBNR approach would mitigate some concerns about late timing of loss recognition mentioned in paragraph 54(b) but it would not resolve the other criticisms cited in that paragraph.

*Accounting for loan commitments*

61. The staff also note that under today's requirements, unless they are accounted for at fair value through profit or loss, loan commitments are scoped out of IAS 39 and accounted for in accordance with IAS 37<sup>20</sup>.
62. Hence, the incurred loss model of IAS 39 does not apply to these loan commitments. Instead, the general accounting model for provisions in IAS 37 applies. By entering into the loan commitment the lender has a present legal obligation (to extend credit) as the result of a past event. Therefore, the timing of the recognition of a provision for credit losses on loan commitments is driven by when a loss becomes *probable*.<sup>21</sup>
63. This results in different outcomes for situations where an individual loan commitment exists or a group of similar commitments because for such a group the probability of the loss is determined by considering the group as a whole.<sup>22</sup> Hence, for a group of similar commitments the probability criterion would often be fulfilled from inception whereas this is very unlikely for an individual loan commitment that cannot be grouped with similar other commitments.
64. If the loss is probable, the measurement of the credit loss is the expected value for large population of loan commitments.<sup>23</sup> For individual loan commitments it

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<sup>20</sup> IAS 39.2(h) and IAS 39.4.

<sup>21</sup> See IAS 37.14(b) and 66-68.

<sup>22</sup> See IAS 37.24 and paragraph 47 above.

<sup>23</sup> See IAS 37.39.

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depends on the single most likely outcome and how other possible outcomes relate to it.<sup>24</sup>

65. Hence, for larger groups of loan commitments IAS 37 in effect requires an expected loss approach already today, which is inconsistent with the incurred loss model in IAS 39. In contrast, for individual loan commitments that cannot be grouped (eg 'big ticket' items) the probable threshold in IAS 37 means expected losses are ignored until they become probable (which will typically only occur after inception of the loan commitment). However, this 'probable' threshold is not necessarily the same as the 'incurred' indicators used in IAS 39.
66. Financial institutions have commented that off-balance sheet exposures such as loan commitments are subject to similar credit analyses and management as other on-balance sheet exposures such as loans, and therefore the accounting should also be consistent. The staff believe that moving to an expected loss approach for loan commitments as well as for financial assets would result in consistency in accounting for financial assets that are being managed in the same way.

***Fair value-based approach***

67. In its deliberations, the Board also considered an impairment loss approach that would be based on the fair value of the financial assets at an impairment date.
68. Under a fair value-based approach, financial assets are accounted for under the current IAS 39 amortised cost model where credit losses (which are implicit in the initial pricing decision) are excluded from the effective interest rate. When a trigger event arises, financial assets would be impaired and recorded at its fair value.
69. The Board has rejected the fair value-based impairment approach for the following reasons:

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<sup>24</sup> See IAS 37.40.

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- (a) For a single measurement category, it results in a mix of an amortised cost model (unimpaired financial assets) and a fair value model (impaired financial assets).
  - (b) A trigger would be required to determine *when* the asset is deemed impaired (adding the problems akin to the ‘incurred’ threshold).
  - (c) A fair value-based approach would require either:
    - (i) *resetting the cost basis*: the fair value at that point in time is used as a deemed cost basis. Resetting the cost basis would require determining a new effective interest rate (on each reset occasion); or
    - (ii) *separate amortisation of the non-credit related components*: the original effective interest rate would be retained for revenue recognition but the non-credit related portion of the fair value changes would have to be amortised separately, which creates complexity.
70. As discussed previously under amortised cost, the three aspects of interest revenue, cost and impairment are integrated. Under the fair value-based approach, the effective return of assets over their lifetime can no longer be reflected in a meaningful way without undue complexity (see paragraph 69(c)). Also, resetting the cost basis to fair value is tantamount to accounting for a sale and then repurchasing the asset (ie a ‘wash sale’) on every impairment occasion. This is inconsistent with the business model classification criterion of IFRS 9 and hence the amortised cost category.
71. Most respondents to the ED and feedback from outreach activities also supported the Board’s rejection of the fair value-based impairment approach. The main reason being that the fair value based approach is not consistent with a cost-based measurement category.

**Other impairment approaches**

72. A few respondents have suggested that the Board should also consider the impairment model for non-financial assets in IAS 36 *Impairment of Assets*.



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They commented that IAS 36 appears to have proved to provide a robust impairment model for non-financial assets during the recent credit crisis.

73. The staff note that for non-financial assets, the aspects of cost basis, impairment and revenue recognition are contained within different IFRSs:
- (a) the cost basis (eg IAS 2 *Inventories*, IAS 16 *Property Plant and Equipment* and IAS 38 *Intangible Assets*);
  - (b) impairment (eg IAS 2 and IAS 36); and
  - (c) revenue recognition (eg IAS 18).
74. For financial assets held at amortised cost, the three aspects of cost basis, impairment and revenue are accounted for within one integrated approach using the effective interest method and are set out in one standard – IAS 39<sup>25</sup>. The effective interest rate is used for revenue recognition purposes as well as in measuring an impairment loss in IAS 39.
75. On the other hand, non-financial assets do not have this integrated link between cost basis, revenue and impairment. These aspects are scattered throughout several IFRSs.
76. Using the IAS 36 impairment approach means impairment would be measured by reference to the higher of fair value less costs to sell and value in use. Both of them are current value measurements and require a current *market* discount rate<sup>26</sup>. This has several ramifications:
- (a) When the cost basis is adjusted following an impairment the effective interest rate would be reset or a separate amortisation for other amounts would be required like for the fair value-based approach – see paragraph 69(c). Hence, this would have a distorting effect on revenue recognition.
  - (b) Using a current discount rate means changes in market interest rates will give rise to impairment losses for accounting purposes. Hence,

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<sup>25</sup> IAS 18 *Revenue* refers to the effective interest rate in IAS 39 for recognition of interest.

<sup>26</sup> See IAS 36.55 for value in use.

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changes in both the risk-free rate and the spread will be causes of impairment. This raises the question of whether a cost-based model is left as neither the cash flow estimates nor the discount rate have any link back to the initial measurement.

- (c) For value in use, combining the entity's estimate of expected cash flows with a market discount rate is problematic. As the basis for conclusions explains, the market rate is required to be used because of concerns that an entity specific rate that reflects management's assessment of the risk specific to the cash flows could not be verified objectively. But the basis for conclusions also concedes that the *logical* answer for an entity-specific measure would be using an entity-specific discount rate.<sup>27</sup> Hence, using the IAS 36 impairment test would mean this problem is inherited for amortised cost measurement of financial assets.

77. Also, the IAS 36 impairment approach requires (except for goodwill and intangible assets with an indefinite useful life<sup>28</sup>) non-financial assets to be tested for impairment when there are indicators of impairment (ie triggers or loss events). This has the following ramifications:

- (a) Most of the indicators in IAS 36 do not apply to financial assets at amortised cost (eg physical damage or obsolescence). However, to the extent that indicators would apply and have a substantive effect, this would create the same problems as an incurred loss approach (eg it is inconsistent with the initial pricing and lending decision in that future credit losses expected at the outset which are included in the pricing are ignored, etc).
- (b) Some indicators in IAS 36 will in substance not be 'indicators'. For example, changes in market interest rates. These change all the time and for financial assets any increase in the market rates shortly after

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<sup>27</sup> See IAS 36.BCZ54.

<sup>28</sup> Paragraph 10 of IAS 36 requires intangible assets with an indefinite useful life and goodwill to be tested for impairment annually.

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initial recognition would result in automatic impairment. The same applies later whenever the market interest rates come back to the level on initial recognition or if an asset was impaired before. Also, IAS 36 refers to ‘evidence [...] from internal reporting that indicates that the economic performance of an asset is, *or will be, worse than expected*’<sup>29</sup> [emphasis added]. This would be similar to an expected loss approach – depending on the entity’s internal reporting – but because of no mechanism to allocate the initial expected loss would recognise that as part of the first impairment from changes in expectations (ie involve a ‘cliff effect’ for the initial expected loss).

78. In summary, the staff consider that the IAS 36 impairment approach has many problems similar to the incurred loss (eg ignoring credit losses initially) and fair value-based (eg a distorted effective interest rate) approaches and is overall a less faithful representation of the economic phenomenon of the lending transaction than the expected loss approach.

**Staff recommendation**

79. Considering the alternative impairment approaches discussed in this paper, the staff first dismiss a fair-value based approach because it results in a mix of an amortised cost and fair value model, which is inconsistent with a cost-based measurement category and the fundamental architecture of IFRS 9. Such an approach would also create significant complexity (eg regarding interest revenue recognition).
80. The staff next dismiss an incurred loss approach because it ignores initially expected credit losses at the outset and therefore overstates interest revenue until a trigger event occurs. This is inconsistent with initial measurement and pricing of the financial assets. Hence, it does not faithfully represent the economic performance of financial assets. Moreover, the incurred loss approach in IAS 39 has created significant application problems and diversity in practice.

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<sup>29</sup> IAS 36.12(g).

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81. The staff next dismiss an IAS 36 impairment approach because it also shares many of the shortcomings of both the incurred loss and fair-value based approach (eg trigger events, disconnect with interest revenue recognition etc).
82. The staff believe that an expected loss approach can establish a link between profitability and credit losses, and hence can portray the economic phenomenon of lending faithfully.
83. An expected loss approach is consistent with the initial measurement of financial assets and can portray the effective return of the financial assets over the expected life of the financial assets.
84. For these reasons the staff recommends the Board tentatively decide to move forward using an expected loss impairment approach.

**Question 1– Impairment approach**

Does the Board agree with the staff recommendation to move forward using an expected loss impairment approach?

If not, what should the impairment approach be and why?

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**Appendix A**

- A1. The following is an extract for IAS 37 Provisions, Contingent Liabilities and Contingent Assets.
- A2. Paragraph 24 of IAS 37 states:

Where there are a number of similar obligations (eg product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

- A3. Example 1 of Appendix C:

**Warranties Example 1**

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

**Present obligation as a result of a past obligating event** – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

**An outflow of resources embodying economic benefits in settlement** – Probable for the warranties as a whole (see paragraph 24).

**Conclusion** – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period (see paragraphs 14 and 24).