
Project	Financial Instruments: Replacement of IAS 39
Topic	Amortised Cost and Impairment – Scope of Expected Loss: Outlook period and conditions

Introduction

Background and purposes

1. This paper will only be discussed *if* the Board agrees with the staff recommendation in agenda paper 1C. Agenda paper 1C asks the Board what the impairment approach should be. In that paper, the staff recommends to move forward using an expected loss impairment approach.
2. The purpose of this paper is to ask the Board for decisions on *what* that expected loss approach should be. Specifically, this paper asks the Board for decisions regarding:
 - (a) the outlook period for expected loss; and
 - (b) conditions to consider when calculating expected loss.
3. This paper addresses the second layer of the diagram and the extending sub layers (refer to Appendix A of paper 1B).
4. The Board should note that this paper is a *conceptual* discussion of the scope of expected loss that should be used in an expected loss approach. In other words, this paper asks *what* outlook period and *what* conditions to consider when determining an expected loss in order to faithfully represent a lending transaction.
5. **This paper does not seek to provide detailed application guidance, or even to consider practical implications of *how* to measure expected loss and the**

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.

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practical expedients that can be applied (for example, using long-term average loss rates).¹ This will be addressed in later papers, if relevant.

Structure

6. The rest of the paper is structured as follows:
 - (a) the outlook period for expected losses – short-term versus lifetime expected losses;
 - (b) staff recommendation and question to the Board on (a);
 - (c) conditions to consider when calculating expected loss:
 - (i) alternative 1 - through-the-cycle approaches;
 - (ii) alternative 2 - based on past and existing conditions only; and
 - (iii) alternative 3 - consider all reasonable and supportable available information ('full scope' expected loss); and
 - (d) staff recommendation and question to the Board on (c).

Outlook period for expected losses

7. Some respondents commented that expected losses beyond the short term cannot be reliably measured. They argue that estimating losses beyond that time horizon would often be less precise, more subjective and less reliable and hence introduce unwarranted volatility in profit or loss.
8. For example, because of the imprecision in long-term estimates, they believe that the estimates will likely change throughout the life resulting in volatility. In their view, only expected losses in the short term should be considered.

¹ The use of probability weighted possible outcomes or single most likely outcomes in determining expected losses will only be discussed after the Board has tentatively decided on an impairment approach for open portfolios, in line with the general approach for redeliberations (see paper 1B). This is because for portfolios the single most likely outcome approximates the expected value. Hence, the differentiation becomes relevant when considering other scenarios than open portfolios.

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9. The staff note that using short term expected loss would also require loss estimates to be updated over time (for losses that have become ‘short term’).
10. Updating short-term expected losses would impact profit or loss as and when subsequent losses become ‘short term’. For example, if it is determined that only losses expected to occur in the next 3 years should be considered in calculating expected losses of a 10-year asset, each year the entity would have to update the expectation for the 3rd year that comes into the ‘short term’ outlook. Hence, by only considering short-term losses, volatility in profit or loss cannot be avoided.
11. However, there is a difference in the volatility in profit or loss that results from short-term and long-term outlook periods:
 - (a) Generally, the uncertainty of the credit loss estimate increases with the length of the outlook period. While discounting has a counter-balancing effect, the overall effect (ie comparing the present values of the changes) can still be that the volatility from changes in estimates is higher for longer term assets with the longer outlook period.
 - (b) Given that an outlook period that is shorter than the life of the asset excludes a part of the lifetime expected loss, this would create artificial volatility from the effect of expectations that later crystallise but were ignored in earlier estimates² (particularly the initial estimate).
 - (c) Excluding part of the lifetime expected loss can also undermine comparability because the loss patterns of different assets are not the same. For example, financial products with early loss patterns (ie credit losses peak in the earlier part of their life) such as car loans or construction loans would have most of the associated credit losses included in the shorter term expected loss. Conversely, for other financial products with late(r) loss patterns the expected loss would

² See paragraph 10.

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exclude most of the credit losses until later on. This would systematically distort any comparison of the risk and the profitability of these products.

- (d) Using an outlook period that is shorter than the life of the asset means some loss information will only later become available in the external financial reporting, ie once it is taken into account in measuring amortised cost and hence affects profit or loss.
12. Hence, financial reporting that faithfully represents the economic characteristics of any (but especially longer-term) assets would have to reflect the uncertainty and volatile impact on profit or loss associated with its entire term (ie lifetime expected loss). Anything other than a *lifetime* expected loss ignores some credit losses and conveys an incomplete picture of the profitability and the pricing of the financial asset – degrading the usefulness of information to users of financial statements. In addition, it would be inconsistent with the initial measurement of the asset.³
13. The staff further note that identifying any threshold for which losses are ‘short term’ and which are ‘long term’ will be arbitrary and elusive. Any threshold the Board decides to add would be an arbitrary cut-off rather than a principles-based approach. This is because time is a *continuous* spectrum, which means it will not be possible to conceptually justify any particular cut-off point (more or less than any other).
14. Moreover, the staff note that any threshold would be prone to different application by different entities in practice. This is already a significant problem

³ See the discussion of the consistency with initial measurement in paragraph BC11(a) of the Basis for Conclusions in the exposure draft *Financial Instruments: Amortised Cost and Impairment* as well as in paragraphs 17 and 80 of paper 1C. The discussion applies by analogy as any expected loss that is less than the lifetime expected loss creates the same type of inconsistency albeit to a lesser degree than an incurred loss approach.

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with the application of the notion of incurred but not reported (IBNR) today, which is similar in this regard.⁴

15. Many respondents support a lifetime expected loss approach. They commented that a longer outlook periods allows for a more realistic and operational assessment of losses. And such an assessment often more closely reflects their internal risk management and reporting systems.

Staff recommendation

16. For the reasons discussed above the staff recommends to move forward using an expected loss approach based on *lifetime expected losses*.

Question 1 – Outlook period

Does the Board agree with the staff recommendation to move forward using an expected loss approach based on *lifetime expected losses*?

If not, what should the outlook period be and why?

Conditions to consider when calculating expected loss

17. This section of the paper addresses what conditions to consider when calculating expected losses. It discusses the following three main alternatives emanating from the comment letters and other feedback:
 - (a) alternative 1 – through-the-cycle approaches;
 - (b) alternative 2 – determine expected loss based on past and existing conditions only; and
 - (c) alternative 3 – consider all reasonable and supportable information and conditions ('full scope' expected loss).

⁴ See paper 1C, paragraphs 57-59.

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Alternative 1 – through-the-cycle approaches

18. In its deliberations, the Board considered through-the-cycle approaches. These approaches generally estimate impairment using statistical parameters derived from historical credit loss data that cover a full economic cycle or several economic cycles.
19. A few respondents commented that using through-the-cycle parameters would avoid betting on the economic future to estimate expected losses. These respondents raised concerns that when expected losses are estimated using a point-in-time approach, the main problem is evaluating in which phase of the economic cycle the entity is originating (or purchasing) the loan. In their view, the estimate would lead to a less reliable assessment of expected losses. They commented that through-the-cycle parameters (observed over a full economic cycle or cycles) are independent from the economic conditions at a particular point in time (eg initial recognition of the asset or the measurement date) and are therefore the best estimates to assess expected losses.
20. The staff note that cycle-average credit losses reflect credit losses for the past cycle or cycles rather than for the periods for which the financial assets exist and are being measured. Applying cycle-average credit losses to assets with a shorter life than the economic cycle results in providing for credit losses that would also relate to future lending. Hence, it does not portray the economic characteristics of the financial assets being measured.
21. However, the staff notes that through-the-cycle parameters subject to appropriate adjustments (eg adjusting for the phase of the cycle and other change in trends) might assist in estimating future expected credit losses.
22. The Board has in the past rejected through-the-cycle approaches that are purely based on past economic cycle/s information because they do not use statistical information to forecast future credit losses for the period for which the financial assets exist. Hence, pure through-the-cycle approaches (with no adjustments) are less likely to be the best estimates to assess expected losses because they rely solely on historical events to set out 'provisioning' levels at the end of the

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reporting period. For information to be *relevant*, financial reporting should reflect expected credit losses that relate to the financial assets being measured and reported, rather than purely on past credit cycle/s.

23. For the above reasons the Board rejected these approaches in the Basis for Conclusions of the exposure draft *Financial Instruments: Amortised Cost and Impairment* (ED)⁵. Most respondents agree with the Board's decision to reject through-the-cycle approaches that would result in losses being recognised for loans that do not yet exist.

Alternative 2 – based on past and existing conditions only

24. A second alternative is to estimate expected loss based only on economic and market conditions prevailing on the respective measurement date and prohibit forecasting future changes in those conditions that could impact cash flows. A few respondents support this approach because, in their view, future changes cannot be reliably predicted and including such information would be subject to significant management judgement. (See paragraph 30 below.)
25. The staff note that economic and market conditions are dynamic and change over time in cycles.⁶ Changes in these conditions typically impact future cash flows. It is not uncommon for entities to take these changes in conditions into account in estimating expected credit losses. Some respondents commented that estimates of expected loss should include expectations of future changes in economic and market conditions beyond the reporting date. For example, many entities use forward looking information such as forward curves and forecasts of future changes in economic growth rates, unemployment rates and collateral values (eg real estate prices) etc in estimating of future credit losses.
26. Some respondents also commented that not factoring in future changes may not give a true indication of expected future cash flows and the recognition of losses could be delayed. Some have also pointed out that assuming no change of

⁵ See paragraphs BC22-BC24.

⁶ The cycles are not uniform but change themselves, though.

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conditions is tantamount to a forecast that is certain not to eventuate as conditions always change. Hence, the reasonableness of (implicitly) mandating such a forecast is highly questionable.

27. The staff note that if changes in economic and market conditions that could impact cash flows are considered in pricing of the financial assets (and therefore priced into the contractual interest rate), then those expected changes in conditions should also be considered in estimating future credit losses.
28. If cash flow (loss) estimates are restricted so that they do not include the effect of future changes in economic conditions then the expected losses omit or overstate some credit losses. Therefore, expected losses would convey an incomplete picture of the profitability and the pricing of the financial asset. Hence, it would be inconsistent with the initial measurement of the asset. The effect is similar to the inconsistency caused by an outlook period that is shorter than the remaining life of the asset (see paragraph 12), albeit resulting from a different way of limiting the scope of the estimate (ie by prohibiting the estimate of changes in conditions rather than curtailing the outlook period).

Alternative 3 – consider all reasonable and supportable information and conditions ('full scope' expected loss)

29. A third alternative is to not limit the use of any available information (that is reasonable and supportable) and take into account future changes in economic and market conditions so that the overall profitability of the financial assets can be faithfully represented.
30. Some respondents are concerned about the flexibility this alternative would provide to management and therefore the lack of rigour in forecasting. These respondents are concerned that the longer the period over which such projections would have to be made, the less reliable the estimates will be and the less evidence there will be to support them. A few respondents are concerned that undue optimism or pessimism in setting expectations could result in volatility that is not related to actual economic conditions. A few respondents argue that

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by allowing entities to consider all available information, it allows entities to speculate on future events and conditions.

31. Respondents who support this alternative commented that inherently, expected credit losses must take into consideration loss events which are expected to occur in the future. Most respondents who support alternative 3 also commented that the changes in expectations must be based upon reasonable forward looking expectations and should be supportable.
32. The staff note that IAS 36 *Impairment of Assets* requires that an entity for calculating value in use:⁷

base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the *range* of economic conditions that *will exist* over the *remaining useful life* of the asset. Greater weight shall be given to external evidence.
[emphasis added]

33. Hence, IAS 36 requires cash flow projections that are based on management's estimates of economic conditions that will exist in the future as well as the range of different possible outcomes. The staff note that this estimate of future economic conditions often goes well beyond only a short-term assessment because the remaining useful life of the non-financial assets assessed for impairment under IAS 36 is often long-term (eg for larger machinery, buildings and particularly for cash generating units such as entire production plants).
34. For time horizons up to five years IAS 36 requires management to use its forecasts to project cash flows. However, if justified by a track record of past estimates, that period can be longer.⁸ The staff consider that because cash flows generated by non-financial assets are not contractually pre-set over the life of the asset cash flow projections for them are subject to many more assumptions than for financial assets and hence more difficult. Therefore, limiting cash flow projections for the purpose of impairment testing financial assets more than for non-financial assets is unwarranted.

⁷ IAS 36.33(a).

⁸ IAS 36.33(b).

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35. For cash flow projections beyond the period covered by forecasts IAS 36 envisages the use of a steady or declining growth rate (including growth rates that turn negative in the future). The staff note that the decision whether to use a declining growth rate (and if so, what decline) means that management has to anticipate future changes (in the growth rate) even for periods beyond that covered by forecasts. IAS 36 also envisages the use of an increase in the rate (future positive changes) if the rate matches objective information about patterns over a product or industry lifecycle.⁹
36. Hence, IAS 36 does not restrict the use of any information but requires entities to consider whether the information used reflects reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset.¹⁰
37. A few respondents also noted that internally generated information on credit quality derived from the entity's experience of actual credit history may be used to support the entity's assessment of recoverable cash flows for financial assets. Interest rate yield curves that are derived from market prices of debt instruments can also provide the entity with information as to the future expectation of interest rates.
38. The staff note that in order to portray the economic profitability faithfully, expected losses should be determined such that they are consistent with how financial assets are priced. If changes in future conditions that could impact cash flows are considered in pricing of the financial assets (and therefore priced into the contractual interest rate), the effect of these changes in future conditions should therefore be considered in estimating future credit losses.
39. The staff also consider that excluding future changes in economic conditions is not warranted given there are circumstances in which it is appropriate to include forecasts and only that reflects the economics of the transaction. For example,

⁹ IAS 36.36.

¹⁰ IAS 36.38.

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forcing entities to exclude future changes in economic conditions means prohibiting any trend analysis.

40. Hence, the staff consider that the expected loss estimate should be ‘full scope’, ie without curtailing the estimate regarding the information that can be considered or the outlook period, including the period for which changes in economic conditions can be considered.

Staff recommendation

41. Of the three alternatives, the staff first dismiss a through-the-cycle approach because through-the-cycle parameters do not portray the economic characteristics of the recognised financial assets (rather it portrays the economic characteristics of the past credit cycle/s).
42. Next the staff dismiss an approach that restricts cash flow estimates so that they do not include any effects of future changes in economic conditions. Conceptually, such an approach creates problems similar to those that limit the outlook period, which defeats the objective of aligning the accounting with the economic phenomenon. Likewise, the staff believes that such an approach will simply recreate many of the problems we have today with an incurred loss impairment approach. Furthermore, such a restriction is inconsistent with IAS 36.
43. The staff recommends that in determining lifetime expected loss entities consider all information and conditions (past, current and future), if this is consistent with how financial assets are priced, and reflects reasonable and supportable assumptions that represent management’s best estimate of the set of economic conditions that will exist over the remaining life of the financial assets. This approach allows entities to portray the economic profitability of the lending transactions faithfully and is also consistent with estimating cash flow projections for calculating value in use in IAS 36.

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Question 2– Conditions to consider when calculating expected loss

Does the Board agree with the staff recommendation that in determining lifetime expected loss entities should consider all information and conditions (past, current and future) provided the assumptions are based on reasonable and supportable information (ie alternative 3)?

If not, what conditions should be considered and why?