Project	**Financial Instruments: Replacement of IAS 39**
Topic	**Amortised Cost and Impairment – Cover paper**

Background

1. Since July 2010, the Board has been considering how to address the feedback received on the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the ED). In summary, the feedback received was that most respondents agreed with a more forward-looking impairment approach based on expected credit losses, but that the expected cash flow model proposed in the ED was operationally difficult.

2. As noted in previous papers, the staff (as well as many respondents) believe that the model proposed in the ED faithfully represents the underlying economics included in the pricing of financial instruments and is consistent with the amortised cost measurement in IFRSs. However, the staff believe the Board needs to consider how the proposed approach should be altered to address the significant operational challenges identified. Most notably, with open portfolios. As a result, to date the Board has made tentative decisions and provided direction during redeliberations to proceed with developing an approach for open portfolios that:

    (a) is based on ***lifetime*** expected loss (EL);

    (b) considers ***all*** reasonable and supportable information (including specific projections of future conditions) when calculating EL;

    (c) allocates the EL estimate over the lifetime for performing or 'good' loans using a ***time-proportionate approach***; and

(d) uses a non-integrated (ie ***'decoupled'***) approach when allocating the lifetime EL and recognising interest revenue.

3. The Board has already discussed the general *mechanics* and particular unique implications of several decoupling methods for allocating EL estimates[1]. The Board has also discussed several different general alternatives for credit impairment jointly with the Financial Accounting Standards Board (FASB)[2].

4. As a result of these discussions, the Boards agreed at the 17 November 2010 joint meeting to further develop and jointly discuss the following approaches[3]:

   (a) *Alternative Model 2*: Immediate recognition of losses expected to occur in a shorter emergence period (ie period over which most losses occur).

   (b) *Alternative Model 4*: Recognition of lifetime expected credit losses using a time-proportionate approach and a 'good' / 'bad' book.

   (c) *Alternative Model 5*: Time-proportionate approach with notional sub-portfolios to accelerate recognition of expected losses and a 'good' / 'bad' book.

5. It is important to note that **Alternative Model 5 is an overlay, or modification, of Model 4**. Model 5 was proposed in response to the concern regarding some loss patterns, and that Model 4 may result in the impairment allowance being inadequate in early periods in some circumstances. Some companies may have reliable data suggesting that losses in particular portfolios are expected to emerge in an accelerated or front-loaded manner (eg 90% of the losses are expected to emerge in the first two years of a five-year portfolio). Model 5 would then be used as a time-proportionate approach which accelerates loss recognition (by dividing the portfolio into notional sub-portfolios).

6. Because Model 5 is a modification of Model 4 (and would only be used when the loss pattern is accelerated)[4], the following agenda papers are written in the

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[1] See agenda paper 3 of the 5 October 2010 meeting, agenda papers 9, 9A, 9B of October 2010 meeting.
[2] See joint agenda papers 1, 1B, 1C from 10-12 November 2010 and joint agenda papers 13, 13A, 13B from 17 November 2010 meeting.
[3] See joint agenda papers 13, 13A, and 13B from 17 November 2010 meeting.

context of allowing the staff to further develop Model 4. Because Model 5 is an overlay, this work will also allow the staff (indirectly) to further develop Model 5. As discussed at the 17 November 2010 joint meeting, Models 2, 4 and 5 will be further jointly discussed in the near term in order to address the specific Alternatives' issues once they are more fully developed.

7. The agenda papers for this meeting focus on some specific considerations for the amortised cost and impairment model, including:

   (a) Agenda paper 1A—Scope of a revised exposure draft related to whether short-term trade receivables should be excluded and addressed later in the project to align with the revenue recognition project.

   (b) Agenda paper 1B—Whether a specific decoupled allocation method should be required in a time-proportionate model (ie straight-line approach or discounted cash flow annuity approach).

   (c) Agenda paper 1C—Definition of 'good' book / 'bad' book in a 'good' book / 'bad' book approach. For example, what principles should govern when to transfer amounts from a 'good' book to a 'bad' book. (This paper may not be discussed at this meeting).

   (d) Agenda paper 1D—Whether different methods are warranted for a single instrument versus a portfolio approach, or will the approach outlined for open portfolios be operational (and appropriate) for single instruments, as well. (This paper may not be discussed at this meeting).

8. The papers above provide analysis around the various topics in order to put the Board in the position of making a decision if/when requested. **At this time, the staff do not request any decisions.** Rather, to further develop the tentative approach in an **<u>efficient</u>** way, the staff would like some direction from the Board.

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[4] Model 4 would be used when the loss pattern is unknown, expected to be relatively even over the life, or expected to be heavier at the end of the life.