February 2010

ARG MEETING 24 FEBRUARY 2010
AGENDA PAPER 4

International Financial Reporting Standards

ED Financial Instruments: Amortised Cost and Impairment

2010

IASC Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASC Foundation or the IASB

IAS 39 Replacement – other related phases Timetable

Project phase	Publications	Finalisation
1. Classification and measurement	IFRS 9 published 12 November 2009	In time for 2009 year end financial statements for financial assets In 2010 for financial liabilities
2. Amortised cost and impairment	**November 2009** **Comments due by 30 June 2010**	**In 2010**
3. Hedge accounting (Board deliberations ongoing)	Target first quarter 2010	In 2010

* The above is in addition to a project on derecognition of financial instruments. ED *Derecognition* was published in March 2009.

IAS 39 Replacement – other related phases

Overview of classification model - IFRS 9 *for financial assets only*

Entity's business model for managing

+

Contractual cash flow characteristics

›

Amortised cost (one impairment method)

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FVO for accounting mismatch (option)

Reclassification required when business model changes

All other instruments:

- Equities
- Derivatives
- Some hybrid contracts
- …

›

Fair Value (No impairment)

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Equities: OCI presentation available (alternative)

Current state: Incurred loss impairment

IAS 39 requires an incurred loss approach for financial assets

- What does that mean?

  Impairment loss only recognised when:

  - Trigger (loss) event occurs
  - Impact can be reliably estimated

- Consequence:
  Expected losses not recognised before trigger events

Expected cash flow approach

- Main features:
  - interest revenue is recognised on the basis of expected cash flows (including initial expected credit losses)
  - impairment results from an *adverse change* in credit loss expectations
  - reversal of impairment loss when expectations change *favourably*
  - re-estimation of expected cash flows each period end

An example…

- A pool of 100 loans with nominal amount of 10,000 per loan
- Contractual interest rate of 10%
- Maturity of 5 years
- Credit loss adjusted expected interest rate from the loan portfolio is 7% using the effective interest rate method.
- Under the current incurred loss model interest would be recognised at 10%.
- At t2, cash flows were revised to reflect higher per annum defaults than originally expected.

Cash flows

1,200,000.00
1,000,000.00
800,000.00
600,000.00
400,000.00
200,000.00
0.00

Currency units

1
2
3
4
5

Period

Initial expected CF
Contractual CF

Income statement effect

120,000.00
100,000.00
80,000.00
60,000.00
40,000.00
20,000.00
0.00
-20,000.00
-40,000.00
-60,000.00
-80,000.00
-100,000.00

Currency units

1 2 3 4 5

Period

Net interest (inc loss) | Credit loss (inc loss) | Net interest (ECF) | Credit loss (ECF)

Balance sheet effect

1,050,000.00
1,000,000.00
950,000.00
900,000.00
850,000.00
800,000.00

Currency units

1 2 3 4 5

Period

C/A (inc loss) C/A (ECF)

Proposed impairment method: Expected cash flow (ECF) approach

Main outcomes of the ECF approach include:

- Earlier recognition of impairment loss
- Eliminates front loading of interest revenue
- Better reflects underlying economics (eg pricing of instruments when lending decision is made)

Presentation

Presentation (face of income statement)

- Contractual interest revenue
  -- Allocation of initial expected credit losses
  = Economic interest revenue (credit cost adjusted)
- Effect of changes in expectations
- Interest expense

Disclosure

Disclosure

Expected credit losses

- ❑Allowance account
- ❑Estimates and/or changes in estimates
- ❑ Loss triangle
- ❑ Others

Quality of assets

- ❑Reconciliation of changes in non-performing assets
- ❑Vintage information

Transition and effective date

Transition

- Does not propose fully retrospective or prospective transition
- Adjust the effective interest rate to approximate the rate that would have been determined at inception using the ECF approach

Effective date

- Around 3 years after final standard with early (voluntary) application permitted

Next steps

- Expert Advisory Panel is set up to explore how operational challenges of the ECF approach might be resolved
- Comment deadline : **30 June 2010**
- Final standard: 2010

Questions

- Does the IASB's proposal provide more useful information for your analysis?
- Given the proposed disclosure requirements, would the management judgement (and possibly P&L volatility) resulting from the proposed model be acceptable to you?
- What are the top 3 disclosures about impairment and/or credit quality that you would like to see in the quarterly financial reports that are currently not required?

Questions

The IASB's proposal is to separately present contractual interest revenue before taking into account the effect of allocating initial expected credit losses.

There are 2 ways of doing this:

(a)on a gross contractual basis (blue line in the next slide)*

(b)on a net basis (pink line in the next slide)**

Which alternative do you prefer?

*multiply the contractual interest rate with the gross contractual balance of the loan

** multiply the contractual interest rate with the net balance (ie after deducting credit losses)

Questions

Presentation of interest
Principal amount: 10,000; Coupon: 12%; Maturity: 10yrs
Actual default higher than initially expected

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.