Project	**Financial instruments: impairment**
Topic	**Cover paper and examples**

Please note that this paper has been reposted on 11 April to correct a minor oversight in the examples presented. In each of the scenarios, Alternatives 2 and 3 representing the different methods for unwinding the discount did not reflect the appropriate net interest revenue amount in Year 1. Each scenario, and both Alternatives 2 and 3, should show 80 as the net interest revenue in year 1. No other changes were made to the paper

Introduction and purpose of paper

1. In January 2011, the International Accounting Standards Board (IASB) and US-based Financial Accounting Standards Board (FASB) issued the joint supplementary document *Financial Instruments: Impairment* (SD) – a supplement to their original exposure drafts (original EDs) which addressed the impairment of financial assets[1]. The comment period for the SD ended 1 April 2011.

2. During the comment period, using feedback already received, the boards discussed issues related to the original EDs that are not within the scope of the SD. Decisions made by the boards during the comment period will be updated, if necessary, based on feedback received and the outcome of other redeliberations related to the SD.

3. Although these papers are being discussed at a meeting after the comment period ended, the papers were drafted during the comment period and relate to issues in the original EDs and not within the scope of the SD. Therefore, feedback received related to the original EDs was utilised in drafting the papers.

4. The papers to be discussed during this meeting are:

[1] The original IASB ED *Financial Instruments: Amortised Cost and Impairment* (original IASB ED), was issued in November 2009. The FASB Proposed Accounting Standard Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (original FASB ED) was issued in May 2010, and included proposals for the impairment of financial assets.

(a) IASB AP 4A/FASB Memo 83 – Interest income recognition and definition of amortised cost;

(b) IASB AP 4B/ FASB Memo 84 – Discounted versus undiscounted expected losses

(c) IASB AP 4C/FASB Memo 85 – Non-accrual principle

(d) IASB AP 4D/FASB Memo 86 – Comment letter summary

(e) IASB AP 4E/FASB Memo 87 – Outreach activities summary

Examples for IASB AP 4A-4C/FASB Memos 83-85

Background

5. The issues discussed in IASB agenda papers 4A-4C / FASB memos 83-85 are interrelated and build on one another. The staff thought it would be helpful to provide some basic examples with numbers to help understand how the issues in AP 4A and 4B/Memos 83 and 84 relate and to illustrate the alternatives to be considered.

6. The discussion relates to originated loans and loans purchased into the 'good book' so the effective interest rate (EIR) used in the examples is based on contractual cash flows (ie it excludes expected credit losses).

7. Agenda paper 4A discusses how to calculate interest revenue (ie whether the amortised cost to which the effective interest is applied should include or exclude credit losses). Two alternatives are presented:

(a) **Alternative 1 (AP 4A)**: A reduction for a credit impairment allowance would not be included when calculating amortised cost.

(b) **Alternative 2 (AP 4A)**: A reduction for a credit impairment allowance would be included when calculating amortised cost.

The staff recommend Alternative 1. So, that alternative is the basis for the illustrated examples.

8. Agenda paper 4B discusses whether you discount the expected loss calculation when determining the impairment balance. The paper describes two broad approaches and identifies a follow-on issue for either approach:

(a) **Alternative A (AP 4B)**: Measure expected losses as **principal only** on an **undiscounted** basis. Follow-on issue would be whether necessary and, if so, how to apply nonaccrual guidance.

(b) **Alternative B (AP 4B)**: Measure expected losses as **all shortfalls** in cash flows (both principal and interest) on a **discounted** basis. Follow-on issue is how to present the unwind of the discount on the impairment allowance in the financial statements. Three possible approaches:

(i) **Alternative 1 (AP 4B) –** include in the impairment losses line item;

(ii) **Alternative 2 (AP 4B) –** show interest revenue line based purely on the originally calculated EIR and the carrying amount of asset *ignoring any losses* and show unwinding of the discount on the impairment amount (ie interest on the impairment amount) separately below the interest revenue line coming to a net interest revenue amount; or

(iii) **Alternative 3 (AP 4B) –** show interest revenue as a single *net* item (combining the interest revenue and the unwind of the interest on the impairment amount) in the income statement and disclose the components (as described in Alternative 2) in the notes to the financial statements.

9. The examples summarise the financial statement impacts of the following combinations:

(a) Undiscounted loss estimates with nonaccrual guidance; and

(b) Discounted loss estimates with the three alternatives in IASB agenda paper 4B/FASB memo 84.

Assumptions

10. The examples assume (for simplicity) that initially all cash flows are expected to be received. At the end of year 1, the expectations are updated and then stay unchanged for the remainder of the life. It is also assumed all payments occur annually at the end of the year.

11. All scenarios have a 5 year bullet loan, principal amount of CU 1,000 with an EIR of 8% based on the full contractual cash flows. The examples assume (for simplicity) that initially all cash flows are expected to be received, until expectations change at the end of year 1 (as described in the various scenarios below). Again, for simplicity, it is assumed all of the impairment loss is immediately recognised (so as if it relates to the foreseeable future period in the 'good book' under the SD). The initial expected cash flows:

Year	**1**	**2**	**3**	**4**	**5**
Beginning loan amount	1,000	1,000	1,000	1,000	1,000
Interest accrued	80	80	80	80	80
Payment expected	(80)	(80)	(80)	(80)	(1,080)
Ending loan amount	1,000	1,000	1,000	1,000	0

12. **Scenario 1:** At the end of year 1, assume that no more interest is expected but principal is expected in full. (Note: This example is designed to show the mechanics of the 3 Alternatives. The assumptions in the example, particularly that an entity would conclude that the principal is not impaired and would not seek expedited collection of the outstanding balance, are not meant to be reflective of actual behavior in practice.)

13. **Scenario 2:** Assume rateable cash shortfalls (ie 20% shortfall of all cash flows expected to occur). Note: this is the only scenario where using an undiscounted principal amount results in the same financial statement outcomes as using a discounted principal and interest amount.

14. **Scenario 3:** Assume both principal and interest are impaired, but at different rates (10% interest shortfall, and 25% principal amount expected over remaining life)

15. Paragraphs 17-19 below show the effects on the financial statements of each of the scenarios and the various alternatives.

16. Paragraphs 20-22 provide the details behind the amounts presented in paragraphs 15-17.

17. Scenario 1 – Year 2: Interest-only loss, but principal will be received

Scenario 1 – Alternative A (AP 4B) – Undiscounted principal only and non-accrual											
Balance sheet						**Income statement**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0	**Interest revenue**	80	80	80	80	80
Allowance for losses						**Non-accrual**		(80)	(80)	(80)	(80)
Net carrying amount	1,000	1,000	1,000	1,000	0	**Interest revenue presented**	80	0	0	0	0
						Impairment losses	0	0	0	0	0

Scenario 1 – Alternative B (AP 4B) – Discounted principal and interest					
Balance sheet					
	1	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0
Allowance for losses	(265)	(206)	(143)	(74)	0
Net carrying amount	735	794	857	926	0

Scenario 1 – Alternative B (AP 4B) – Discounted principal and interest																	
Income statement																	
Alternative 1 (4B)						**Alternative 2 (4B)**						**Alternative 3 (4B)**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross interest revenue	80	80	80	80	80	**Gross interest revenue**	80	80	80	80	80						
						Unwind of discount		(21)	(16)	(11)	(6)						
						Net interest revenue	80	59	64	69	74	**Net interest revenue**	80	59	64	69	74
Impairment loss	265	21	16	11	6	**Impairment loss**	265					**Impairment loss**	265				

18. Scenario 2 – Year 2: Rateable loss, 20% of all payments (principal and interest) expected not to occur

Scenario 2 – Alternative A (AP 4B) – Undiscounted principal only and non-accrual											
Balance sheet						**Income statement**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0	Interest revenue	80	80	80	80	80
Allowance for losses	(200)	(200)	(200)	(200)	0	Non-accrual		(16)	(16)	(16)	(16)
Net carrying amount	800	800	800	800	0	Interest revenue presented	80	64	64	64	64
						Impairment losses	200	0	0	0	0

Scenario 2 – Alternative B (AP 4B) – Discounted principal and interest					
Balance sheet					
	1	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0
Allowance for losses	(200)	(200)	(200)	(200)	0
Net carrying amount	800	800	800	800	0

Scenario 2 – Alternative B (AP 4B) – Discounted principal and interest																	
Income statement																	
Alternative 1 (4B)						**Alternative 2 (4B)**						**Alternative 3 (4B)**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross interest revenue	80	80	80	80	80	**Gross interest revenue**	80	80	80	80	80						
						Unwind of discount		(16)	(16)	(16)	(16)						
						Net interest revenue	80	64	64	64	64	**Net interest revenue**	80	64	64	64	64
Impairment loss	**200**	**16**	**16**	**16**	**16**	**Impairment loss**	**200**					**Impairment loss**	**200**				

19. Scenario 3 – Year 2: Non-rateable loss, 10% of interest and 25% of principal expected not to occur

Scenario 3 – Alternative A (AP 4B) – Undiscounted principal only and non-accrual											
Balance sheet						**Income statement**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0	**Interest revenue**	80	80	80	80	80
Allowance for losses	(250)	(250)	(250)	(250)	0	**Non-accrual**		(8)	(8)	(8)	(8)
Net carrying amount	750	750	750	750	0	**Interest revenue presented**	80	72	72	72	72
						Impairment losses	250	0	0	0	0

Scenario 3 – Alternative B (AP 4B) – Discounted principal and interest					
Balance sheet					
	1	**2**	**3**	**4**	**5**
Gross Balance	1,000	1,000	1,000	1,000	0
Allowance for losses	(210)	(219)	(229)	(239)	0
Net carrying amount	790	781	771	761	0

Scenario 3 – Alternative B (AP 4B) – Discounted principal and interest																	
Income statement																	
Alternative 1 (4B)						**Alternative 2 (4B)**						**Alternative 3 (4B)**					
	1	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**
Gross interest revenue	80	80	80	80	80	**Gross interest revenue**	80	80	80	80	80						
						Unwind of discount		(17)	(18)	(18)	(19)						
						Net interest revenue	80	63	62	62	61	**Net interest revenue**	80	63	62	62	61
Impairment loss	210	17	18	18	19	**Impairment loss**	210					**Impairment loss**	210				

20. Scenario 1 – Year 2: Interest-only loss, but principal will be received

Alt A (4B) – Undiscounted principal only with nonaccrual									**Alt B (4B) – Discounted principal and interest**					
Year		**1**	**2**	**3**	**4**	**5**	**Total**		**1**	**2**	**3**	**4**	**5**	**Total**
Expected cash flows			0	0	0	1,000				0	0	0	1,000	
Shortfall expected			80	80	80	80				80	80	80	80	
Expected losses (principal only)		0	0	0	0	0								
Expected losses (PV of shortfall at 8%)									265	206	143	74	0	
Amortised cost excludes credit losses														
Amortised cost balance														
Amortised cost (excl. loss)		1,000	1,000	1,000	1,000	1,000			1,000	1,000	1,000	1,000	1,000	
Interest accrued **(P&L)**	**A**	80	80	80	80	80	400	**D**	80	80	80	80	80	400 **D**
Original payment expected		(80)	(80)	(80)	(80)	(80)			(80)	(80)	(80)	(80)	(80)	
Write-off/Payment						(1,000)							(1,000)	
End Amort Cost (excl. loss)	**F**	1,000	1,000	1,000	1,000	0			1,000	1,000	1,000	1,000	0	
Expected Losses/Allowance														
Allowance balance			0	0	0	0				265	206	143	74	
Nonaccrual **(P&L)**	**B**		80	80	80	80	320	**E**		0	0	0	0	0 **E**
Unwinding **(P&L)**	**B**		0	0	0	0	0	**E**		21	16	11	6	55 **E**
Shortfall principal and interest			0	0	0	0				(80)	(80)	(80)	(80)	
Ending allowance balance	**G**	0	0	0	0	0			265	206	143	74	0	
							80	**=D-E**						345 **=D-E**
Impairment losses **(P&L)**	**C**	0					0		265					(265)
Net P&L	**=A-B-C**	**80**	**0**	**0**	**0**	**0**	**80**		**(185)**	**59**	**63**	**69**	**74**	**80**
Ending carrying amount	**=F-G**	**1,000**	**1,000**	**1,000**	**1,000**	**0**			**735**	**794**	**857**	**926**	**0**	

21. Scenario 2 – Year 2: Rateable loss, 20% of all payments (principal and interest) expected not to occur

Alt A (4B) – Undiscounted principal only with nonaccrual									**Alt B (4B) – Discounted principal and interest**						
Year		**1**	**2**	**3**	**4**	**5**	**Total**		**1**	**2**	**3**	**4**	**5**	**Total**	
Expected cash flows			64	64	64	864				64	64	64	864		
Shortfall expected			16	16	16	216				16	16	16	216		
Expected losses (principal only)		200	200	200	200	0									
Expected losses (PV of shortfall at 8%)									200	200	200	200	0		
Amortised cost excludes credit losses															
Amortised cost balance															
Amortised cost (excl. loss)		1,000	1,000	1,000	1,000	1,000			1,000	800	800	800	800		
Interest accrued **(P&L)**	**A**	80	80	80	80	80	400	**D**	80	80	80	80	80	400	**D**
Original payment expected		(80)	(80)	(80)	(80)	(80)			(80)	(80)	(80)	(80)	(80)		
Write-off/Payment						(1,000)							(1,000)		
End Amort Cost (excl. loss)	**F**	1,000	1,000	1,000	1,000	0			1,000	1,000	1,000	1,000	0		
Expected Losses/Allowance															
Allowance balance			200	200	200	200				200	200	200	200		
Nonaccrual **(P&L)**	**B**		16	16	16	16	64	**E**		0	0	0	0	0	**E**
Unwinding **(P&L)**	**B**		0	0	0	0	0	**E**		16	16	16	16	64	**E**
Shortfall principal and interest			0	0	0	0				(16)	(16)	(16)	(216)		
Ending allowance balance	**G**	200	0	0	0	0			200	200	200	200	0		
							336	**=D-E**						336	**=D-E**
Impairment losses **(P&L)**	**C**	200					(200)		200					(200)	
Net P&L	**=A-B-C**	**(120)**	**64**	**64**	**64**	**64**	**136**		**(120)**	**64**	**64**	**64**	**64**	**136**	
Ending carrying amount	**=F-G**	**800**	**800**	**800**	**800**	**0**			**800**	**800**	**800**	**800**	**0**		

22. Scenario 3 – Year 2: Non-rateable loss, 10% of interest and 25% of principal expected not to occur

Alt A (4B) – Undiscounted principal only with nonaccrual									**Alt B (4B) – Discounted principal and interest**					
Year		**1**	**2**	**3**	**4**	**5**	**Total**		**1**	**2**	**3**	**4**	**5**	**Total**
Expected cash flows			72	72	72	822				72	72	72	822	
Shortfall expected			8	8	8	258				8	8	8	258	
Expected losses (principal only)		250	250	250	250	0								
Expected losses (PV of shortfall at 8%)									210	219	229	239	0	
Amortised cost excludes credit losses														
Amortised cost balance														
Amortised cost (excl. loss)		1,000	1,000	1,000	1,000	1,000			1,000	800	800	800	800	
Interest accrued **(P&L)**	**A**	80	80	80	80	80	400	**D**	80	80	80	80	80	400 **D**
Original payment expected		(80)	(80)	(80)	(80)	(80)			(80)	(80)	(80)	(80)	(80)	
Write-off/Payment						(1,000)							(1,000)	
End Amort Cost (excl. loss)	**F**	1,000	1,000	1,000	1,000	0			1,000	1,000	1,000	1,000	0	
Expected Losses/Allowance														
Allowance balance			250	250	250	250				210	219	229	239	
Nonaccrual **(P&L)**	**B**		8	8	8	8	32	**E**		0	0	0	0	0 **E**
Unwinding **(P&L)**	**B**		0	0	0	0	0	**E**		17	18	18	19	72 **E**
Shortfall principal and interest			0	0	0	0				(63)	(62)	(62)	(258)	
Ending allowance balance	**G**	250	0	0	0	0			210	219	229	239	0	
							368	**=D-E**						328 **=D-E**
Impairment losses **(P&L)**	**C**	250					(250)		210					(210)
Net P&L	**=A-B-C**	**(170)**	**72**	**72**	**72**	**72**	**118**		**(130)**	**64**	**64**	**64**	**64**	**118**
Ending carrying amount	**=F-G**	**750**	**750**	**750**	**750**	**0**			**790**	**781**	**771**	**761**	**0**	