



To:	AASB members	Date:	27 January 2011
From:	Christina Ng	Agenda Item:	8.1
Subject:	Impairment - financial assets measured at amortised cost	File:	

Action

Note key differences (set out in this memo) between the IASB's forthcoming supplemental impairment model and the IASB's original ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*.

Consider staff preliminary observations in Agenda Paper 8.2 to assist staff in formulating the basis of the AASB's submission to the IASB's forthcoming supplemental document.

Background

1. IASB ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* was issued in November 2009 to seek comments on a proposed expected loss model. The model proposed an approach that incorporates the assessment for impairment based on expected losses into the measurement of amortised cost financial assets via the calculation of effective interest rates (EIR).
2. Since July 2010, the IASB has been considering how to address the comments received on ED/2009/12. The IASB noted that most respondents agreed with a more forward-looking impairment approach based on expected losses. AASB's overall position was not in support of the expected loss model proposed in ED/2009/12 for both conceptual and operational reasons. An issue raised by the AASB and many others relates to the operational difficulties in implementing the proposed measurement/impairment model, most notably, for financial assets managed in an open portfolio, including variable rate financial assets. Variable rate financial assets are commonly managed on an open portfolio basis in Australia.
3. The IASB decided to consider how the proposed measurement/impairment approach in ED/2009/12 should be revised to address the operational challenges when accounting for open portfolio financial assets, as a priority, and has since developed a new (or supplemental)

impairment model. However, the IASB's forthcoming supplemental document specifically scopes-out issues concerning variable rate instruments.

4. Based on the comments received, the IASB has found that many entities manage their assets using a 'good' book/'bad' book approach (Agenda paper 8.3) and therefore built its supplemental impairment model based on this method. Staff have identified some key features of the supplemental impairment model (provided in the following table) based on the IASB's tentative decisions to date.

Table: Key features between ED/2009/12 and supplemental impairment models

Topic	ED/2009/12	Supplemental document to ED/2009/12
Measurement model	Expected loss based on expected cash flow model	Expected loss based on 'good' book/'bad' book model (Agenda paper 8.3)
Scope	All financial instruments measured at amortised cost	Only financial assets managed in open portfolio
Allocation of loss method and loss recognition in P&L	<ul style="list-style-type: none"> Initial expected losses – recognised/spread through the life of the instrument Subsequent expected losses – recognised immediately 	<ul style="list-style-type: none"> No distinction between initial and subsequent expected losses Expected loss determined by: <ul style="list-style-type: none"> ➤ good book¹: the higher of: <ul style="list-style-type: none"> - expected losses recognised over the life of instruments using a time-proportionate² method; and - losses expected to occur within the foreseeable future and no less than 12 months after the reporting date; and ➤ bad book³: all expected losses recognised immediately
Discount rate	Initial expected losses embedded in effective interest rate (EIR) [that is, IAS 39 EIR less initial expected loss]	Between the risk free rate and IAS 39 EIR (in order to facilitate the calculation of an EIR that brings forward losses)
Allowance amount on balance sheet	Allowance balance grows consistently over the life of instruments and adjusted for changes in estimates	Allowance balance covers (i) at least next 12 months of 'good' book losses and (ii) all of 'bad' book losses
Presentation on face of P&L	<ul style="list-style-type: none"> Gross interest (based on IAS 39 EIR) (Less) Initial expected loss Net interest Changes in estimates of expected loss (Impairment) 	<ul style="list-style-type: none"> Gross interest (based on IAS 39 EIR) Impairment

1 Performing assets are generally kept in the 'good' book.

2 Under the (lifetime) time-proportionate approach, the expected loss is allocated over the total life of the portfolio of the 'good' book by building up an allowance that at each measurement date is equal to a proportion of the current expected loss estimate determined on the basis of the portfolio time period that has passed (i.e. the life-to-date) divided by the total life.

3 Non-performing assets are generally in the 'bad' book.

5. The IASB has commenced drafting proposals on the supplemental impairment model as a 'supplemental document' to the original ED/2009/12 and intends to publish it by the end of January 2011. The IASB expects to use the comments received on the supplemental document and the original ED/2009/12 to determine whether a single impairment model should be applied to all financial assets or whether multiple impairment models should be developed for different types of financial assets (for example, trade receivables, single instruments and loans managed in closed portfolios).
6. Staff have identified some observations on the IASB's supplemental impairment model (Agenda paper 8.2) for discussion at the February 2011 AASB meeting. These observations are based on the IASB's tentative decisions to date. Preliminary issues and views might be presented verbally at the AASB meeting.

Next steps

7. Staff will provide a verbal update on any further issues that emerge from key features of the supplemental impairment model.
8. The IASB supplemental document will have a comment period of 60 days and is expected to be issued by the time of the AASB's February 2011 meeting. Given that the next AASB meeting is on 16-17 March 2011, staff propose that an AASB submission on the supplemental document be finalised out-of-session with the assistance of a subcommittee of AASB members.

Attachments

Agenda paper 8.2 – Staff observations on the IASB forthcoming supplemental impairment model

Agenda paper 8.3 – How financial institutions manage and assess credit risk and the notion of 'good' book/'bad' book

IASB Supplemental Document to ED/2009/12 (to be emailed to Board members, assuming the document is published before the February 2011 meeting)