AASB 9-10 June 2010
Agenda paper 5.3

AASB Exposure Draft

ED 189
November 2009

Financial Instruments: Amortised Cost and Impairment

Comments to AASB by 17 May 2010

Australian Government

Australian Accounting
Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 17 May 2010. This will enable the AASB to consider Australian constituents’ comments in the process of formulating its own comments to the IASB, which are due by 30 June 2010. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Respondents to the IASB are asked to send their comments electronically through the ‘Open to Comment’ page on the IASB website (www.iasb.org)

All non-confidential submissions to the AASB will be made available to the public on the AASB website: www.aasb.gov.au.

Obtaining a Copy of this AASB Exposure Draft

This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

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AASB REQUEST FOR COMMENTS

In light of the Australian Accounting Standards Board's (AASB's) policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached International Accounting Standards Board (IASB) Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft. In particular, constituents are asked to comment on, in each question, whether the proposals are acceptable conceptually and are practicable—whether in the context of a financial institution or a non-financial institution; and

(b) the 'AASB Specific Matters for Comment' listed below.

The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

AASB Due Process

Comments should be submitted to the AASB by 17 May 2010. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

In addition to seeking written comments, the AASB plans to hold roundtables in Melbourne and Sydney in March 2010 to provide a forum for constituents and Board members to discuss the proposals included in the Exposure Draft. The locations and specific dates will be detailed on the AASB's website at http://www.aasb.gov.au/News/Upcoming-events.aspx.

The AASB, together with fellow members of the Asian-Oceanian Standard-Setters Group (AOSSG), are also considering the Exposure Draft jointly to provide input from the region to the IASB. The AOSSG is a grouping of accounting standard-setters in the Asian-Oceanian region.

The AASB also plans to meet with key constituents early in the exposure period to discuss the likely impact of the proposals, including their practical implications for both financial institutions and for entities with trade receivables. The AASB also invites constituents to contact the AASB staff with issues concerning the proposals early in the comment period to help facilitate its work with the AOSSG.

AASB Specific Matters for Comment

1. The AASB would particularly value comments on whether:

   (a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

      (i) not-for-profit entities; and

      (ii) public sector entities;

   (b) overall, the proposals would result in financial statements that would be useful to users; and

   (c) the proposals are in the best interests of the Australian and New Zealand economies.

November 2009

Exposure Draft ED/2009/12

Financial Instruments: Amortised Cost and Impairment

Comments to be received by 30 June 2010

International
Accounting Standards
Board®

Exposure Draft

FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

Comments to be received by 30 June 2010

ED/2009/12

This exposure draft *Financial Instruments: Amortised Cost and Impairment* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **30 June 2010.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction and invitation to comment

Reasons for publishing the exposure draft

IN1 IAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The International Accounting Standards Board inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.

IN2 Many users of financial statements and other interested parties have told the Board that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged the Board to develop a new standard of financial reporting for financial instruments that is principle-based and less complex. Although the Board has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.

IN3 In October 2008, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis, the Board joined with the US Financial Accounting Standards Board (FASB) in setting up the Financial Crisis Advisory Group (FCAG). The FCAG was asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The FCAG published a report in July 2009. In that report the FCAG identified delayed recognition of losses associated with loans (and other financial instruments) and the complexity of multiple impairment approaches as primary weaknesses in accounting standards and their application. One of the FCAG's recommendations was to explore alternatives to the incurred loss model that use more forward-looking information.

IN4 Earlier, in April 2009, in response to the input received as a result of their work responding to the global financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the Board with the FASB announced an accelerated timetable for replacing their respective financial instruments standards.

The IASB's approach to replacing IAS 39

IN5 The Board noted requests from interested parties that the accounting for financial instruments should be improved quickly. The G20 leaders recommended that the Board take action by the end of 2009 to improve and simplify the accounting requirements for financial instruments. To achieve this, the Board divided its project to replace IAS 39 into three main phases. As the Board completes each phase, it will delete the relevant portions of IAS 39 and, along with its current project on the derecognition of financial instruments, create an IFRS that will eventually replace IAS 39. The Board published an exposure draft on derecognition in March 2009. As part of the first phase of replacing IAS 39 the Board published an exposure draft on classification and measurement in July 2009.

IN6 This exposure draft proposes requirements for how to include credit loss expectations in the amortised cost measurement of financial assets. The Board decided to address this aspect as the second phase because the classification and measurement decisions from the first phase form the foundation for the measurement basis (including impairment). Moreover, as a result of its deliberations on impairment the Board decided to seek input on the feasibility and operational aspects of the expected cash flow approach before publishing an exposure draft. In June 2009 a Request for Information was posted on the IASB's website inviting views from interested parties by 1 September 2009. The IASB staff also obtained additional input on operational aspects through an extensive outreach programme.

IN7 Responses to the Request for Information and the outreach programme particularly highlighted the difficulty of deriving estimates of expected cash flows over the life of the financial asset, which requires using historical data that might be difficult to obtain or not exist. However, the Board observed that estimation uncertainty and the necessity for management to use significant assumptions and judgement are not unique to the estimates of expected cash flows for the purpose of amortised cost measurement of financial instruments. IAS 1 *Presentation of Financial Statements* sets out several examples in the section about sources of estimation uncertainty. For example, other areas of financial reporting that often necessitate estimates involving management's difficult, subjective or complex judgement include estimating the recoverable amount of non-financial assets, provisions dependent on the outcome of litigation, restoration or decommissioning obligations that relate to actions that will be taken decades after the measurement date reflecting technology that will be available in the future, insurance obligations and pension obligations. The Board also noted that deriving fair values when observable market prices are not available also requires significant assumptions and judgement. The Board plans to seek the advice of an expert advisory panel (see paragraph IN12) on the nature and extent of guidance necessary to derive the estimates of expected cash flows over the life of a financial asset.

IN8 This exposure draft also addresses some of the concerns that the FCAG identified in its report. The proposed requirements would use more forward-looking information than the incurred loss model. They would also result in earlier recognition of credit losses because they avoid the delay resulting from the 'loss event' threshold of the incurred loss model.

Presentation of the contents of this exposure draft

IN9 The proposals in this exposure draft would replace the amortised cost (including impairment) requirements in IAS 39 for financial instruments. The proposals would also result in consequential amendments to other IFRSs and to the guidance on those IFRSs. For the convenience of readers, all proposed amendments are set out in this booklet. The Basis for Conclusions is set out in a separate booklet.

IN10 In order to promote discussion of the proposals, the publication of the exposure draft is accompanied by numerical examples of the calculation mechanics on the IASB website (in the section for the project to replace IAS 39, second phase regarding impairment of financial assets). The examples were prepared by the IASB staff and do not form part of this exposure draft.

Next steps

IN11 The Board plans to develop an IFRS from the proposals in this exposure draft. The Board expects that the IFRS will be published in 2010 and would be available for early application. However, the Board expects that the IFRS will not become mandatory until about three years after it is issued. This reflects the Board's acknowledgement that implementing the proposed approach would require a substantial lead-time.

IN12 The Board also plans to form an expert advisory panel that will advise the Board on the operational aspects of implementing the proposals and help the Board to undertake some field testing. That panel would also help the Board identify further practical expedients.

IN13 The Board and the FASB are committed to working together to develop a comprehensive standard to improve the measurement and reporting of financial instruments. The Board has chosen to complete the project in three phases. However, the FASB believes that it will be important to its constituents to be able to comment on a proposed standard including classification, measurement, impairment and hedge accounting at the same time. It is not uncommon for the boards to deliberate separately on joint projects and then subsequently to reconcile any differences in their technical decisions.

Summary of the proposals and invitation to comment

The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

(a) respond to the questions as stated

(b) indicate the specific paragraph or paragraphs to which the comments relate

(c) contain a clear rationale

(d) describe any alternatives the Board should consider.

The Board is not seeking comments on aspects of IAS 39 not addressed in this exposure draft.

Comments should be submitted in writing so as to be received no later than **30 June 2010**.

Objective of amortised cost measurement (paragraphs 3–5)

The exposure draft proposes stating the objective of amortised cost measurement. The proposed description of the objective is 'to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument.' The exposure draft further expands on that objective by clarifying:

- that amortised cost is a measurement that combines current cash flow information at each measurement date with a valuation of those cash flows that reflects conditions on initial recognition of the financial instrument; and
- the types of amounts that are allocated over the expected life of the financial instrument (including for a financial asset the initial estimate of expected credit losses).

Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

Measurement principles (paragraphs 6–10)

The exposure draft proposes to underpin the objective of amortised cost measurement with measurement principles. These are:

(a) Amortised cost shall be calculated using the effective interest method. Hence, amortised cost is the present value of the expected cash flows over the remaining life of the financial instrument discounted using the effective interest rate.

(b) The estimates of the cash flows are expected values at each measurement date. Hence, estimates of amounts and timing of cash flows are the probability-weighted possible outcomes.

(c) The effective interest method is the allocation mechanism for interest revenue and interest expense. The effective interest rate used for this purpose reflects the nature of the financial instrument's interest (type of interest formula), ie what part of the contractual interest rate (if any) is reset.

The requirements in IAS 39 for calculating amortised cost and the effective interest rate are mainly included in the definition of terms and some paragraphs in the application guidance. The definitions in IAS 39 are, in essence, measurement guidance rather than a definition. Most of the guidance reflects application of the effective interest method to fixed rate instruments. The exposure draft would establish principles for the amortised cost calculation and elevate some guidance to the main body of the standard. The lengthy definitions in IAS 39 would be shortened. The measurement principles would apply to both fixed rate and variable rate instruments. Overall, the exposure draft would provide a more principle-based approach to establishing measurement requirements for amortised cost.

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

Objective of presentation and disclosure (paragraphs 11 and 12)

The exposure draft proposes stating the objective of presentation and disclosure in relation to financial instruments measured at amortised cost. The proposed description of the objective is providing 'information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense, and the quality of financial assets including credit risk.' The exposure draft further emphasises the importance of explaining to users of the financial statements the overall effect on the entity's performance and financial position and the interaction between different aspects of the information provided (including a discussion of the causes of both that overall effect and any interaction between different aspects).

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

Presentation (paragraph 13)

The exposure draft proposes the following line items to be separately presented in the statement of comprehensive income:

(a) gross interest revenue (calculated using the effective interest method before taking into account expected losses);

(b) the effect of allocating the initial expected credit losses, which shall be presented as a reduction of gross interest revenue (item (a) above);

(c) net interest revenue (the subtotal of items (a) and (b) above);

(d) gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost; and

(e) interest expense (calculated using the effective interest method).

The measurement approach proposed in the exposure draft would require an entity to take into account the initial estimate of expected credit losses when calculating amortised cost and to allocate that amount over the expected life of a financial asset. The proposed presentation requirements reflect that proposed measurement approach and are designed to provide transparency about the different factors that affect interest revenue, interest expense and experience adjustments from revising cash flow estimates.

Question 6

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

Disclosure (paragraphs 14–22)

In order to meet the objective for disclosures (see Questions 5 and 6) the exposure draft proposes to require:

(a) mandatory use of an allowance account to account for credit losses with disclosure of a reconciliation and the entity's write-off policy.

(b) disclosures about estimates and changes in estimates, including:

   (i) information about inputs and assumptions used in determining credit losses;

   (ii) disaggregation of gains and losses resulting from changes in estimates and an explanation of those changes; and

(iii) information that compares the development of the credit loss allowance over time with cumulative write-offs together with a qualitative analysis if the effect of changes in estimates is significant.

(c) disclosure of stress testing information if an entity prepares such information for internal risk management purposes.

(d) disclosures about the quality of financial assets that reconcile changes in an entity's non-performing assets with supplementary qualitative information.

(e) information about the origination and maturity of financial assets (vintage information).

The exposure draft would require disclosures about amounts presented in the statement of comprehensive income, inputs and assumptions used for determining credit loss estimates, and the quality of financial assets measured at amortised cost. The proposed disclosure requirements reflect that the amounts in the statement of financial position and the statement of comprehensive income, in isolation, are not sufficient to allow users of financial statements to evaluate the effects of financial instruments on an entity's financial position and performance as well as its related risk exposures.

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

Effective date and transition (paragraphs 23–29)

The Board will review the effective date in due course, but expects that the IFRS will not become mandatory until about three years after it is issued. The Board expects to permit early application of the IFRS.

The exposure draft proposes specific requirements in paragraphs 24–27 for transition to the proposed IFRS. In its deliberations leading to the exposure draft, the Board also considered an alternative simplified transition approach that would use the original effective interest rate determined in accordance with IAS 39 rather than an adjusted effective interest rate as set out in paragraph 25 (alternative transition approach). The Board preferred the proposed approach because it provides more relevant information. The discount rate used in the proposed approach is closer to the effective interest rate that would have been determined in accordance with the proposed measurement approach had it been applied retrospectively. The Board believed the benefit of more relevant information would outweigh the additional complexity and cost of preparing that information. The Board also considered providing an exemption from the requirement to provide comparative information in accordance with the proposed requirements in the year of initial application. However, the Board believed that the benefit of comparative information that uses the proposed requirements would outweigh the additional complexity and cost of preparing that information.

The exposure draft also proposes specific disclosure requirements in paragraphs 28 and 29 in relation to transition.

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

Question 9

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

Practical expedients (paragraphs B15–B17)

The exposure draft proposes guidance on practical expedients for calculating amortised cost. It sets out principles that practical expedients would have to be consistent with and provides two examples of practical expedients:

(a) using a provision matrix for trade receivables.

(b) using two separate present value calculations to determine amortised cost.

The exposure draft includes practical expedients in order to facilitate cost-effective ways of determining amortised cost for situations in which a simplified calculation is an appropriate approximation of the outcome that would result from applying the effective interest method as proposed in the exposure draft.

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

[Draft] International Financial Reporting Standard X *Financial Instruments: Amortised Cost and Impairment* ([draft] IFRS X) is set out in paragraphs 1–29 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Financial Instruments: Amortised Cost and Impairment*

Objective

1 The objective of this [draft] IFRS is to establish principles for the measurement at *amortised cost* of *financial assets* and *financial liabilities* that will present useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows. The principles in this [draft] IFRS complement the principles for recognising, classifying, measuring, presenting and providing disclosures about financial assets and financial liabilities in IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*.

Scope

2 This [draft] IFRS shall be applied to all items within the scope of IAS 39 that are measured at amortised cost.

Subsequent measurement at amortised cost

Objective of amortised cost measurement

3 The objective of amortised cost measurement is to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the *financial instrument*.

4 For the purpose of this cost-based measurement the effective return is determined on the basis of the initial expectations about cash flows over the expected life of the financial asset or financial liability and its initial carrying amount. Hence, amortised cost is a measurement that combines current cash flow information at each measurement date with a valuation of those cash flows that reflects conditions on initial recognition of the financial instrument.

5 The effective return reflects an allocation over the expected life of the instrument of fees, points paid or received, *transaction costs* and other premiums or discounts as well as the initial estimate of expected credit losses on a financial asset.

Measurement principles

6 Amortised cost shall be calculated using the *effective interest method*. Hence, amortised cost is the present value calculated using the following inputs:

(a) the expected cash flows over the remaining life of the financial instrument; and

(b) the *effective interest rate* as the discount rate.

7 Amortised cost reflects at each measurement date current inputs regarding the cash flow estimates. As a cost-based measurement, amortised cost also reflects an input relating to initial measurement, which is the effective interest rate to the extent that it is not contractually reset to current conditions (eg the effective interest rate of a fixed rate financial instrument or a constant spread of a variable rate financial instrument).

8 The estimates for the cash flow inputs are expected values. Hence, estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes.

9 The cash flow inputs used for amortised cost are based on expected cash flows because the objective is to provide information about the effective return.

10 The effective interest method determines the allocation of interest revenue and interest expense. The effective interest rate used for this purpose reflects how the contract sets the interest payments for the financial instrument (ie what part of the contractual interest rate, if any, is reset).

The proposed presentation and disclosure requirements are included in the exposure draft together with the related measurement requirements in order to facilitate understanding of the proposals. In finalising [draft] IFRS X the Board may treat the presentation and disclosure requirements as amendments of IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*, respectively.

Presentation and disclosure

Objective of presentation and disclosure

11 An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense, and the quality of financial assets including credit risk.

12 In order to meet this objective an entity shall:

(a) provide as a minimum the information required by paragraphs 13–22; and

(b) provide the information in a way that explains to users of the financial statements the overall effect on the entity's performance and financial position and the interaction between different aspects of the information provided. Such an explanation shall include a discussion of the causes of both the overall effect and the causes of any interaction between different aspects of the information provided.

Presentation

13 The statement of comprehensive income shall include line items that present the following amounts for the period:

(a) gross interest revenue (calculated using the effective interest method before taking into account the allocation of the initial estimate of expected credit losses).

(b) the portion of initial expected credit losses allocated to the period, which shall be presented as a reduction of gross interest revenue (item (a) above).

(c) net interest revenue (the subtotal of items (a) and (b) above).

(d) gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost.

(e) interest expense (calculated using the effective interest method).

Disclosure

Classes of financial instruments and level of disclosure

14 When this [draft] IFRS requires disclosures by class of financial asset or financial liability, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments.

An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Allowance account

15 **For financial assets measured at amortised cost an entity shall use an allowance account to account for credit losses. An entity shall disclose for each class of financial assets:**

(a) a reconciliation of changes in that account during the period; and

(b) its *write-off* policy.

Estimates and changes in estimates

16 **An entity shall disclose information that explains estimates and changes in estimates that are required to determine amortised cost.**

17 An entity shall explain the inputs and assumptions used in determining expected credit losses. For this purpose an entity shall disclose:

(a) the basis of inputs (eg internal historical information or rating reports) and the estimation technique used to determine initial expected credit losses;

(b) if changing one or more of the inputs to reasonably possible alternative assumptions would significantly change the initial expected credit loss or subsequent changes in credit loss:

(i) that fact; and

(ii) the effect of those changes and how it was derived;

(c) for changes in estimates, an explanation of what estimates have changed, the cause of the change and the new inputs and assumptions used; and

(d) if there has been a change in estimation technique, disclosure of that change and the reason for the change.

18 Paragraph 13(d) requires separate presentation in the statement of comprehensive income of the gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost. An entity shall explain those gains and losses. For this purpose an entity shall disclose:

(a) a disaggregation of these gains and losses into:

(i) the amount attributable to changes in estimates of credit losses; and

(ii) the amount attributable to other factors (eg changes in estimates of prepayment rates).

(b) further quantitative and qualitative analyses for these gains and losses if:

(i) these gains and losses have a significant effect on profit or loss; or

(ii) a particular portfolio, period of origination or geographical area has significant effects on these gains and losses.

19 An entity shall disclose for each class of financial assets:

(a) a comparison between the development of the credit loss allowance over time and cumulative write-offs; and

(b) a qualitative analysis of the effect of changes in credit loss estimates on this comparison if that effect is significant.

Stress testing

20 If an entity prepares stress testing information for internal risk management purposes it shall disclose that fact and information that enables users of financial statements to understand:

(a) the implications for the financial position and performance of the entity; and

(b) the entity's ability to withstand the stress scenario or scenarios.

Credit quality of financial assets

21 For financial assets measured at amortised cost an entity shall disclose for each class of financial assets:

(a) a reconciliation of changes in *non-performing* **financial assets during the period; and**

(b) a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account if that interaction is significant.

Origination and maturity (vintage) information

22 For financial assets measured at amortised cost an entity shall disclose for each class of financial assets information showing the year of origination and the year of maturity (vintage information).

Effective date and transition

Effective date

23 An entity shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies this [draft] IFRS in its financial statements for a period before [date to be inserted after exposure], it shall disclose that fact and at the same time apply the amendments set out in Appendix C.

Transition

24 For the purposes of the transitional provisions in paragraphs 25–29, the date of initial application is the beginning of the annual period for which an entity first applies the requirements in this [draft] IFRS.

25 For financial instruments measured at amortised cost that were initially recognised before the date of initial application of this [draft] IFRS the objective is to approximate the effective interest rate that would have been determined in accordance with this [draft] IFRS if it had applied on initial recognition of the financial instrument. This is accomplished by applying an effective interest rate transition adjustment to the effective interest rate previously determined in accordance with IAS 39.

26 In determining the effective interest rate transition adjustment an entity shall use all available historical data and supplement them as needed with information for similar financial instruments for which the effective interest rate is determined in accordance with this [draft] IFRS (ie financial instruments initially recognised around the date of initial application).

27 An entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if this [draft] IFRS had always been applied but use as the effective interest rate the rate previously determined in accordance with IAS 39 adjusted for the effective interest rate transition adjustment.

Disclosure

28 In explaining the effect of the initial application of this [draft] IFRS in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* an entity shall provide a qualitative analysis of:

(a) the effect on profit or loss that results from the difference between the effective interest rate determined in accordance with this [draft] IFRS (including the transition requirements in paragraphs 24–27) and the rate used in accordance with the entity's previous accounting policy; and

(b) how that effect (item (a) above) relates to the amount of the transition adjustment to the amortised cost of financial assets.

29 In applying paragraph 19, an entity need not disclose information about periods before the earliest prior period presented.

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

The following terms are defined in paragraph 11 of IAS 32 or paragraph 9 of IAS 39 and are used in this [draft] IFRS with the meanings specified in IAS 32 or IAS 39:

(a) fair value

(b) financial asset

(c) financial instrument

(d) financial liability

amortised cost A cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense.

effective interest method A method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) that uses the effective interest rate.

effective interest rate The rate that (or spread that, in combination with the interest rate components that are reset in accordance with the contract,) exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or financial liability.

non-performing The status of a financial asset that is more than 90 days past due or is considered uncollectible.

transaction costs Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

write-off A direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery and has ceased any further enforcement activities.

Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

Measurement principles (paragraphs 6–10)

Amortised cost

B1 Amortised cost is the amount at which a financial asset or financial liability is measured at initial recognition adjusted over time as follows:

(a) minus principal repayments;

(b) plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount; and

(c) plus or minus any addition or reduction resulting from the effect of revising estimates of expected cash flows (eg regarding prepayments or uncollectibility) at each measurement date.

The initial measurement adjusted as set out above results in the carrying amount that is the present value of the expected cash flows over the remaining life of the financial instrument discounted using the effective interest rate (see paragraph 6) at the respective measurement date.

B2 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual cash flows and the revised estimate of expected cash flows. In accordance with paragraph 6, the entity recalculates the carrying amount by computing the present value of expected cash flows (on the basis of the revised estimate) using the financial instrument's effective interest rate. Any adjustment is recognised in profit or loss and presented in the statement of comprehensive income in accordance with paragraph 13(d).

Expected cash flows

B3 The cash flow inputs used for amortised cost are expected cash flows. In accordance with paragraph 8 the estimates are derived as expected values. An entity shall estimate the expected cash flows considering:

(a) all contractual terms of the financial instrument (eg prepayment, call and similar options);

(b) fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*) to the extent they are not included in the initial measurement of the financial instrument; and

(c) for financial assets, credit losses over the entire life of the asset.

For financial liabilities estimates of expected cash flows do not reflect the entity's own non-performance risk.

B4 For the purpose of calculating amortised cost the expected cash flows may be estimated on a collective basis (eg on a group or portfolio level) or an individual basis. The basis for estimates may be changed during the life of a financial asset. For example, after a default or addition to a watch list, a financial asset may be removed from a portfolio and added to a different portfolio or the expected cash flows may be estimated individually for that financial asset. Irrespective of whether expected cash flows are estimated on a collective or an individual basis the estimate is always an expected value (see paragraph 8).

B5 When an entity determines whether it estimates expected cash flows on a collective or an individual basis it shall:

(a) use the approach that provides the best estimate; and

(b) ensure that the approach used does not result in double-counting of credit losses.

B6 For the purpose of estimating on a collective basis the effect of credit losses on expected cash flows, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (eg on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of expected cash flows for groups of such assets by indicating the debtors' ability to pay all amounts due according to the contractual terms of the financial assets being evaluated.

B7 In estimating the effect of credit losses on expected cash flows entities may use various sources of data, which may be internal or external. For example, possible data sources are internal historical credit loss experience, internal ratings, credit loss experience of other entities, and external ratings, reports and statistics. Entities that have no entity-specific credit loss experience or insufficient experience may use peer group experience for comparable financial assets (or groups of financial assets).

B8 Historical data such as credit loss experience are adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical data are based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in expected cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial asset or in the group of financial assets and their magnitude). The methodology and assumptions used for estimating the effect of credit losses on expected cash flows are reviewed regularly to reduce any differences between estimates and actual credit loss experience.

B9 When using historical credit loss rates in estimating expected cash flows, it is important that information about historical credit loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical credit loss rates were observed. Therefore, the method used shall enable each group to be associated with information about past credit loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

B10 The estimate of expected cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable. Any collateral obtained as a result of foreclosure is not recognised as an asset separate from the collateralised financial asset unless it meets the recognition criteria for an asset in other IFRSs.

Allocation mechanism for interest revenue and interest expense

B11 In accordance with paragraph 10 the effective interest rate reflects how the contract sets the interest payments for the financial instrument. The effective interest rate is first determined on initial recognition of a financial instrument. The effective interest rate is determined in relation to the component or components that are reset in accordance with the contract. For example:

(a) for a fixed rate financial instrument the effective interest rate is the discount rate that results in a present value of the expected cash flows (determined in accordance with paragraph B3) that equals the carrying amount (ie the initial measurement) of the financial instrument (initial effective interest rate).

(b) for a floating rate financial instrument that resets a benchmark interest component (eg LIBOR plus 100 basis points) the effective interest rate is not determined as a single constant rate. Instead, a combination of the spot curve[*] for the benchmark interest rate and a spread is used for discounting. This spread is derived by iteration so that the present value of the expected cash flows (determined in accordance with paragraph B3) equals the carrying amount (ie the initial measurement) of the financial instrument (initial effective spread).

B12 Contractual resets of the interest cash flows of a financial instrument alter the effective interest rate to the extent that the interest rate is adjusted (and in relation to the component or components affected). For example:

(a) for a fixed rate financial instrument no component of the contractual interest is reset. Hence, the effective interest rate remains constant over the life of the financial instrument (ie the initial effective interest rate is used to calculate amortised cost at each measurement date).

(b) for a floating rate financial instrument that resets a benchmark interest component (eg LIBOR plus 100 basis points), periodic re-estimation of cash flows to reflect changes in the benchmark interest rate alters the effective interest rate in relation to that benchmark component. This means that the spot curve for the benchmark interest rate is updated while the initial effective spread remains constant. Hence, each cash flow of the floating rate financial instrument is discounted using a rate that is the combination of:

(i) the applicable spot rate for each cash flow date; plus

(ii) the initial effective spread.

B13 The effective interest method generally allocates by way of amortisation any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the financial instrument. However, if the period to which the fees, points paid or received, transaction costs, premiums or discounts relate is a shorter period than the expected life of the instrument these amounts are allocated over that shorter period. The effect of that allocation is an adjustment to the interest revenue or interest expense for the financial instrument over that shorter period.

[*] The spot curve is alternatively referred to as the zero coupon curve.

For example, the relevant allocation period is shorter than the instrument's expected life when a premium or discount on a variable rate instrument reflects changes in the benchmark rate since the variable interest rate was reset. In that case, the appropriate allocation period is the period to the next such reset date. If, however, the premium or discount results from, for example, a change in credit risk compared with that reflected in the credit spread over the variable rate specified in the instrument it is allocated over the expected life of the instrument or the period to any earlier reset of the credit spread that reflects a repricing to then current conditions. For other variables or amounts that are not reset to market rates such as transaction costs the relevant allocation period is the expected life of the instrument.

B14 If the terms of a financial instrument are renegotiated or otherwise modified because of financial difficulties of the debtor, any impairment is measured by calculating amortised cost using the effective interest rate before the modification of terms. Any resulting adjustment of the carrying amount is recognised in profit or loss and presented in the statement of comprehensive income in accordance with paragraph 13(d).

Practical expedients

B15 An entity may use practical expedients in calculating amortised cost if their overall effect is immaterial. Practical expedients shall be consistent with the following principles:

(a) the calculation incorporates the effect of the time value of money (except for cash flows relating to short-term receivables if the effect of discounting is immaterial);

(b) the calculation includes all expected cash flows for all of the remaining life of the financial instrument (not only for some part of the remaining maturity); and

(c) the calculation results in a present value that equals the initial measurement of the financial instrument (ie the calculation does not give rise to a loss because of a difference between the initial measurement of a financial instrument and its carrying amount determined using the practical expedient at that point in time).

B16 An example of a practical expedient is determining the amortised cost of trade receivables using a provision matrix. The entity would use its historical loss experience on trade receivables to estimate the expected credit losses. A provision matrix might, for example, specify fixed provision rates depending on the number of days a receivable is past due (eg 3 per cent if less than 90 days, 20 per cent if 90–180 days etc). Depending on the diversity of its customer base the entity would use appropriate grouping if its historical loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geography, product type, customer rating, collateral or trade credit insurance, or type of customer (such as wholesale or retail). Assuming that the trade receivables are without a stated interest rate and are so short-term that the effect of discounting is immaterial (see paragraph B15(a)), the entity would not impute interest. Hence, for those trade receivables the entity would neither determine an effective interest rate nor recognise any interest revenue. Instead, the entity would measure the trade receivables on initial recognition at their invoice amount less the initial estimate of undiscounted expected credit losses, which would also be their amortised cost at that point in time (see paragraph B15(c)). The initial estimate of undiscounted expected credit losses would be treated as a reduction of the invoice amount in determining the revenue to which the trade receivable relates (eg from the sale of goods).

B17 Entities may also use practical expedients for the allocation over the expected life of a financial asset of the initial estimate of expected credit losses in lieu of the effective interest method if the difference in the outcomes of that method and the alternative allocation mechanism is immaterial. For example, an entity might determine amortised cost using two separate present value calculations:

(a) the first calculation determines amortised cost excluding the effect of expected credit losses; and

(b) the second calculation determines the present value of expected credit losses (as a separate calculation) using a discount rate that is different from the effective interest rate (eg a risk-free rate). The entity determines an amortisation profile for the present value of the initial estimate of expected credit losses and accounts for the amortisation charge for the period as a reduction of the interest revenue that arises from the first calculation (see (a) above). Any change in the present value of expected credit losses as a result of revising the estimate of expected credit losses is recognised in profit or loss and presented as gains and losses resulting from changes in estimates (see paragraph 13(d)).

Presentation (paragraph 13)

B18 Items that refer to amounts calculated using the effective interest method shall include only amounts that:

(a) are interest in accordance with that method; or

(b) represent the effect on interest revenue or interest expense of hedging relationships that qualify for hedge accounting.

B19 Any amounts other than those in paragraph B18 shall not be included in items that refer to amounts calculated using the effective interest method. Examples are:

(a) foreign exchange gains or losses.

(b) gains or losses in relation to hedging transactions that do not qualify for hedge accounting.

(c) gains or losses from derecognition of financial assets or liabilities.

(d) fees or transaction costs that are not included in determining the effective interest rate.

(e) interest received or paid on financial instruments not classified as amortised cost (eg coupon interest received on a bond that is held for trading purposes).

Disclosure

Classes of financial instruments and level of disclosure (paragraph 14)

B20 Paragraph 14 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. These classes are determined by the entity and are, thus, distinct from the measurement categories of financial instruments (which determine how financial instruments are measured and where changes in fair value are recognised).

B21 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this [draft] IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Allowance account (paragraph 15)

B22 The reconciliation of changes in the allowance account for credit losses shall reconcile the balances at the beginning and end of the period showing at a minimum:

(a) increases resulting from the allocation of initial expected credit losses, ie amounts presented as a reduction of gross interest revenue in accordance with paragraph 13(b);

(b) increases resulting from changes in estimates of expected credit losses, ie amounts included in the gains and losses presented in accordance with paragraph 13(d);

(c) decreases resulting from changes in estimates of expected credit losses, ie amounts included in the gains and losses presented in accordance with paragraph 13(d); and

(d) write-offs.

B23 An entity shall include all write-offs in the reconciliation of changes in the allowance account (ie on a gross basis as both an addition to and a use of the allowance account). This applies even if a financial asset becomes impaired and is written off in the same period. Hence, direct write-offs against the contractual amount of financial assets without using an allowance account are prohibited.

Comparison of loss allowance with cumulative write-offs (paragraph 19)

B24 The comparison of the development of the credit loss allowance over time with cumulative write-offs shall be provided in tabular format (an example of a possible format is provided below).

Year of origination	20X1	20X2	20X3	20X4	Total
	CU	CU	CU	CU	CU[*]
Credit loss provision (cumulative):					
At the end of the origination year	xx	xx	xx	yy	
One year later	xx	xx	yy		
Two years later	xx	yy			
Three years later	yy				
Gross provision for credit losses (before write-offs)	yy	yy	yy	yy	zz
Cumulative write-offs as a result of delinquencies	xx	xx	xx	xx	zz
Cumulative write-offs as a result of foreclosures	xx	xx	xx	xx	zz
Total cumulative write-offs	zz	zz	zz	zz	zz
Net provision for credit losses (gross provision for credit losses less cumulative write-offs)	zz	zz	zz	zz	zz

B25 The qualitative analysis of the effect of changes in credit loss estimates on this comparison is a narrative explanation of the causes of the development and how they relate to the write-offs.

[*] In this [draft] IFRS, monetary amounts are denominated in 'currency units (CU)'.

Stress testing information (paragraph 20)

B26 The information that an entity provides about stress testing would typically include (but is not limited to):

(a) how such stress tests are conducted;

(b) a description of the stress scenario used and the related assumptions; and

(c) the outcome of the stress testing, including any significant conclusions.

Credit quality of financial assets (paragraph 21)

B27 The reconciliation of changes in non-performing financial assets shall reconcile the nominal amounts at the beginning and end of the period showing at a minimum:

(a) increases resulting from reclassifications of performing loans as non-performing (ie deterioration of credit quality);

(b) increases resulting from acquisition of non-performing loans;

(c) decreases resulting from recoveries through enforcing securities;

(d) decreases resulting from recoveries due to payments of the debtor;

(e) renegotiations; and

(f) write-offs.

B28 The qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account is a narrative explanation of how the two types of changes relate to each other and any common causes of the changes.

Origination and maturity (vintage) information (paragraph 22)

B29 The information showing the year of origination and maturity shall be provided:

(a) on the basis of nominal amounts; and

(b) in tabular format (an example of a possible format is provided below).

	Year of origination				
	20X1	20X2	20X3	20X4	Total
	CU	CU	CU	CU	CU
Maturity					
20X3	xx	xx	xx		zz
20X4	xx	xx	xx	xx	zz
20X5	xx	xx	xx	xx	zz
20X6		xx	xx	xx	zz
20X7		xx		xx	zz
20X8				xx	zz
Total	zz	zz	zz	zz	zz

Transition (paragraph 26)

B30 The principle set out in paragraph 26 can be applied in different ways, for example:

(a) by using ratio analysis to infer the effective interest rate transition adjustment using information for similar financial instruments that are initially recognised near the date of initial application of this [draft] IFRS; or

(b) by using the adjustment to the effective interest rate that reflects the effect of allocating the initial expected credit losses that is determined for similar financial instruments that are initially recognised near the date of initial application of this [draft] IFRS. When using this approach an entity shall ensure that the resulting adjusted effective interest rate is not lower than the risk-free interest rate that applied on the date of initial recognition of the financial instrument.

Defined terms

Transaction costs

B31 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Write-off

B32 Write-offs can relate to a financial asset in its entirety as well as portions of a financial asset. For example, after an entity has enforced a security and recovered 30 per cent of a financial asset, the remaining 70 per cent might be written off if the entity does not expect to collect any further amounts from that financial asset.

B33 At the time a financial asset is written off the expected loss would be 100 per cent of the write-off amount. In accordance with paragraph B23 an entity shall not write off any amount without including it as an addition to and a use of the allowance account.

B34 The definition of a write-off means that the entity has no reasonable expectations of recovering the related amount. Therefore, a write-off constitutes a derecognition event.

Appendix C
Amendments to other IFRSs

The amendments in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies this [draft] IFRS for an earlier period, it shall apply these amendments for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

IFRS 7 *Financial Instruments: Disclosures*

C1 Paragraph 16 is deleted. Paragraph 20 is amended and paragraph 44H is added as follows:

Significance of financial instruments for financial position and performance

Statement of comprehensive income

Items of income, expense, gains or losses

20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IAS 39;

(ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified from equity to profit or loss for the period;

(iii) held-to-maturity investments (excluding those separately presented in the statement of comprehensive income in accordance with [draft] IFRS X);

(iv) loans and receivables (excluding those separately presented in the statement of comprehensive income in accordance with [draft] IFRS X); and

(v) financial liabilities measured at amortised cost (excluding those separately presented in the statement of comprehensive income in accordance with [draft] IFRS X);

(b) [deleted] ~~total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;~~

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets or financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;

(d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39~~; and~~.

(e) [deleted] ~~the amount of any impairment loss for each class of financial asset.~~

Effective date and transition

44H [Draft] IFRS X *Financial Instruments: Amortised Cost and Impairment*, issued in [date to be inserted after exposure] deleted paragraph 16 and amended paragraph 20. It also amended paragraph B5 in Appendix B. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies [draft] IFRS X for an earlier period, it shall apply the amendments for that earlier period.

C2 In Appendix B (Application guidance), paragraph B5 is amended as follows:

Significance of financial instruments for financial position and performance

Other disclosure – accounting policies (paragraph 21)

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

(a) for financial assets or financial liabilities designated as at fair value through profit or loss:

(i) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss;

(ii) the criteria for so designating such financial assets or financial liabilities on initial recognition; and

(iii) how the entity has satisfied the conditions in paragraph 9, 11A or 12 of IAS 39 for such designation. For instruments designated in accordance with paragraph (b)(i) of the definition of a financial asset or financial liability at fair value through profit or loss in IAS 39, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph (b)(ii) of the definition of a financial asset or financial liability at fair value through profit or loss in IAS 39, that disclosure includes a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

(b) the criteria for designating financial assets as available for sale.

(c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 38 of IAS 39).

(d) [deleted] ~~when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:~~

~~(i)~~ ~~the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write down, increased directly) and when the allowance account is used; and~~

~~(ii)~~ ~~the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 16).~~

(e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.

(f) [deleted] ~~the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 20(e)).~~

(g) when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 36(d)).

Paragraph 122 of IAS 1 (as revised in 2007) also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

IAS 18 *Revenue*

C3 Paragraph 30 is amended and paragraph 39 is added as follows:

Interest, royalties and dividends

30 Revenue shall be recognised on the following bases:

(a) interest shall be recognised using the effective interest method as set out in ~~IAS 39, paragraphs 9 and AG5–AG8~~ [draft] IFRS X;

(b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and

(c) dividends shall be recognised when the shareholder's right to receive payment is established.

Effective date

39 [Draft] IFRS X *Financial Instruments: Amortised Cost and Impairment*, issued in [date to be inserted after exposure] amended paragraph 30. An entity shall apply that amendment for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies [draft] IFRS X for an earlier period, it shall apply the amendment for that earlier period.

IAS 28 *Investments in Associates*

C4 Paragraph 31 is deleted, paragraphs 32 and 33 are amended and paragraph 41D is added as follows:

Application of the equity method

Impairment losses

31 [Deleted] ~~After application of the equity method, including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of IAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.~~

32 The investor ~~also~~ applies the requirements of IAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.

33 After application of the equity method, including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of IAS 36 *Impairment of Assets* to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate. Because goodwill that forms part of the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36 ~~*Impairment of Assets*~~. Instead,

the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount~~, whenever application of the requirements in IAS 39 indicates that the investment may be impaired~~. An impairment loss recognised in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate. Accordingly, any reversal of that impairment loss is recognised in accordance with IAS 36 to the extent that the recoverable amount of the investment subsequently increases. In determining the value in use of the investment, an entity estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions, both methods give the same result.

Effective date and transition

41D [Draft] IFRS X *Financial Instruments: Amortised Cost and Impairment*, issued in [date to be inserted after exposure] deleted paragraph 31 and amended paragraphs 32 and 33. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies [draft] IFRS X for an earlier period, it shall apply the amendments for that earlier period.

IAS 39 *Financial instruments: Recognition and Measurement*

C5 Paragraphs 58 and AG93 and one heading are amended. In paragraph 9 the definitions of amortised cost of a financial asset or financial liability, effective interest method, and transaction costs, the heading above paragraph 63 and paragraphs 63–65, the heading above paragraph AG5 and paragraphs AG5–AG8, and the heading above paragraph AG84 and paragraphs AG84–AG92 are deleted. Paragraph 108D is added.

Measurement

Impairment and uncollectibility of financial assets

58 **For financial assets that are carried at cost or classified as available for sale an ~~An~~ entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply ~~paragraph 63 (for financial assets carried at amortised cost),~~ paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.**

Effective date and transition

108D [Draft] IFRS X *Financial Instruments: Amortised Cost and Impairment*, issued in [date to be inserted after exposure] amended paragraph 58 and deleted paragraphs 63–65. It also amended paragraph AG93 and deleted paragraphs AG5–AG8 and AG84–AG92. An entity shall apply those amendments for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies [draft] IFRS X for an earlier period, it shall apply the amendments for that earlier period.

C6 In Appendix A (Application guidance), a heading and paragraph AG93 are amended as follows:

Measurement (paragraphs 43–70)

Impairment and uncollectibility of financial assets (paragraphs 58–70)

Interest ~~income~~ revenue after impairment recognition

AG93 Once an available-for-sale financial asset or a group of similar available-for-sale financial assets has been written down as a result of an impairment loss, interest ~~income~~ revenue is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Approval by the Board of *Financial Instruments: Amortised Cost and Impairment* published in November 2009

The exposure draft *Financial Instruments: Amortised Cost and Impairment* was approved for publication by thirteen of the fifteen members of the International Accounting Standards Board. Messrs Garnett and Leisenring voted against publication. Their alternative view is set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Robert P Garnett	
Gilbert Gélard	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
James J Leisenring	
Patricia McConnell	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

[Draft] amendments to guidance on other IFRSs

The following [draft] amendments to guidance on IFRSs are necessary in order to ensure consistency with [draft] IFRS X Financial Instruments: Classification and Measurement *and the related amendments to other IFRSs. In the amended paragraphs, new text is underlined and deleted text is struck through.*

IFRS 7 *Financial Instruments: Disclosures*

IGA1 In the guidance on implementing IFRS 7, the heading above paragraph IG13 and paragraph IG13 are deleted.

IAS 18 *Revenue*

IGA2 In the appendix accompanying IAS 18, example 14 is amended as follows:

Rendering of services

14 *Financial service fees.*

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

(a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognised in profit or loss, the fees are recognised as revenue when the instrument is initially recognised.

(i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IAS 39 is classified as a financial asset 'at fair value through profit or loss'.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs[*] (as defined in ~~IAS 39~~ [draft] IFRS X), are deferred and recognised as an adjustment to the effective interest rate.

(ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IAS 39, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in ~~IAS 39~~ [draft] IFRS X), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

(iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as 'at fair value through profit or loss', the origination fees received are included, with the related transaction costs (as defined in ~~IAS 39~~ [draft] IFRS X) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from

[*] In *Improvements to IFRSs* issued in May 2008, the Board replaced the term 'direct costs' with 'transaction costs' as defined in paragraph 9 of IAS 39. This amendment removed an inconsistency for costs incurred in originating financial assets and liabilities that should be deferred and recognised as an adjustment to the underlying effective interest rate. 'Direct costs', as previously defined, did not require such costs to be incremental.

origination fees and transaction costs relating to the right to provide services, such as investment management services.

(b) *Fees earned as services are provided.*

(i) *Fees charged for servicing a loan.*

Fees charged by an entity for servicing a loan are recognised as revenue as the services are provided.

(ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IAS 39, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

(iii) *Investment management fees.*

Fees charged for managing investments are recognised as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in ~~IAS 39~~ [draft] IFRS X, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

(c) *Fees that are earned on the execution of a significant act.*

The fees are recognised as revenue when the significant act has been completed, as in the examples below.

(i) *Commission on the allotment of shares to a client.*

The commission is recognised as revenue when the shares have been allotted.

(ii) *Placement fees for arranging a loan between a borrower and an investor.*

The fee is recognised as revenue when the loan has been arranged.

(iii) *Loan syndication fees.*

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognised as revenue when the syndication has been completed.

IAS 39 *Financial Instruments: Recognition and Measurement*

IGA3 In the guidance on implementing IAS 39, the Questions and Answers B.24–B.27, E.4.1–E.4.3 and E.4.5–E.4.8 are deleted.

IFRIC 12 *Service Concession Arrangements*

IGA4 In the illustrative examples accompanying IFRIC 12, paragraphs IE3 and IE26 are amended as follows:

Example 1: The grantor gives the operator a financial asset

Arrangement terms

IE3 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year and that the operator expects to collect all cash flows.

Example 3: The grantor gives the operator a financial asset and an intangible asset

Arrangement terms

IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year and that the operator expects to collect all cash flows.

November 2009

Basis for Conclusions
Exposure Draft ED/2009/12

Financial Instruments: Amortised Cost and Impairment

Comments to be received by 30 June 2010

International
Accounting Standards
Board®

Basis for Conclusions on Exposure Draft

FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

Comments to be received by 30 June 2010

ED/2009/12

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Financial Instruments: Amortised Cost and Impairment* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **30 June 2010.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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ALTERNATIVE VIEW

Basis for Conclusions on the exposure draft *Financial Instruments: Amortised Cost and Impairment*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing the proposals in the exposure draft *Financial Instruments: Amortised Cost and Impairment*. Individual Board members gave greater weight to some factors than to others.

BC2 The Board has long acknowledged the need to improve the accounting requirements for financial instruments. In the light of the global financial crisis and the urgent need to improve the accounting for financial instruments and to make it easier for users of financial statements to understand the financial reporting information, the Board proposes to replace IAS 39 *Financial Instruments: Recognition and Measurement* in several phases. In pursuing such an approach, the Board acknowledged the difficulties that might be created by differences in timing between this project and other projects, in particular phase II of the project on insurance contracts.

BC3 In July 2009 the Board published the exposure draft *Financial Instruments: Classification and Measurement* as part of the first phase of its project to replace IAS 39. That exposure draft proposed to replace the classification categories in IAS 39 with two primary measurement categories for financial instruments—fair value and amortised cost. Hence, there would be one single impairment model for financial assets measured at amortised cost. In the light of the responses received on those classification and measurement proposals, and the redeliberations by the Board since, the exposure draft *Financial Instruments: Amortised Cost and Impairment* proposes a new impairment model for the amortised cost category. The Board noted that the global financial crisis revealed significant weaknesses of the incurred loss model in IAS 39.

BC4 The exposure draft proposes requirements for the impairment of financial assets but also for amortised cost measurement as a whole.

BC5 The Board plans to develop an IFRS from the proposals in the exposure draft. The Board expects that the IFRS will be issued in 2010 and would be available for early application. However, the Board expects that the IFRS will not become mandatory until about three years after it is issued.

BC6 The Board is also committed to the convergence of IFRSs and US GAAP requirements for financial instruments. There are many detailed differences between the impairment models in IFRSs and US GAAP, making it impossible to achieve convergence on the basis of existing requirements. The Board will consider publishing for comment any proposals that the US Financial Accounting Standards Board (FASB) may publish, to the extent that they are different from the proposals contained in the exposure draft.

Proposals

Scope

BC7 The Board has not yet reconsidered the scope of IAS 39. The scope of IAS 39 and its interaction with other standards have resulted in some application and interpretation issues. However, in the context of the first phase of the project to replace IAS 39—classification and measurement—the Board decided to address the scope of IAS 39 during a later phase of the project. The Board noted that the scope of IAS 39 had not been raised as a matter of concern during the global financial crisis.

BC8 Hence, like the classification and measurement proposals, the exposure draft incorporates by reference the scope of IAS 39 but limits it to financial instruments that are measured at amortised cost.

Impairment model

BC9 The discussion paper *Reducing Complexity in Reporting Financial Instruments* published in March 2008 asked respondents how financial instruments that would not be measured at fair value should be measured, including when impairment losses should be recognised and how the amount of impairment losses should be measured. Respondents had varied views ranging from preferences for an expected loss model to a modified incurred loss model or retaining the existing requirements in IAS 39.

Criticisms of the incurred loss model

BC10 The incurred loss impairment model in IAS 39 prohibits including any credit loss estimate in determining the effective interest rate. Instead, credit losses are recognised only if there is objective evidence of impairment as a result of a loss event that occurred after initial recognition of the financial asset and the effect of that loss event on the future cash flows can be reliably estimated.

BC11 The incurred loss impairment approach has been criticised for many reasons, including:

(a) The approach is internally inconsistent because expected losses are implicit in the initial measurement of the asset, but not taken into account in determining the effective interest rate used for subsequent measurement. This results in a systematic overstatement of interest revenue in the periods before a loss event occurs. In effect, subsequent impairment losses are in part reversals of inappropriate revenue recognition in earlier periods.

(b) Incurred losses lag expected losses, which creates an information deficiency. Changes in credit risk are not recognised because of the thresholds required to be crossed before recognising any impairment loss. This creates a systematic bias towards late recognition of credit losses that is inconsistent with the cash flow expectations in relation to the financial asset. Once the recognition threshold is crossed the incurred loss model results in a 'cliff effect' whereby an impairment loss is recognised after initial recognition of the financial asset that in part reflects credit losses that were expected (but not recognised) from the outset.

(c) The incurred loss model is inconsistent with how entities make lending decisions—in particular the pricing of financial instruments, which includes a risk premium that is intended to cover credit losses expected to arise from that type of instrument. It is also inconsistent with the risk management of many financial institutions that have an economic perspective of the return on their financial assets and economic capital, which takes into account the effect of credit loss expectations.

(d) If a loss has been incurred it is not always clear when the loss event took place. The incurred loss model's recognition threshold for impairment losses (ie objective evidence as a result of a loss event) has resulted in significant diversity in practice and many application problems. This diversity has significantly undermined comparability.

(e) In some cases, a loss is recognised in profit or loss even though the original expectations have not changed. This is the case if the initial credit loss expectation crystallises so that the expected loss becomes 'incurred'. This results in misleading financial information because it suggests a deterioration in the quality of financial assets while there has been no such change. Hence, the underlying economic phenomenon is not faithfully represented.

(f) It is not clear when to reverse a previously recognised impairment loss.

BC12 The global financial crisis brought many of these criticisms to the fore. In October 2008, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis, the Board joined with the FASB in setting up the Financial Crisis Advisory Group (FCAG). The FCAG was asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The FCAG published a report in July 2009. In that report the FCAG identified delayed recognition of losses associated with loans (and other financial instruments) as a primary weakness in accounting standards and their application. One of the FCAG's recommendations was to explore alternatives to the incurred loss model that use more forward-looking information.

BC13 Many respondents to the Request for Information on the feasibility of the expected cash flow approach (posted on the IASB website in June 2009) also highlighted criticisms of the incurred loss model. The outreach activities conducted by the IASB staff highlighted similar criticisms of the incurred loss model.

BC14 In the light of the criticisms of the incurred loss model the Board discussed two possible alternative impairment approaches for assets measured at amortised cost–an expected loss approach and a fair value-based approach. The Board also considered the relative merits of a statistical or 'dynamic' provisioning approach. The Board's rationale for proposing an expected loss approach and rejecting other approaches is included below.

Impairment based on fair value

BC15 The Board considered an approach whereby an impairment loss would be measured by reference to the fair value of a financial asset at the impairment date. Proponents of that approach argue that fair value is the most relevant measure for impairment loss because it results in the immediate recognition of economic losses. The Board rejected that approach because it believed that measuring an impairment loss using the fair value of a financial asset is inconsistent with a cost-based approach and would introduce undue complexity.

BC16 Amortised cost is calculated using the effective interest method. That method determines the carrying amount and revenue recognition pattern for a financial asset as part of an integrated calculation. The effective interest rate used in recognising revenue is also used in measuring an impairment loss. In that sense, the carrying amount of a financial asset, the associated revenue recognition and impairment calculations are interrelated.

BC17 This would not be the case for a fair value-based impairment approach. Under that approach, the link between the carrying amount, revenue recognition and impairment is broken by the measurement of impairment loss at fair value. As a consequence, the discount rate that reconciles expected cash flows with the carrying amount of the asset is no longer the effective interest rate, which is incompatible with amortised cost measurement.

BC18 The Board noted that any impairment approach based on fair value would in effect require fair value accounting on a contingent basis (ie once the criterion or criteria for impairment have been met). This adds complexity because an impairment trigger would be required. The Board noted that many respondents to the discussion paper of March 2008 highlighted the difficulties in applying impairment indicators.

BC19 An impairment approach based on fair value would also, for a single measurement category, result in a mix of an amortised cost model and a fair value model. This would create significant complexity arising from combining two conceptually very different models. The Board noted that this mixed approach in IAS 39 has created significant complexity, created application problems, and resulted in anomalous revenue recognition in periods subsequent to the impairment date to adjust for the effects of non-credit related factors.

BC20 The Board noted that after an impairment on a fair value basis, either the fair value at that point in time would have to be used as a deemed cost basis or the non-credit related portion of the fair value changes would have to be amortised separately. An approach that resets the cost basis to fair value would require determining a new effective interest rate at that point in time, in effect treating the impairment event as if it were the acquisition of the impaired asset on that date. Any further impairment would again reset the cost basis, which in turn would again override the previous effective interest rate. Hence, the relationship between the measurement basis for revenue recognition and the interest revenue would become meaningless.

BC21 Alternatively, retaining the effective interest rate for revenue recognition purposes would require separate amortisation of the non-credit related portion of the fair value changes. This would result in the relationship between the carrying amount of the financial asset and the related interest revenue breaking down. Any further impairment would complicate this approach as it would require adjusting the amortisation of separately recognised non-credit related amounts.

Through-the-cycle approaches

BC22 The Board also considered through-the-cycle approaches whereby an entity estimates impairment on a portfolio of financial assets using statistical parameters derived from historical credit loss data that cover a full economic cycle or several economic cycles. One of those approaches, 'dynamic provisioning', amounts to increasing provisions for loan losses in 'good times' (when few credit losses are identified) and depleting those reserves in 'bad times' (when credit losses crystallise). Proponents of that approach argue that it results in the earlier recognition of credit losses and a more even distribution of losses over an entire economic cycle, which would mitigate procyclicality. The Board rejected through-the-cycle approaches because they do not use the statistical information to forecast future credit losses but rather rely solely on historical events to set out 'provisioning' levels at the end of the reporting period. This would result in an allowance for credit losses that does not reflect the economic characteristics of the financial assets at the measurement date and recognising an impairment loss on initial recognition of a financial asset.

BC23 The Board noted that the objective of financial reporting is to present useful information to users of financial statements. For information to be useful, it must be neutral and portray the economic characteristics of the recognised financial assets. Recognising an allowance for losses solely on the basis of conditions that may not be predictive of future credit losses amounts to reporting something other than the economic characteristics of the financial assets being measured. For example, applying the cycle-average of credit losses to assets with a shorter life than the economic cycle results in providing for credit losses that would also relate to financial assets that will be originated after the reporting date, ie future lending.

BC24 The Board also noted that 'dynamic provisioning' would result in an allowance based on cycle-average credit losses when a financial asset is first recognised. Therefore, this approach would result in recognising an impairment loss on initial recognition of a financial asset. The Board believed that recognising a loss on initial recognition of the financial asset for financial reporting purposes even though there is no economic loss from the asset in question would result in unfaithfully representing the underlying economic phenomenon.

The proposed approach

BC25 After considering alternative impairment approaches, the Board decided to propose an expected loss approach to determining impairment. The proposals would require an entity to include the initial estimate of the expected credit losses for a financial asset in determining the effective interest rate. Therefore, the initial estimate of the expected credit losses would be allocated over the expected life of the financial asset. Hence, the proposed approach would not result in an impairment loss immediately after initial recognition (as a result of using amortised cost for subsequent measurement). Instead, under the proposed approach impairment losses would result only after initial recognition of the financial asset from an adverse change in the estimate of expected credit losses. The proposed approach would not include any indicators or triggering events as a threshold for estimates or changes in estimates.

BC26 Before making its proposals, the Board considered concerns about the operational challenges of implementing an expected loss approach, in particular:

(a) that the requisite system changes would be extensive and costly, and would require significant lead-time to implement;

(b) how the proposed approach might be applied to variable rate instruments; and

(c) the interaction between applying the approach on a collective basis or an individual basis.

BC27 To understand those concerns better, the Board in June 2009 posted on the IASB website a Request for Information on the feasibility of an expected loss approach, including potential simplifications of that approach. The Board received 89 comment letters.

BC28 Respondents to the Request for Information raised a variety of issues for the Board to consider in proceeding with the project. These fell broadly into the following categories:

(a) requests for additional guidance or clarification regarding the application of the proposed approach;

(b) indications of costs and lead-time regarding adoption of the proposed approach; and

(c) suggestions for simplifications of the proposed approach.

BC29 A large majority of respondents agreed that the proposed approach is a significant operational challenge and would entail substantial costs and lead-time to implement. Respondents also highlighted

(a) the difficulty of deriving estimates of expected cash flows over the life of the financial asset, which requires using historical data that might be difficult to obtain or not exist; and

(b) challenges in incorporating expected credit losses in the effective interest calculation.

BC30 Despite the difficulties and costs associated with adopting an expected loss approach, the Board favoured that approach for several reasons. Estimation uncertainty and the necessity for management to use significant assumptions and judgement are not unique to the estimates of expected cash flows for the purpose of amortised cost measurement of financial instruments. IAS 1 *Presentation of Financial Statements* sets out several examples in the section about sources of estimation uncertainty. Other areas of financial reporting that often necessitate estimates involving management's difficult, subjective or complex judgement for example include estimating the recoverable amount of non-financial assets, provisions dependent on the outcome of litigation, restoration or decommissioning obligations that relate to actions that will be taken decades after the measurement date reflecting technology that will be available in the future, insurance obligations and pension obligations. The Board also noted that deriving fair values when observable market prices are not available also requires significant assumptions and judgement.

BC31 The Board believes that the proposed approach would reflect lending decisions more faithfully than existing requirements because it would not include any indicators or triggering events as a threshold for considering estimates of credit losses (and changes in those estimates) for financial reporting purposes. Hence, the initial estimate of expected credit losses would be included in determining the effective interest rate.

BC32 In contrast, the incurred loss impairment model in IAS 39 prohibits including any credit loss estimate in determining the effective interest rate. Instead, under that impairment model credit losses are recognised only if there is objective evidence of impairment as a result of a loss event that occurred after initial recognition of the financial asset and the effect of that loss event on the future cash flows can be reliably estimated.

BC33 The Board noted that eliminating the incurred loss model's recognition threshold for impairment losses would remove some significant weaknesses of that impairment model. The proposed impairment approach would result in earlier recognition of credit losses than the incurred loss impairment model in IAS 39 (ie avoid the systematic bias towards late recognition of credit losses and the resulting 'cliff effect'). The proposed impairment approach with appropriate presentation and disclosures would also provide transparency that would allow users of financial statements to distinguish the effect of initial estimates of credit losses (which affect the economic return) and the effect of later changes in estimates (which provide information about a change in the credit quality of a financial asset). In addition, by eliminating the recognition threshold the proposed approach would also avoid the problems associated with applying that threshold and the resulting diversity in practice.

BC34 The proposed approach would measure an impairment loss as the difference between the carrying amount of the financial asset before the change in estimate and the present value of the expected cash flows of that asset after including the change in estimate. An entity would be required to revise its cash flow estimates, including the effect of credit losses, on each measurement date. The effect of a change in estimate would be recognised in profit or loss in the period of the change.

BC35 Under the proposed approach a reversal of an impairment loss would result from a favourable change in the estimate of expected credit losses. As the proposed approach would not include any indicators or triggering events as a threshold for changes in estimates there would be automatic reversals of impairment losses as the estimates change.

BC36 The Board noted that because the initial estimate of the expected credit losses for a financial asset is included in determining the effective interest rate there could be a gain from a favourable change in credit loss expectations even if no impairment loss had previously been recognised. Hence, the carrying amount of the financial asset could exceed its initial carrying amount. The Board noted that economically, this increase in the carrying amount represented a gain from an improvement in the quality of the financial asset. Hence, the Board believed such a gain would be useful information and therefore saw no reason to preclude its recognition. The Board also noted that the extent of such a gain was inherently limited to the difference between the initial carrying amount and the present value of the full contractual cash flows discounted using the effective interest rate.

BC37 By including the initial estimate of expected credit losses in determining the effective interest rate the proposed approach would also avoid the systematic overstatement of interest revenue in periods before a loss event occurs and use a subsequent measurement that is internally consistent with the initial measurement.

BC38 In proceeding to this exposure draft the Board addressed some of the main concerns of respondents to the Request for Information:

(a) The Board decided to use a design for the exposure draft that emphasises the objective and is principle-based. Many respondents suggested that adopting such a style would help reduce complexity and mitigate operational challenges by facilitating the use of solutions that work best in the specific circumstances of an entity.

(b) The exposure draft provides principle-based guidance on the application of the proposed approach on a collective basis or an individual basis, and changes between those bases. Many respondents argued that such principle-based guidance and allowing entities to choose between a collective basis or an individual basis was an important factor in mitigating the operational challenges as well as facilitating the most appropriate basis for deriving cash flow estimates (including expected credit losses). Many respondents also agreed that in contrast to an incurred loss model the concept that underpins the proposed approach would not require a switch from a collective to an individual basis for financial assets that show individual signs of impairment.

(c) The Board also decided to clarify some aspects as respondents had suggested. The exposure draft clarifies that an entity should use point-in-time estimates (at the measurement date) rather than through-the-cycle estimates (see paragraph B8). The Board's rationale was that set out in the discussion of 'dynamic provisioning', ie that using through-the-cycle estimates is inconsistent with measurement of the financial assets at the measurement date and, thus, financial reporting more generally. The exposure draft (see paragraph 8) also clarifies that the cash flow estimates are expected values rather than the most probable value (ie the individual most likely outcome). Another clarification in the exposure draft relates to the use of entity-specific and external data (see paragraph B7).

(d) The Board decided to address the requests for simplifications of the proposed approach by adding a section on practical expedients to the exposure draft's application guidance. That section sets out some general principles that govern practical expedients. It also includes a specific example that addresses concerns that the proposed approach would be unduly complex for straightforward instruments such as trade receivables. Another example illustrates how the allocation of the initial estimate of expected credit losses over the expected life of the financial asset might be simplified.

BC39 In order to address concerns about the substantial lead-time that would be required to implement the proposed approach the Board also decided to indicate in the introduction to the exposure draft that it expects that the IFRS it plans to develop from the exposure draft will not become mandatory until about three years after it is issued.

BC40 The Board also decided to form an expert advisory panel. That panel will advise the Board about the extent and nature of any final guidance necessary and any further practical expedients that should be considered and will help the Board to undertake some field testing of the proposals.

BC41 The Board also decided to clarify the application of the proposed approach to variable rate interest instruments. The Board rejected an approach that would reset the effective interest rate, ie an iterative calculation that changes the effective interest rate so that the carrying amount would unwind to changed cash flow estimates. The Board noted that resetting the effective interest rate would result in a smoothing effect that is inconsistent with both the notion of amortised cost and the underlying economic phenomenon. Instead, the Board decided to require an entity to adjust the carrying amount in order to ensure that it unwinds to the remaining expected cash flows. The Board believes that this adjustment reflects the underlying economic phenomenon (interest rate indexed principal repayments) and is consistent with the notion of amortised cost.

Subsequent measurement at amortised cost

BC42 The Board noted that impairment is an integral part of amortised cost measurement. Hence, this exposure draft proposes requirements not solely in relation to impairment but for amortised cost measurement as a whole.

BC43 Overall, because the proposed impairment approach is based on expected credit losses, the proposals would result in an expected cash flow approach to amortised cost measurement. In accordance with IAS 39, other inputs of the amortised cost calculation, such as for prepayments, already reflect estimates of expected outcomes. The Board believed in that sense the proposed approach would eliminate the exception to the overall approach that the incurred loss model created.

BC44 The exposure draft articulates the objective of amortised cost measurement and provides a more principle-based approach to establishing measurement requirements for amortised cost. The exposure draft includes guidance that addresses both fixed rate and variable rate instruments (in a more balanced way than IAS 39).

Objective of amortised cost measurement

BC45 The exposure draft sets out the objective of amortised cost measurement, which is to provide information about the effective return of a financial instrument by allocating interest revenue or interest expense over the expected life of the instrument.

Measurement principles

BC46 The drafting reflects the Board's decision to use a design that is principle-based. The measurement principles reflect the objective of amortised cost measurement. The principles relate to the calculation of amortised cost as a present value calculation and the two major inputs used. These are the expected cash flows at each measurement date and the allocation mechanism (ie the effective interest method).

BC47 The Board noted that the use of the effective interest rate, which is set at initial recognition, as the discount rate reflects that amortised cost is a cost-based measurement. This is different from fair value, which uses a current market rate for discounting.

BC48 Each of these principles is accompanied by application guidance together with guidance on practical expedients.

Presentation

BC49 The Board noted that information about interest revenue on a contractual basis before including the effect of expected credit losses is important. Respondents both to the Request for Information and staff outreach activities emphasised this point. For example, the information is used to compute the interest margin on a comparable basis for interest revenue and interest expense (a crucial performance indicator). Therefore, the Board decided to propose presentation requirements that provide transparency about the different factors that affect interest revenue, interest expense and experience adjustments from revising cash flow estimates.

BC50 The Board also noted that the presentation and disclosure proposals respond to widespread criticism from users of financial statements and the demand for more comprehensive information about the credit quality of financial assets (see paragraph BC61).

BC51 Hence, the proposed presentation requirements would provide disaggregated information about interest revenue before including the effect of expected credit losses, the effect of allocating the initial estimate of expected credit losses over the expected life of the financial instrument and the economic return as a subtotal. In addition, the effect of changes in estimates would be presented as a separate line item.

Disclosure

BC52 The exposure draft would require disclosures about amounts presented in the statement of comprehensive income, inputs and assumptions used for determining credit loss estimates, and the quality of financial assets measured at amortised cost.

BC53 The Board noted that the amounts in the statement of financial position and the statement of comprehensive income, in isolation, are not sufficient to allow users of financial statements to evaluate the effects of financial instruments on an entity's financial position and performance as well as its related risk exposures. In discussing the proposed disclosures the Board observed that many of the disclosures would provide useful information irrespective of the impairment model used for financial reporting purposes. Hence, the Board indicated that it was likely to mandate many of the proposed disclosures independently of the final decisions on the impairment model.

Allowance account

BC54 The Board decided to propose mandating the use of an allowance account. The Board received feedback from users of financial statements that direct write-offs against the contractual amount of financial assets without use of an allowance account would conceal useful information about the credit quality of the financial asset. The Board noted that direct write-offs (ie without use of an allowance account) undermine comparability between entities.

BC55 Respondents to the Request for Information and others indicated that information about 'actual' losses would be useful. The Board noted that it is difficult to decide what losses are 'actual' losses. The Board believed that disclosure about write-offs was the best proxy for 'actual' losses and decided to define write-off in order to clarify the related disclosure requirement as well as enhance comparability between entities.

BC56 The Board decided to propose a reconciliation of changes in the allowance account in order to provide transparency about the development of that account.

Estimates and changes in estimates

BC57 The Board noted that determining amortised cost requires estimates that include significant judgement. In order to enhance transparency the Board decided to propose disclosures about inputs and assumptions including changes in estimates, reasonably possible alternative assumptions, and estimation techniques.

BC58 The Board also noted that information about the effect of changes in estimates is important. Therefore, the exposure draft proposes disclosures that disaggregate those changes by identifying the portion that relates to credit losses. Further explanation would be required where changes in estimates have a significant effect or are attributable to particular causes.

BC59 The Board noted that in another area of financial reporting—insurance contracts—disclosure that compares the development of provisions with actual outcomes is used to provide information about difficult estimates. The Board decided to propose a similar requirement to enhance disclosures about estimates. Therefore, the exposure draft proposes a disclosure that compares the development of the credit loss allowance over time and cumulative write-offs.

Stress testing

BC60 The Board noted that information about stress testing is useful and could enhance the disclosures about the effect of assumptions and reasonably possible alternative assumptions. However, the Board noted that not all entities prepare this type of information and that mandating it would be unduly onerous in those cases. Hence, the Board decided to require disclosures about stress testing if an entity prepares such information for internal risk management purposes.

Credit quality of financial assets

BC61 Respondents to the Request for Information and others suggested that information about non-performing financial assets at amortised cost would be useful. This information about the credit quality of financial assets would provide transparency about their credit quality irrespective of the impairment approach used for financial reporting. The Board was informed that there has been increasing general acceptance of a 'more than 90 days' past due criterion and that using that criterion would promote comparability between entities. The Board found these arguments persuasive and decided to propose disclosures about non-performing financial assets and to define 'non-performing'. The Board noted that this proposal is consistent with the requests of many users of financial statements over a significant period of time.

Origination and maturity (vintage) information

BC62 The Board was also informed that information about origination and maturity of financial assets (often called 'vintage' information) is useful information because:

(a) it allows users to assess credit risk that is associated with particular vintages; and

(b) it facilitates the analysis of the quality of the lending business that users of financial statements perform.

BC63 Therefore, the Board decided to propose disclosures about the year of origination and the year of maturity of financial assets measured at amortised cost.

BC64 The Board decided to propose requiring the information to be disclosed as nominal amounts because the nominal basis is more useful for the purpose of the analysis of the quality of the lending business. The Board also considered that using the carrying amount might create significant practicability issues regarding impairment assessments performed on a portfolio level if the portfolio includes assets from different vintages.

Effective date and transition

Effective date

BC65 The Board will set the effective date for the proposed requirements when it approves the IFRS. The Board recognises that many countries require time for translation and that the introduction of mandatory requirements of IFRSs is often legally binding. In addition, entities will require time to implement new standards.

BC66 The Board normally sets an effective date of between six and eighteen months after issuing an IFRS. However, in the light of the responses received on the Request for Information the Board expects that the IFRS it plans to develop from the exposure draft will not become mandatory until about three years after it is issued. This reflects the Board's acknowledgement that implementing the proposed approach would require substantial lead-time.

BC67 The exposure draft proposes permitting earlier application of the IFRS to allow an entity to apply the enhanced guidance on the impairment of financial assets and amortised cost as a whole. The Board noted that it would be unlikely that many financial institutions would apply the proposed requirements early but that entities outside the financial services sector might want to choose to do so. The Board is aware that the substantial lead-time it intends to allow for implementation would result in a long period during which two different impairment approaches would be eligible. However, because of the diversity in practice of applying the incurred loss model of IAS 39 the Board believes that there is a lack of comparability between entities today. On balance, the early application of a superior impairment model would outweigh the concerns about a lack of comparability.

Transition

BC68 The Board considered several alternative transition approaches. The Board noted that the transition to the proposed approach involve a trade-off between the most useful information (which implies retrospective application) on the one hand and operational challenges and potential use of hindsight (which implies prospective application) on the other hand.

BC69 The Board rejected fully retrospective application. The proposed approach uses the initial estimate of expected credit losses as an important estimate that determines the effective interest rate and, thus, interest revenue allocation over the life of the financial instrument. The Board noted that it was unlikely that many entities had performed this kind of estimate in the past. Hence, the Board was concerned that this estimate would often involve a degree of hindsight that precludes retrospective application.

BC70 The Board also rejected fully prospective application. The Board noted that using prospective application would mean 'phasing in' the proposed approach over a period that depends on the nature of the financial instruments of each entity. Hence, because of the long remaining maturities that some financial instruments have, using prospective application might 'grandfather' the incurred loss model for a significant volume of financial instruments for many years despite the criticisms that resulted in the proposal to replace it. The Board also noted that such a 'phasing approach' would mean that entities would have to operate two different impairment models in parallel for possibly long periods. This would create operational challenges for accounting systems, which would need to have a dual capability.

BC71 The Board considered a 'customised transition approach' that would:

(a) provide an exception to prospective application that permits entities to choose retrospective application if the required information is available without using hindsight; and

(b) on transition determine the amortised cost of financial instruments that were initially recognised before adoption of the proposed approach (and for which retrospective application is not applied) as follows:

(i) use as the discount rate the effective interest rate previously determined for these instruments in accordance with IAS 39 (ie not modifying the effective interest rate for credit loss expectations as would be required under the proposed approach); and

(ii) use the cash flow estimates in accordance with the proposed approach (ie include all expected credit losses over the remaining life of the instrument irrespective of whether they are incurred).

BC72 The Board rejected this customised transition approach because of its negative effect on equity as a higher discount rate (the effective interest rate determined without factoring in initially expected credit losses) is applied to lower cash flow estimates that reflect expected credit losses and the knock-on effect on interest revenue after transition. However, the Board decided to include this transition approach in the invitation to comment and ask respondents for their views on this alternative.

BC73 The Board also discussed a transition approach that would reset the effective interest rate using a collar that has the following boundaries:

(a) the risk-free interest rate as a floor; and

(b) the contractual interest rate as a cap (ceiling).

BC74 The Board rejected this approach because it is complex, has significant conceptual weaknesses and would entail operational difficulties.

BC75 The Board decided to propose a transition approach that would determine an adjustment to the effective interest rate previously determined in accordance with IAS 39 with the objective that the adjusted rate would approximate the effective interest rate that would have been determined under the proposed approach. In determining that adjustment entities would have to use all available historical data and supplement them as needed with information for similar financial instruments for which the expected effective interest rate under the proposed approach has been determined (ie instruments originated or acquired near transition). This principle could be applied in different ways, for example by using ratio analysis.

BC76 The Board decided to propose this transition approach because in the Board's view it offered the best balance between useful information and operational aspects (ie the difficulty and cost of applying it).

BC77 In the light of the effect that the transition approach would have on interest revenue the Board decided to propose specific disclosures that would explain the effect of the initial application of the proposed approach on profit or loss. This effect would result from the difference between the effective interest rate determined in accordance with the transition requirements and the rate used in accordance with the entity's previous accounting policy. The disclosures would also explain how that effect relates to the amount of the transition adjustment.

Consequential amendments to other IFRSs

BC78 The Board noted that the proposed approach would eliminate the impairment indicators in IAS 39. Hence, the proposed changes would affect IAS 28 *Investments in Associates*, which incorporates the impairment indicators of IAS 39 by reference in order to determine whether it is necessary to recognise any additional impairment loss on the investment in the associate in accordance with IAS 36 *Impairment of Assets*. The Board believed that using the impairment indicators in IAS 36 (rather than carrying forward those in IAS 39 solely for the purpose of applying IAS 28) would simplify existing accounting requirements and reduce complexity in financial reporting.

BC79 The Board also discussed whether a consequential amendment to IFRS 4 *Insurance Contracts* would be necessary. IFRS 4 uses an impairment test for reinsurance assets that is based on the incurred loss model in IAS 39. However, the Board decided against a consequential amendment in order to retain the requirement in IFRS 4 until the Board finalises its active project on insurance contracts. The Board was also concerned about unintended consequences as the result of only changing the impairment approach without revisiting the measurement basis for reinsurance assets in its entirety.

Alternative view on exposure draft

Alternative view of Robert P Garnett and James J Leisenring

AV1 Messrs Garnett and Leisenring voted against publication of the exposure draft *Financial Instruments: Amortised Cost and Impairment*, for the reasons set out below.

AV2 Many respondents to the IASB Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach commented that the model as proposed was complex and the cost of installing and implementing such a model would be substantial. Messrs Garnett and Leisenring accept that those comments are accurate and believe that the proposed approach fails to provide sufficient benefit in improving financial information to justify those costs. They also do not believe that the results of applying the model will be auditable and thus will not be verifiable, a desirable attribute of financial information.

AV3 The Basis for Conclusions addresses criticisms of the current incurred loss model in paragraphs BC10–BC14, in particular that incurred losses lag expected losses, and thus the amount recognised as an impairment is 'too little, too late'. If the required measurement attribute for these assets was fair value, the carrying amount would certainly reflect market expectations of anticipated losses throughout, and would represent the maximum amount of loss that should be recognised. But because these assets are recognised at amortised cost, the Board rejected a fair value impairment-only model for the reasons set out in paragraphs BC15–BC21.

AV4 All methods of impairment recognition require judgement and concerns about earnings management will not be eliminated by any approach. Messrs Garnett and Leisenring, however, believe that the expected loss model exacerbates concern about earnings management because the loss expectations of management cannot be audited. Whether a loss has been incurred can be debated on the basis of current circumstances. Whether a loss is a reasonable expectation of the future is virtually impossible to dispute in most practical circumstances.

AV5 Messrs Garnett and Leisenring are also concerned that the proposed methodology is not practical to apply to individually material loans and should be allowed to be applied only to a portfolio of homogeneous loans.

AV6 Messrs Garnett and Leisenring believe that if amortised cost is retained as a measurement attribute the incurred loss model is consistent with a notion of recoverable cost. They also believe that the incurred loss model can be refined to accelerate the timing of loss recognition appropriately and to require recognition of more realistic provisions of incurred loss than seem to be the case in some environments today.