New on the Horizon: ED/2009/12 Financial Instruments: Amortised Cost and Impairment

International Financial Reporting Standards
November 2009
Foreword

The proposals included in ED/2009/12 Financial Instruments: Amortised Cost and Impairment (ED) relate to two areas of financial reporting which are very close to the heart of most financial institutions: interest margin and credit losses. They are key performance indicators and, in the case of impairment, intrinsically part of internal risk management and the measurement of regulatory capital.

During the recent global financial crisis there has been criticism of the present accounting requirements for credit losses on financial assets. The so-called “incurred” loss model, which prohibits an impairment loss being recognised until a loss event is identified, has been blamed for delayed recognition of impairment and systematic overstatement of revenue.

In April 2009 the Group of Twenty leaders called on accounting standard setters to improve accounting standards on valuation and impairment, and to reduce the complexity of accounting for financial instruments. In its report published in July 2009 the Financial Crisis Advisory Group noted delayed recognition of losses associated with loans, structured products and other financial instruments and the complexity of multiple impairment approaches to recognising asset impairment as weaknesses in accounting standards and their application. The IASB’s response has been a comprehensive review of all aspects of accounting for financial instruments that would result in the replacement of the current IAS 39 Financial Instruments: Recognition and Measurement. The ED, issued on 5 November 2009, is one of the key steps in this process.

The proposals contained in the ED represent a significant change to the current requirements on recognition of impairment losses for financial assets and their presentation and disclosure in the financial statements. The proposals also would impact the calculation of amortised cost, application of the effective interest method, and in particular, presentation of interest on the face of the statement of comprehensive income. All entities reporting under IFRSs are likely to be affected, but the impact will be greatest for financial institutions – both in terms of the implementation efforts required and the effects on reported profits and capital. There would be significant operational challenges associated with implementation of the proposals in the ED. Also, the proposals in the ED potentially could reduce the amounts that many commercial entities recognise as sales revenue. The decision by the IASB to form an Expert Advisory Panel to examine these issues is a welcome development.

As the Board has learned from responses to its outreach efforts, the proposals in the ED would require significant time and resources, for both the initial implementation and ongoing financial reporting. While the ED offers a comment period of eight months, in view of the importance of the issues and their wide-ranging impact, we encourage all interested parties, including users and preparers of financial statements, to act now to evaluate the proposals and join in the debate so as to contribute to the development of robust and operational solutions to improve accounting in this sensitive area.

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

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Content

Our New on the Horizon publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of New on the Horizon considers the proposed requirements of ED/2009/12 Financial Instruments: Amortised Cost and Impairment (ED).

The text of this publication is referenced to the ED and to selected other current IFRSs in issue at 12 November 2009. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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1. Executive summary

- The ED is part of the IASB’s wider project to replace IAS 39 *Financial Instruments: Recognition and Measurement* over the next year. It introduces far-reaching changes to the measurement and disclosure of interest income and expense, and impairment.

- The measurement proposals in the ED apply to both financial assets and financial liabilities stated at amortised cost. The impairment proposals apply to financial assets measured at amortised cost.

- The ED defines the objective of amortised cost measurement. It explains the measurement principles for calculating amortised cost using the effective interest method, including for variable rate instruments.

- Amortised cost would be calculated as the present value of the current estimates of future cash flows. For a financial asset, estimates of expected cash flows would include expected credit losses over the expected life of the asset.

- An entity would be permitted to estimate the expected cash flows either on an individual basis or on a collective / portfolio basis, depending on which basis yields the more reliable estimate.

- The effective interest rate (EIR) would be the rate that discounts the expected future cash flows to arrive at the financial instrument’s initial carrying amount. For a fixed rate instrument, the EIR would be a single rate and would remain constant over the expected life of the instrument. For a variable rate instrument involving contractual resets of interest cash flows, the EIR would be a combination of the contractually reset rate and a fixed initial spread, and would not be a single constant rate. The fixed initial spread would remain unchanged during the life of the instrument. Application of the proposals to instruments with contractual reset features such as credit spreads would present additional challenges.

- The ED permits the use of practical expedients in calculating amortised cost if their overall effect is immaterial. An example might be determining the amortised cost of short-term trade receivables using a provisioning matrix and without discounting. Irrespective of whether entities use the practical expedient, the proposals in the ED potentially could reduce the amounts that many commercial entities would recognise in respect of sales revenues and receivables.

- The ED proposes to replace the current incurred loss model for the assessment of impairment of financial assets measured at amortised cost with an expected cash flow approach (ECF approach).

- Under the ECF approach recognition of a credit-related loss would not require an entity to identify first any specific loss event(s) or impairment triggers. Rather, an entity would estimate the expected credit losses at inception of the asset and then at each subsequent measurement date. No gain or loss would be recognised at inception, and the initial expected losses would reduce the EIR. Any gain (or loss) on a subsequent reassessment would be recognised immediately in the statement of comprehensive income.

- It is not clear whether current estimates of future cash flows should include assumptions about changes in economic and market conditions after the measurement date.
The ED proposes new presentation format, in particular additional line items to be presented in the statement of comprehensive income. It also proposes extensive disclosures with the objective of providing enhanced information on the credit quality of an entity’s assets, management estimates and changes therein, and the nature and extent of adjustments recognised as a result of changes in those estimates. This represents a significant change compared to current practice.

Unlike current IAS 39, under IFRS 9 *Financial Instruments* an impairment assessment would apply only to assets measured at amortised cost. Accordingly, the ECF approach would become the single impairment model for financial assets.

The Board expects that the final standard would not be mandatory until about three years after it is issued. Early adoption would be permitted.

The ED proposes retrospective application but at transition would allow use of EIRs that would approximate the EIRs that would have been determined in accordance with the proposals in the ED. The EIRs so determined would be used to restate comparative amounts.

The deadline for comments on the ED is 30 June 2010.

The Board is in the process of setting up an Expert Advisory Panel whose role would be to advise the Board and the U.S. Financial Accounting Standards Board (FASB) with respect to operational issues surrounding the application of the ECF approach, and to assist in field testing and identifying further practical expedients.

The IASB and the FASB remain committed to working together to develop a converged solution on financial instruments accounting, including impairment. FASB’s proposals for financial instruments are due in the first quarter of 2010, and the IASB intends to publish simultaneously a request for views on the FASB’s proposed impairment model.
2. Introduction and background

The IASB is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard IAS 39.

The IAS 39 replacement project, and in particular its timeline, is driven in part by requests for reform from the Group of Twenty (G20) and other constituents. Following the G20 summit in April 2009, the Leaders’ Statement called on accounting standard setters, including the IASB and the FASB, to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the international accounting setters to complete their convergence project by June 2011. In its report published in July 2009 the Financial Crisis Advisory Group (FCAG), a group set up jointly by the IASB and the FASB, 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.

The IAS 39 replacement project has three main phases:

- classification and measurement of financial instruments (IFRS 9 published on 12 November 2009);
- amortised cost and impairment of financial assets (ED/2009/12 published on 5 November 2009, the subject of this publication); and
- hedge accounting (an exposure draft is scheduled to be published in the first quarter of 2010).

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process.

The ED contains proposals forming phase II of the IAS 39 replacement project. As a precursor to the ED, in June 2009 the IASB issued a Request for Information on the feasibility of an expected loss approach to impairment of financial assets. The comment period on this request closed on 1 September 2009. The responses received by the Board were deliberated as part of the development of the proposals in the ED.

IFRS 9 was published on 12 November 2009 and addresses the classification and measurement of financial assets only. While originally it was the Board’s intent to address classification and measurement of financial liabilities together with financial assets, financial liabilities now will be addressed separately to allow further deliberation on the role of credit risk in liability re-measurement. An exposure draft on classification and measurement of financial liabilities is planned for the first quarter of 2010. A final standard incorporating the remaining aspects of the three phases is scheduled for the fourth quarter of 2010.

At the time of publication, the IASB has issued a number of other exposure documents that form part of, or are relevant to, the IAS 39 replacement project.

In March 2009 the IASB published Exposure Draft ED/2009/3 Derecognition, which proposes new guidance on when a financial asset should be removed from an entity’s statement of financial position, and increased disclosures about transfers of assets. The comment period closed on 31 July 2009. Currently the IASB plans to complete this project by mid-2011.
In May 2009 the IASB published Exposure Draft ED/2009/5 *Fair Value Measurement* (the fair value measurement ED) which proposes new guidance on the principles to be applied in determining fair values when IFRSs require or permit use of fair values. The proposed guidance in the fair value measurement ED also would apply to any measurements of fair values of financial instruments that would be required under the IAS 39 replacement project. The comment period for the fair value measurement ED ended on 28 September 2009. The IASB plans to issue a new standard in the third quarter of 2010.

The IASB and the FASB recently reiterated their commitment to working together to develop a converged solution on financial instruments accounting and published a joint statement on 5 November 2009 detailing how they intend to fulfil this commitment. The FASB intends to publish its proposals on financial instruments accounting in the first quarter of 2010 in a comprehensive exposure draft that would address classification and measurement, impairment and hedge accounting. The IASB intends to publish a request for views on the FASB’s proposed impairment model at the same time. The two Boards will consider together the comments received on their respective impairment models. The FASB’s tentative decisions to date on impairment of financial assets are discussed in section 5.

The purpose of this publication is to summarise the key features of the proposals in the ED and highlight potential impacts and conceptual and application issues identified to date so as to facilitate informed debate and comment on the proposals.
3. Amortised cost and effective interest rate

3.1 Overview of proposals

Financial assets and financial liabilities at amortised cost

**Inputs**
- Initial carrying amount
- Expected cash flows *
- Spot curve

Fixed rate instrument
- Determine effective interest rate (EIR)

Floating rate instrument
- Determine initial effective spread (EIR = contractual reset + initial spread)

**Inputs**
- Revised estimate of cash flows *
- Spot curve

Revise amortised cost

Adjustment of carrying amount made through profit or loss
(interest + gains / losses from changes in estimates)

* group or individual – whatever gives best estimates
3.2 Amortised cost measurement: objective and measurement principles

The IASB is proposing an objective for amortised cost measurement in that it should provide information about the “effective return” on a financial asset or financial liability by allocating interest income or expense over its expected life. The effective return would reflect an allocation of all expected contractual cash flows, including the initial estimate of expected credit losses on a financial asset, over the expected life of the instrument.

The ED explains that amortised cost measurement 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. The ED proposes that the amortised cost of a financial instrument at each measurement date would be determined by discounting the expected cash flows over the remaining life of the financial instrument using the EIR as the discount rate.

**Observations**

Currently, while IAS 39 explains how amortised cost is calculated, it does not specify the objective of an amortised cost measurement or clearly identify the measurement principles involved. As part of addressing the impairment approach for financial assets, the Board acknowledged that impairment is an integral part of amortised cost measurement. Hence, it decided to propose in the ED requirements that go beyond just impairment and address amortised cost measurement as a whole.

3.3 Estimating expected cash flows

The expected cash flow estimates used to determine the amortised cost at each measurement date would reflect current information at that date. In estimating the expected cash flows of a financial instrument an entity would consider:

- all contractual terms (e.g., principal and interest repayments, prepayment options, call options, etc.);
- fees and points paid or received between the transacting parties; and
- for a financial asset, expected credit losses over the life of the asset.

**Observations**

In contrast to the last point above, currently under IAS 39 an entity is not permitted to consider future credit losses in determining the EIR in calculating amortised cost.

The ED clarifies that for financial liabilities, estimates of expected future cash flows would not reflect the entity’s own non-performance risk.

3.3.1 Expected value vs. most probable value

The ED proposes that cash flow estimates are expected values. It also proposes that the amounts and timing of these cash flows would be determined based on probability-weighted possible outcomes, rather than based on the most probable value representing the individual most likely outcome.
Observations

IAS 39.9

Currently, while IAS 39 requires an entity to use estimated future cash receipts and payments in determining the EIR, there is no further guidance as to whether the future cash flows are determined using probability-weighted possible outcomes or as the most probable value representing the individual most likely outcome.

3.3.2 Individual vs. collective assessment

ED/2009/

When calculating amortised cost, the ED proposes that the expected cash flows may be estimated on a group or portfolio level (i.e., on a collective basis) or an individual basis. The basis applied should provide the best estimate of expected cash flows, and the entity should ensure that credit losses are not double-counted. The basis may be changed during the life of the financial instrument as deemed appropriate. When estimating expected cash flows, including credit losses on a collective basis, financial assets would be grouped on the basis of similar credit risk characteristics that are indicative of the debtors’ ability to pay all the contractual amounts when due. For example, financial assets may be grouped based on internal credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors.

Observations

The proposals in the ED with respect to choosing between individual assessment and collective/portfolio assessment are different from the existing guidance in IAS 39.

IAS 39.9

Currently, for the purpose of determining the EIR, IAS 39 permits an entity to estimate expected cash flows for individual financial instruments as well as for groups of financial instruments. IAS 39 does not provide further guidance on when an entity should use either the portfolio or individual approaches.

IAS 39.64

For the purpose of assessing impairment in respect of financial assets measured at amortised cost, IAS 39 requires that an entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, then the entity includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment. The proposals in the ED do not contain similar prescriptive guidance and so would allow entities to select assessment methods that are most appropriate in the circumstances.

Determination of expected future losses at origination may be easier to grasp conceptually for a group of financial assets that share similar credit risk characteristics than for a single financial asset. This is because, at origination, an entity’s estimate of the most likely outcome in respect of each individual financial asset would be that it would receive the full contractual payments over its term as, otherwise, it is unlikely that the financial asset would have been originated. In contrast, when looking at a portfolio it is expected, even at inception, that some contractual payments will not be received, although at that time it may not be known which specific assets will fail to perform. The two Board members who voted against the proposals in the ED have highlighted this issue, suggesting that the expected loss approach should apply only to portfolios of assets. However, in many instances, entities’ asset mixes may be such that creating pools of similar assets for estimating cash flows on a collective basis may not be possible for some or maybe even the majority of their financial assets.
3.3.3 Sources of data for developing cash flow estimates

In estimating expected cash flows entities may use internal and external sources of data. Possible data sources cited in the ED include internal historical credit loss experience, internal ratings, credit loss experience of other entities, and external ratings, reports and statistics.

Historical data would be adjusted on the basis of current observable data to reflect current conditions at the measurement date. Changes in cash flows should reflect and be directionally consistent with changes in related observable data such as changes in unemployment rates, property prices, commodity prices, etc. An entity would be required to review, on a regular basis, its methodology and assumptions with the objective of minimising differences between its loss estimates and the actual losses experienced.

The ED proposes that estimates of expected cash flows of a collateralised financial asset would include 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 would not be recognised as a separate asset unless it meets the recognition criteria for an asset in another IFRS.

Observations

The ED requires an entity to estimate expected cash flows over the remaining life of a financial instrument. Also, the entity would be required to use current cash flow information at each measurement date to measure amortised cost. To the extent that an entity uses historical data to estimate cash flows the ED requires such historical data to be adjusted on the basis of current observable data, to reflect the effects of current conditions. The ED’s proposal to use current data reflecting current conditions might be read in either of two ways:

- an entity estimates future cash flows based on economic and market conditions prevailing at the reporting date, and it does not forecast future changes in circumstances that could impact cash flows; or
- an entity estimates future cash flows based on expectations of future changes in economic and market conditions beyond the reporting date and how such changes would impact cash flows.

It is not clear to us from the ED as to which of the above two approaches an entity should apply. For example, an entity has a portfolio of similar loans and data about unemployment in a specific region is a key factor in estimating expected cash flows on these loans. At the reporting date, the unemployment rate in the region is 8 percent. However, consensus estimates at the reporting date are that the unemployment rate will increase to 11 percent by the time the loans are due for repayment. It is not clear as to which approach, i.e., 8 percent or 11 percent unemployment, the entity should use in estimating future cash flows on these loans.

We note that the latter approach (i.e., taking into account expectations of changes beyond the reporting date) would require additional efforts from preparers in forecasting future changes and, at the same time, may increase the scope for subjectivity in management’s estimates. However, similar to the present concerns about identifying when a loss event has occurred, the former approach (i.e., ignoring potential changes in market conditions after the reporting date) could lead to additional complexities in terms of distinguishing between current conditions existing at the reporting date and future changes. Furthermore, it might be argued that the outcome under the former approach may not be a true reflection of management’s expected economic return on the instrument. In particular, a gap may emerge between the expectations on which contractual credit spreads are based and the estimates underlying the financial reporting, leading to persisting concerns as to possible overstatements of revenues and delays in recognition of losses.
Similarly, in respect of collateralised assets, it is not clear from the ED whether, in determining the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, the entity should consider only the fair value of the collateral on the reporting date as representative of the circumstances that exist on the reporting date, or consider the expected changes in the fair value of the collateral between the reporting date and the expected realisation date.

Estimating future cash flows which incorporate expected credit losses over the entire life of a financial asset would be a very challenging task for many entities, in particular those operating in the financial sector. Although judgement has to be applied in estimating the amount and timing of credit losses under the current incurred loss model, this quantitative judgement relates to a much smaller population of financial assets for which loss events have occurred, rather than to all financial assets. In addition, once a loss event has occurred there is often more data available in support of the estimates. Many question whether estimates required under the proposed ECF approach could reliably be made at all and believe that the proposals would create increased opportunities for “earnings management,” i.e., management could choose to alter reported profits by changing subjective estimates. The two dissenting Board members state that they believe that the results of applying the proposed approach would not be auditable. However a counter-argument can be made that determining the fair value of a financial asset using valuation models also may require cash flows to be estimated over the entire life of a financial instrument and, in circumstances when markets are not active, such estimates may be highly subjective (i.e., Level 3 valuations). Preparers already are required to disclose fair values for all financial assets under IFRS 7 Financial Instruments: Disclosures.

### 3.4 Effective interest rate

Similar to the requirements in IAS 39, the ED proposes that the effective interest method be used to determine amortised cost and the allocation of interest revenue or expense over the expected life of the financial asset or liability. In addition, the ED proposes that the EIR reflect the contractual terms relating to interest receipts or payments (i.e., the part of the contractual interest rate, if any, that is reset).

The EIR first would be determined on initial recognition of a financial instrument. For a fixed rate financial instrument the EIR would be the rate that results in a present value of the expected cash flows that equals the carrying amount upon initial recognition (i.e., initial measurement). This EIR would remain the same over the life of the financial instrument.

For a variable rate financial instrument in which a component(s) of the contractual interest rate is reset the EIR would not be determined as a single constant rate. For example for a bond that pays LIBOR (benchmark rate) plus 100 bps instead of a single constant rate, a combination of the spot curve for the benchmark interest rate and a spread would be used for discounting the estimated cash flows. The entity would determine the “initial effective spread” upon initial recognition by iteration so that the present value of the expected cash flows equals the carrying amount upon initial recognition. Subsequently, contractual resets of interest cash flows would alter the EIR to the extent that the interest rate is adjusted; however, the initial effective spread would remain unchanged. Hence, for an instrument that pays interest at LIBOR plus 100 bps, the updated EIR at each measurement date would be determined by using the updated LIBOR spot curve and the initial effective spread.
Observations

The initial EIR, or the initial effective spread once determined on initial recognition, would remain unchanged throughout the expected life of the financial instrument. Since estimates of expected cash flows, including expected credit losses for a financial asset, at initial recognition would impact the EIR, the accuracy and reliability of these estimates would be critical as they would have a continuing impact on the amortised cost and interest revenue or expense over the expected life of the financial instrument.

The ED provides a welcome clarification of how the amortised cost principles apply to variable rate financial instruments. Currently IAS 39 does not contain guidance similar to the proposals in the ED, and in the absence of such guidance a number of different approaches might be used, for example:

- updating the EIR based on the actual benchmark rate that was set for that respective period;
- or
- updating the EIR by taking into account expectations of future interest rates, and changes in these expectations.

The present IAS 39 guidance on EIR for floating rate instruments focuses on altering the EIR based on periodic re-estimation of cash flows to reflect movements in market rates of interest. This has led to a debate as to whether certain instruments with contractual reset features, such as inflation indexation or indexation to an entity’s revenue, qualify as floating rate instruments. In a tentative decision in October 2008, the IASB stated that a floating rate financial instrument is an instrument with contractually variable cash flow amounts arising from changes in market variables. We note that in contrast to current IAS 39, the proposals in the ED on variable rate instruments would appear to apply more broadly to instruments with interest rate components that are reset in accordance with the contract.

However, while the ED articulates the application of amortised cost requirements to variable rate financial instruments more clearly than the existing IAS 39, in practice entities will face application challenges resulting from contractual resets of terms other than benchmark interest rates. For example, while most variable rate financial instruments have a constant credit spread, for some instruments the contract specifies changes in the credit spread to reflect changes in the credit standing of the borrower. Computation and re-computation of the EIR as these variables reset can be complicated. The effect might be acute in the case of increased rates applicable to borrowers in default. In addition, such contractually predetermined changes in margin do not fit easily within the guidance in the ED on calculation of EIR for fixed and floating rate financial instruments. This is because for such instruments neither the contractual interest rate nor the spread is fixed. It would be useful for the Expert Advisory Panel to consider these matters.

We note that the classification criteria in the newly issued IFRS 9 would preclude many financial assets for which applying the EIR method has proven challenging in the past (e.g., loans for which returns are linked to a percentage of a borrower’s revenue) from being measured at amortised cost as they do not have contractual terms that are solely payments of principal and interest on the principal outstanding. While this would avoid the complications in applying the EIR method to such assets, unless and until the IASB decides to align the accounting for financial liabilities to the IFRS 9 guidance in respect of financial assets, the application challenges in respect of revenue-linked and similar financial liabilities remain pertinent.

Currently, the guidance in IAS 39 implies that an entity should determine a single EIR in respect of a financial instrument, including a floating rate financial instrument. The proposals in the ED and the examples prepared by the IASB staff to illustrate the calculation mechanics of the proposals in the ED imply that the EIR for a variable rate instrument would not be a single...
interest rate. Instead there would be a separate EIR determined for each interest period within the expected life of a variable rate instrument. For example, an entity purchases a three-year variable rate bond that pays 12-month Libor plus 300 bps. On initial recognition, the entity determines that the Libor curve indicates that the Libor forward rates for a one-year loan commencing today, at the end of year one, and at the end of year two are 5 percent, 6.68 percent and 6.79 percent respectively. Using estimates of expected credit losses the entity determines, by the process of iteration, that the initial effective spread is 0.54 percent. In measuring amortised cost, for the purpose of discounting the cash flows arising from the annual interest payments and the principal repayment, the entity would use a combination of the relevant Libor spot rates and the initial effective spread. For example, for discounting the interest cash flows due at the end of year two, the entity would use the Libor spot rate for a two-year borrowing (i.e., 5.84 percent) plus the initial effective spread (i.e., 0.54 percent). Subsequent to initial recognition, the changes in the Libor curve would result in changes in the EIRs, although the initial effective spread would remain constant. The effect of this approach would be that in each year the interest revenue would be recognised by using the EIR comprising the updated Libor spot rate plus the initial effective spread.

The IASB staff has prepared numerical examples illustrating the calculation mechanics of the proposals in the ED, although the examples do not form part of the ED.

3.5 Practical expedients

The ED permits an entity to use practical expedients in calculating amortised cost if the overall effect of using these expedients is not materially different to using the effective interest method. The objective of the practical expedients is to facilitate cost-effective ways of determining amortised cost when a simplified calculation is an appropriate approximation of the outcome obtained by applying the proposals in the ED. While the ED permits use of practical expedients, it requires the expedients used to be consistent with certain principles. In particular the calculation should:

- incorporate the effect of the time value of money (except if the effect of discounting is immaterial);
- include all expected cash flows for the remaining life of the financial instrument; and
- result in a present value that equals the initial measurement of the financial instrument.

An example of a practical expedient proposed in the ED is the use of a provision matrix for trade receivables. When the effect of discounting trade receivables is immaterial, an entity would not need to determine an EIR or recognise any interest revenue over the life of the receivable. Instead, the entity would measure the trade receivables and revenue on initial recognition at the invoice amounts less the initial estimate of undiscounted expected credit losses.

Observations

The use of practical expedients proposed by the ED will be welcomed by many entities outside the financial sector that were concerned about the impact of having to put in place processes to calculate EIR on short-term trade receivables. However, as discussed below, we note that irrespective of whether entities use the practical expedient the proposals in the ED potentially would reduce the amounts that many commercial entities initially would recognise in respect of sales revenues and receivables.
The ED suggests a practical expedient in respect of trade receivables that would permit an entity to not compute the EIR if the effect of discounting is immaterial. This is consistent with the guidance in IAS 39 that permits short-term receivables and payables with no stated interest to be recognised at the original invoice amount if the effect of discounting is immaterial. However, application of the ECF approach still would require an entity to estimate the expected credit losses and deduct them from the nominal amount invoiced to determine the amount to be recognised as a receivable and as revenue. For example, an entity originates 100 invoices for an aggregate amount of CU 1,000 during a week; the invoices are contractually due for payment in three months. On performing a portfolio assessment at initial recognition the entity estimates, based on historical collection patterns as adjusted for current conditions, that it would collect only CU 950. Assuming that the impact of discounting is immaterial, under the proposals in the ED the entity would recognise the receivables and revenue at CU 950. This could represent a change from current practice whereby entities do not estimate future credit losses at initial recognition. Currently the entity would recognise the receivables and revenue in the above example at CU 1,000 (assuming that the revenue recognition criteria in IAS 18 Revenue are met, including that it is probable that the economic benefits associated with each sale transaction, i.e., cash due on invoices, will flow to the entity).

It appears that the same result (i.e., revenues and receivables being recognised at amounts reduced for expected credit losses) would occur even if the entity applies the effective interest method as proposed in the ED to such receivables, because the practical expedient is intended only to avoid the effect of discounting. This would however, potentially create a conflict with the existing guidance in paragraph AG79 of IAS 39 that permits short-term receivables and payables with no stated interest to be measured at the original invoice amount if the effect of discounting is immaterial; the ED does not propose any amendment to this paragraph.
4. The proposed expected cash flows approach

The flowchart below provides an overview of the expected cash flow (ECF) approach to impairment proposed in the ED.

In applying the ECF approach to financial assets an entity would:

- determine the expected credit losses on a financial asset upon initial recognition and include them in arriving at the initial EIR;
- recognise the contractual interest revenue, less the initial expected credit losses, over the life of the instrument;
- build up a provision over the life of the asset for expected credit losses;
- reassess the expected credit losses and other expected cash flows each period; and
- recognise immediately the effects of any changes in credit loss or other cash flow expectations.

Under the ECF approach expected losses would be included in the estimates of cash flows without any need first to identify a loss event or other impairment indicator.
Unlike current IAS 39, under IFRS 9 an impairment assessment would apply only to assets measured at amortised cost. Accordingly, the model proposed in the ED would become the single impairment model for financial assets.

Observations

The proposed ECF approach would be a significant change from the existing incurred loss impairment approach under IAS 39. While IAS 39 currently requires an entity to estimate cash flows in determining an asset's EIR and in computing amortised cost, the entity is precluded from including future credit losses in these estimates.

For example, a financial institution originates at par a four-year CU 1,000 loan bearing interest at 10 percent p.a. Assume that transaction costs associated with the loan origination are nil and the contractual interest rate is the market rate for such a loan. The financial institution estimates upon initial recognition that it will collect the first three annual interest instalments in full but will realise only 95 percent of the contractual amounts due in respect of the principal repayment and the last interest instalment. Under the incurred loss model, the financial institution would recognise interest income using an EIR of 10 percent and would account for the credit losses only once an impairment trigger has occurred. Under the ECF approach the EIR determined using expected cash flows would be 8.8 percent after allowing for the expected shortfall of cash payments of CU 55 in year four. Using this EIR, the amortised cost of this loan (net of allowance) at the end of year two would be CU 975. If at the end of year two the financial institution revises its expectation of recovery on the principal and last interest instalment to 90 percent, then the revised carrying amount arrived at by discounting the revised cash flows by the original EIR would be CU 928. A loss of CU 47 (i.e., CU 975 - CU 928) would be recognised immediately in profit or loss as a result of the change in estimate.

The proposed ECF model is likely to present a considerable operational challenge to implement. It may require significant system changes and additional resources to generate the required information on an ongoing basis.

The likely impact of the proposals for the majority of entities would be a reduction in the amount reported in the statement of comprehensive income as net interest revenue. The EIR determined under the ECF approach would be lower than that determined under the incurred loss approach as the latter approach does not permit expected but not incurred credit losses to be incorporated in determining the EIR. Also, as a portion of the contractual credit spread is reduced in arriving at the EIR (on account of the expected credit losses), the EIRs on different assets may be more similar.

In periods prior to a credit loss being “incurred”, the net interest revenue determined using the ECF approach (i.e., contractual interest less expected credit losses at inception) would be lower than that under the incurred loss model. The difference would be exacerbated for a growing asset portfolio. In the reporting period in which a loss is incurred, the credit loss recognised in the statement of comprehensive income usually would be higher under the incurred loss model than that under the ECF approach, as under the latter approach part of the loss would have been recognised in previous periods through the “build-up” of the credit allowance account by way of reduction of net interest revenue.

A consequence of applying the ECF approach would be that there could be a gain from a favourable change in credit loss expectations subsequent to initial recognition even if no impairment loss had been recognised previously. Also, the carrying amount of the financial asset could exceed its initial carrying amount, and possibly even the asset’s nominal amount. Returning to the example above, assume that the financial institution instead determines at
the end of year two that it would collect all remaining interest instalments and the principal repayment in full. The financial institution then would discount the revised cash flows estimates at the 8.8 percent EIR and would compute the amortised cost at the end of year two as CU 1,021. Not only will the financial institution realise a gain of CU 46 (i.e., CU 1,021 - CU 975) without having recognised an impairment loss previously, but also the amortised cost would be higher than the asset’s nominal amount of CU 1,000. The Board acknowledges this possibility in the basis for conclusions to the ED and notes that economically this increase in the carrying amount represents a gain from an improvement in the quality of the financial asset. The Board believes that such a gain would be useful information and hence sees no reason to preclude its recognition.

We note that currently under IAS 39, if an entity purchases a financial asset in respect of which a credit loss has been already incurred at the purchase date, the EIR would reflect this incurred loss. The entity may realise a gain subsequently, without any impairment loss being recognised previously, if the entity’s estimates of cash flows from that asset improve subsequent to initial recognition such that the earlier estimate of incurred loss is reversed (e.g., the borrower’s financial condition improves significantly).

In responding to the criticisms of the incurred loss impairment model, the Board considered as alternatives to the ECF approach, the “fair value-based” approach and “through-the-cycle” approaches. Under the fair value-based approach an impairment loss would be measured by reference to the fair value of the financial asset (a similar concept exists currently in IAS 39 for available-for-sale financial assets). The Board rejected this approach as it was viewed as inconsistent with a cost-based measurement approach. A fair value-based approach would result in a measurement model that mixes characteristics of both amortised cost and fair value thereby leading to additional complexity.

The Board considered also through-the-cycle approaches, under which 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, which is commonly described as “dynamic provisioning” has the objective of 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 dynamic provisioning believe that it results in the earlier recognition of credit losses and a more even distribution of losses over an entire economic cycle, which helps mitigate procyclicality. Under this approach an entity would recognise an impairment loss upon initial recognition of a financial asset; in contrast the ECF approach does not result in recognition of a loss on initial recognition. The Board rejected this approach as recognition of an impairment loss on initial recognition of a financial asset is inappropriate since no economic loss occurs on initial recognition. Also, in situations when the expected life of the financial asset is shorter than the economic cycle, a through-the-cycle approach would result, in effect, in recognition of impairment losses on future lending.

The ECF approach may result in more rapid increases in loss provisions as compared to the current IAS 39 model if economic conditions and market expectations affecting the financial assets deteriorate compared to an entity’s previous estimates. Conversely, provision levels may show a steeper improvement when economic conditions and market expectations improve.

The proposed ECF approach differs from the guidance with respect to measurement of losses on financial assets under the Basel Committee on Banking Supervision’s capital adequacy framework (commonly known as “Basel II”) that is applied in many jurisdictions for assessing capital adequacy of financial institutions. Although the precise differences will depend on how
the regulatory requirements have been implemented by a particular entity, some high level differences emerge. These include the following:

- Basel II requires estimation of the probability of default in the next 12 months, rather than over the life of the financial asset.
- Basel II requires estimates of losses to be made using historical data collected over a long period of time and requires the data to be appropriate, while the ED proposes that current cash flow information is used that reflects conditions at the time of measurement (see observations in section 3.3.3).

The estimates of cash flows that are required by the ED maybe different from those used for regulatory capital purposes under Basel II. Therefore, financial institutions may not be able to utilise estimated cash flows calculated for regulatory capital purposes for financial reporting purposes. However, it is possible that much of the underlying data that is used to calculate relevant regulatory measures also may be useful in developing estimates of expected losses under the ECF approach. While the objective of general purpose financial reporting is different from prudential supervision and regulation, it is expected that the Expert Advisory Panel will include on its agenda consideration of the similarities and differences between the Basel II and the ECF approaches, and potential for efficiencies.
5. **FASB proposals**

Similar to the IASB’s IAS 39 replacement project, the FASB also is developing its proposals to improve reporting for financial instruments under U.S. generally accepted accounting principles (U.S. GAAP). These proposals are tentative and not complete and a fully developed or final version has not yet been published.

Based on the FASB’s tentative decisions to date, under U.S. GAAP financial assets would be accounted for at fair value. Changes in fair value would be recognised in profit or loss. However, if an entity’s business strategy is to hold debt instruments with principal amounts for collection of contractual cash flows rather than to sell the financial instruments to a third party, certain changes in fair value for those instruments may be recognised in other comprehensive income. At its 21 October 2009 meeting the FASB decided tentatively that the impairment loss recognised in a reporting period would be the decrease in the net present value amount of cash flows expected to be collected. In estimating the amount of future cash flows, an entity would consider all available information relating to past events and existing conditions that are relevant to the collectability of the financial asset(s), such as the remaining payment terms, the financial condition of the issuer, expected defaults, collateral values, and existing environmental factors such as industry, geographical, economic, and political data that indicate that some contractual cash flows are not expected to be collected. However, the entity would not consider possible future scenarios.

**Observations**

Up to now, the FASB has elucidated only the broad principles to be applied in identifying and measuring impairment losses. The FASB’s tentative decisions to date indicate certain similarities with the ED’s proposed ECF approach in that the entity considers expected cash flows, collateral values, etc. However, the FASB’s tentative decision prohibits an entity from considering possible future scenarios. Pending further elaboration by the FASB on the reason for its tentative decision to prohibit consideration of possible future scenarios in estimating cash flows and further clarification of the requirement in the ED with respect to the use of current data that reflects current conditions (see observations in section 3.3.3), we note that there exists potential for difference with respect to estimation of expected cash flows between the impairment models being considered by the two Boards.

Also, we note that there currently are a number of differences between U.S. GAAP and IFRSs on measurement of amortised cost. For example, U.S. GAAP requires certain internal costs to be included in the measurement of an asset and it prohibits deferring and amortising initial discounts in certain circumstances. Such differences would impact the estimation of EIR and thus income recognition under both accounting frameworks. Although the FASB has made it clear that it will address accounting for credit losses and recognition of interest income in its financial instruments project, we note that the FASB has not indicated whether it will establish an overriding objective and principles for the calculation of amortised cost in a manner similar to the proposals in the ED.
6. Presentation

6.1 Presentation of interest income

The ED proposes significant changes to the presentation of interest income and impairment in the statement of comprehensive income, requiring the following to be shown:

- gross interest revenue calculated using EIR before taking into account the initial estimate of expected credit losses
  \[ \text{Less: adjustment for allocation of initial expected credit losses} \]
  \[ = \text{net interest revenue} \]
- gains and losses resulting from changes in estimates in relation to financial assets and liabilities measured at amortised cost; and
- interest expense calculated using the EIR.

The gross presentation of interest income is intended to provide transparency through disaggregated information and to allow users to see the amount of adjustment to contractual revenue for the period that will contribute to the build up of the allowance for credit losses.

The proposed presentation would be supported by more detailed disclosures including disaggregation of gains and losses from changes in estimates into those attributable to changes in estimates of credit losses and those attributable to other factors.

The ED is prescriptive as to what should and should not be included in the line items in the statement of comprehensive income that refer to amounts calculated using the effective interest method. For example, it prohibits inclusion of foreign exchange gains and losses, gains and losses in relation to hedging transactions that do not qualify for hedge accounting, or interest on financial instruments not classified as at amortised cost.

Observations

Under the proposals it no longer would be possible to present impairment losses as a separate line in the statement of comprehensive income as is the current practice of many financial institutions. Additional disclosures (see section 7) will provide more information on the credit quality of financial assets, but information on what losses have been “incurred” according to the current model no longer would be available. This may be a significant change for users of financial statements who currently employ incurred loss data in assessing the performance of financial institutions.

The proposed presentation means that entities would have to calculate two EIRs in respect of each financial instrument or each portfolio of financial instruments: the EIR based on the contractual cash flows before inclusion of expected future losses (this would be similar to the EIR under the current requirements in IAS 39), and the EIR after inclusion of expected future losses. The ED does not provide any explanation or guidance in this area, but it appears that this presentation would require two amortised cost calculations to be performed throughout the life of a financial instrument: one based on contractual terms without inclusion of future credit losses and one including future credit losses. This may impose an additional burden on preparers.

The proposed presentation would change the current practice for entities that present interest on financial assets held for trading in the interest line in order to match it against interest costs incurred in the funding of those assets such that both are included in the overall reported net interest margin. This change could have a significant impact on the reported net interest margin.
Disclosures

7.1 Summary
The ED proposes extensive additional disclosure requirements, which would amend IFRS 7.

Observations
The additional disclosures proposed in the ED could require preparers to make significant changes to their information systems in order to capture and accumulate the detailed information required to comply with the proposed disclosure requirements.

Similar to the existing requirements of IFRS 7, some of the disclosures in the ED would be required by class of financial instruments. The ED does not propose changing the existing guidance under IFRS 7 in respect of determining what constitutes a “class” of financial instruments. A “class” is different from a measurement “category” or “classification” of a financial instrument as defined in IAS 39 or IFRS 9. As is the case at present, judgement would be required to determine the appropriate classes and the granularity of disclosures.

7.2 Allowance account

The ED proposes:

- mandatory use of an allowance account to account for credit losses and it prohibits direct write-offs of financial assets;
- disclosure of a reconciliation of the allowance account, by class of financial asset, showing the following as a minimum:
  - increases resulting from the allocation of initial estimates of expected credit losses;
  - increases and decreases resulting from changes in estimates of expected credit losses;
  - write-offs; and
- disclosure of an entity’s write-off policies for each class of financial assets.

The ED proposes a definition of “write-off”. The Board believes that disclosure of write-offs would be the best proxy for disclosure of “actual losses”. Respondents to the Request for Information and other users of financial statements indicated that information about “actual losses” would be useful.

Observations
Currently IAS 39 permits an entity to recognise a reduction in the carrying amount of a financial asset due to impairment, and any subsequent increase from the reversal of a previously recognised impairment, either directly or through use of an allowance account. In contrast the ED proposes mandatory use of an allowance account to account for credit losses and gains.

When an entity uses an allowance account to recognise impairment losses, IFRS 7 currently requires a reconciliation of changes in that account during the reporting period for each class of financial assets. However, unlike the proposals in the ED, IFRS 7 does not mandate any particular minimum requirements for the reconciliation.

The ED’s proposed definition of a “write-off” may not always be consistent with policies that some entities apply to write off financial assets deemed uncollectible. In particular the ED requires that for there to be a write-off the entity should have ceased any further enforcement activities. However there may be situations in which financial institutions write off loans as, in...
their view, there is no reasonable expectation of further recovery even though the recovery process may continue. Corporate entities may follow similar approaches in respect of writing off trade receivables.

### 7.3 Estimates and changes in estimates

**ED/2009/12**

The ED proposes extensive disclosures in the notes to the financial statements of the estimates made and subsequent changes to these estimates. These include:

- inputs and assumptions used in determining expected credit losses, including:
  - the basis of inputs;
  - if significant, the effects of changing the inputs to reasonably possible alternatives;
  - for changes in estimates, an explanation of what estimates have changed, the cause of the change and the new inputs and assumptions used;
  - for any change in the estimation technique used, an explanation of the change and the reason for it;
- explanation of the gains and losses resulting from changes in estimates, as shown on the face of the statement of comprehensive income, including:
  - disaggregation into the gains and losses attributable to changes in estimates of credit losses and those attributable to other factors;
  - further analysis, both quantitative and qualitative, of significant gains and losses, or if a particular portfolio, period of origination, or geographical area has a significant effect on these gains and losses; and
- a comparison between the development of the credit loss allowance over time and cumulative write-offs, and a description of the impact of changes in estimates on this comparison, if significant.

**Observations**

Some of these requirements may present significant challenges for many entities. In particular, disaggregation of gains and losses on re-estimations into those caused by credit risk and those caused by other factors may prove difficult in practice if both events occur in the same period and have a joint impact on the estimated cash flows. This may be an operational issue which could benefit from consideration by the Expert Advisory Panel.

### 7.4 Stress testing

**ED/2009/12.20**

The ED proposes that if an entity carries out stress testing for internal risk management purposes, then the fact that the stress test is done is disclosed along with information that would enable users of the financial statements to understand:

- the implications for the entity's financial position and performance; and
- the entity's ability to withstand the stress scenarios.

**Observations**

As these disclosures are required only if the entity actually is performing stress testing, the proposal should not require significant additional effort for preparers. The proposal is based on stress testing prepared for internal risk management purposes and does not refer to stress testing information prepared for other purposes, such as regulatory requirements.
It is not clear to us from the ED as to what would qualify as “stress testing” for the purpose of the proposed disclosure requirements. Entities may perform a variety of scenario analyses and risk analyses and it is not clear as to what forms of analyses would constitute “stress testing.” Also, entities may carry out stress testing for portfolios of assets and liabilities, and it may not always be feasible to isolate from these tests the effects of stress testing on assets measured at amortised cost.

7.5 Credit quality of financial assets

The ED requires the following disclosures by class of financial assets:

- a reconciliation of movements in non-performing assets; (financial assets are defined as non-performing when a counterparty has failed to make a payment 90 days after it is contractually due or the asset is considered uncollectible); and
- if significant, a qualitative analysis of the interaction between movements in non-performing financial assets and movements in the allowance account.

The ED proposes certain minimum information to be shown in the reconciliation.

Observations

The above disclosures on credit quality of financial assets are in addition to those in IFRS 7. As a “90 days overdue” status is often used as a benchmark for an assessment of credit quality of financial assets, this disclosure is likely to increase comparability between different entities. However, to the extent that entities do not currently collect such data, system changes or additional processes would be necessary.

7.6 Vintage information

The ED proposes disclosure, by class of financial assets, of the year of origination and the year of maturity (in the ED referred to as “vintage information”). The disclosure has to be made in a tabular form on the basis of the assets’ nominal amounts.

Observations

The proposed disclosure of vintage information by class of financial assets may lead to extensive and voluminous disclosures for financial institutions. The extent of the disclosure, and the resultant need for data collection, would depend on how an entity defines “classes” of financial assets for the purpose of this disclosure.

Further, disclosure of vintage information on the basis of the nominal amounts may provide, on its own, limited information to the users of the financial statements as it would not reflect the extent to which the entity has created an allowance for credit losses against these nominal amounts and so would not reflect accurately the risk to which the entity is exposed at the reporting date.
8. Effective date and transition

The Board expects that the final IFRS would not become mandatory until about three years after it is issued. Earlier application would be permitted.

Observations

Many respondents to the Request for Information on the feasibility of the ECF approach estimated the required lead time for adoption of the ECF approach to be within a range of two to three years from the issuance of a final standard. The Board’s view on the mandatory effective date reflects their acknowledgement of the implementation challenges and the extended lead time that many entities may require.

However, as the Board plans to issue a final standard on amortised cost and impairment in the fourth quarter of 2010 and has expressed an intention for all phases of the revision to IAS 39 to have a single effective date, entities may have, in practice, approximately two years to implement the requirements of the final IFRS on impairment. The effective date for the recently issued IFRS 9 is 1 January 2013.

The ED proposes retrospective application. However, for financial instruments recognised before the date of initial application, the ED allows an entity to approximate the EIR that would have been determined in accordance with the ED had it been applied on initial recognition of these financial instruments. The ED proposes that the rate determined under IAS 39 be adjusted and refers to this adjustment as the “EIR transition adjustment”.

In determining the EIR transition adjustment maximum use should be made of available historical data, appropriately adjusted to take into account information for similar financial instruments for which the EIR has been determined in accordance with the proposals in the ED (i.e., products originated or acquired close to the transition date).

The ED allows flexibility in arriving at the approximate EIR and describes two possible ways in which such approximations could be made:

- using ratio analysis to infer the EIR transition adjustment using information for similar financial instruments that are recognised initially near the date of initial application of the final IFRS; or
- using the expected margin on similar financial instruments that are recognised initially near the date of initial application of the final IFRS; if this approach is applied the adjusted EIR cannot be below the risk-free interest rate in effect on the date of initial recognition of an instrument as a risk-free interest rate is a natural floor.

The Board is requesting comments on an alternative approach, which would require an entity to use the EIR calculated under the existing IAS 39 for the purpose of restatement of the comparative information, and also on an ongoing basis to recognise interest income and expense for the remaining expected lives of the instruments existing at the transition date. An entity would be required to estimate on transition the cash flow estimates in accordance with the proposals in the ED (including expected credit losses over the remaining life of a financial asset), which then would be discounted using the EIR determined under existing IAS 39 to arrive at the amortised cost of the financial instrument on the transition date.

The date of initial application would be the beginning of the annual period for which an entity first applies the requirements of the final IFRS.
Observations
The proposed approach to estimating EIR for financial assets recognised before the date of initial application is a pragmatic proposal which should reduce the burden on preparers and reduce the difficulties in determining what losses were “expected” as of a date in the past.

Transitional adjustments arising under the proposals are likely to have a negative impact on equity for many entities. This is because the proposed model would result in an earlier recognition of credit losses than the existing incurred loss model in IAS 39. The alternative approach for which the Board is seeking views, although simpler, may increase the negative adjustment to equity as future expected cash flows, which are reduced by expected credit losses, would be discounted using an EIR which was determined using contractual cash flows that excluded any reduction for expected credit losses.

The ED does not propose any consequential amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards. Under IFRS 1 the transitional requirements in other standards do not apply to a first-time adopter’s transition to IFRS, except where specified. This would mean that first-time adopters would not be able to take advantage of the transitional requirements proposed in the ED.

Transition disclosures
Upon transition, to explain the effect of initial application in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, an entity would disclose a qualitative analysis of the effect on profit or loss of the difference between EIRs determined in accordance with the proposals in the ED and the EIRs determined in accordance with the entity’s previous accounting policy, and how this effect relates to the amount of the transition adjustment to the amortised cost of financial assets.
9. Expert Advisory Panel

The Board is assembling an Expert Advisory Panel (EAP) that will advise the Board on operational issues surrounding the application of the ECF approach. The FASB also has decided to participate in the EAP.

The EAP would have the following objectives:

- to advise the Boards on how operational challenges arising from the IASB’s ECF approach and the FASB’s approach might be resolved; in particular:
  - how best to address process-driven implementation issues; the EAP is expected to provide analyses and develop practical solutions for this purpose;
  - what guidance would be useful for the Boards to provide and in what format, i.e., educational guidance or as part of authoritative literature; and
- to assist in organising and running field testing of any proposals made by the IASB.

Possible issues already identified for the EAP’s attention include:

- lack of historical data;
- estimates for individual financial instruments;
- estimates on a portfolio and individual level;
- implications of “actual” losses;
- correlation in portfolios;
- migration of instruments over time;
- penalty payments;
- recovery costs;
- interaction with Basel II requirements;
- implications of probability of pre-payment;
- estimates using data from secondary sources;
- application of the requirements to variable rate instruments;
- possible alternatives for the allocation of the initially expected losses;
- determination of the initial expected spread; and
- applying the ECF approach to specific types of instruments (e.g., instalment loans or revolving facilities).

Observation

As the proposals in the ED would change radically the current accounting for interest and impairment and would present considerable operational challenges in implementation for many entities, the creation of the EAP is a welcome development which should help in development of practical solutions and assist in both the development of and transition to a new standard.
10. Other matters

10.1 Interaction with other IFRSs

As part of its deliberations on impairment of financial assets, the Board identified other IFRSs that potentially could be impacted by the proposal to remove the existing guidance in IAS 39 pertaining to the incurred loss approach to impairment.

**Impairment loss on an investment in an associate**

Under IAS 28 *Investments in Associates* an investor uses the impairment triggers under the incurred loss model in IAS 39 to determine whether it is necessary to recognise any additional impairment loss on an investment in an associate. If such indicators exist, then the entire carrying amount of the investment in the associate is tested for impairment in accordance with IAS 36 *Impairment of Assets*. As the ED proposes to remove the impairment indicators in IAS 39 they no longer would be available to be used under IAS 28.

To address this situation, the ED proposes an amendment to IAS 28 that would require an entity to use the impairment indicators in IAS 36 instead of the indicators in IAS 39 to determine whether additional impairment testing is required for an investment in an associate. Hence, under the proposed amendment to IAS 28, impairment indicators, testing and measurement of any additional impairment loss would be governed by one standard (i.e., IAS 36) rather than two separate standards.

**Impairment of reinsurance assets**

Under IFRS 4 *Insurance Contracts* impairment testing of reinsurance assets is undertaken if there is objective evidence of a loss event that occurred after initial recognition of the reinsurance asset, and the loss event has a reliably measurable impact on the amount due from the reinsurer. In the Basis of Conclusions for IFRS 4 the Board noted that the most appropriate impairment test for reinsurance assets would be based on the incurred loss model in IAS 39 as the impairment test should focus on credit risk.

In its deliberations leading up to the ED, the Board noted a potential issue that might result from the proposal to remove guidance on loss events or triggers from IAS 39. While IFRS 4 refers to objective evidence of loss events, it does not provide further guidance in this respect. The potential issue that could arise is whether the guidance on loss events existing in IAS 39 today would continue to be an appropriate analogy for the purpose of interpreting IFRS 4 even after it would have been eliminated as a result of the ED.

The Board determined that eliminating the loss event guidance in IAS 39 would not result in a change in accounting policies for entities applying IFRS 4 to reinsurance assets; for loss event identification regarding reinsurance assets the inferences from the loss event guidance existing in IAS 39 today would remain as valid after replacement of IAS 39 as they are today. Hence the Board decided not to change the guidance in IFRS 4 with respect to impairment of reinsurance assets.