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

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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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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.