



Request for Information (‘Expected Loss Model’)

Impairment of Financial Assets: Expected Cash Flow Approach

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1. Background (1)

- In phase 2 of its project to replace IAS 39 the IASB intends to determine **one valid** impairment model for financial assets
- In its deliberations to date the Board discussed the following approaches:
 - Incurred loss approach (as currently required in IAS 39)
 - Expected cash flow approach (expected loss model)
 - Fair value-based approach
- So far now no decision has been taken



1. Background (2)

- The implementation of a new impairment model could result in considerable ramifications for preparers. Therefore this Request for Information seeks input on the application challenges such an expected loss model would have
- Those information will be considered when developing ED proposals
- The Request for Information was issued on 25 June 2009
- Responses are to be received by 1 September 2009
- Exposure Draft on impairment of financial assets planned for publication in October 2009



2. Definition of the approach (1)

Discussed in the May 2009 meeting of the IASB (refer to agenda paper 5A of this meeting). Main features of the expected cash flow approach include:

- Interest revenue is recognised on the basis of expected cash flows (including expected credit losses) upon the initial recognition of an instrument
- Impairment results from an adverse change in credit loss expectations (ie expectations of credit losses are higher than those previously expected)
- An impairment loss is recognised in profit and loss and is measured as the difference between the carrying amount of the financial asset and the present value of the revised expected cash flows of that asset



2. Definition of the approach (2)

- When determining the present value of expected cash flows, fixed rate instruments are discounted using the effective interest rate calculated upon the initial recognition of the instrument and variable rate instruments are discounted using the current effective interest rate
- Subsequent or additional impairment loss is recognised through continuous re-estimation of credit loss expectations
- Reversal of impairment loss is recognised in profit or loss when there is a favourable change in credit loss expectations (ie expectations of credit losses are less than those previously expected)



2. Definition of the approach (3)

Question 1

Is the approach defined clearly? If not, what additional guidance is needed, and why?



3. Operability of the approach (1)

- Current incurred loss model:
 - Expected credit losses implicitly considered when calculating the effective interest rate upon initial recognition of the instrument, as those expectations are incorporated in the nominal interest rate
 - Subsequent recognition of expected losses not yet incurred as well as changes in those expectations are explicitly prohibited
 - An entity's systems need to provide information regarding objective evidence that a financial asset is impaired (triggering events indicating impairment)
- Expected loss model
 - Objective evidence not necessary
 - An entity's systems rather need to provide expected future cash flows generated by financial assets held together with a continuous re-estimation of expected credit losses



3. Operability of the approach (2)

Question 2

Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?



4. Cost of implementing and applying the approach (1)

- Applying an expected loss model requires different information than the current incurred loss model:
 - In a first step the systems and processes of an entity have to be adapted accordingly, which will result in additional costs and requires some lead time
 - Application on an ongoing basis will result in processing a higher data volume compared to the current model ⇒ does this regularly result in higher ongoing costs?



4. Cost of implementing and applying the approach (2)

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?



5. Variable rate instruments (1)

- For subsequent measurement the effective interest rate method is to be applied to both the expected loss model and the incurred loss model
- The financial mathematical mechanics of this method applied to variable rate instruments lead to operational challenges, which can be solved in alternative ways
- The Request for Information addresses the following two issues:
 - Amortisation of upfront costs, and
 - Impairment of variable rate instruments



5. Variable rate instruments (2)

- IAS 39 requires upfront costs (any fees, points paid or received, transaction costs and other premiums or discounts) to be amortised over the expected life of the instrument.
- There are two main approaches for amortising upfront costs:
 - **Approach A:** Amortise upfront costs using the original effective interest rate calculated upon initial recognition of the instrument. Under this approach, the initially determined amortisation pattern would remain constant; it remains unaffected by changes in the variable benchmark interest rate.
 - **Approach B:** Recalculating the amortisation pattern for the upfront costs on the basis of an updated estimate for the remaining variable interest receipts to maturity. Under this approach, the amortisation pattern for the upfront costs would change each period in response to changes in the variable benchmark interest rate.



5. Variable rate instruments (3)

- An impairment loss is to be recognised if the carrying amount of a variable rate instrument exceeds the present value of its expected cash flows, discounted at the current effective interest rate. When an impairment loss is recognised, a portion of future contractual interest receipts that are still expected to be received partially become in substance repayments of principal because the contractual interest cash flow exceeds the effective interest accrual.
- The following approaches could be considered for treating the ‘repayment of principal’ in those situations:
 - **Approach A:** Recalculate the effective interest rate so that the still expected future interest receipts (based on the forward curve updated from time to time) and the still expected principal receipts are discounted to the carrying amount, consistently with AG7 of IAS 39. This would require continuous resetting of the effective interest rate post-impairment.



5. Variable rate instruments (4)

It also raises the issue of sequencing two steps:

- 1 recalculating the current effective interest rate at each measurement date (which requires a carrying amount as a starting point); and
 - 2 revisions of the cash flow estimates regarding the expected shortfalls of contractual receipts (which requires the current effective interest rate in order to be converted into a present value – ie the carrying amount).
- **Approach B:** Keep the effective interest rate constant after an impairment and treat changes in the carrying amount resulting from changes in the variable benchmark interest rate as a ‘catch up’ adjustment in accordance with AG8 of IAS 39. A ‘catch up’ adjustment is used because the changes in the cash flows no longer relate solely to interest receipts but also (often predominantly) relate to an in substance principal payment.



5. Variable rate instruments (5)

Question 4

How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.



6. Portfolio of financial assets (1)

- In many cases an impairment model will be applied to a portfolio of financial assets rather than to each financial asset individually (mainly for high volume-low-amount-populations)
- If losses are identified on specific assets within that portfolio, the following approaches for further treatment are possible:
 - a) Changing from a collective to an individual assessment. The impaired assets have to be removed from the portfolio. Subsequent measurement has to be determined separately for those assets and the remaining portfolio
 - b) Despite the identified losses the portfolio will still be assessed on a collective basis



6. Portfolio of financial assets (2)

Question 5

How would you apply the approach if a portfolio of financial assets was previously assessed on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?



7. Possible simplifications

Question 6

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?



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