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Financial Instruments: Amortised Cost and Impairment

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1. Objective

- To improve the usefulness of financial statements by improving the transparency of provisions for losses on loans and the credit quality of financial assets.
- To improve the accounting for provisions for losses on loans taking into consideration expected losses, resulting in more timely recognition of losses.
- To reflect the economic reality of lending by recognising interest revenue as a credit cost adjusted return, which eliminates the front-loading of interest revenue.



2. Scope

- The requirements of this [draft] standard shall be applied to all items within the scope of IAS 39 that are measured at amortised cost.



3. Overview Expected Loss Model

The proposed expected loss model requires an entity:

- to determine the expected credit losses on a financial asset when that asset is first obtained;
- to recognise contractual interest revenue, less the initial expected credit losses, over the life of the instrument;
- to build up a provision over the life of the instrument for the expected credit losses;
- to reassess the expected credit loss each period;
- to recognise immediately the effects of any changes in credit loss expectations.



4. Measurement Principles (I)

- Amortised cost shall be calculated using the effective interest method. Hence, amortised cost is the present value calculated using the following inputs:
 - a) the expected cash flows over the remaining life of the financial instrument; and
 - b) the effective interest rate as the discount rate.
- The estimates for the cash flow inputs are expected values. Hence, estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes.
- The effective interest method determines the allocation of interest revenue and interest expense. The effective interest rate used for this purpose reflects how the contract sets the interest payments for the financial instrument (i.e. what part of the contractual interest rate, if any, is reset).



4. Measurement Principles (II) - Amortised Cost

- Amortised cost is the amount at which a financial asset or financial liability is measured at initial recognition adjusted over time as follows:
 - a) minus principal repayments;
 - b) plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount; and
 - c) plus or minus any addition or reduction resulting from the effect of revising estimates of expected cash flows (e.g. regarding prepayments or uncollectibility) at each measurement date.



4. Measurement Principles (III) - Expected cash flows

- An entity shall estimate the expected cash flows considering:
 - a) all contractual terms of the financial instrument (e.g. prepayment, call and similar options);
 - b) fees and points paid or received between parties to the contract that are an integral part of the effective interest rate to the extent they are not included in the initial measurement of the financial instrument; and
 - c) for financial assets, credit losses over the entire life of the asset (for financial liabilities estimates of expected cash flows do not reflect the entity's own non-performance risk).
- When an entity determines whether it estimates expected cash flows on a collective or an individual basis it shall:
 - a) use the approach that provides the best estimate; and
 - b) ensure that the approach used does not result in double-counting of credit losses.
- Guidance on the use of historical data



4. Measurement Principles (IV) - Allocation mechanism for interest revenue and expense

- Paragraphs B11 and B12 in Appendix B include further application guidance in determining the effective interest rate initially and subsequent resetting for fixed rate and floating rate financial instruments.
- Paragraphs B13 and B14 in Appendix B include application guidance in how to treat any fees, points paid or received, transaction costs and other premiums and discounts as well as renegotiated or otherwise modified terms of the financial instrument.



4. Measurement Principles (V) - Practical expedients

- An entity may use practical expedients in calculating amortised cost if their overall effect is immaterial. Those shall be consistent with the following principles:
 - a) the calculation incorporates the effect of the time value of money (except for short-term receivables if the effect of discounting is immaterial);
 - b) the calculation includes all expected cash flows for all of the remaining life of the financial instrument; and
 - c) the calculation results in a present value that equals the initial measurement of the financial instrument.
- An example is determining the amortised cost of trade receivables using a provision matrix based on an entity's historical loss experience.
- Another example in paragraph B17 in Appendix B.



5. Presentation

The statement of comprehensive income shall include the following five line items:

$$\begin{aligned} & \text{Gross interest revenue (= contractual interest revenue)} \\ & \text{— Initial expected credit losses (portion allocated to the period)} \\ & \hline & \text{= Net interest revenue (= economic interest revenue)} \end{aligned}$$

Gains and losses resulting from changes in credit loss expectations

Interest expense



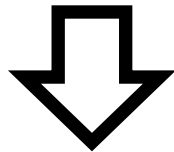
6. Defined terms

- Amortised cost, effective interest method, effective interest rate, transaction costs:
 - Definitions in accordance with the definitions in IAS 39.9.
- Non-performing:
 - The status of a financial asset that is more than 90 days past due or is considered uncollectible.
- Write-off:
 - A direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery and has ceased any further enforcement activities.



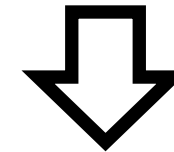
7. Disclosures (I)

Disclosures



Expected credit losses

- Allowance account
- Estimates and changes in estimates
- Loss triangle
- Stress testing



Credit quality of financial assets

- Reconciliation of changes in non-performing assets
- Origination and maturity (vintage) information



7. Disclosures (II) – Allowance account

- For financial assets measured at cost an entity shall use an allowance account to account for credit losses. An entity shall disclose for each class of financial assets:
 - a) a reconciliation of changes in that account during the period; and
 - b) its write-off policy.
- The required reconciliation shall reconcile the balances at the beginning and end of the period showing at a minimum:
 - a) increases resulting from the allocation of initial expected credit losses;
 - b) increases resulting from changes in estimates of expected credit losses;
 - c) decreases resulting from changes in estimates of expected credit losses; and
 - d) write-offs.
- Reconciliation has to be done on a gross basis including financial assets that become impaired and are written off in the same period. Hence, direct write-offs against the contractual amount of financial assets without using an allowance account are prohibited.



7. Disclosures (III) – Loss triangle

- An entity shall disclose for each class of financial assets a comparison between the developments of the credit loss allowance over time and cumulative write-offs (so-called *loss triangle*).
- The comparison shall be provided in a tabular format. Paragraph B24 in Appendix B contains the displayed example.

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



7. Disclosures (IV) – Reconciliation of changes in non-performing assets

- For financial assets measured at cost an entity shall disclose for each class of financial assets:
 - a) a reconciliation of changes in non-performing financial assets during the period; and
 - b) a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account if that interaction is significant .
- The required reconciliation shall reconcile the nominal amounts at the beginning and end of the period showing at a minimum:
 - a) increases resulting from reclassifications of performing loans as non-performing;
 - b) increases resulting from acquisition of non-performing loans;
 - c) decreases resulting from recoveries through enforcing securities;
 - d) decreases resulting from recoveries due to payments of the debtor;
 - e) renegotiations; and
 - f) write-offs.

7. Disclosures (V) – Origination and maturity (vintage) information

- An entity shall disclose for each class of financial assets information showing the year of origination and the year of maturity (vintage information).

- The information shall be provided:
 - on the basis of nominal amounts; and
 - in tabular format.

- Paragraph B29 in Appendix B contains the displayed example.

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



8. Transition

- The ED does not propose fully retrospective or prospective transition.
- For financial instruments measured at amortised cost that were initially recognised before initial application of this [draft] : approximate the effect interest rate by applying an effective interest rate transition adjustment.
- In determining this transition adjustment an entity shall use all available historical data and supplement them as needed with information for similar instruments for which the effective interest rate is determined in accordance with this [draft] IFRS.
- An entity shall adjust the opening balance of each affected component of equity for the earliest period presented and the other comparative amounts disclosed for each period presented as if this [draft] IFRS had always been applied but use the effective interest rate previously determined in accordance with IAS 39 (plus transition adjustment).



9. Effective date

- To be set upon approval of the final IFRS.
- Due to the expected lead-time for implementing the expected loss model the final IFRS will not become mandatory until about three years after it is issued.
- Therefore, the final standard would be mandatorily applicable for annual periods beginning on or after 1 January 2014 as the earliest.
- Earlier application will be permitted.



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