

# INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/09

## FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT



### Background

The International Accounting Standards Board (IASB) has issued for comment an Exposure Draft (ED) of proposed changes to the accounting for financial instruments. The ED sets out proposals that would replace the amortised cost and impairment requirements in IAS 39 commonly referred to as the 'incurred loss model' with an 'expected loss impairment approach' which uses more forward-looking information than the incurred loss model and requires the inclusion of credit loss expectations in the amortised cost measurement of financial assets.

The ED reflects discussions of the Financial Crisis Advisory Group (FCAG), which was set up in October 2008 as part of the IASB's joint approach with the US standard setter, the Financial Accounting Standards Board (FASB) to dealing with issues arising from the global financial crisis. The ED also draws on the responses that the IASB received from a 'Request for Information' it posted on its website in June 2009 and from the additional input on operational aspects received by the IASB staff through an extensive outreach programme.

The IASB's and the FASB's projects to replace their existing financial instruments standards have been accelerated in response to calls from the G-20, the Financial Stability Board and other constituents.

The ED is the second exposure draft issued by the IASB setting out proposals to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The first exposure draft, issued in July 2009, set out proposals to simplify the approach for the classification and measurement of financial instruments in comparison to the current requirements set out in IAS 39. On 12 November 2009, the IASB finalised Phase I of the IAS 39 replacement project by issuing IFRS 9 *Financial Instruments*. The scope of IFRS 9 is currently limited to the classification and measurement of financial assets. The IASB will continue its work on financial liabilities, in particular measurement issues related to the effects of changes in an entity's own credit risk on fair value measurement, and will include the requirements for those instruments in IFRS 9 in due course. The final exposure draft will deal with hedge accounting.

The IASB plans to develop an IFRS from the proposals in the ED for amortised cost and impairment, and expects to publish the IFRS in the second quarter of 2010. The IASB anticipates that the IFRS will not be mandatory until about three years after it is issued but earlier application would be available subject to specific transitional provisions. The IASB also plans to obtain input from its Expert Advisory Panel on operational aspects of the implementing the proposals in the ED and to undertake some field testing.

### STATUS

Exposure draft

### EFFECTIVE DATE

To be confirmed

### ACCOUNTING IMPACT

Significant changes proposed for financial instrument accounting

## Proposals

### Scope

The proposals would apply to all financial assets and financial liabilities within the scope of IAS 39 that are measured at amortised cost.

### Subsequent measurement at amortised cost

#### *Objective of amortised cost measurement*

The ED states that the objective of amortised cost measurement is to provide information about the effective return on financial assets or financial liabilities by allocating interest revenue or expense over the expected life of the financial instrument.

The ED clarifies that the effective return (effective interest rate):

- is determined on the basis of the initial expectations about cash flows over the expected life of the financial instrument; and
- reflects an allocation of fees, points paid or received, transaction costs, other premiums or discounts and an initial estimate of expected credit losses (financial assets only) over the expected life of the financial instrument.

#### *Measurement principles*

The proposals in the ED clarify that amortised cost is a present value calculation using the effective interest method. Amortised cost is the present value of the financial instrument, using expected cash flows over its remaining life, and the effective interest rate as the discount rate.

The Application Guidance to the proposals notes that amortised cost is the amount at which a financial instrument is measured at initial recognition:

- minus principal repayments;
- plus or minus the amortisation of the difference between the initial amount and the maturity amount using the effective interest method; and
- plus or minus any changes resulting from the effect of revising estimates of the expected cash flows (for example, in respect of prepayments or uncollectibility) at each measurement date.

This adjustments result in a revised carrying amount at each measurement date that is the present value of the expected cash flows over the remaining life of the financial instrument discounted at the appropriate effective interest rate. For a fixed rate instrument, this will be the rate calculated on initial recognition of the financial instrument; for variable rate instruments, this will be updated at each reporting date (see below). In addition, any revision in estimates of payments or receipts will require the carrying amount of the financial instrument (or group of financial instruments) to be revised by computing the present value of the expected cash flows on the basis of the revised estimates using the effective interest rate. Any adjustment is recognised in profit or loss and presented in the statement of comprehensive income.

The ED also clarifies that cash flow inputs for amortised cost measurement are the probability-weighted possible outcomes for the amounts and timing of the cash flows.

The Application Guidance notes that an entity takes the following into account when estimating expected cash flows:

- All contractual terms of the financial instrument (eg prepayment, call and similar options);
- Fees and points paid or received to the extent they are not included in the initial measurement of the financial instrument; and
- Expected credit losses over the entire life of the asset (financial assets only).

An entity's own non-performance risk is excluded from the analysis (financial liabilities only).

The proposal for the use of expected losses when determining future cash flows for financial assets represents a very significant change from current practice, where impairment is recognised on an incurred loss basis (that is, where objective evidence of a loss has to exist before any account is taken of that loss).

The Application Guidance notes that expected cash flows may be estimated on an individual instrument basis or collective basis (eg on a group or portfolio level). When determining whether to estimate expected cash flows on a collective or individual basis an entity is required to use the approach that provides the best estimate and ensure the approach does not result in double-counting of credit losses. The basis chosen may be changed during the life of a financial asset.

In addition, when expected credit losses are estimated on a collective basis, financial assets may be grouped on the basis of similar credit risk characteristics that are indicative of the debtor's ability to pay all amounts due according to the contractual terms of the financial assets being evaluated (e.g. credit risk evaluation, industry, geographical location, collateral type and other relevant factors).

When estimating the effects of credit losses on expected cash flows, an entity may use internal and external sources of data such as historical credit loss experience (or peer group experience for comparable financial assets or groups of financial assets when there is insufficient entity-specific experience), internal and external ratings, credit loss experience of other entities, and reports and statistics. Historical data, such as credit loss experience, is required to be adjusted on the basis of current observable data to reflect the effects of current conditions, and the methodology and assumptions used for estimating the effects of credit losses on expected cash flows are required to be reviewed regularly to reduce differences between the estimated and actual credit loss experience.

When an entity uses historical credit loss rates to estimate expected future cash flows, the information about the historic loss rates that is to be applied to groups needs to be defined in a manner that is consistent with the groups for which the historic credit loss rates were observed.

For a collateralised financial asset, the estimated expected cash flows are required to reflect the cash flows that may result from foreclosure less the cost of obtaining and selling the collateral whether or not foreclosure is probable. Any collateral obtained from the foreclosure is not recognised as a separate asset unless it meets the recognition criteria for an asset in other IFRSs.

The proposals in the ED also clarify that the effective interest rate used for allocating interest revenue and interest expense 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).

The Application Guidance notes that the effective interest rate is determined in relation to the component or components that are reset in accordance with the contract. For example:

- For a fixed rate instrument – the effective interest rate is the rate that results in the present value of the expected cash flows being equal to the carrying amount on initial recognition (i.e. initial measurement) of the financial instrument. Hence the effective interest rate remains constant over the life of the financial instrument; and
- For a floating rate instrument that resets a benchmark interest component (eg LIBOR plus 100 basis points) – the effective rate is a not a single constant rate; instead it is a combination of the spot curve for the benchmark interest rate and a spread. The spread is derived by iteration so that the present value of the expected cash flows is equal to the carrying amount on initial recognition (i.e. initial measurement) of the financial instrument. Essentially the spot curve is updated while the initial effective spread remains constant. Hence, the cash flow is discounted using a rate that is a combination of the applicable spot rate for each cash flow date and the initial effective spread.

The Application Guidance also notes that any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate are amortised over the expected life of the financial instrument or a shorter period, if they relate to a period that is shorter than the expected life.

If the terms of a financial instrument are renegotiated or modified due to financial difficulties of the debtor, impairment is measured by calculating the amortised cost using the effective interest rate before the modification. Any adjustment to the carrying amount is recognised in profit or loss and presented in the statement of comprehensive income.

The Application Guidance also provides for the use of practical expedients in calculating amortised cost if their overall effect is immaterial. An entity may use a practical expedient if it is consistent with the following principles:

- The calculation incorporates the time value of money (except for cash flows on short-term receivables if the effect of discounting is immaterial);
- The calculation includes all expected cash flows for all the remaining life of the financial instrument; and
- The calculation results in a present value on initial recognition that equals the initial measurement of the financial instrument on the basis of the detailed requirements of the proposed standard (i.e. the application of the practical expedient does not result in a different initial carrying amount).

The examples of practical expedients provided in the Application Guidance include the use of a provision matrix, based on an entity's historical loss experience, for determining the amortised cost of trade receivables and the use of two present value calculations for the allocation over the expected life of a financial asset of the initial estimate of expected credit losses in lieu of the effective interest method.

### Presentation and disclosure

The proposals in the ED would require an entity to present the following line items in its statement of comprehensive income:

- Gross interest revenue calculated using the effective interest method before the allocation of the initial estimate of expected credit losses;
- The portion of expected credit losses allocated to the period as a reduction of gross interest revenue;
- Net interest revenue (as the subtotal of the previous two items);
- Gains and losses resulting from changes in estimates in relation to financial instruments measured at amortised cost; and
- Interest expense calculated using the effective interest method.

The proposals in the ED would require an entity to provide a number of disclosures including:

- • An allowance account to account for credit losses on financial assets which discloses for each class of financial assets a reconciliation of the changes in the account during the year and its write-off policy;
- Information that explains estimates and changes in estimates that are used to determine amortised cost;
- Stress testing information that enables users of the financial statements to understand the implications for the financial position and performance of the entity, and the entity's ability to withstand the stress test scenarios. This disclosure is only required if an entity prepares stress testing information for internal risk management purposes;
- For each class of financial asset measured at amortised cost, a reconciliation of changes in non-performing financial assets during the period and, if significant, a qualitative analysis of the interaction between changes in non-performing financial assets and the allowance account; and
- For each class of financial assets measured at amortised cost, information showing the year of origination and the year of maturity (vintage information).

The ED also contains a number of explanatory paragraphs which provide additional guidance on the information to be included in the presentation and disclosure items listed above.

## Consequential amendments to other accounting standards

The proposals set out in the exposure draft would result in consequential amendments being made to a wide range of other accounting standards and interpretations. These include changes to IFRS 7 *Financial Instruments: Disclosures*, to amend the requirement to disclose information about certain financial assets and financial liabilities, and total interest income and interest expense calculated using the effective interest method if that information is presented separately in the statement of comprehensive income in accordance with the new standard, and to IAS 28 *Investments in Associates* which would remove the requirement for the investor to apply IAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.

## Effective date and transition

The IASB anticipates that the new standard will not be mandatory until at least three years after the date of issuance of a final IFRS in order to allow for sufficient lead-time for implementing the proposed requirements. However earlier application would be permitted.

The ED proposes transitional requirements which represent neither fully retrospective nor fully prospective application. Instead the transitional approach would approximate the effective interest rate that would have been determined in accordance with the measurement principles in the new standard if it had been applied on the initial recognition of the financial instrument. This is accomplished by applying an effective interest rate transition adjustment to the effective interest rate previously determined in accordance with IAS 39.

The new standard would require an entity to determine the effective interest rate transition adjustment using all available historical data, supplemented as required with information for similar financial instruments for which the effective interest rate is determined in accordance with the measurement principles in the new standard.

On initial application of the new standard, an entity would need to adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the proposals in the new standard have always applied.

On explaining the effects of initial application of the new standard in accordance with IAS 8 an entity would be required to provide a qualitative analysis of:

- the effect on profit or loss that results from the difference between the effective interest rate determined in accordance with the new standard and the rate used in accordance with its previous accounting policy; and
- how that effect relates to the amount of the transitional adjustment to the amortised cost of financial assets;

On initial application of the new standard, an entity will be exempt from providing certain comparative disclosures related to the development of the credit loss allowance.

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