6 November 2009

Straight away

IFRS bulletin from PricewaterhouseCoopers

IASB issues ED ‘Financial instruments: Amortised cost and impairment’

What is the issue?

The IASB is proposing fundamental changes to the impairment guidance for financial assets accounted for at amortised cost. This is the second stage of the IAS 39 replacement project. The ED proposes an ‘effective return’ approach to amortised cost measurement. For financial assets, this implies an ‘expected cash flow’ (ECF) impairment model.

The proposed approach is built upon the premise that interest charged on financial instruments includes a premium for expected losses, which should not be included as part of interest revenue/income, and results in an allocation of the initial estimate of expected credit losses over the expected life of the financial asset. The lender will be required to identify the ‘effective interest rate’ (EIR) component at the inception of an instrument that represents compensation for the expected losses. Interest income is recognised over the life of the instrument at the EIR, net of the expected loss component identified at inception. The premium associated with the expected losses is reflected each period as a reduction in the basis of the receivable (effectively a provision for bad debts).

Unlike the incurred loss model currently required under IAS 39, the ECF approach does not wait for evidence that an impairment has occurred, but instead requires a continuous assessment of the expected cash flows over the life of the instrument. No impairment losses will be recognised if the original expectations of the expected losses prove accurate. The premium associated with the initial estimate of expected losses will have already reduced the receivable balance to the amount expected to be collected. However, if more losses are expected than originally estimated, an impairment charge will be recognised for the decrease in the expected cash flows. If favourable changes to loss expectations occur, a credit to income will be recognised for the increase in expected cash flows. The approach requires the use of allowance account for credit losses. Direct write-offs are prohibited.

The ED sets out robust presentation and disclosure requirements to ensure that users can evaluate the financial effect of interest revenue and interest expense, and the credit quality of financial assets held by the entity. In particular, it requires:

- Presentation of the gross contractual interest revenue, a reduction to gross interest revenue reflecting the portion of initial expected credit losses allocated to the period, and a subtotal for the net (economic) interest revenue;
- Presentation of gains and losses resulting from changes in estimates in relation to financial assets and liabilities measured at amortised cost;
- Reconciliation of changes in credit loss allowance account (with minimum required line items) and the entity’s write-off policy;
- Disaggregation of gains and losses into amounts attributable to changes in credit loss expectations and other factors;
- Comparison between the development of credit loss allowance over time and cumulative write-offs (a loss triangle);
- Explanation of inputs, assumptions and methodology used in determining expected credit losses and changes thereto, sensitivity analysis, and stress testing if performed internally;
- Reconciliation in the movement of non-performing loans (defined as 90 days or more overdue);
- Origination and maturity (vintage) information for financial assets at amortised cost;
- Further qualitative and quantitative disclosures depending on the entity’s specific circumstances.

The IASB recognises that there are significant operational challenges in implementing and applying the ECF approach. Estimating cash flows over the life of the instrument and the complexity of the EIR methodology are expected to be two of the most difficult areas. The IASB is therefore setting up an Expert Advisory Panel to advise the Board on the operational issues surrounding application of the ECF approach and possible practical expedients and to facilitate field testing. The ED has an unusually long exposure period, with comments requested by 30 June 2010. This long exposure period is to facilitate the work of the Expert Advisory Panel. The Expert Advisory Panel will consider both the IASB and FASB impairment models.

The FASB impairment model is still under development and both Boards would like the impairment guidance to arrive at similar outcomes. However, a 'converged' impairment standard may be a challenge if the broader financial instruments guidance of the IASB and the FASB is not converged.

A final IFRS on amortised cost and impairment is expected by the end of 2010. The Board expects that the IFRS will not become mandatory until about three years after it is issued.

Am I affected?

All entities that hold financial assets carried at amortised cost will be affected. The proposals will have the greatest impact on banks and other financial institutions that have significant investments in loans and receivables. The proposed model will equally apply to trade receivables routinely held by entities that are not financial institutions, so corporate entities should also evaluate the effect of the proposals.

Entities transitioning to IFRS before the proposed effective date need to consider the implications of the proposals on their transition plans. First-time adopters should consider if they need to implement systems that will comply with the current IAS 39 incurred loss model in light of the proposed expected loss model which would require further systems changes.

What do I need to do?

The IASB is seeking comments on the ED by 30 June 2010. We encourage management to reply, giving special consideration to the operational side of the expected cash flow approach and 'field testing' the model. We also encourage you to follow the discussions of the Expert Advisory Panel, as these will provide the basis for the detailed operational guidance in the final standard.

If you have questions on the proposals or require further information, please speak to your regular PwC contact.