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IFRS in Focus
IASB and FASB issue joint proposals on impairment of financial assets

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The Bottom Line

- The supplement has been developed jointly by the IASB and FASB and proposes amendments to the expected loss model included in the IASB's exposure draft on amortised cost and impairment issued in November 2009.
- The proposals would only apply to assets managed on an open portfolio basis.
- Under the proposed impairment model expected losses in a 'good book' are recognised over time while expected losses on a 'bad book' are immediately recognised in profit or loss.
- The proposed approach would require entities to make loss estimates across different time periods which may require adjustments to processes and systems.
- Lifetime expected credit loss estimates consider all information available including internal and external information.
- Provisions for credit losses would be presented as a separate expense line item in profit or loss rather than as a reduction in interest revenue.
- Short-term trade receivables are not subject to the impairment considerations in the supplement and will be considered as part of discussions on the revenue recognition project.

The proposals

On 31 January 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued a jointly developed supplementary document *Financial Instruments: Impairment* ('the Supplement') to the November 2009 IASB exposure draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*. The proposals in the Supplement stem from the Boards' consideration of the feedback received on each of their respective exposure drafts. Additionally, the IASB has included an appendix to the Supplement which proposes separate presentation and disclosure requirements. The FASB has not yet discussed presentation and disclosure requirements.

The IASB proposals in the Supplement are part of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The proposals, if finalised, would apply to all debt instruments, such as loans and debt securities that are measured at amortised cost under IFRS 9 *Financial Instruments*.

The Supplement develops the existing proposals to replace the incurred loss impairment models in IAS 39 and US GAAP with an expected loss impairment model. The proposals address only open portfolios of assets (i.e., portfolios which are constantly changing) as the Boards consider these portfolios to be most challenging when applying an impairment model. However, the Supplement also requests feedback from constituents on potential issues in applying the proposals to individual items or closed portfolios. The Boards will then consider these responses when they address closed portfolios and individual assets.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

A brief history

The incurred loss impairment model in IAS 39 and the equivalent US GAAP requirements were criticised during the financial crisis for delaying recognition of losses and not incorporating more forward looking information.

To address these concerns, both Boards issued separate proposals on impairment. Under the proposals in the IASB's ED, the amortised cost of a financial asset would be the present value of the future expected cash flows from the asset, including consideration of future credit losses. Credit losses expected at initial recognition of a financial asset would be recognised by reducing the amount of interest revenue recognised on the financial asset by incorporating the expected credit losses into the effective interest rate of the asset. Any subsequent changes to the estimate of future credit losses would be immediately recognised in profit or loss.

This approach was based on the rationale that credit risk is a key input into the pricing of the asset and therefore initial estimates of future credit losses should be a component of interest revenue recognition, while subsequent changes in credit risk are not part of the pricing of the asset and should be recognised in profit or loss immediately.

Many comment letters acknowledged the conceptual merits of the proposals in the ED but identified operational concerns and questioned whether the possible improvement in financial reporting would justify the significant costs and effort required to implement the proposals. Many financial statement preparers also questioned whether the proposals could realistically be applied to open portfolios of financial assets, which is how credit risk is managed for many entities (particularly financial institutions).

Scope

The proposals in the Supplement would apply to financial assets measured at amortised cost under IFRS 9 and managed on an open portfolio basis. Short-term trade receivables, for which discounting for the time value of money would be immaterial, are not within the scope of the Supplement.

Still to come

The IASB has not yet discussed all of the proposals contained in their original exposure draft. Instead, they have chosen first to request additional feedback on the most challenging aspects of the proposed model (e.g., application to open portfolios). The IASB will then address the remaining topics while considering the feedback received on the proposals in the Supplement. Items yet to be discussed and therefore not addressed in the Supplement include:

- impairment considerations for individual financial assets, assets held in a closed portfolio, other problem loans, purchased loans, investments in debt securities, and trade receivables;
- methods for measuring credit losses;
- definitions for the terms 'write-off' and 'non-performing';
- the objective of amortised cost measurement;
- interest revenue recognition; and
- disclosures related to stress testing, vintage information and credit quality.

Observation

Respondents to both the IASB's original ED on impairment and ED/2010/0 Revenue from Contracts with Customers expressed concern with the proposals that would require trade receivables to be recognised net of initial expected credit losses (resulting in a reduction in revenue rather than a separate bad debt expense). The IASB decided that this issue should be discussed as part of the revenue recognition project and any decision then incorporated into the impairment guidance.

Good book versus bad book

The Supplement differentiates between a 'good book' and a 'bad book' depending on management's expectations about the collectability of the cash flows of the financial asset. An asset would be transferred to the 'bad book' when the entity's credit risk management objective changes for that asset from receiving contractual payments from the debtor to recovery of all or a portion of the financial asset. The lifetime expected losses for assets in the 'good book' would be recognised over time while the lifetime expected losses for assets transferred to the 'bad book' would be recognised immediately in profit or loss.

Entities that do not manage their credit risk by differentiating assets based on a 'good book' and 'bad book' basis would still be required to differentiate their assets for purposes of determining an impairment allowance

Impairment – The 'good book' approach

The Supplement proposes that for financial assets where it is appropriate to recognise expected credit losses over time (the 'good book'), the allowance amount would be determined as the higher of (1) expected credit losses applying the time-proportional approach and (2) credit losses expected to occur in the foreseeable future (defined in the Supplement as not less than twelve months after the reporting date).

Observation

The time-proportional approach with a minimum floor allowance of credit losses expected to occur in the foreseeable future is the result of both Boards compromising on their original proposals but attempting to preserve both of their respective objectives. The IASB's objective has focused on reflecting credit losses as a component of pricing the financial asset while the FASB's objective has focused on ensuring the allowance account is sufficient to absorb all expected credit losses.

Entities would be provided with a choice of how to recognise expected credit losses under the time-proportional approach. They could use either:

- the remaining lifetime expected credit losses of the portfolio multiplied by the ratio of the portfolio's current age to the portfolio's expected life (a straight-line approach); or
- the remaining lifetime expected credit losses of the portfolio converted into annuities based on the portfolio's expected life (an annuity approach).

Under the time-proportional approach, both the age (i.e., time since initial recognition) and expected life of the portfolio are determined based on weighted averages.

Observation

In developing the expected life for a portfolio, entities will need to consider prepayment options, call options, extension options, other options and asset defaults. Therefore, the weighted average expected life of the portfolio is not as simple as calculating the weighted average life based on contractual maturities. Entities may need to consider external factors such as movements in interest rates and other factors correlated to prepayment and call options in developing the expected life of the portfolio.

Under the straight-line approach an entity would be permitted to use either discounted or undiscounted expected losses. An entity that chooses to apply either the discounted straight-line approach or the annuity approach may utilise any reasonable discount rate between the risk free rate and the effective interest rate.

Observation

While requiring a single approach may have improved comparability, the IASB ultimately agreed that entities should be permitted to utilise any of the three approaches (straight-line undiscounted, straight-line discounted or the annuity approach), thus allowing entities with more sophisticated systems and processes to achieve a "more precise allocation" of expected losses.

The inclusion of a minimum floor allowance equal to the credit losses expected to occur in the foreseeable future (defined as not less than twelve months from the reporting date) is intended to ensure that a sufficient allowance is recognised for asset classes that experience higher default rates early in the asset's life, and that, under the time-proportional approach, the cumulative impairment allowance is not negative.

Example

An entity manages two portfolios of performing loans ('good books'). Portfolio A comprises loans with a nominal balance of CU 1,000,000 and Portfolio B comprises prime mortgage loans with a nominal balance of CU 50,000,000. The table below provides the information the entity will use in calculating impairment for the two portfolios using the straight-line undiscounted time-proportional approach as permitted in the Supplement.

Portfolio	Remaining Lifetime Expected Credit Losses	Weighted Average Age	Weighted Average Expected Life	Time-proportional Amount	Foreseeable Future Period (FFP)	Expected Credit Losses During FFP	Impairment Allowance
	A	B	C	D = A x (B/C)	E	F	G = > of D or F
A	3,000	1 year	3 years	1,000	1 year	2,500	2,500
B	75,000	3 years	12 years	18,750	1 year	12,000	18,750

Greater losses are expected on Portfolio A in the foreseeable future than the allowance calculated under the time-proportional approach and therefore the entity records an allowance amount equal to those losses anticipated in the foreseeable future. The allowance amount for Portfolio B as calculated under the time-proportional approach exceeds those losses expected in the foreseeable future and therefore the entity records an allowance amount as calculated under the time-proportional approach.

Impairment – The 'bad book' approach

When an asset is transferred from a 'good book' to a 'bad book', all remaining expected credit losses are recognised immediately.

The IASB's appendix to the Supplement proposes that for transfers between the 'good book' and the 'bad book', the allowance balance should be transferred based on the time-proportional approach. Under this approach, a portion of the portfolio's 'good book' allowance account, based on the age of the asset being transferred, would be transferred to the 'bad book' allowance account when the asset is transferred. The 'good book' allowance account would be depleted and a new target allowance balance for the 'good book' established. The asset being transferred to the 'bad book' would recognise an impairment loss for the remaining expected loss not transferred from the 'good book' allowance account.

Example

Assume an entity manages an open portfolio of homogeneous loans. Management's objective with respect to a particular loan with lifetime expected losses of CU100 has changed from collecting principal and interest payments to recovery of the principal. The entity has determined the loan should be managed within their 'bad book' based on their internal credit risk management process and that the expected losses should be recognised immediately. The troubled loan has an age of 1 year and a 5 year expected life. Therefore, the entity will transfer CU 20 (1/5 x 100) of the portfolio's 'good book' allowance account related to the loan into the 'bad book' allowance account and recognise the remaining CU 80 as impairment loss. After the transfer, the portfolio's 'good book' allowance account now needs to be re-estimated accordingly.

Observation

The IASB also considered 'full depletion' and 'no depletion' approaches for transfers between the 'good book' and the 'bad book'. The full depletion method would have transferred the asset's entire expected loss amount from the portfolio's 'good book' allowance so that no impairment loss would be recognised for the 'bad book' but the portfolio's 'good book' allowance would be under its target level by the amount of the transfer. The no depletion approach would not have transferred any allowance from the portfolio's 'good book' allowance and recognised the entire expected loss amount as impairment loss once the asset has been transferred to the 'bad book'. Regardless of the method used, the amount of provision expense recognised in profit or loss would be the same. The IASB's decision to propose the partial depletion approach was made so that a single approach was used for the disclosure reconciliations of the allowance accounts and they would be comparable across entities.

Expected credit loss estimates

The Boards have clarified that the lifetime expected credit loss estimate should consider all available internal and external information. This would include historical data and current economic conditions as well as supportable forecasts of future events and future economic indicators. The estimate of future conditions should be consistent with both currently available information and management's internal forecasts. The estimate of expected credit losses should be updated at least at each reporting date.

Observation

The Boards have converged their proposals with respect to developing expected loss estimates. The IASB's original ED permitted the use of various sources of data, including both internal and external data, in estimating the effect of credit losses on future cash flows but included little guidance on how to develop estimates of future events. The FASB's ED required consideration of all available information on past events and current conditions in the development of estimates on expected losses, but did not consider potential future economic events beyond the reporting date.

Entities may need to develop two separate expected loss estimates, one for the lifetime expected losses under the time-proportional approach and a second for losses expected to occur in the foreseeable future period in determining the minimum floor for the allowance under the 'good book' approach. The foreseeable future period is a constant period of time and would not change from period to period, but may vary in length between asset classes with different characteristics.

Presentation and disclosure

The appendix to the Supplement proposes presentation and disclosure requirements related to the proposals in the Supplement. The appendix proposes that impairment losses would be presented as a separate expense line item in profit or loss (a significant change from the IASB's original proposals which would have presented credit losses as a reduction of interest revenue).

The proposed disclosures intend to provide financial statement users with information about:

- activity in the allowance account;
- factors that could impact credit losses for the 'good book';
- significant gains or losses from changes in expected loss estimates, particularly arising from specific portfolios or geographic areas;
- the credit risk management process and how the 'good book' and 'bad book' distinction has been made;
- management's assessment of expected losses;
- inputs and assumptions used in estimating credit losses; and
- performance of expected loss estimates with actual outcomes (e.g., backtesting).

The appendix proposes that the disclosures related to impairment should be provided at a sufficiently disaggregated level in order to reflect the credit characteristics of the portfolio and also proposes to permit incorporation by cross-reference to other publicly available statements when the required disclosures are already included in other documents. This may be the case for banks who file reports with regulators which include similar disclosure requirements.

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