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IFRS Project Insights

Financial Instruments: Impairment

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The IASB's financial instrument project will replace IAS 39 *Financial Instruments: Recognition and Measurement.* The Financial Instruments project is being addressed by the IASB in phases: Classification and Measurement, Impairment, Hedge Accounting and Offsetting of Financial Assets and Liabilities.

The objective of the Impairment phase is to improve transparency of provisions for credit losses and the credit quality of financial assets, recognise credit losses more timely and eliminate the front-loading of interest income. In November 2009, the Board issued ED/2009/12 *Amortised Cost and Impairment* (ED) for public comment proposing an expected cash flow model for measuring financial instruments at amortised cost, including recognition of credit losses through a reduction of interest revenue by using an integrated effective interest rate.

The comment letter responses on ED/2009/12 and input from the Expert Advisory Panel identified significant operational challenges relating to implementation and application of the expected cash flow model and compliance with the disclosure requirements. Comment letter respondents were also overwhelmingly supportive of the IASB and FASB (collectively "the Boards") develop a converged impairment model. The FASB had issued separate impairment proposals as part of their comprehensive proposals on financial instruments and hedge accounting which included recognition of lifetime expected credit losses at the time the estimate is made (i.e., immediate recognition).

The Boards began joint discussions in September 2010 attempting to reconcile their differing objectives. The IASB's objective has focused on credit risk being a component in the pricing of financial assets (i.e., into the coupon interest rate) and therefore should be incorporated as part of interest revenue recognition. The FASB's objective has focused on ensuring a sufficient allowance amount is reserved to cover all future expected credit losses.

On 31 January 2011, the Boards issued a joint Supplement to ED/2009/12. The Boards are developing an alternative approach for the recognition of expected losses based on the mixed views expressed by constituents to the proposals in the joint Supplement. The Boards formed an internal subworking group of select Board members and project staff to lead the development of a new variation of the impairment recognition model based on the feedback received.

Summary of tentative decisions reached since the issuance of the Supplement

Amortised Cost Measurement

The Boards tentatively decided that the calculation of amortised cost for a financial asset would not include a reduction for the credit impairment allowance.

Estimating Expected Losses

The joint Supplement described what information to consider in developing estimates of expected losses, but did not provide guidance on any specific methodology for estimating expected losses. The Boards tentatively decided that expected losses would be estimated based on an objective of using an expected value approach (i.e., a probability-weighted average approach) but acknowledged that using reasonable methods to approximate expected values would be permitted including the use of information such as loss rates, probability of defaults (PDs), loss given defaults (LGDs) and exposure at defaults (EADs). Additionally, the Boards have tentatively decided that the objective of estimating expected losses would also be a present

value calculation (i.e., discounting future cash flows); however, the Boards acknowledge that several statistical approaches may approximate a present value amount.

Recognition of Expected Losses

The Boards are developing an impairment model based on three separate categories (buckets) of credit quality The Boards tentatively decided that for assets in buckets 2 and 3 with increased levels of credit concern, the allowance would be recognised as the full lifetime expected loss. For bucket 1 where no specific credit concern has been identified but where it is likely that credit losses will emerge within the portfolio (eg IBNR), the Boards tentatively decided to keep the allowance calculation operationally simple by using either 12 or 24 months' worth of expected losses or for the remaining expected life if that is less than 12 or 24 months. The Boards also tentatively agreed to require the use of an annual loss rate (or a 24 month loss rate) rather than an annualised loss rate.

In determining when to transfer assets between bucket one and bucket two, while the Boards made no formal decisions, they expressed support for the staffs to further develop a principle for transfer based on the deterioration of credit quality (a 'relative' credit risk approach). The Boards recognise that a principles-based approach may result in inconsistent application among entities so they will focus on developing disclosure requirements in an attempt to minimise the effect of diversity in application. The Boards asked the staffs to further consider the development of a principle for transfers amongst the buckets, the indicators that should be provided in making the transfer assessment and the disclosure requirements that would enhance comparability across entities.

Accounting for Purchased Debt

The Boards tentatively decided that entities that purchase 'good book' assets would recognise revenue on the same basis as originated assets; that is, the effective interest rate would be determined based on the contractual cash flows of the asset. However, for purchased 'bad book' assets, the Boards tentatively decided on a separate revenue recognition approach where the effective interest rate would be based on the cash flows expected to be received rather than the contractual cash flows. The Boards acknowledged they will need to revisit this decision based on the feedback received on the joint Supplement.

Defined Terms

The Boards tentatively decided to define a write-off as "a direct reduction of the amortised cost of a financial asset resulting from uncollectibility". Additionally, the Boards tentatively decided that an asset would be considered uncollectible if the entity has no reasonable expectation of recovery. An asset would be written off, partially or fully, in the period in which the entity has no reasonable expectation of recovery.

Presentation

The Boards tentatively decided that the unwinding of the discount associated with the use of a present value estimation would be unwound (accreted) through the impairment losses line item in profit or loss. The Boards also anticipate developing disclosures to provide additional transparency related to this amount.

Disclosure

The IASB has tentatively decided that:

- disclosure of an entity's write-off policy would be required including a discussion related to whether assets written off are still subject to enforcement activity and the amount of assets written off that the entity is pursuing collection.
- recoveries of previously written-off assets would be included as a separate line item in the reconciliation of changes in the allowance account.
- disclosure of stress testing information would not be required in the final standard.
- for financial assets measured at amortised cost, require a reconciliation of changes in non-performing financial assets during the period for assets that are 90 days past due, but not included in the 'bad book'.

- remove the definition of 'non-performing' proposed in the original exposure draft because it is no longer needed for the proposed disclosures.
- information showing the year of origination and the year of maturity (vintage information) would not be required in the final standard.

Thinking ahead

- The proposals, if finalised, will have the greatest impact on those entities that are financial instrument intensive and measure their financial assets at amortised cost such as many lending institutions (banks and other financial institutions). However, the impact would not be limited to financial institutions as all entities are likely to have assets measured at amortised cost (e.g. investments in debt instruments such as corporate and government bonds measured at amortised cost under IFRS 9).
- The adoption of an expected loss model would be a significant challenge for many entities that will impact not only finance, but also would require involvement of and integration between risk management, corporate reporting and investor relations.
- Entities would be required to assess expected credit losses on *all* amortised cost assets irrespective of whether a loss trigger event has occurred.
- Entities would need to determine what period represents the foreseeable future for each managed portfolio.
- Application of the time-proportional approach includes estimating the weighted average expected life of a portfolio; this would include consideration of prepayment options, call options, extension options, other options and asset defaults.
- Accounting policies and controls would need to be established to ensure that credit loss estimates are reviewed continuously.
- Entities may need to upgrade their information technology capabilities to ensure that robust sources of data are available to support their estimates of credit losses as well as providing information for the required disclosures.

Next steps

The IASB expects to issue an exposure draft either during the first quarter of 2012.

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