IFRS in brief: special edition

IASB and FASB seek comments on common impairment model for financial assets

What's the issue?

The IASB and FASB ('the boards') have issued a 'supplementary document' to their original proposals on impairment of financial assets. This document, entitled *Financial instruments: Impairment*, proposes a common approach to the timing of recognition of expected credit losses on financial assets managed in an open portfolio. The proposals reflect the feedback received on the boards' original impairment models and will assist the boards in developing a common approach to credit loss recognition.

What are the key provisions?

Common proposal

The supplement proposes a dual impairment model driven off the credit characteristics of the financial assets. This is consistent with how banks manage credit risk and is often referred to as a 'good book' and 'bad book' approach.

Financial assets in the 'good book'. Impairment will be recognised on a portfolio basis over the life of the book such that the allowance account is the higher of:

1) the time-proportionate expected credit losses; and

2) the credit losses expected to occur within the foreseeable future (but not less than 12 months).

The supplement does not describe how to measure expected credit losses. However, it illustrates how to use expected loss estimates and the weighted average age and life of a portfolio to calculate the time-proportionate expected credit losses.

Financial assets in the 'bad book'. The boards have concluded it is not appropriate to recognise impairment losses over time on a 'bad book'. Instead, the entire amount of the lifetime expected credit losses will be recognised immediately.

Whether or not it is appropriate to recognise expected credit losses over time depends on the degree of uncertainty about the collectability of a financial asset. When collectability becomes so uncertain that the entity's credit risk management objective changes from receiving regular payments to recovery, it is no longer appropriate to recognise impairment losses over time, and the financial asset should be transferred into a 'bad book'. Financial assets therefore move between the 'good book' and the 'bad book' according to the entity's internal risk management policies.

Alternative approaches

The common proposal is the result of the boards' joint discussions on an impairment model for credit losses that addresses the primary objectives of the individual boards. However, some board members prefer the models that they were developing separately. The supplement therefore also seeks comments on the boards' respective approaches, in addition to the common proposal.

Under the IASB alternative approach in the supplement, an entity recognises the time-proportionate lifetime-expected credit losses on a 'good book' with no 'floor', and the full amount of lifetime-expected losses on a 'bad book'. This reflects the IASB view that expected credit losses are priced into the margin earned on financial assets.

Under the FASB alternative approach, an entity immediately recognises all credit losses expected to occur in the foreseeable future, with no minimum period specified. There is also no split between 'good book' and 'bad book'. This reflects the FASB objective of ensuring a sufficient impairment allowance at any point in time.

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Scope

The scope of the proposals is limited to open portfolios − that is, portfolios that contain financial assets with similar credit characteristics irrespective of the time of their origination. The boards invite comments as to whether the proposed approach is suitable for closed portfolios, individual instruments and any other types of instrument. For the IASB, the proposals exclude from the scope short-term trade receivables, pending re-deliberations of the revenue exposure draft.

The boards are not re-exposing other aspects of the impairment model, such as measurement of credit losses or interest revenue recognition. They will continue re-deliberating these issues based on the feedback received from their original exposure drafts while the supplement is open for comment.

IASB-only appendix

The supplement contains an IASB-only appendix, which seeks input on:

- presentation and disclosure proposals driven off the common approach;
- 'decoupling' of the effective interest rate and recognition of expected credit losses; and
- application of the common proposal to loan commitments and financial guarantees.

Am I affected?

The common proposal will mainly affect financial institutions that manage their financial assets on an open-portfolio basis. If the proposals are extended to other types of portfolio and financial assets, they may affect any entity that holds financial assets measured at amortised cost under IFRS 9/AASB 9 *Financial Instruments,* or those not measured at fair value through net income under the FASB tentative classification and measurement model.

What do I need to do?

The comment deadline is 1 April 2011. The IASB expects to finalise the impairment requirements by June 2011. It has not yet decided when the proposals will be mandatory. The FASB expects a final update on the credit impairment model to be issued in 2011.

Management should assess the impact of the proposals and consider commenting on the supplement to ensure their views are considered.