January 2011

Snapshot: Supplement to the Exposure Draft Financial Instruments: Amortised Cost and Impairment

In November 2009 the International Accounting Standards Board (IASB) published an exposure draft *Financial Instruments: Amortised Cost and Impairment* (the original ED).

This snapshot is a brief introduction to a supplement to the original ED. The supplement is published by the IASB and the US-based Financial Accounting Standards Board (FASB).

The proposals form part of the IASB's response to the global financial crisis and are consistent with recommendations made by the G20, the Financial Stability Board, the Financial Crisis Advisory Group and others.

Objective:	To develop a common approach with the FASB for an expected loss impairment model for open portfolios[1] of financial assets measured at amortised cost.
Project stage:	This is a supplement to the IASB's original ED. It is being published jointly with the FASB, with an IASB-only appendix. This supplement retains the fundamental concept of impairment proposed in the original ED while addressing operational concerns that were raised.
Next steps:	During the comment period for this document, the IASB will continue to discuss the proposals in the original ED that are outside the scope of the supplementary document. When finalised the new impairment requirements will be added to IFRS 9 *Financial Instruments*.
Project to replace IAS 39:	This is part of the second stage of the three-phase project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The first phase, dealing with the classification and measurement of financial instruments, has been completed. The third phase, dealing with hedge accounting, is continuing.
Comment deadline:	The supplementary document is open for public comment until 1 April 2011. The IASB's target completion date for impairment accounting is 30 June 2011.

[1] A portfolio to which financial assets are added during the portfolio's life as new assets are originated or purchased.

The snapshot has been prepared by staff and is not an official technical document of the IASB.

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What is the background?

Why are the boards addressing impairment accounting?

In November 2009 the IASB published the original ED that proposed replacing the incurred loss model in IAS 39 with an expected loss model for the credit impairment of financial assets.

When using an incurred loss model, loans may be written down (impaired) only when evidence (known as a trigger event) is available that a loan or portfolio of loans will not be repaid in full.

The incurred loss model attracted criticism during the financial crisis because it does not permit credit losses to be recognised until a trigger event has occurred, even when those losses are expected. This led to complaints that loan losses were recognised 'too little, too late'.

Responding to the financial crisis

In the light of requests by investors, the Financial Crisis Advisory Group (FCAG)[2], the Financial Stability Board (FSB) and others to address this issue, the IASB proposed moving to an expected loss model. This approach would require entities to determine and account for the expected credit losses on a financial asset when originated or acquired.

The original proposals addressed issues in the G20's April 2009 report, *Declaration in Strengthening the Financial System*, which called on accounting standard-setters:

- to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information; and
- to improve accounting standards for provisions.

Benefiting from information gained in response to the original ED, the supplementary document proposes changes to the original ED to address operational issues for open portfolios while replicating the outcomes of the original ED as closely as possible.

[2] The FCAG is a group of senior leaders with broad experience of international financial markets formed to advise the boards on their response to the financial crisis.

How did the IASB address stakeholders' concerns?

Responses to the original ED showed that constituents supported a change to an expected loss model.

However, respondents said that the model proposed in the original ED would present some operational difficulties. This view was supported by the Expert Advisory Panel (EAP), a group established by the IASB that comprised credit risk management and systems experts from around the world.

The IASB was told that information from accounting and risk management information systems would need to be used together in order to implement the original proposals but that these systems are generally maintained separately. To make the necessary systems changes would be costly and take a significant period of time. In addition, significant operational concerns were raised about the original ED's proposed model when applied to open portfolios.

The EAP recommended some variations to address these concerns. The proposals in the supplementary document incorporate many of those recommendations.

How do these proposals differ from the original ED?

The proposals in the supplementary document are based on suggestions from the EAP and retain many of the principles from the original ED. The supplementary document addresses some of the major operational difficulties identified, particularly for open portfolios. The objective of the proposals is to yield similar results to the original ED, while being easier for entities to implement.

The scope of the supplementary document is narrow – it applies only to financial assets measured at amortised cost[3] and managed in an open portfolio, excluding short-term trade receivables.

Allocation of expected losses

The original ED proposed that entities should recognise interest revenue, less initial expected credit losses, over the life of a financial asset by adjusting the interest rate used to calculate interest revenue. This was proposed to show the relationship between expected credit losses and the pricing of loans.

Responses indicated that this was operationally difficult to implement. This is because interest rates that are used to determine interest revenue are calculated in accounting systems, whereas expected losses are monitored in credit systems. Moreover, these accounting and credit functions are not integrated.

To achieve a similar outcome more simply, the IASB proposed separating the calculation of interest rates from the recognition of expected losses. This is known as the 'decoupled approach'.

'Good book' – 'bad book'

Many financial institutions have two broad groups of financial assets that are monitored differently: loans that are considered problematic (the 'bad book') and those that are not (the 'good book'). Financial assets in the 'good book' are generally monitored on a portfolio basis, while those in the 'bad book' are managed more closely and, often, on an individual basis.

The supplementary document proposes separate methods to recognise expected losses for these groups.

For the 'good book', expected losses are recognised over time, using a 'time-proportional' approach. For the 'bad book', expected losses are recognised immediately.

Time-proportional approach

With these points in mind, an allowance balance or loan loss provision would be recognised for all financial assets measured at amortised cost, but the amount of the balance will differ depending on whether an asset is in the 'good book' or 'bad book'.

Using the 'time-proportional' approach, an allowance is calculated as a portion of the remaining lifetime expected losses on the portfolio. The portion is determined on the basis of the age of the portfolio.

[3] Often we refer to these assets as 'loans', but the proposals in the supplementary document would apply to all financial assets measured at amortised cost and managed in open portfolios, except for short-term trade receivables.

Minimum ‘good book’ allowance

In some cases, recognising a time-proportional amount for the ‘good book’ may result in actual losses occurring that exceed the allowance balance at the time of the loss. For example, this might occur if a portfolio has a concentration of loans that are expected to default early in their life.

To address this concern, the boards decided that it was necessary to set a minimum allowance balance (a floor). So, the allowance balance for the ‘good book’ will be the greater of:

(a) the time-proportional amount (as described above), and;

(b) the expected losses for the foreseeable future (the floor).

The foreseeable future is the period for which an entity can develop specific projections of events and conditions to estimate expected losses for the portfolio, and is required to be no less than 12 months.

New presentation and disclosure requirements

The supplementary document contains an appendix (Appendix Z) that includes presentation and disclosure requirements proposed only by the IASB. The FASB has not yet considered these presentation and disclosure proposals.

The original ED proposed disclosures that related to the initially proposed impairment model and general disclosures about the credit quality of financial assets. The disclosures proposed in Appendix Z are specific to the new impairment proposals and are included to give constituents a more robust view of the proposed impairment model. They do not relate to the credit quality of financial assets as the IASB has already received comments on those proposals in the original ED. The disclosures relating to credit quality will be redeliberated in the light of those earlier comments.

How did we achieve a common solution?

Background

In May 2010 the FASB published the proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED). This included proposals on the impairment of financial assets, and like the IASB's original ED, it proposed moving to a more forward-looking impairment model.

The FASB ED proposed that the lifetime expected credit losses should be recognised in the same period when a financial instrument is acquired or originated. This differed from the IASB's proposals in the original ED that the initially expected credit losses be allocated over the life of the instrument. The objective of the model in the FASB ED was to ensure that credit losses will always be recognised before they occur.

Convergence efforts

After receiving feedback on their respective exposure drafts, the boards began to redeliberate jointly how to account for the impairment of financial assets.

Although both boards agreed to require an expected loss model, they initially disagreed about when the expected losses should be recognised. The IASB maintained that expected losses should be recognised over the life of the instruments, whereas the FASB continued to believe that expected losses should be recognised in the period of the assets' initial recognition.

However, both boards recognise the importance of convergence on this topic, and the proposals in the joint document represent a common solution.

Common solution

To reach a common solution the proposal incorporates elements of the separate models that the IASB and the FASB were developing.

The proposals in the supplementary document establish a minimum allowance balance for expected losses that is at least equal to losses as they occur. This addresses the concern that insufficient reserves for expected losses are created for the 'good book', and thus credit loss information is communicated to investors too late.

However, the proposals ensure that the 'good book' would have an allowance balance based on the time-proportional amount of expected losses, subject to a minimum amount. The time-proportional amount recognises those losses over the life of the instrument to reflect the relationship between loss expectations and the pricing of loans.

What happens now?

Next steps

The boards have not yet redeliberated all of the proposals in their original exposure drafts because they wanted to address open portfolios first, since they raise the most challenging operational issues. In addition, the boards would like feedback on these aspects of the proposals before finalising an impairment model.

During the comment period for this document, the IASB will continue to discuss other aspects of the proposals in the original ED, including methods for measuring credit losses, definitions of the terms ‘write-off’ and ‘non-performing’, and the treatment of short-term trade receivables.

After receiving responses to the supplementary document, the boards will consider how to apply the proposals to other financial assets, including closed portfolios and individual instruments.

The IASB intends to finalise the requirements on accounting for the impairment of financial assets by 30 June 2011.

The effective date for the proposals will be discussed during redeliberations.

How can I comment on the document?

The document includes specific questions on the IASB’s proposals. Respondents are invited to comment on any or all of the questions contained in the document, including the IASB-only Appendix Z, and to comment on any other issue that the IASB should consider in finalising the proposals. The IASB’s redeliberations of the proposals will take place in public meetings.

The deadline for comments on the document is 1 April 2011. Please visit www.ifrs.org to view the document and submit your comments.

Stay informed

The boards will announce on their websites the dates of any meetings at which they discuss the responses to the supplementary document.

To stay up to date about the project, you can visit the impairment project page, http://go.ifrs.org/impairment, or sign up for free email alerts. Details of the original exposure draft, including a previous snapshot, can be found here along with information on the supplementary proposals.

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