Impairment — a major step forward in achieving convergence

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) have continued to redeliberate their new “three-bucket” expected loss approach to the impairment of financial assets. At their joint Board meeting on 14 and 15 December 2011, the Boards made significant progress and agreed on several tentative decisions.

The Boards addressed four critical conceptual questions:

- **The principle of transfer when recognition of lifetime expected losses is appropriate** will be based on fulfilling two criteria: (1) when there has been a more than insignificant deterioration in credit quality since initial recognition; and (2) when the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable. The assessment of the transfer will generally be based on the probability of default.

- The **Bucket 1 impairment allowance** would capture losses on financial assets expected in the next 12 months (for example, the 12 month probability of default multiplied by the loss given default).

- The **differentiating factor between Bucket 2 and Bucket 3** will be based on the “unit of evaluation”, that is, when financial assets in Bucket 1 deteriorate in credit quality, these financial assets will move to Bucket 2 when assessed collectively and to Bucket 3 when assessed individually.

- **Grouping of financial assets for impairment evaluation** will be allowed if the financial assets have shared risk characteristics. However, individual assessment will be required if the financial assets have no shared risk characteristics or are individually significant.

The Boards agreed that the “three-bucket” impairment approach should be applied to retail loans, commercial loans and debt securities. Entities will need to evaluate all available reasonable and supportable information including the Boards’ proposed list of forward-looking indicators. This includes both general and specific indicators related to particular types of financial assets.

The Boards have yet to discuss the disclosure requirements and the application to purchased financial assets, trade receivables, lease receivables, commitments and guarantees. Moreover, the Boards have not yet concluded as to whether the new impairment approach is applicable to improvement in the credit quality of financial assets (that is, whether the model would be symmetrical).
Financial assets would move into Buckets 2 or 3 when two criteria are met: (1) There has been a more than insignificant deterioration in credit quality; and (2) It is at least reasonably possible that cash flows are not recoverable.

Overview of the “three-bucket” approach
In previous meetings, the Boards decided to pursue the “three-bucket” expected loss approach to the impairment of financial assets measured at amortised cost that falls within IFRS 9 Financial Instruments.

The guiding principle of the “three-bucket” approach reflects the general pattern of the deterioration in the credit quality of financial assets. Under this approach, all financial assets are initially classified in Bucket 1 irrespective of credit quality.

Principle of transfer when recognition of lifetime expected losses is appropriate
The Boards have tentatively decided that the principle for transferring financial assets out of Bucket 1 will be based on two criteria:

1) When there has been a more than insignificant deterioration in credit quality since initial recognition
   And
2) When the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable.

The assessment of when recognition of lifetime expected losses is required will generally be based on the probability of default, rather than whether a loss will actually be realised or the magnitude of the loss. Hence, the assessment does not take into account the value of collateral, although it is reflected in the estimate of lifetime expected loss.

Also, the Boards have asked the staff to develop examples to clarify the scope of “reasonably possible” by considering:

- The differences in practice between IFRS and US GAAP when interpreting the term “reasonably possible”.
- The likelihood that cash shortfalls begin to increase at an accelerated rate as an asset deteriorates (e.g., this may be the dividing line between investment and non-investment grade financial assets, which is roughly equivalent to a greater than 10% probability of default).

Under this approach, high-quality assets would not transfer as quickly as poorer quality assets to Buckets 2 and 3.

Impairment allowance for Bucket 1
Previously, the Boards had agreed that the allowance for Bucket 1 would be less than the remaining lifetime expected credit losses, while the allowance for Bucket 2 and Bucket 3 would represent the full remaining lifetime expected credit losses.

At the December Joint Board meeting, the Boards decided that the allowance for financial assets in Bucket 1 should focus on capturing the losses expected over the next 12 months (for example, the probability of default in the next 12 months multiplied by the loss given default). The expected losses refer to shortfalls in all cash flows related to loss events expected over the next 12 months, not simply the cash shortfalls expected in the next 12 months.

The Boards' decision to opt for a "not too big, not too complex" 12 months provision, rather than basing it on 24 months' expected losses, or making it principles-based, responds to concerns raised by constituents. This decision is intended to serve as a practical way to address the “too little, too late” problem.

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If a financial asset shares risk characteristics with other assets, the entity starts to assess these assets at a more aggregated level, then these assets would move to Bucket 3.

When deciding whether financial assets should transfer out of Bucket 1, if the entity can assess the deterioration in credit quality on a collective basis, then the financial assets would move to Bucket 2. Otherwise, the financial assets would move directly to Bucket 3 when assessed on an individual basis. For the financial assets that have transferred to Bucket 2, if the entity starts to assess these assets individually, then these assets would move to Bucket 3.

Differentiating factor between Bucket 2 and Bucket 3

The Boards tentatively decided that the retention of Bucket 3 would provide valuable information content and that the “unit of evaluation” should be the differentiating factor between Bucket 2 and Bucket 3.

When deciding whether financial assets should transfer out of Bucket 1, if the entity can assess the deterioration in credit quality on a collective basis, then the financial assets would move to Bucket 2. Otherwise, the financial assets would move directly to Bucket 3 when assessed on an individual basis. For the financial assets that have transferred to Bucket 2, if the entity starts to assess these assets individually, then these assets would move to Bucket 3.

Grouping of financial assets for impairment evaluation

The Boards agreed with the staff’s proposals that “shared risk characteristics” should be used as a basis for when and how entities aggregate individual financial assets into groups in assessing whether transfer out of Bucket 1 is appropriate. This includes:

- If there are shared risk characteristics for a sub-group, then entities may not group these assets at a more aggregated level.
- If a financial asset cannot be grouped with other assets that have shared risk characteristics or if a financial asset is individually significant, then entities are required to perform an individual assessment.
- If a financial asset shares risk characteristics with other assets, entities are permitted to choose either an individual or collective assessment.

The use of an ‘expected value’ notion in estimating losses

The Boards agreed that guidance is needed regarding appropriate methods for estimating expected values, that is, a probability-weighted mean calculated based on the possible outcomes and the likelihood of each outcome.

The Boards asked the staff to further analyse the following in achieving the expected value objective:

- Practicality and the need to identify practical expedients (e.g., the use of fair value of collateral for collateral-dependent instruments).
- Inappropriate avoidance of undesirable outcomes (e.g., the expected loss is not the same as the most likely outcome; when there is a low probability of default with high loss outcomes, the most likely outcome when looking at an individual or small number of instruments could be no loss even though an allowance would be required based on probability-weighted cash flows).

How we see it

Preparers will welcome any practical expedients as these will reduce the operational complexity of the new impairment approach.

Application of the new impairment approach to retail loans, commercial loans and debt securities and proposed indicators

The Boards agreed that the “three-bucket” approach can be applied to retail loans, commercial loans, and debt securities.

The analysis under this approach will be based on all available, reasonable, supportable information such as historical data, current economic conditions, and expected economic conditions.

The Boards decided that no bright line will be prescribed when applying the credit deterioration model. This applies to:

- Retail and commercial loans: there will be no presumption resulting in the recognition of lifetime losses expected losses on the basis of delinquency, such as a specified number of days past due.

The Boards agreed with the staff’s proposed indicators, in assessing when the financial assets should be transferred from Bucket 1 to Buckets 2 or 3.

Proposed general indicators and specific indicators for loans and debt securities

### General indicators

- Change in general economic conditions
- Change in industry conditions
- Change in market indicators of credit risk
- Change in re-origination rates
- Change in management approach
- Change in company performance
- Change in company prospects
- Change in collateral values
- Change in credit quality enhancement/support
- Change in the loan documentation
- Change in expected performance of the borrower
- Others

### Specific indicators

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Looking ahead

The Boards plan to continue to discuss and develop their impairment approach further. There are some important topics remaining which will be deliberated by the Boards. These include:

- Whether the approach is symmetrical: the applicability of the principle and indicators to financial assets that may improve in credit quality such that they warrant a transfer back into Bucket 1 from Buckets 2 or 3
- Disclosures
- Application to purchased financial assets, including those acquired in a business combination
- Application to trade receivables
- Application to lease receivables
- Application to commitments and guarantees

The Boards emphasised that robust disclosures will be critical to support the principle-based impairment approach and to ensure comparability between entities.

The Boards are keen to develop a single impairment approach that will be applicable to various types of financial assets and all entities, both financial and non-financial institutions. Also, the Boards are committed to arrive at a converged solution to account for credit impairment under IFRS and US GAAP and to complete the impairment project as quickly as possible.

The second exposure draft is expected to be published in the second quarter of 2012. The expected effective date for IFRS 9 Financial Instruments: Impairment is for annual periods beginning on or after 1 January 2015, with earlier application permitted. However, this effective date may be postponed if there are further delays in the impairment project. The impairment requirements are expected to be adopted together with all other IFRS 9 requirements that have been previously finalised.

The Boards are committed to develop a single impairment model in their continuing attempt to achieve convergence between IFRS and US GAAP on this issue.

How we see it

We expect the new impairment approach to result in significant changes to current systems and processes, particularly with respect to the integration between credit risk management and financial reporting. Entities will be required to gather an extensive amount of data, both historical and current, in order to apply the new impairment approach and provide the necessary disclosures. This is likely to take a number of years to implement.

In addition, we strongly encourage all entities to use the opportunity to field-test the new approach, provide feedback to the Boards, and participate in the IASB and FASB staff outreach activities. This is essential to ensure a robust standard is developed that is operationally viable and serves the interest of all stakeholders.

Further reading

This is our fifth publication on the Boards’ redeliberations of the proposed impairment approach. Earlier decisions made by the Boards can be found in:

- Supplement to IFRS outlook Issue 61 (November 2009): New proposals for financial instruments at amortised cost
- Supplement to IFRS outlook Issue 95 (February 2011): IASB and US FASB propose a joint approach to accounting for credit losses
- IFRS Development Issue 9 (June 2011): A new approach to credit impairment is in the works
- IFRS Development Issue 11 (July 2011): New credit impairment approach takes shape

Other thought leadership and relevant materials on impairment are as follows:

- IFRS Outlook (Mar/April 2011): What we think of the new proposed approach for impairment of financial assets
- Survey (September 2011): The IASB’s new impairment model: views of European financial institutions

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