IFRS 9 Impairment of financial assets – a step closer to completion

Overview
The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) continue to make progress on their “three-bucket” expected loss approach for estimating the impairment of financial assets. It appears that the Boards have now largely completed their joint deliberations of the primary principles of the model.

At their joint meeting this week, the Boards outlined the key components of an expected loss calculation, clarified the impairment measurement objective for financial assets classified in Bucket 1 and addressed trade receivables without a significant financing component. Overall, at this meeting, the Boards aimed to clarify certain terms and the methods expected to be implemented to achieve the objectives of the new model.

Expected losses
Under the Boards’ proposed model, expected losses form the basis for determining impairment. Even before the “three-bucket” model was contemplated, the Boards agreed that an estimate of expected losses is not equivalent to a single best estimate or most likely outcome.

To help companies apply the expected loss principle, the Boards describe the key components of an estimate of expected losses as including:
- All reasonable and supportable information considered relevant in making the forward-looking estimate
- A range of possible outcomes that considers the likelihood and reasonableness of those outcomes (e.g., a range of possible outcomes could include a minimum of two probability-weighted outcomes, but the use of a single most likely outcome would not be appropriate)
- The time value of money

The Boards agree that an entity would consider only information that is reasonably available without undue cost and effort. In establishing these elements of an expected loss calculation, the Boards have clarified that the expected loss calculation is not required to include every scenario.

How we see it
The clarifications should, in part, address concerns that the Boards’ prior decisions would necessarily require complex statistical analysis to calculate an expected loss.

What you need to know
- In measuring expected credit losses, the IASB and the FASB clarified that an entity should consider a range of possible outcomes that takes into account the likelihood and reasonableness of those outcomes.
- In considering a range of possible outcomes, an entity would not be required to consider every scenario in its probability-weighted analysis.
- The Boards clarified that various approaches could be used to measure expected losses for financial assets that would be classified in Bucket 1 under the “three-bucket” approach.
- The Boards tentatively agreed that an expected loss approach would apply to all trade receivables without a significant financing component, but non-financial institutions may make use of certain existing practices to make their calculations.
- An exposure draft on impairment is expected to be issued in the second half of 2012.
Impairment allowance for Bucket 1

At their December 2011 meeting, the Boards decided that the allowance for financial assets in Bucket 1 would capture losses expected over the next 12 months. Feedback to the Boards indicated that some preparers interpreted this decision as mandating a single measurement approach with the probability of default being an explicit input.

To articulate more clearly what the impairment measurement for financial assets in Bucket 1 should be, the Boards confirmed that the measurement should reflect expected losses for those financial assets on which a loss event is expected in the next 12 months. The Boards further clarified that the losses being measured should capture the cash shortfalls expected over the lifetime of the financial assets that are associated with the likelihood of a loss event in the next 12 months, not simply the cash shortfalls over the next 12 months.

More importantly, the Boards acknowledged that various approaches could be used to estimate the Bucket 1 allowance, as long as they contain the required elements of an expected loss. The models used to estimate the allowance for financial assets in Bucket 1 would not be required to have a “12 month probability of a loss event” as an explicit input.

Trade receivables without a significant financing component

The Boards tentatively decided that an expected loss model should be applied to trade receivables without a significant financing component. However, the Boards also tentatively decided to provide a practical expedient to enable entities to calculate expected losses using certain current practices (e.g., grouping receivables by age and applying historical loss rates).

However, to meet the required elements of an expected loss, an entity may need to adjust its historical loss rates to incorporate forward-looking expectations. In addition, the current portion of trade receivables would need some amount of impairment allowance to fully incorporate an expected loss approach. However, the Boards have indicated that their intention is that the tentative decision should not represent a significant change in practice.

How we see it

Notwithstanding the Boards’ intention, the proposed guidance may result in companies recording a higher allowance for trade receivables without a significant financing component, including potentially on initial recognition.

However, providing a practical expedient to calculate expected losses should make the impairment approach easier for non-financial institutions to implement.

What’s next

The Boards still need to discuss disclosures, transition, the application to off balance sheet items (e.g., loan commitments and financial guarantees) and the interaction with the classification and measurement project.

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For further details on previous tentative decisions made by the Boards, please see our publication, IFRS Development Issue 21 (December 2011): Impairment – a major step forward in achieving convergence and IFRS Practical Matters (March 2012): Impairment – assessing the impact of the new proposal, which can be found at www.ey.com/ifrs.