Impairment of financial assets – the last details?

What’s happened?
At the joint meeting in July 2012, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) discussed the disclosures required to accompany the proposed IFRS 9 *Financial Instruments* expected loss impairment model and its application to loan commitments and financial guarantee contracts. At a separate meeting, the IASB also discussed IFRS-only disclosures, transition provisions and the application of the model to: originated credit-impaired financial assets; deteriorated credit-impaired financial assets; and reclassified assets.

In these meetings, the staff indicated that the proposed model will no longer be referred to as the “three-bucket” approach. Instead, the discussions were focused on whether the expected losses are calculated on a 12-month or lifetime basis (the former equating to Bucket 1 and the latter equating to Buckets 2 and 3). The Boards have previously defined the 12 months’ expected losses as the expected losses for those financial assets on which a loss event is expected to occur in the next 12 months. Also, the Boards have previously decided that 12 months’ expected losses will be replaced by lifetime expected losses when the following transfer criteria are met:

1. There has been a more than insignificant deterioration in credit quality since initial recognition
2. It is at least reasonably possible that some or all of the contractual cash flows may not be collected

Following the meetings, the IASB proposed developing an exposure draft that would take into account all aspects of the expected loss model. The FASB, however, is planning to continue discussions on the following topics: scope of purchased credit-impaired assets; modifications; debt securities; nonaccrual; and transition. In addition, the FASB indicated its plans to further consider its application guidance and the feedback received during its outreach activities.

How we see it
We will continue to work with both Boards in the standard setting process, with the goal of improving the standards and the usefulness and comparability of financial information.

In the meantime, we encourage all entities to provide feedback to the Boards, and to participate in the staff’s outreach activities, to ensure development of a robust standard that is operationally viable and serves the interests of all stakeholders.
**New qualitative and quantitative disclosures will be introduced to accompany the proposed expected loss impairment model.**

**Disclosures**
The Boards considered the proposed disclosures that are to provide information about how expected credit losses are estimated and the migration of financial assets from 12 months’ expected losses to lifetime expected losses.

New qualitative and quantitative disclosures will be introduced to complement or amend the existing IFRS 7 *Financial Instruments: Disclosures* and US GAAP disclosure requirements.

**How we see it**
There is a good balance between qualitative and quantitative disclosures that address the trade-off between the operational burden for preparers and useful information for readers. However, these disclosures may be onerous for non-financial institutions.

**The proposed disclosures for the expected loss impairment model**

<table>
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<th>Quantitative disclosures</th>
<th>Proposed disclosures</th>
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<td>1</td>
<td>√</td>
<td>Expected loss calculations</td>
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<tr>
<td></td>
<td></td>
<td>‣ The inputs, assumptions and estimation techniques used.</td>
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<td></td>
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<td>‣ The assessment of whether the transfer criteria for recognising lifetime expected losses are met.</td>
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<td>Discount rate*</td>
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<td>‣ A description of the discount rate elected including any significant assumptions made.</td>
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<td>3</td>
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<td>Interest revenue*</td>
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<td></td>
<td></td>
<td>‣ The amount of interest revenue that is calculated on the gross carrying amount calculated on the net carrying amount and based on a credit-adjusted yield.</td>
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<td>4</td>
<td>√</td>
<td>Collateral</td>
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<tr>
<td></td>
<td>√</td>
<td>‣ The quality of collateral.</td>
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<td></td>
<td></td>
<td>‣ Required only for those financial assets that are credit-impaired and have lifetime expected losses.</td>
</tr>
<tr>
<td></td>
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<td>‣ These disclosures include the accounting policy, the financial impact of collateral on the credit risk exposure and the balance of fully collateralised financial assets.</td>
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<td>Reconciliation of the gross carrying amount</td>
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<td></td>
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<td>‣ The opening balance, the changes and the closing balance, analysed by assets that have 12 months’ expected losses and lifetime expected losses.</td>
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<td>Reconciliation of the impairment allowance balance</td>
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<td>√</td>
<td>‣ A description of changes in the allowance balance.</td>
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<td></td>
<td></td>
<td>‣ The opening balance, the changes and the closing balance analysed by assets that have 12 months’ expected losses and lifetime expected losses.</td>
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<td>Credit risk analysis</td>
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<td>Required only if more detailed credit risk profile disclosures are not already required by regulators</td>
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<td></td>
<td></td>
<td>‣ A description of how the credit risk categories are determined.</td>
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<td>‣ The gross carrying amount analysed both by the credit risk categories and by whether 12 months’ or lifetime expected losses are recognised.</td>
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<td>Purchased credit-impaired financial assets</td>
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<td></td>
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<td>‣ A comparison of the purchased credit-impaired assets and those assets that were not purchased as impaired, including the gross carrying amount, the impairment allowance, the contractual cash flows expected to be collected and the contractual cash flows not expected to be collected.</td>
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<tr>
<td></td>
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<td>‣ The amount recognised due to favourable changes in the contractual cash flows not expected to be collected, the effect of this change on net income and whether this change is recognised as a decrease in the allowance balance or an increase in the gross carrying amount.</td>
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<tr>
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<td>Individually assessed financial assets with lifetime expected losses</td>
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<td>‣ The gross carrying amount and the impairment allowance balance.</td>
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<td>10</td>
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<td>Financial assets that have been modified, have defaulted or are 90 days past due*</td>
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<td>Required only for assets that have been modified and lifetime expected losses are recognised.</td>
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<td>These disclosures include the gross carrying amount, the gross carrying amount that has changed from lifetime to 12 months’ expected losses, the modification gain or loss that is adjusted against the gross carrying amount and the impairment allowance, and the default rate on modified assets.</td>
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<td>Required only for assets that have defaulted. These disclosures include the gross carrying amount and related allowance.</td>
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<td>Required only for assets that are 90 days past due but 12 months’ expected losses are still recognised.</td>
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<td>These disclosures include the gross carrying amount and related allowance.</td>
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* These are IFRS-only disclosures
Originated credit-impaired financial assets
The IASB tentatively extended the accounting treatment of purchased credit-impaired financial assets to those originated assets that are credit-impaired on initial recognition. The effective interest rate (EIR) is adjusted for initial loss expectations and the allowance will reflect any changes in lifetime expected losses since initial recognition.

Originated credit-impaired financial assets are expected to be rare. For example, this will include assets that are substantially modified such that the original assets are derecognised.

Deteriorated credit-impaired financial assets
For financial assets for which lifetime expected losses are recognised, the IASB tentatively decided to require an entity to assess, at each reporting date, whether there is objective evidence of a loss event as per the existing incurred loss guidance in paragraphs 59(a) - (e) of IAS 39 Financial Instruments: Recognition and Measurement. If met, an entity would need to calculate the interest revenue based on the carrying amount net of the impairment allowance.

Reclassified assets
It will be rare for there to be changes in the IFRS 9 classification and measurement business model that require reclassification of financial assets from fair value through profit or loss to amortised cost or to fair value through other comprehensive income (OCI).

However, when this does occur, the IASB tentatively decided that, on the reclassification date, an entity would treat a reclassified financial asset the same as a financial asset on initial recognition. The fair value becomes the new carrying amount of the reclassified financial asset and the EIR is determined on the reclassification date.

Summary of the proposed expected loss impairment approach

- Originated, purchased, reclassified or modified debt instruments measured at amortised cost or fair value through OCI
- Lease receivables
- Irrevocable loan commitments and financial guarantee contracts

On initial recognition, are the IAS 39 incurred loss criteria met?

- No

On initial recognition, is the simplified approach required or available and elected?**

- Yes
- No

12 months’ general approach

- Interest calculated on gross carrying value
- 12 months’ expected losses

At each subsequent reporting period, are the transfer criteria met?

- Yes
- No

Purchased credit-impaired approach

- Credit-adjusted EIR
- No day 1 loss allowance
- Lifetime expected losses based on subsequent changes

Simplified approach

- Interest calculated on gross carrying value
- Lifetime expected losses

At each subsequent reporting period, are the IAS 39 incurred loss criteria met?

- Yes
- No

Lifetime general approach

- Interest calculated on gross carrying value
- Lifetime expected losses

At each subsequent reporting period, are the IAS 39 incurred loss criteria met?

- Yes
- No

Deteriorated credit-impaired approach

- Interest calculated on net carrying value
- Lifetime expected losses

* The “simplified approach” is required for trade receivables without a significant financing component and may be elected, when available, for trade receivables with a significant financing component and lease receivables.

** In subsequent periods, if there is an improvement in the credit quality of the financial assets such that the transfer criteria are no longer met, then an entity would record 12 months’ rather than lifetime expected losses on these financial assets.
Loan commitments and financial guarantee contracts
The Boards tentatively decided that the proposed expected loss impairment model will apply to loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS 9 and US GAAP. Expected credit losses on such contracts will be presented separately as a liability rather than as part of the impairment allowance.

The scope includes loan commitments for which an entity has an irrevocable legal obligation to extend credit. When determining expected credit losses, an entity will estimate the portion of the undrawn facility that will be converted into a loan, based on the expected usage over the commitment period.

The IASB also tentatively decided that expected losses for commitments and guarantees will be discounted using the risk-free rate, adjusted for risks specific to the cash flows unless the estimated cash shortfalls have already been adjusted to reflect the risk. The accounting for related fees will not be impacted and will be addressed as part of the revenue recognition project.

Interaction with other phases of IFRS 9
The IASB tentatively decided that the impairment requirements will be available for preparers to adopt in the complete version of IFRS 9. This will include the general hedge accounting requirements and the revised classification and measurement requirements.

Early application will be permitted only if the entire IFRS 9 package is adopted.

What’s next?
An exposure draft is expected to be issued in the fourth quarter of 2012, with the final standard expected in the first half of 2013.

Transition provisions
The first of the two criteria for a transfer from 12 months’ to lifetime expected losses is based on the deterioration of the credit quality. Full retrospective application of the proposal would therefore require the use of the initial credit quality data as and when financial assets were initially recognised, in order to assess whether the criterion is met. If the use of initial credit quality data requires undue cost or effort, as a transition relief, an entity may perform the impairment assessment only using the second transfer criterion based on the collection of the contractual cash flows.

In addition, entities are not required to restate comparative periods, but will be permitted to restate the comparative periods, unless this would require the use of hindsight.

Similarly, an entity will also be permitted to disclose the amount adjusted for each financial statement line for the prior period that is affected by the initial application of the new impairment requirements as per paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, unless this would require the use of hindsight. However, for the period of initial application, an entity will be required to show the effect of the adoption of the new impairment requirements.

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