Supplement to ED/2009/12 Financial Instruments: Impairment

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Content

1. Background (1)

- The IASB has split its project to replace IAS 39 into three phases, in which a new impairment model is addressed within phase two.
- In November 2009 the IASB published the exposure draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*. The comment period ended on 30 June 2010. 193 comment letters have been received.
- In addition, a panel of credit risk experts, the Expert Advisory Panel (EAP), was established to advise the IASB on the operational implications of applying the proposals in the exposure draft.
- In May 2010 the FASB published a proposed Accounting Standards Update on accounting for financial instruments, including guidance on classification and measurement, credit impairment and hedge accounting requirements.

1. Background (2)

- While most constituents supported in principle the expected cash flow model proposed in the exposure draft, many thought it was operationally too difficult to apply, especially with regard to the integrated method to determine the effective interest rate and in the context of open portfolios.
- It has also been criticised that the IASB and the FASB have started overworking their respective impairment models separately. The boards' constituents have consistently stressed the importance of achieving a common solution to the accounting for impairment.

2. Joint IASB/FASB-Document

- Initially, IASB and FASB started their deliberations to refine the impairment models proposed in their respective exposure drafts separately.

- Based on the request of the G20, the Financial Stability Board and in the feedback received from respondents on the exposure drafts for convergence in such an important area, further deliberations have been performed jointly by both boards.

- The result is the impairment model for certain financial assets proposed in that supplementary document, which can be seen as a compromise between the two models developed independently by the boards.

2.1. Scope (1)

- The proposals in this supplementary document would be applied to financial assets that are measured at amortised cost if they are managed on an open portfolio basis, except short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial.
- Definition of **portfolio**:

  A grouping of financial assets with similar characteristics that are managed by a reporting entity on a collective basis. In an open portfolio, assets are added to the portfolio through its life by origination or purchase, and removed through its life by write-offs, transfer to other portfolios, sales and repayment. In a closed portfolio, assets are not added to the portfolio through its life, and are removed by write-offs, transfer to other portfolios, sales and repayment.

2.1. Scope (2)

Question 2
Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all financial assets.

2.2. Differentiation in „*good book*“ and „*bad book*“ (1)

- For the purpose of determining the impairment allowance for financial assets that are managed on an open portfolio basis, those assets are differentiated into the following two groups:
  - assets for which it is appropriate to recognise expected credit losses over a time period (considering a minimum impairment allowance amount) (often referred to as the „*good book*“), and
  - assets for which the entire amount of expected credit losses shall be recognised immediately (often referred to as the „*bad book*“).
- The differentiation depends on the degree of uncertainty about the collectibility of a financial assets.
- An entity shall differentiate the two groups on the basis of its internal credit risk management.

2.2. Differentiation in „*good book*“ and „*bad book*“ (2)

- It is no longer appropriate to recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity’s credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.
- Entities that do not manage credit risk of financial assets depending on the uncertainty about their collectibility shall apply this principle in a similar way. For example, an entity might comply with the principle using criteria such as
  - days past due;
  - whether the expected return is below the risk-free interest rate; or
  - when management identifies loans as doubtful (sometimes also considered by an entity as ‘problem loans’).

2.2. Differentiation in „*good book*“ and „*bad book*“ (3)

Question 6
Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7
Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Question 8
Do you agree with the proposed requirements to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

2.3. Impairment allowance for the „*good book*“ (1)

- For this group of financial assets the impairment allowance to be recognised is the higher of:
  - the time-proportional expected credit losses; and
  - the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity’s reporting date) (minimum ‘floor’ amount)
- An entity shall develop its estimate of expected credit losses for the remaining lifetime or foreseeable future as required by paragraph 2, considering all available information. Paragraph B5 contains further application guidance.
- This supplement does not mandate a specific approach for developing loss estimates for the expected life of an open pool of financial assets. Paragraph B7 contains application guidance with regard to possible approaches.

2.3. Impairment allowance for the „*good book*“ (2)

- All estimates of expected credit losses shall be updated, at a minimum, at the time an entity prepares its annual or interim financial statements (reporting date).

Question 3
Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

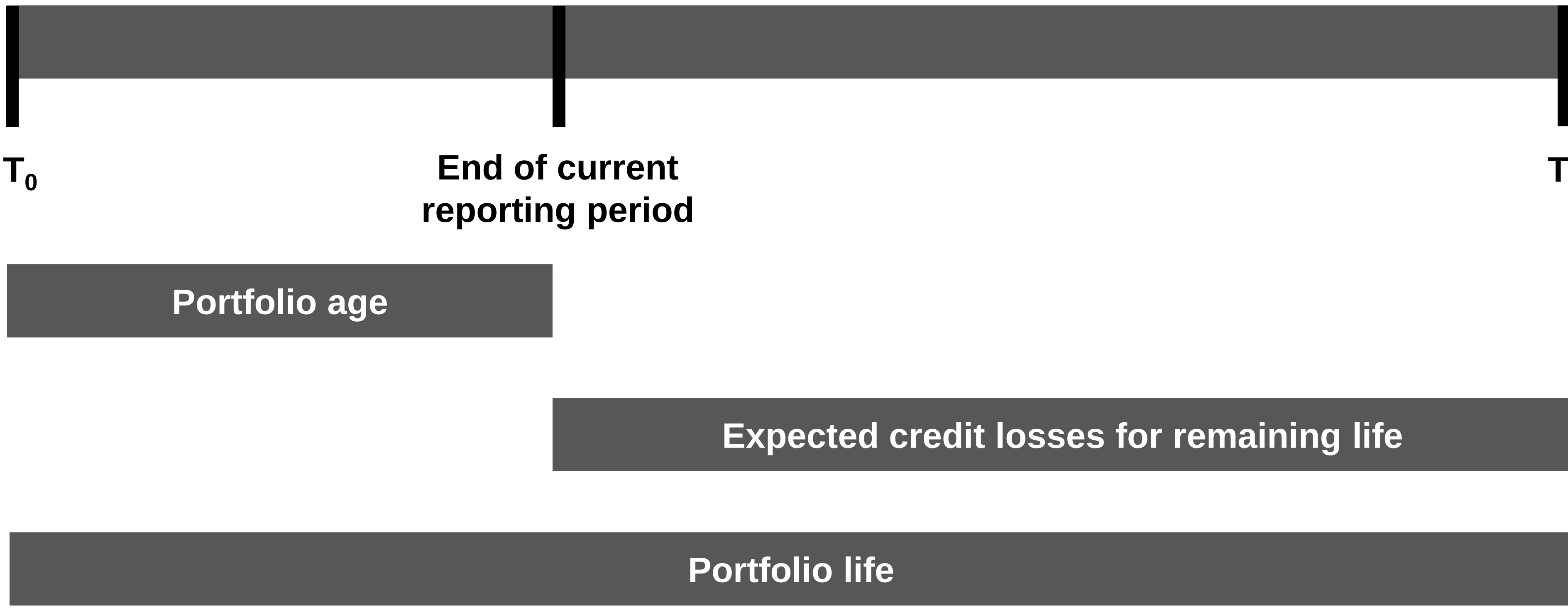
Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

2.3.1. Time-proportional expected credit losses (1)

- An entity shall determine the time-proportional expected credit losses in accordance with paragraph 2(a)(i) either:
  - by multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio's age to its expected life (ie a straight-line approach using either a discounted or undiscounted estimate); or
  - by converting the entire amount of the credit losses expected for the remaining life of the portfolio into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolio's age (ie an annuity approach, which by definition, uses a discounted estimate).
- The joint document contains illustrative examples showing the mechanics of both possible approaches.
- The age and total expected life of the portfolio are weighted averages, which are updated at each reporting date.

2.3.1. Time-proportional expected credit losses (2)

Components of the calculations



2.3.1. Time-proportional expected credit losses (3)

- The age of a portfolio is based on the time that the financial assets within the portfolio have been outstanding since they were initially recognised by the entity.
- The total expected life of a portfolio is based on the time that the financial assets within the portfolio are expected to be outstanding from inception to maturity (for example, considering prepayment, call, extension and similar options and defaults).

Question 4
Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

2.3.2. Discount rate

- When using a discounted expected credit loss amount, an entity may use as the discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate (as used for the effective interest method in IAS 39).

Question 11

The boards are seeking comment with respect to the flexibility related using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

2.3.3. Expected credit losses within the foreseeable future (1)

- For this group of financial assets the credit losses expected to occur within the foreseeable future period shall be recognised at least as an impairment allowance.
- An entity would make its best estimate of credit losses expected to occur in the future time period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections.
- The foreseeable future time period shall be no less than twelve months after an entity’s reporting date.
- Paragraphs B11 - B16 contain further application guidance.

2.3.3. Expected credit losses within the foreseeable future (2)

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

2.3.3. Expected credit losses within the foreseeable future (3)

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

2.4. Impairment allowance for the „*bad book*“

- For this group of financial assets the entire amount of expected credit losses shall always be recognised immediately as an impairment allowance.
- All estimates of expected credit losses shall be updated, at a minimum, at the time an entity prepares its annual or interim financial statements (reporting date).

2.5. Interim conclusion

- An important weakness that has been identified with respect to the current impairment models under IFRSs and US GAAP is delayed recognition of credit losses associated with financial assets.
- This supplementary document proposes a revised approach for an impairment model for financial assets in open portfolios that would recognise credit losses from initial recognition of a financial asset. The timing of recognition would vary according to the differentiation of financial assets into two groups as described in paragraphs 2, 3 and B2 - B4.

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

2.6. Separate IASB and FASB approaches

- The model described in the supplementary document is being proposed by the IASB and FASB because both boards are committed to reaching a common solution to impairment accounting.
- However, the IASB and the FASB had been developing separately models that would address their differing primary objectives.

2.6.1. IASB approach

- The IASB approach is consistent with the common model with the exception of considering the credit losses expected to occur in the foreseeable future (the floor), ie for this group of financial assets the impairment allowance to be recognised are always the time-proportional expected credit losses.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why, or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

2.6.2. FASB approach

- This approach does not include the differentiation of the financial assets into two groups. All credit losses expected to occur within the foreseeable future (not explicitly set at a minimum of twelve months) shall be recognised as an impairment allowance immediately.

Question 13
Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why, or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

3. IASB-only document (Appendix Z)

- The IASB published an additional document in appendix Z which includes amended proposals for presentation and disclosure in relation to the impairment model proposed in the joint IASB/FASB-document.
- The FASB has not yet deliberated presentation and disclosure requirements in relation to the proposed impairment model for open portfolios.
- Furthermore, the IASB-only document contains questions with regard to determining the effective interest rate and whether loan commit-ments and financial guarantee contracts should be within the scope.

3.1. Decoupled approach for determining the EIR

- This document proposes that the credit loss estimate does not affect the cash flows used to determine the effective interest rate (ie a non-integrated, or ‘decoupled’ approach). In contrast, the IASB’s original ED proposed an integrated approach that would have included the initial estimate of expected losses in the cash flows used to determine the effective interest rate.

Question 14Z
Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

3.2. Scope (1): Loan commitments

- Loan commitments that are not included within the scope of IAS 39 (or IFRS 9) are included within the scope of IAS 37.
- Loan commitments and loans are often managed using the same business model and information systems irrespective of whether the credit exposure is accounted for in accordance with IAS 39 or IAS 37.
- Constituents have urged the IASB to align the impairment requirements for all credit exposures irrespective of their type (ie whether loans or loan commitments) and locate them in a single standard.

Question 15Z
Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

3.2. Scope (2): Financial guarantee contracts

- In the ED/2010/8 *Insurance Contracts*, the IASB asked whether all financial guarantee contracts should be brought within the scope of the proposed IFRS on insurance contracts (and hence excluded from the scope of IAS 39 and IFRS 9).
- The IASB has not yet deliberated the responses to this question and acknowledges the uncertainty about which requirements will apply to financial guarantee contracts.
- Since these contracts are currently within the scope of IAS 39, the IASB encourages constituents to consider the proposed requirements in this document in the light of the present scope of IAS 39 (and thus IFRS 9).

Question 16Z
Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

3.3. Presentation

- The statement of comprehensive income shall include separate line items that present the following amounts for the period:

  a) interest revenue (calculated using the *effective interest method*)

  b) impairment losses (including reversals of impairment losses)

Question 17Z
Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

3.4. Disclosure

- The proposed disclosure requirements are solely related to the impairment model proposed in that supplementary document. These are:
  - Classes of financial instruments and level of disclosure
  - Allowance account
  - Expected credit loss estimates
  - Credit risk management
- The remaining disclosure requirements in the IASB's original exposure draft (ie stress testing, vintage information and credit quality of financial assets) are not addressed in this document.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

3.4.1. Classes of financial instruments and level of disclosure

- Paragraph Z6 uses the same wording (except for the reference to portfolio grouping) than the corresponding paragraphs in ED/2009/12 and in IFRS 7.
- Paragraphs BZ20 and BZ21 contain the following examples of grouping financial assets into classes:

BZ20 As an example for a financial institution, financial assets might be grouped into classes based on the following characteristics:

(a) government and central banks (further disaggregated into countries with AA ratings (or equivalent) and above, and countries with A rating (or equivalent) and below);

(b) financial institutions;

(c) corporate;

(d) retail (further disaggregated into secured by real estate collateral, qualifying revolving retail, retail loans to small and medium-sized entities and other);

(e) securitised financial assets; and

(f) below investment-grade.

BZ21 As an example for a non-financial institution, financial assets might be grouped into classes based on the following characteristics:

(a) collateralised wholesale;

(b) non-collateralised wholesale;

(c) collateralised retail;

(d) non-collateralised retail; and

(e) credit card business.

3.4.2. Allowance account (1)

- For financial assets measured at amortised cost an entity shall use an allowance account for credit losses. An entity shall disclose for each class of financial assets:
  a) separate reconciliations of changes during the period in the allowances determined in accordance with paragraph 2(a) und (b);
  b) if the amount determined in accordance with paragraph 2(a)(ii) is higher than that determined in accordance with paragraph 2(a)(i), the difference between those amounts; and
  c) a reconciliation of the nominal amounts of the financial assets for which the impairment allowance is determined in accordance with 2(b) . That recon-ciliation shall include disclosure of the nominal amount of financial assets for which the impairment allowance henceforth is determined in accordance with paragraph 2(a) due to a modification of contractual term(s).
- The disclosure requirements shall be presented in tabular format. Paragraph BZ22 contains the example shown on the next slide.

3.4.2. Allowance account (2)

Allowance for financial assets for which credit losses are recognised over a time period (paragraph 2(a)) [Column A]		Allowance for financial assets for which the entire amount of credit losses is recognised (paragraph 2(b)) [Column B]		Total allowance account [Column C]		Total profit or loss [Column D]	Nominal amount of the financial assets for which the entire amounts of credit losses is recognised (paragraph 2(b)) [Column E]	
Opening balance	XX	Opening balance	XX	Opening balance	XX		Opening balance	XX
							Add: originations/ purchases	XX
Less: transfers to Column B	(XX)	Add: transfers from Column A	XX				Add: transfers from Column A	XX
Add: transfers from Column B	XX	Less: transfers to Column A	(XX)				Less: transfers to Column A	(XX)
Less: write-offs	(XX)	Less: write-offs	(XX)	Less: write-offs	(XX)		Less: write-offs	(XX)
Less: reversals	(XX)	Less: reversals	(XX)	Less: reversals	(XX)			
Less: disposals	(XX)	Less: disposals	(XX)	Less: disposals	(XX)		Less: disposals	(XX)
Additions / releases	YY	Add: additional credit losses	YY	Additions / releases and additional credit losses	YY	(YY)		
Additional provision for minimum allowance amount (see paragraph 2(a)(ii)) (if applicable)	ZZ			Additional provision for minimum allowance amount (see paragraph 2(a)(ii)) (if applicable)	ZZ	(ZZ)		
Closing balance	XX	Closing balance	XX	Closing balance	XX	(YZ)	Closing balance	XX

3.4.2. Allowance account (3)

- For financial assets for which the impairment allowance is determined in accordance with paragraph 2(a) an entity shall disclose in a tabular format for the current annual period and the previous four annual periods:
  a) the total nominal amount of the financial assets;
  b) the total amount of expected credit losses;
  c) the amount of the impairment allowance; and
  d) if applicable, the amount determined in accordance with paragraph Z7(b).

3.4.2. Allowance account (4)

- When a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance in accordance with paragraph 2, the amount that is transferred between the impairment allowances for the two groups shall be determined in accordance with paragraph 2(a)(i), ie the time-proportional expected credit loss will be transferred.

Question 19Z
Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

3.4.3. Expected credit loss estimates (1)

- An entity shall disclose information that explains the estimates and changes in estimates that are required to determine the impairment allowance.
- An entity shall explain the inputs and assumptions used in determining the entire amount of expected credit losses and the amount of expected credit losses expected to occur within the foreseeable future, including the time period used as the foreseeable future and how that determination was made. For this purpose an entity shall disclose, separately for both amounts
  a) the basis of inputs (eg internal historical information or rating reports) and the estimation technique;
  b) an explanation of the changes in estimates and the cause of the change (eg loss severity, change in portfolio composition); and
  c) If there has been a change in estimation technique, disclosure of that change and the reason for the change.

3.4.3. Expected credit loss estimates (2)

- An entity shall disclose quantitative and qualitative analyses of significant positive or negative effects on impairment losses that are caused by a particular portfolio or geographical area.
- An entity shall disclose information about how previous estimates of expected losses compare with actual outcomes:
  - a) when an entity performs back testing, it shall disclose a quantitative analysis that compares the actual outcomes and the previous estimate of expected credit losses. The analysis shall enable users to understand the difference between the actual outcomes and the previous estimate;
  - b) When an entity does not perform back testing, it shall disclose a qualitative analysis of expected credit losses and the actual outcomes to enable users of its financial statements to understand the differences between the actual outcomes and the entity's previous estimate.

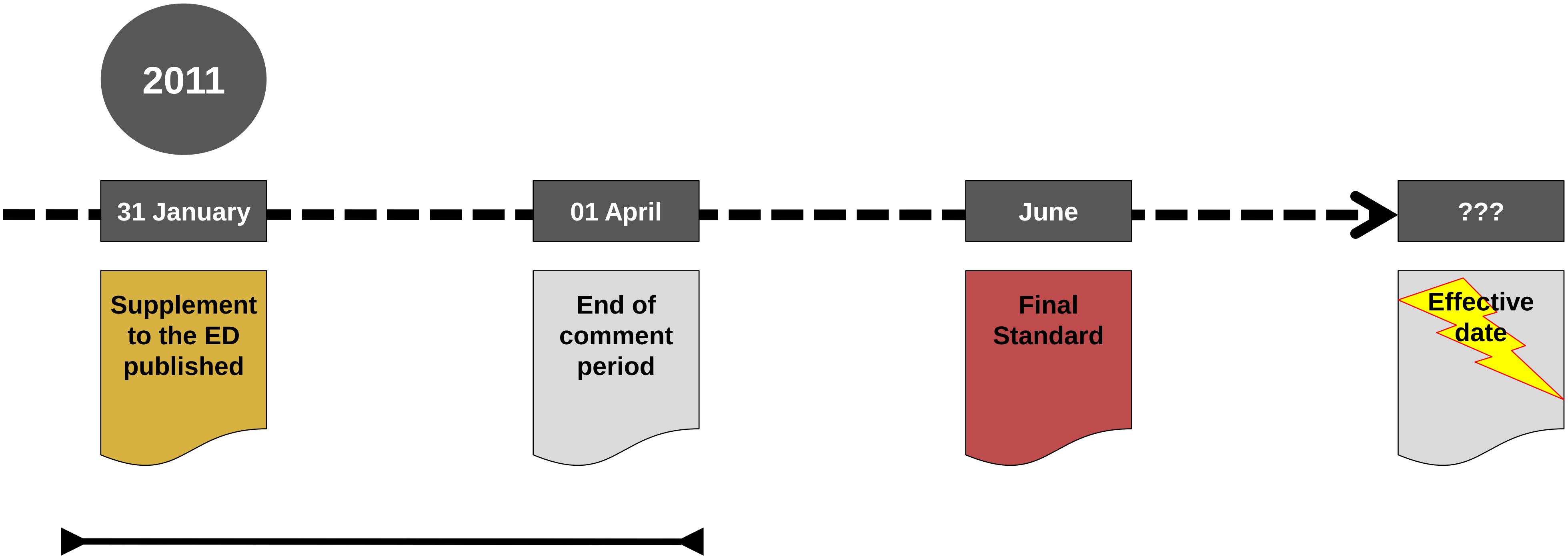
3.4.4. Credit risk management (1)

- An entity shall disclose information about its internal credit risk management processes in order to enable users of its financial statements to gain a better understanding of the relationship between how financial assets are managed and how expected credit losses are estimated.
- An entity shall disclose by credit risk rating grades:
  a) the nominal amount of financial assets in a grade; and
  b) other information including:
     i. the entire amount of expected credit losses for a grade; and
     ii. the amount of credit losses expected to occur within the foreseeable future (see paragraph 2(a)(ii)) for a grade.
- The number of grades shall not exceed the number the entity uses for internal credit risk management purposes. However, at a minimum the grades must allow differentiation between financial assets in accordance with paragraph 2(a) and (b).

3.4.4. Credit risk management (2)

- An entity shall also disclose:
  a) a qualitative analysis that describes the criteria used to determine how financial assets are managed to distinguish between the two groups in accordance with paragraph 2(a) and (b);
  b) when an entity uses internal credit rating grades, information about those rating grades. This can happen by providing, for example, a comparison with external ratings (if available), a description of the credit rating grades used, and if an entity uses a *watchlist*, a description and the criteria for including or no longer including financial assets in the watchlist;
  c) how the internal credit rating grades are assigned to financial assets for which impairment allowances are determined in accordance with paragraph 2(a) and (b); and
  d) when applicable, how the watchlist relates to the criteria that determine whether the entity applies paragraph 2(a) or paragraph 2(b).

4. Next steps



- **Continue discussions on aspects of the original ED not affected by the supplementary document**
- **Outreach activities**

Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany ®

Thank you very much for your attention!

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