Project: **Request for views on FASB FSPs**

Topic: **FSP No. FAS 115-2, FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments***

Introduction

1. On 9 April 2009, the FASB finalised and issued FASB staff position (FSP) No. FAS 115-2, FAS 124-2 *Recognition and Presentation of Other-Than-Temporary Impairments*. The objective of the FSP was to amend the other-than-temporary impairment (OTTI) guidance in US GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosures of OTTI on debt securities in the financial statements. The FASB stated that the amendments are intended to address long-standing application issues identified in US GAAP.

2. This paper presents the following:

   (a) a summary of US GAAP changes resulting from the FSP;

   (b) an analysis of major differences between IFRSs and US GAAP (by reference to the IASB *Request for Views on FASB proposals*);

   (c) an analysis of responses received;

   (d) summary staff observations; and

   (e) a question to the Board.

Summary of US GAAP changes

3. Refer to paper appendix A3 for the full text of the FSP.

Scope

4. In finalising the FSP, the FASB decided to limit the change to the OTTI impairment model to debt securities (the draft FSP also proposed amending the OTTI requirements for equity securities). The FSP does not apply to financial assets other than those in security form that are in the scope of the relevant pronouncements.

Recognition

5. The FASB decided to replace the existing requirement that that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert that (new assertions):

   (a) the entity does not have the intent to sell the security; and

   (b) it is more likely than not the entity will not have to sell the security before recovery of its amortised cost basis.

6. The FSP incorporates examples of factors from existing literature on OTTI assessment for debt securities and adds guidance on how those factors interact with the new assertions.

7. If an entity does not expect to recover the entire amortised cost basis of the security, a debt security is considered OTTI. However, if management makes the new assertions for the *remaining* amortised cost basis (ie the previous amortised cost basis less any credit loss of the current period) the entity recognises only the 'credit portion' of the impairment in profit or loss and the reminder (non-credit losses) in other comprehensive income (OCI).

8. Subsequent increases and decreases (if not an additional OTTI) in the fair value of available-for sale (AFS) debt securities will be included in OCI.

9. For held-to-maturity (HTM) debt securities non-credit losses are recognised in OCI and amortised over the debt security's remaining life by offsetting the recorded value of the security (unless it is subsequently sold or there are additional credit losses).

Measurement

10. Credit losses are determined using an entity's best estimate of the present value of cash flows expected to be collected from the debt security. The increase in expected prepayments should be considered in the estimate of the present value.

Presentation

11. An entity will be required to present the total OTTI amount in profit or loss with an offset of the amount recognised in OCI. For example,

Total OTTI losses	(10,000)
Portion of loss recognised in OCI (before taxes)	4,000
Net impairment losses recognised in earnings	(6,000)

12. Amounts related to the non-credit portion of OTTI recognised in accumulated OCI must be separately presented for AFS and HTM debt securities.

Disclosures

13. The FASB made amendments to require entities to disclose:

    (a) the cost basis of AFS and HTM debt securities by major security type;

    (b) the methodology and key inputs, such as performance indicators of the underlying assets in the security, loan to collateral value ratios, third-party guarantees, levels of subordination, and vintage, used to measure the portion of a credit loss related OTTI by major security type; and

(c) a rollforward of amounts recognised in profit or loss for debt securities for which an OTTI has been recognised and the non-credit portion of the OTTI that has been recognised in OCI.

14. The FASB also made amendments to require that major security classes are based on the nature and risks of the security (additional types of securities will be included in the list of major security types listed in FAS 115 *Accounting for Certain Investments in Debt and Equity Securities*).

15. Moreover, additional disclosures and all existing disclosures will be required for interim periods.

Transition and effective date

16. The FSP is effective for interim and annual periods ending after 15 June 2009 (early adoption permitted for periods ending after 15 March 2009 but only if FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, are early adopted as well). Similarly, if an entity early adopts FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments,* or FSP FAS 157-4, this FSP must be early adopted. Comparative disclosures are not required in the first period of adoption.

17. On adoption there will be a cumulative-effect adjustment as of the beginning of the period of adoption that reclassifies the non-credit component of a previously recognised OTTI from retained earnings to accumulated OCI if management makes the new assertions. There will also be a consequential adjustment to the amortised cost basis used to calculate accretable yield (ie the non-credit component of a previously recognised OTTI will no longer be amortised through profit or loss).

Analysis of major differences between IFRSs and US GAAP (as amended by the FSP)

18. IFRS impairment requirements for financial assets are very different than US GAAP impairment requirements for financial assets in security form. The IASB *Request for views* summarised the major differences. Please refer to paper appendix 16B.

Analysis of responses received on the *Request for views on FASB proposals*

19. The IASB *Request for views on FASB proposals* asked stakeholders for any views they had to help the IASB decide whether to consider formulating any proposals for public comment.

20. The following analysis focuses on views relating to whether the IASB should consider formulating further proposals rather than views on the FASB's final amendments themselves.

21. The IASB received more than 46 responses from constituents related to the FSP on impairment by the close of business on 20 April. We have continued to receive responses after this deadline for the submission of views. Appendix 1 of this paper provides an analysis of respondents by type and geographical location.

Summary comments

22. Overall, respondents welcomed the IASB's initiative in seeking views. Many respondents also commented that the 30 day period given to submit views was appropriate.

23. Almost all respondents emphasised the importance of following due process should the IASB decide to propose any amendments. Respondents also noted that any proposals should have an appropriate comment period. Moreover, some respondents were critical of the lack of due process exercised in finalising the FSP. Respondents were concerned about whether the consequences of the FSP and the constituents' comment letters were adequately considered. Respondents noted that the FSP proposals were issued for a 15 day comment period and finalised within 1 day of the comment deadline. (The IASB staff has received some informal feedback from US GAAP reporting entities highlighting a number of application issues and possible unintended consequences since issuance of the FSP.)

24. Different views as to actions that the IASB should consider ranged from:

    (a) doing nothing, but focusing on the broader project to replace IAS 39;

    (b) limited amendments to recognition of impairment losses for AFS debt instruments; and

    (c) limited amendments to recognition of impairment losses and impairment triggers (ie to include the notions of management intent and recovery for AFS debt instruments).

25. Respondents who supported that the IASB make short-term amendments generally suggested a timeline similar to that of the FSP, ie an effective date of 15 June 2009. (However, please note the comments from other respondents regarding appropriate due process as set out below).

26. Some of the respondents that supported doing nothing suggested that the Board might consider aspects of the FSP as part of the broader project on financial instruments.

27. No respondents recommended that the IASB should attempt to replicate within IFRSs the FASB approach as set out in their FSP.

28. However, a small number of respondents suggested that the IASB go beyond the *scope* of the FSP amendments to address impairment requirements for AFS equity instruments and requirements for the reversal of impairment losses for AFS equity instruments. Some noted the ‘significant or prolonged’ decline notion in IAS 39 is difficult to apply.

29. The staff noted a split in views between respondents by type. In general, most users suggested that the IASB focus on the broader project to replace IAS 39 while many financial institutions and related industry groups (ie banking and insurance associations) were supportive of some form of limited amendment.

30. The Standards Advisory Council (SAC) also submitted a response that:

    (a) emphasised the importance of due process;

    (b) supported developing a new standard on financial instruments as a matter of urgency; and

    (c) includes a survey of SAC members, according to which most members advised against a piecemeal change of AFS impairment in isolation.

31. The following paragraphs summarise respondents’ reasoning for the main views expressed.

Do nothing and focus on the broader project to replace IAS 39

32. Many respondents suggested that the IASB do nothing. These respondents argued that:

    (a) **the FASB amendments do not improve financial reporting.** Many respondents (in particular users) do not believe that the bifurcation of impairment losses between profit or loss and OCI provides useful information. Moreover, some respondents strongly agreed with the dissenting views posed by FASB members in the FSP. Several respondents were concerned that the changes would reduce investor confidence in financial statements.

(b) **piecemeal amendments add complexity and confusion**. In line with responses to the IASB exposure draft *Investments in Debt Instruments* published in December 2008, many respondents were opposed to piecemeal amendments and preferred that any issues relating the reporting of financial instruments be addressed in the IASB/FASB broader project on financial instruments.

(c) **existing IFRS and US GAAP impairment requirements for financial assets in security form are significantly different.** Many respondents noted that existing requirements are significantly different, and that creating any type of 'level-playing field' would necessitate a substantial amendment to IAS 39 that would be difficult and costly to implement for preparers as well as creating an interpretation burden and costs for users. Thus, any piecemeal amendment of such a complex area was considered inappropriate given that the IASB is seeking to replace IAS 39. Some respondents also noted that with proper due process, it is unlikely that any amendments would be finalised for the 2009 reporting period.

(d) **it is difficult or impossible to apply the FSP amendments**. Several respondents noted it is difficult or argued that it is impossible to disaggregate impairment between credit losses and other losses as in the current market conditions, liquidity risk is inextricably intertwined with credit risk. Moreover, some respondents question whether the assertions set out in the FSP are operational.

(e) **the IASB should focus on the IASB/FASB comprehensive project on financial instruments**. All respondents supported an accelerated approach to the joint project on financial instruments. Respondents believe that convergence in requirements for reporting financial instruments should be a priority for both boards. Several respondents agreed that making any limited amendments would delay the comprehensive project. Some respondents acknowledged the significant differences between IFRSs and US GAAP and noted that convergence cannot be achieved through limited amendments. These respondents suggested that the IASB prioritise and focus all its resources on the comprehensive project.

(f) **new requirements for reporting for financial instruments should be principles based rather than rules based**. Some respondents were concerned that any amendments in response to the FSP would be rules based while they preferred IFRSs to be principles based. This was also reflected in concerns about an undue increase in complexity that would result from such amendments.

33. In addition, some respondents expressed concerns about the independence of standard setting bodies. These respondents commented that accounting standards are not regulatory tools and that standard setters should not only consider the needs of specific industries, regions and their regulators. Some respondents also commented on a potential 'race to the bottom' in standard setting when one standard setter competes to match the changes of another.

Limited amendments to recognition of impairment losses for AFS debt instruments

34. Some respondents (notably financial institutions and related industry groups) proposed that the IASB consider adopting amendments similar to those of the FSP to the *AFS* (but not the HTM) impairment model in IAS 39. They preferred disaggregating impairment losses for AFS debt instruments into two components, (i) a component related to credit losses and (ii) a non-credit component (ie the remainder of a fair value decline attributable to other factors). The credit loss component would be recognised in profit or loss while the non-credit component is recognised in OCI. (The staff notes that such amendments will have implications on the amount of regulatory capital required for some financial institutions.)

35. Respondents in support of this approach argued that such amendments:

(a) are a feasible short term fix (despite significant differences between IFRSs and US GAAP);

(b) do not compromise the comprehensive project on financial instruments;

(c) improve the relevance of financial statements; and

(d) maintain a level playing field between IFRSs and US GAAP.

36. As some respondents pointed out, disaggregating a fair value decline into a credit loss component and a remainder was discussed at the round tables held in November and December 2008 in response to the global financial crisis. While separate recognition of these components in profit or loss and OCI, respectively, was mostly supported by preparers from the financial services industry, users were opposed to such an approach and were only prepared to support disaggregation by way of disclosure in the notes.

37. The respondents' view on the feasibility of a short term amendment should be considered against the background that no respondent supported replicating the revised OTTI model in its entirety but only some aspects of it, which affects feasibility. For example, respondents supporting adopting disaggregating impairment losses typically did not support changing the scope of requirements (eg to securities) or adopting the prohibition of reversals of impairment losses for AFS debt instruments (or at the same time proposed that US GAAP be changed in this respect)..

Limited amendments to recognition of impairment losses and impairment triggers ie to include the notions of management intent and ability

38. A small number of respondents proposed that the IASB also consider amendments to requirements as to when impairment should be assessed. In addition to amendments to the recognition of impairment losses outlined above, these respondents requested amendments to incorporate the notions of management intent (ie whether management intends to sell an AFS debt instrument) and ability (ie whether an entity could be required to sell the AFS debt instrument before recovery of its amortised cost basis or whether it is able to hold it to recovery of its amortised cost basis).

39. Respondents in support of this approach argued that in practice, impairment assessment is arbitrary, and therefore management should be given discretion on determining when impairment occurs.

SAC feedback

40. The SAC consulted its members. In summary, the members' responses were as follows:

    (a) There was unanimous support for the importance of due process – even for urgent amendments.

    (b) There was also unanimous support for developing a simplified new global standard on financial instruments together with the FASB (as recommended by the G20 and supported by the IASCF Trustees and the IASB's Monitoring Group) as a matter of urgency. However, some members were concerned about the timeline that envisages proposals to be published by November 2009.

    (c) Most members advised the IASB against any attempt to take immediate steps to amend IFRSs in response to the FSP. Those members were concerned about piecemeal quick fixes and looking at impairment in isolation, in particular as the AFS category may not be part of the new standard. Some members would consider supporting a limited change in response to the FSP with some linking it to whether the timeline for the new global standard could be met, whether the changes would improve financial reporting or whether the changes would be consistent with the likely direction of the new standard (rather than reducing differences with US GAAP).

Summary staff observations

41. The staff notes that the reclassification amendment issued in October 2008 already allows an entity to reclassify any type of eligible financial asset (whether in security form or not) from AFS to loans and receivables (LAR), and to apply an incurred loss impairment measurement model to that instrument.

42. The staff notes that no respondents suggested that the IASB replicate the FSP as issued. The staff further notes that none of the alternative approaches proposed by respondents result in accounting outcomes identical to those that would result under the issued FSP. The staff also notes that any actions that the IASB might pursue could result in more differences between IFRSs and US GAAP than exist

today. Thus, none of the suggestions would result in ‘levelling the playing field’. Indeed, one user responded ‘Any demand to “level the playing field” is in reality a quest for false comparability given the significant differences that exist and only aids the misrepresentation of economic performance.’

Question to the Board
Does the Board wish the staff to develop any proposals regarding the impairment of financial assets separately from the broader project to replace IAS 39? If so, what proposals does the Board wish the staff to develop, and why?

Appendix 1

Respondent type	Number
Accountancy body	4
Accounting firm	3
Financial Institution	9
Individual	2
Industry group[1]	10
International organisation	3
Other	1
Professional body	3
Regulator	2
Standard setting body	5
User	4
Total	46

Geographical region	Number
Africa	1
Asia Pacific	2
Australia/ New Zealand	5
Europe	20
International	10
North America	8
Total	46

[1] Mainly consisted of banking and insurance associations.