IASB/FASB Meeting
Week commencing 11 April, 2011

IASB Agenda reference	**4E**
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Staff Paper

Project	**Accounting for Financial Instruments: Impairment**
Topic	**Summary of Outreach for Supplementary Document on Impairment**

Introduction

1. In January 2011, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) issued the joint supplementary document (SD), *Financial Instruments: Impairment*, as a supplement to their original exposure drafts (original EDs) which addressed the impairment of financial assets. The comment period for the SD ended on 1 April 2011.

2. During the comment period, the IASB and FASB organised and conducted outreach meetings with a variety of constituents including preparers, users, auditors, national standard setters and regulators. The outreach plan encompassed constituents from across various jurisdictions including North America (the US, Canada, and Mexico), Europe, Asia, Oceania, and South America. The outreach meetings were conducted in the form of in person meetings, phone calls, video conferences, and group forums. The joint outreach program encompassed commentary from over 1,000 constituents, representing over 100 different organisations in the aggregate.

3. Representatives from both the IASB staff and FASB staff participated in most meetings. Having joint representation ensured that both boards would benefit from understanding the full spectrum of perspectives. Many of the meetings were also attended by board members.

4. The purpose of the following memo is to summarise the views expressed by constituents on the SD during outreach meetings.

Overall summary and key points

5. Generally speaking, the views expressed by IFRS and US GAAP constituents had common themes. There were some major differences related to the objective of an impairment amount, but otherwise the major themes that surfaced through the outreach activities were consistent. Further, the themes the staff heard during outreach activities are consistent with the general themes in the comment letters.

6. The detailed comments are provided beginning in the next section. The key points are summarised here:

   (a) Convergence in a high quality standard is extremely important.

   (b) Constituents would have like more time to evaluate and test the proposals.

   (c) The definition of when to move an asset between the 'good' and 'bad book' needs to be refined. Many constituents recognised the importance of these definitions, but stated that the drafted words would lead to non-comparability in application. Some requested a bright line be established by the standard setters (for consistency) and some preferred that no bright line be established, but that the application guidance be clarified.

   (d) The definition of 'foreseeable future period' was said to be vague and to lead to counter-intuitive results in its application (eg when the economy is in a downturn, more provisions would be expected but the foreseeable future period decreases thereby potentially decreasing provisions overall). Similarly to the definition of when to transfer between the 'good book' and 'bad book', some requested a bright line be established and some preferred no bright line be established, but to clarify the words. The bright lines that were suggested were geographically different. For example,

      (i) In the US, 24 months was suggested many times to be in line with the US regulators stress testing guidelines.

(ii) Outside the US, 12 months was suggested many times as this would be in line with Basel requirements and many companies' internal budgeting and forecasting processes as well as because it would make the foreseeable future period a less 'dominant' component of the overall model.

(e) The foreseeable future period losses will likely be the amount used, as opposed to the time-proportional amount, for the 'good book' allowance (ie the floor would tend to apply). However, the follow-on comment to this was geographically different. For example,

(i) In the US, constituents believed this was a reason to not require the time-proportional calculation. Generally, US constituents favour a model that focuses on the allowance balance and that it is sufficient to cover losses expected to occur in the foreseeable future period.

(ii) Outside the US, constituents believed this was a reason to eliminate the 'floor' in the 'good book' and just use a time-proportional calculation. Generally, IFRS constituents favour a model that focuses on presenting information that shows that the pricing of financial assets is linked to expected loss estimates.

(f) Many constituents were concerned with having to perform two separate calculations and how to explain and understand the allowance balance given that it potentially could switch between the floor and the time-proportional amount from period to period.

US Preparers and Auditors Outreach Summary

Global Convergence and Due Process

7. Preparers stressed the importance of convergence on impairment for financial assets. Preparers noted the burden of operational complexities and inefficiencies, especially among large multi-national institutions, that would be associated with maintaining different impairment models under IFRSs and US GAAP. These preparers commended the boards for their commitment to

arriving at a converged solution. Some preparers expressed confusion around the interaction between the boards' objectives in the proposed model.

8. Preparers and auditors emphasised that the final converged standard should put forth an impairment model that is operational, understandable, and auditable. Preparers and auditors expressed concern around the model in the SD, as it seemed to be a compromise between the two boards. Although convergence is a priority, preparers and auditors do not favour a converged solution which increases complexity and detracts from auditability and understandability. In other terms, these constituents do not want convergence priorities to trump the quality of the final standard.

9. Preparers noted that the boards issued the SD during year-end reporting season, and it was difficult to fully assess the implications of the model on raw data (ie undertake back testing) within the comment period. Preparers asserted that they need additional time to complete thorough testing, which they believed was vital in avoiding unintended consequences of any new impairment model. Many preparers and auditors requested an extension of the 60-day comment period for the SD.

Overall Commentary on the Proposed Impairment Model

10. US preparers and auditors supported the development of an impairment model which addressed the 'too little, too late' concern. The pro-cyclicality of reserving was an overriding concern of these constituents. Furthermore, they supported moving away from the 'probable' threshold in current US GAAP. Preparers also supported the incorporation of more forward looking information to establish provisions.

11. Preparers did express some concerns around an impairment model based upon expected losses. Many preparers stated that an expected loss model placed additional emphasis on management's estimates and would create additional tensions with auditors and regulators. Some preparers and auditors suggested developing an impairment model using a modified incurred loss notion, which had a reduced recognition threshold and considered forward-looking

information in loss estimation. These constituents believed that a modified incurred loss model may strike an appropriate balance between current impairment guidance and the complexities of an expected loss model.

12. Some preparers and auditors supported the development of a single impairment model for all financial assets. Other preparers and auditors noted that a 'one size fits all' impairment model may not be appropriate, suggesting that separate impairment models should exist for homogeneous loans measured collectively for impairment, non-homogeneous loans measured individually for impairment, and investment securities.

13. Preparers and auditors supported the 'decoupling' of interest income recognition and credit losses. Many preparers and auditors acknowledged that the SD impairment model addressed the operational concerns with the original IASB ED associated with an integrated effective interest rate. These preparers and auditors believed that the time proportional component of the 'good book' provision effectively achieved a similar objective to that of the integrated effective interest rate, irrespective of these constituents' opinions regarding the conceptual merits of that objective. A section below will highlight constituents' feedback on the 'good book' provision.

14. Most US preparers agreed with the merits of a 'good book' versus 'bad book' approach. These preparers agreed that this terminology was consistent with credit risk management. Other preparers believed that large pools of small, homogeneous assets are not necessarily managed on a separate (ie 'good book' vs. 'bad book') basis. In addition, non-financial institutions noted that they may apply the notion of 'good book' and 'bad book' differently, as they have a different business model from financial institutions, manage their financial assets in different ways, and are subject to different regulatory requirements, if any. As highlighted in the following sections, preparers and auditors were most concerned about the importance the SD impairment model places on definitions (eg 'good book', 'bad book', 'foreseeable future'). Many preparers and auditors noted that without much stronger definitions around key terms, this model would not be operational, auditable, or understandable and comparability would be compromised.

15. Most preparers and auditors had not yet spent significant time reviewing the discounting options related to expected losses. However, generally these constituents noted that the flexibility in choosing whether or not to discount expected losses and in choosing an appropriate discount rate would detract from comparability. They highlighted the risk that auditors may enforce a bright line in this area to drive consistency, if the issue is not more definitively addressed by the boards.

16. In the US, the disclosure proposals were not a main focus of the outreach discussions as the proposed disclosures are in an IASB-only appendix to the SD. However, some feedback was received. For example, preparers and auditors both highlighted that the risk of decreased comparability, stemming from entity-specific judgments regarding items such as expected losses, the foreseeable future period, and the point of 'bad book' transfer, could be combated through enhanced disclosure. Preparers seemed especially concerned about disclosures around entity specific credit risk management (ie 'watch list' and 'bad book' transfer policies) and underwriting policies, as these disclosures may serve to undermine competitive advantage. Preparers also expressed concern around whether certain proposed disclosures would be meaningful to investors' understanding of the provision amount, such as back testing disclosures.

'Good Book'

17. US preparers showed mixed support for the calculation of the impairment provision for the 'good book'. Most preparers believed that the foreseeable future floor will often result in the higher allowance amount when performing the 'higher of' test. As a result, in the US, they generally support a 'good book' allowance based solely on the foreseeable future period because they view the time-proportional calculation as more complex and not always recognising an allowance balance that would cover losses expected to occur in the foreseeable future. This would eliminate the need to do two calculations.

18. These constituents agreed with the notion of a 'floor' in the model (or that the model should only have the 'floor' amount), but were concerned about the lack

of clarity in defining the foreseeable future period. Most of these constituents agreed that the foreseeable future period would fluctuate based on the economic environment in a manner that could be viewed as counterintuitive (ie shortening during turbulent economic periods). Preparers argued that auditors and regulators may seek to impose a bright line on the foreseeable future period which may be a different bright line depending on which regulator is defining it. As a result, they were concerned that there would be decreased comparability and there would not be converged application. Some believed that the guidance should limit the foreseeable future period to 12 months. Other preparers argued that the foreseeable future period should extend upwards to 24-36 months, as they believe this is a typical period over which an entity can generate the most precise loss estimates.

19. In addition, these preparers noted that a longer foreseeable future period may prevent the need for 'bad book' accounting, which would serve to simplify the model. One preparer posed a question as to whether the foreseeable future period represented the period in which economic conditions deteriorate (ie increased likelihood for loss or 'default events') or actually take a loss (ie completed foreclosure). Other preparers believed that due to differing interpretations of 'default events' the foreseeable future losses should focus on projected charge offs in that period.

20. Some US preparers understood the objective of linking the pricing of the asset to the recognition of credit losses, but argued that recognition of credit losses in a rateable fashion was not reflective of actual loss experience. In other terms, some preparers noted that the greatest exposure to losses exists as the loan is originated and credit risk is reduced over the life of the loan, and the allowance balance should follow a similar pattern. Ultimately, these constituents argued that the objective of linking the pricing of the asset to the recognition of credit loss did not reconcile to objectives related to the 'too little, too late' concern. In addition, one constituent that shared with us the results of applying the model in the SD to their particular portfolios did not believe that the time-proportional approach (TPA) met the objective in the IASB's original ED.

21. In addition, preparers were unsure about the application of the TPA calculation to very short term receivables (eg credit cards) and revolving loans. Some preparers had feasibility concerns around data tracking necessary to calculate the weighted average age and weighted average life necessary for the TPA calculation. On some asset classes (eg mortgage loans) variability in prepayments and interest rates may increase the operational complexity of the TPA calculation. Some preparers and auditors identified that the TPA component of the 'good book' calculation may increase operational complexity by applying impairment at a lower level than an overall portfolio level, possibly disaggregating by vintage and/or geographic information in establishing loan pools.

22. Many US preparers believed that performing two calculations for the 'good book' increased the costs of complying with the guidance and provided limited benefits, as they argued that the foreseeable future floor would often exceed the TPA. Preparers also expressed concern over explaining to investors the composition of the 'good book' allowance balance, as it could result in a mix of TPA and foreseeable future floor amounts. Furthermore, transfers between the 'good book' and 'bad book' would complicate roll-forward disclosures around the provision.

'Bad Book'

23. Preparers agreed, in principle, that a 'bad book' asset should have a provision for the full expected lifetime loss. Despite agreeing with the conceptual merits of a 'bad book' provision, some preparers commented that the requirement to calculate three separate provision amounts (ie lifetime expected loss to be used in the TPA calculation and the 'bad book' provision, foreseeable future expected loss, and expected losses for regulatory purposes) increases the complexity of reporting impairment provisions.

24. Preparers did express some concern with the definition of the 'bad book', noting the potential for decreased comparability across entities. Under the proposed model, preparers believed that there was significant risk that the same asset could be managed in a 'good book' by one entity and a 'bad book'

by another entity. Often, US preparers viewed the 'bad book' as individually impaired assets (similar to a SFAS 114 notion). Most believed that the boards would have to refine this definition, but many did not support a 'bright line' in determining 'bad book' classification. For example, an entity may contact a customer about missed payments but that does not necessarily mean the entity's objective shifted from collection of contractual cash flows to recovery. Some preparers believed that this definition should be modified to focus on collectability, rather than credit risk management strategy, perhaps using a 'more likely than not' threshold. Other preparers suggested that the definition of 'bad book' align with regulatory non-accrual requirements to ensure consistency. That is, some preparers and auditors suggested that the point of transfer from a 'good book' to a 'bad book' align with regulatory reporting requirements, based on key metrics such as days past due and loan-to-value ratios. Preparers consistently argued that a narrow versus a broad definition of 'bad book' would have a material effect on the provision amount.

25. Preparers also questioned whether assets could move back to the 'good book' from the 'bad book'. The staff clarified that transfers between the 'good book' and the 'bad book' are two-directional, and therefore could move back into the 'good book'. Some preparers favoured a two-way transfer because they believed that it could lead to improvements over current GAAP (eg troubled-debt restructuring accounting). In other terms, some preparers supported the ability for an asset to move back to the 'good book' after undergoing a restructuring in the 'bad book'.

US Private Company Preparers

26. The staff conducted outreach with several small community banks and credit unions regarding the proposed impairment model under the SD. Generally, these constituents' concerns with the model aligned with those outlined in preceding sections of this memo. Smaller institutions supported the development of a single impairment model for all financial assets, and emphasised the need for a scope limitation for short-term receivables. These constituents agree with the 'good book' versus 'bad book' delineation, arguing

that the 'bad book' definition should align with the regulatory 'nonaccrual' definition.

27. Smaller institutions seemed especially concerned with the TPA and their current systems' inability to track necessary data to perform the calculation. These constituents emphasised that most of their assets are revolving, recurring, or short term in nature, and raised questions regarding how the TPA may apply to these types of assets. Ultimately, smaller institutions were uncertain how the proposed impairment model would materially change their current provision amounts, acknowledging that it would dramatically impact their systems and methodology associated with computing loan loss provisions for 'good' assets. These constituents acknowledged that they consider some forward looking, or 'foreseeable future', qualitative adjustments to historical charge off rates when estimating provision amounts under the current incurred loss model (ie they view this as very similar to the 'floor' calculation). They believe that a foreseeable future period could be reasonably set at 12-24 months.

28. These constituents believed that the boards should consider an effective date and transition deferral for small private entities. Smaller institutions believed that the necessary testing and system upgrades would take significantly longer than for those institutions of greater scale.

International Preparers and Auditors Outreach Summary

29. Non-US (international) preparers and auditors generally had similar views regarding the specifics of the model in the SD as those expressed by US preparers and auditors, but differed in their views relating to the objective of the model. It is important to note that, like US constituents, IFRS constituents stressed the importance of convergence for impairment and the need for additional exposure time (ie to accommodate more advanced testing).

30. Generally, international preparers and auditors placed greater importance on the objective of linking the pricing of the asset to credit loss expectations. These constituents agreed with the conceptual merits of the integrated effective interest rate of the original IASB ED, but sought a more operational method for meeting that objective. These constituents supported the TPA component of

the ‘good book’ provision, as being consistent with the objective, but more operational.

31. Many of these constituents agreed with US constituents that requiring two calculations for the ‘good book’ provisions was operationally complex and did not meet the cost-benefit threshold. Many were concerned that conceptually it was inappropriate to combine the TPA and the foreseeable future concepts in one calculation. They believed that both the TPA and the foreseeable future period floor achieved different objectives, and once combined neither objective could ever be met in its entirety.

32. They were also concerned that the foreseeable future would be likely to usually be the basis for the allowance balance. Unlike the most common US perspective, many international preparers believed that to address this, the foreseeable future floor should be eliminated from the ’good book’ calculation for purposes of operational simplicity and to allow the relationship between loss expectations and pricing to be reflected. These constituents do not agree with the merits of the floor mitigating early loss patterns, and many are especially troubled by the ‘day-one loss’ issue. Very few international preparers agreed with the notion of a ‘day-one loss’ related to open pools of assets. Many international preparers believe that a ‘day-one loss’ does not reflect the underlying economics of lending transactions. International preparers’ concerns about the day-one effect of the floor were not alleviated by the argument that losses should normalise in portfolio aggregation. They did not believe this argument holds for new products nor in growing or contracting economic conditions or for purchases of loans. International preparers and auditors expressed concern that the foreseeable future floor gives management an opportunity to record a large offset initially, and the ability to reverse that reserve later in the asset’s life.

33. IFRS constituents view early loss patterns as more of a function of an economic cycle than a portfolio specific concern to be incorporated into the impairment model. They argue that these early loss patterns should be implicitly considered in the TPA computation. In other terms, some preparers

believed that the allowance should be established reflecting the pattern of losses.

34. In addition, they believe that the 'bad book' can act as a 'floor' for impairment allowances removing the need for the foreseeable future floor.

35. International preparers and auditors agree with US preparers and auditors that a provision balance composed of both the floor and TPA for different portfolios diminishes the relevance and understandability of the allowance account. They were concerned that users would have difficulty understanding allowance balances for single entities (due to the TPA and floor being applied for different portfolios and because this would change over time) and in comparing entities.

36. Like US constituents, these constituents also raised concerns that the foreseeable future period may vary depending on economic conditions in a manner that seems counter-intuitive.

37. Some international constituents acknowledged that they could accept a floor for the 'good book' if it were set at 12 months, if that was the only way of achieving a converged solution. They proposed 12 months as it aligns with Basel II expected loss estimates when using the 'internal ratings-based' approach, and because it coincides with their budgeting processes and because a 12 month cut would result in the floor less frequently exceeding the TPA calculation.

38. Fundamentally, many IFRS constituents argue that sufficient reserving as prioritised through the floor for the 'good book' (ie 'too little, too late' concern) is a prudential responsibility enforced by regulators and financial reporting should not incorporate this as a primary concern.

User Outreach Summary

39. Generally speaking, feedback from user outreach was consistent across geographies. Therefore, all user feedback is combined in one section.

40. Overall, the staff communicated with investors representing more than 20 different organisations. These users were comprised of buyside investors, sellside analysts, regulators and industry representatives of investors and analysts. Of the sellside analysts, some were accounting specialists, while most specialised in financial institutions including multi-national banks, large to medium sized US and regional banks, specialty finance companies and insurance companies. Almost all of the analysts that the staff spoke with were equity analysts. A few of the analysts had previous experience as credit analysts. One analyst was a lender to insurance companies and financial institutions.

41. Overall, users focused on understanding the calculation of expected losses and the total loss estimates so that they could decide how to use that information. They were concerned with getting granular disclosures in the financial statements so that they could do their own analysis. Their primary concern was with lack of comparability in entities applying the model proposed in the SD because of the 'higher of' test (ie entities could flip back and forth between the foreseeable future period and the TPA as the 'good book' allowance amount). They believe it would be important to mitigate this concern with adequate disclosure. These overall concerns are explained in further detail below.

42. However, generally, users were supportive of the model set forth in the SD and felt that a converged solution was extremely important. Users were also generally supportive of developing a single impairment model for all financial assets because interpreting the several existing models under current guidance has become burdensome and confusing. Many users believe the SD impairment model represents an improvement from the current impairment model based on incurred losses with a probable threshold and agreed that the estimate of expected losses should be more forward looking.

43. Users agreed that the current impairment model resulted in a delayed recognition of losses, and the objective of any new impairment model should address this issue. Users also emphasised the desire to mitigate the procyclicality of reserving for future losses. However, without more testing,

many users noted the difficulty in evaluating the extent to which the proposal would resolve either the delayed recognition of losses or the mitigation of procylicality. A few users felt the proposal was unnecessarily complicated and that the boards should consider a less complex model based on incurred losses with a reduced threshold for recognition of losses. A few users suggested that expected lifetime losses should be recognised on 'day one' because that would provide the best information about future expected losses.

44. Some users favoured the objective to link the pricing of the asset with the recognition of credit losses, while others focused more on capital adequacy and balance sheet concerns around mitigating procyclicality of reserving. However, generally users appreciated that the model offered the 'higher of' the TPA or the foreseeable future floor for 'good book' assets. Most users understood the basic rationale behind the TPA, but some felt that at any point in time the balance sheet should reflect adequate reserves to cover losses expected to occur in the foreseeable future. Some users were concerned that it would be difficult to understand and interpret the information provided by the model when a mix of lifetime expected losses, the TPA, and the foreseeable future floor were reported by asset category. Understandability of the model would become especially difficult if the underlying impairment methodology by asset category changed from period to period.

45. Users were also concerned about the definition of 'foreseeable future'. Some users felt there would be a lack of comparability in foreseeable future periods between entities, while other users felt that this difference would be informative with appropriate disclosure. Some users were concerned that the foreseeable future period would shorten in times of crisis, which could result in fewer losses being taken.

46. Many users questioned whether the delineation between a 'good book' and 'bad book' provided an informative difference, given the potential diversity in practice associated with a transfer to the 'bad book'. Users tended to prefer a standard market trigger for the 'bad book' transfer, but believed that, if left to entity-specific judgments, disclosure around the specific inputs used in

determining 'bad book' status would be very important[1]. Some users question why if the foreseeable future floor extended beyond 12 months, 'bad book' accounting would be necessary (ie the foreseeable future losses updated each period would eventually cover lifetime losses). Many users thought in terms of a non-performing loan (or, in the US, non-accrual status) as a trigger for 'bad book' transfer. Some users voiced concern that there would be an incentive to keep assets out of the bad book in order to reduce reported impairments.

47. Generally, users supported the IASB proposed disclosures. However, users did state that disclosures would be most useful if they provided granular information, and did not lend themselves to boilerplate language. Users favoured granular disclosures for 'good book' and 'bad book' related to collateral information, credit ratings, pay-offs, pay-downs, roll forward information, and credit grade migration. Users emphasised that lifetime loss estimates (for the 'good book' and 'bad book') would be a very important disclosure, as this would be a key input in determining the adequacy of managements' reserve estimates. These constituents believed that the disclosures should depict the quality of managements' estimates (ie actual versus expected outcomes). Several users said that they just needed granular information about the lifetime credit losses and the basis for expectations and the users would develop their own allowance amount. US and international users requested that information be included in the disclosures regarding loan modifications and restructurings.

Private Company Users

48. It is important to note that the staff's outreach with private company users was limited to a US perspective.

49. These users were concerned that the TPA calculation may be too difficult for many smaller institutions to perform. They believe the limited access to data and increased exposure to revolver-type assets may make the calculation of weighted average age and weighted average life to be used in the TPA

[1] Such disclosures are proposed in the IASB-only Appendix Z.

operationally complex. Furthermore, making full life loss estimates on 'good' assets may be more difficult for smaller institutions given limited sophistication of credit risk systems.

50. These users preferred a 12 month foreseeable future floor, as they believed that anything beyond that time period would be highly unreliable. In addition, they believed that the shorter term nature of assets held by smaller institutions makes a longer foreseeable future period less relevant.

51. These users supported the concepts outlined in the IASB proposed disclosures, but cited some concerns for preparers of smaller institutions financial statements. For example, back testing disclosures may pose a serious burden on the resources of a smaller institution while providing limited benefit to users because they already realised charge off data. These users did support a disclosure related to the allowance account breakdown by credit grade. In addition, these users supported disclosure about inputs used to determine the foreseeable future period (if not set at a bright line), the weighted average age of a portfolio, the weighted average life of a portfolio, and estimated lifetime losses.

Bank Regulator Outreach Summary

52. The staff performed outreach with US, national, and international regulators. The regulators were also in strong support of achieving a common solution globally.

53. Bank regulators agreed with the 'good book' versus 'bad book' approach, as they believe entities are currently managing assets on a similar basis. Regulators understood the two objectives of the SD impairment model. US regulators were more comfortable with recognising losses immediately and building a model based on the floor in isolation while other regulators were generally comfortable with the proposal in the SD. Regulators consistently supported the floor to avoid under-provisioning, but did not reach a consensus on the length of the foreseeable future period. US regulators noted that they use a 24 month period for stress testing purposes, but commercial credit and

credit cards may have a foreseeable future period of only 12 months. Other regulators believe that the foreseeable future period should align with jurisdictional regulations (eg align with Basel II regulatory reporting).

54. Regulators believed that regulatory definitions and indicators of default would be sound metrics for triggering ‘bad book’ accounting treatment.