Staff Paper

Project **Impairment**

Topic **General approach after SD**

Purpose of this paper

1. The comment period for the joint supplementary document *Financial Instruments: Impairment* (SD) – a supplement to the original exposure drafts (original EDs) which addressed the impairment of financial assets[1] – ended 1 April 2011. Using those comments received, as well as feedback from outreach activities, the staff have identified four high level possible alternatives for moving the impairment project forward.

2. Before discussing the alternatives, the staff stress that one message that has been consistently received, regardless of jurisdiction or type of respondent, is that there should be a converged solution for impairment. Many believe that for the financial instruments project the most important part on which to reach a converged solution is impairment.

3. The purpose of this paper is to present those possible broad approaches, so that the boards can make a decision on next steps to give the staff direction. The possible approaches are to:

[1] The original IASB ED *Financial Instruments: Amortised Cost and Impairment* (original IASB ED), was issued in November 2009. The FASB Proposed Accounting Standard Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (original FASB ED) was issued in May 2010, and included proposals for the impairment of financial assets.

(a) **Alternative 1** – Finalise the approach developed by the IASB based on deliberations prior to convergence discussions[2] (ie a time-proportional approach for a 'good book' and full lifetime expected losses for a 'bad book');

(b) **Alternative 2** – Finalise the approach developed by the FASB based on deliberations prior to convergence discussions[3] (ie recognise losses expected to occur in the 'foreseeable future' period);

(c) **Alternative 3** – Finalise the model in the SD; or

(d) **Alternative 4** – Develop a variation of the previous proposals, taking into account the feedback from the original EDs and the SD.

Alternatives

Alternatives 1 and 2 – Finalise the preferred approach of some IASB or FASB members

4. In the SD's Basis for Conclusions, paragraphs BC69-BC86 discussed that some members of each board preferred one component of the joint approach over the other. Generally speaking, some IASB members preferred the time-proportional approach with a 'good book' / 'bad book' split without a floor in the 'good book'. And, generally speaking, some FASB members preferred using the foreseeable future period to calculate and recognise expected credit losses with no 'good book' / 'bad book' differentiation.

5. Those two approaches were each trying to maintain the objective each board had in their original EDs. For the IASB, that objective was to maintain a link between the pricing of the financial assets and the initial expected credit losses. For the FASB, the objective was that the allowance balance should be sufficient to cover losses expected to occur in some defined time period (ie in the FASB's original ED the lifetime expected losses, after some further deliberations taking into account feedback on that ED it was the foreseeable future period).

[2] as discussed in paragraphs BC69-BC77 of the SD
[3] as discussed in paragraphs BC78-BC86 of the SD

6. The staff note that the feedback received on the SD does not indicate a single preferred approach. The feedback received was geographically split in that constituents in the US generally preferred the FASB approach, and constituents elsewhere generally preferred the IASB approach (if having to make a choice between the two approaches), supporting the boards respective objectives. However, it is important to note that both the FASB and IASB have some constituents who prefer the other boards' approach, and that some constituents prefer an entirely different approach, or a variation of the SD.

7. The boards could choose to finalise either of the above two approaches jointly. The staff note, however, that the boards have already had extensive deliberations on each of these two approaches in developing the original EDs and then the SD and were unable to obtain sufficient support from both boards for either approach. The feedback received does not provide any new information that the staff believe would change the direction of either boards' previously expressed views when given these two alternatives. Therefore it is unlikely pursuing either of these approaches would result in reaching a converged solution.

Alternative 3 – Finalise the SD approach

8. The approach in the SD combines components of both of the approaches above into a single model which uses a 'higher of' test for loans in the good book. As discussed in the comment letter summary[4], most of the feedback on the SD approach was consistent across jurisdictions in the issues and concerns that were raised, but were different in the suggested solutions to address those issues and concerns. We have highlighted some of the main feedback received for the purposes of this paper.

9. The greatest concern that was expressed by many respondents was over having to make two calculations to determine the allowance for the 'good book' – a time-proportional calculation using the remaining lifetime expected losses and the floor calculation using the foreseeable future expected losses. They viewed the dual calculation as operationally difficult, lacking conceptual merit, and

[4] IASB agenda paper 4D / FASB Memo 86 of the week of 5 April board meeting

providing confusing information to users. For example, because of the 'higher of' test, the calculation of the allowance account may be based on the time-proportional calculation one period and the foreseeable future period the next. Constituents expressed concern about how to explain the outcomes to investors.

10. To resolve this concern, many respondents suggested that the model should have only one calculation for the good book allowance amount. However, depending on the geographical location, the calculation that was suggested to be removed from the overall model was different. Consistent with the comments in paragraph 6, constituents in the US generally felt that removing the time-proportional calculation would create a better model. Whereas, constituents in other parts of the world suggested that removing the foreseeable future floor would create a better model. It was generally asserted, however, that the 'foreseeable future' period was not well understood as to how long the period would be. Moreover, almost all constituents expressed concern that inconsistent application as to the time period used would inevitably result in comparability issues amongst similar entities. Consequently, they felt that bright lines would be established by regulators and auditors to address different application.

11. Some constituents were not as concerned about the dual calculation. However, they expressed the concerns about the 'foreseeable future' highlighted in the previous paragraph. Some suggestions were that the floor could be based on incurred losses, could be a bright line of 12 months (or a different bright line), or could be calculated another way. Others suggested that the pattern of recognising losses could be based on the same pattern as losses were expected to occur.

12. Overall, the boards did not receive strong support for the SD as published and as mentioned above there were differing suggestions to respond to the issues and concerns raised. Should the boards choose to finalise this approach, they will have to consider these issues during redeliberations, particularly the concerns raised about the calculations in the good book introduced to accommodate the board's different objectives, along with other concerns expressed by constituents.

Alternative 4 – Develop a new variation of the proposals

13. A fourth alternative is to take all the information that has been gathered so far and develop a new variation for an impairment model that is a common approach.

14. As mentioned above, the feedback received on the SD was not very supportive of the joint approach as drafted (although constituents were complimentary of the boards reaching a common approach – and stressed the importance of reaching a high-quality common solution). Included in the feedback were several suggested improvements, or different variations of the proposals.

15. This alternative would entail using the feedback the staff has received during the processes related to both of the original EDs and the SD to develop a variation that both boards agree upon that appropriately considers feedback received. Given the importance of improving impairment accounting as a matter of urgency this work would need to be undertaken expeditiously.

Staff recommendation and question to the boards

16. The staff note that a subgroup of board members and senior staff from both the FASB and IASB has already been created to discuss the feedback from the SD.

17. The staff recommend Alternative 4 as the way forward for the impairment project. The staff recommend that the established internal working group develop some specific suggestions to move forward, such as baseline models or objectives to be presented to the boards for deliberation. Once an overall objective and general approach for an impairment model is agreed to by the boards, then the specifics of the model can be further developed making maximum use of feedback already obtained.

18. The staff prefer this alternative because the boards did not receive strong support for the proposals in the SD and significant issues were raised. Also, the staff do not think that it is likely that the two boards will be able to reach a common solution based on either Alternative 1 or 2. Constituents have stressed the importance of a common solution, which the staff believe is most achievable if the boards pursue Alternative 4.

Question to the boards
Do the boards agree with the staff recommendation in paragraph 17 to use Alternative 4 and develop a variation of the previous proposals, taking into account the feedback from the original EDs and the SD as a general plan for moving forward on the impairment project? Why or why not? If not, what would the boards like to do, and why?