

**STAFF PAPER**
**16 – 20 July 2012**
**REG IASB Meeting**

<b>Project</b>	<b>Financial Instruments: Impairment</b>		
<b>Paper topic</b>	<b>Summary of decisions to date (information only)</b>		
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**Summary of tentative decisions to date (Background information only)**

1. Impairment for financial assets at amortised cost would follow a “three-bucket” approach based on deterioration in credit quality.
2. With one exception, all originated and purchased financial assets would start in Bucket 1 and would move into Bucket 2 or Bucket 3 as credit quality deteriorates (herein referred to as the “general approach”). However, purchased financial assets for which, at acquisition, the entity has an explicit expectation of credit losses (that is, purchased credit-impaired assets) would follow a different approach (that is, the “purchased credit-impaired approach”).
3. At a future meeting, the FASB will further consider the scope of transactions which will follow the purchased credit-impaired approach. In developing recommendations on that issue, the IASB asked the IASB staff to proceed with keeping the scope similar to the scope of existing IFRSs under which accretion to expected cash flows is currently required. However, the FASB requested the FASB staff to also explore an approach whereby purchased credit-impaired financial assets would include assets that have experienced a more than insignificant deterioration in credit quality since the seller originated them and it

is at least reasonably possible that all or some of the contractual cash flows may not be collected.

### **General approach**

4. At each reporting date, an entity should assign all originated and purchased financial assets within the scope of the “general approach” into one of three categories:
  - (a) Bucket 1 – Financial assets that have not met the threshold for recognition of lifetime expected credit losses. This category includes both assets evaluated individually and assets evaluated as a group.
  - (b) Bucket 2 – Financial assets evaluated as a group that have met the threshold for recognition of lifetime expected credit losses.
  - (c) Bucket 3 – Financial assets evaluated individually that have met the threshold for recognition of lifetime expected credit losses.
5. The following principles should be utilized for grouping financial assets for purposes of evaluating whether financial assets have met the threshold for recognition of lifetime expected credit losses.
  - (a) Assets would be grouped on the basis of “shared risk characteristics.”
  - (b) An entity would not group financial assets at a more aggregated level if shared risk characteristics for a subgroup would indicate whether recognition of lifetime losses is appropriate.
  - (c) If a financial asset cannot be included in a group because the entity does not have a group of similar assets, or if a financial asset is individually significant, the entity would be required to evaluate that asset individually.
  - (d) If a financial asset shares risk characteristics with other assets held by the entity, the entity would be permitted to evaluate those assets individually or within a group of financial assets with shared risk characteristics.
6. The recognition of lifetime expected credit losses applies to financial assets in which the extent of credit deterioration subsequent to initial recognition indicates

that (a) there has been a more than insignificant deterioration in credit quality, and (b) it is at least reasonably possible that some or all of the contractual cash flows may not be collected. This assessment would be based on the likelihood of not collecting some or all of the contractual cash flows as opposed to incorporating the “loss given default” in the assessment. The model will include indicators for when the recognition of lifetime expected losses may be appropriate. Financial assets would subsequently transfer to Bucket 1 (after previously deteriorating and transferring to Bucket 2 or Bucket 3) if the initial transfer notion from Bucket 1 is no longer met.

7. In applying the credit deterioration model to publicly traded debt instruments (that is, debt securities), the boards decided against a bright-line presumption resulting in recognition of lifetime expected losses (for example, when the fair value of a security is less than a specified percentage of the amortized cost basis for some specified time period). In applying the credit deterioration model to commercial and consumer loans, the boards decided against a presumption resulting in recognition of lifetime expected losses based on an explicit bright line (for example, reaching a particular delinquency status). The boards emphasized that robust disclosures will be critical to support the principle-based impairment model and to ensure comparability between entities.
8. Additionally, the boards have directed the staff to develop examples to illustrate that the “reasonably possible” criterion differs from how it may currently be interpreted in GAAP (particularly in the U.S.) and primarily refers to when the likelihood of cash shortfalls begins to increase at an accelerated rate as an asset deteriorates.

### **Estimating Expected Losses**

9. Estimating lifetime losses should not require a detailed estimate for periods far in the future, but the degree of detail necessary in forecasting estimated losses decreases as the forecast period increases. The estimate of expected credit losses should reflect the following:
  - (a) All reasonable and supportable information considered relevant in making the forward-looking estimate

- (b) A range of possible outcomes and the likelihood and reasonableness of those outcomes (that is, it is not merely an estimate of the “most likely outcome”)
  - (c) The time value of money.
10. An entity should consider information that is reasonably available without undue cost and effort in estimating expected credit losses.
  11. The IASB tentatively decided to permit an entity to use a current discount rate between, and including, the risk-free rate and the effective interest rate when discounting expected losses to provide operational relief to entities. The IASB noted that the choice of rate was an accounting policy choice that must be applied consistently in the accounting for the impairment allowance of an asset over its life. The IASB noted that this IASB-only decision would also be relevant in determining the discount rate used to discount expected losses for trade receivables and lease receivables (see below).

#### **The Bucket 1 measurement approach**

12. The Bucket 1 measurement approach would be expected losses for those financial assets on which a loss event is expected in the next 12 months. With an entity’s Bucket 1 measurement, expected losses are all cash shortfalls expected over the lifetime (that is, the full loss content) that are associated with the likelihood of a loss event in the next 12 months; that is, the losses being measured are not only the cash shortfalls over the next 12 months. Various approaches can be used to estimate the expected losses, including approaches that do not include an explicit “12-month probability of a loss event” as an input.

#### **Interest income**

13. Interest income would be measured by applying the effective interest rate to an amortized cost balance that is not reduced for credit impairment since acquisition.

#### **The Purchased Credit-Impaired Approach**

14. As already indicated, a different approach to credit impairment would apply to “purchased credit-impaired” assets. As discussed earlier, at a future meeting, the

FASB will further consider the scope of transactions which will follow the “purchased credit-impaired approach.”

15. Purchased credit-impaired assets would be initially assigned to either Bucket 2 or Bucket 3. These assets would always be categorized outside of Bucket 1, even if there are improvements in credit quality after purchase.
16. Purchased credit-impaired assets would be presented in the statement of financial position at the transaction price under US GAAP (or fair value under IFRSs) (without presentation of an allowance for expected contractual cash shortfalls implicit in the purchase price). Disclosure would be required of the expected contractual cash shortfalls implicit in the purchase price.
17. Interest income would be measured based on expected collectible cash flows estimated at the date of acquisition (that is, the purchase price would be accreted to expected cash flows).
18. A separate credit impairment expense would not be recognized at the date of acquisition as a result of limiting the recognition of interest income for these credit-deteriorated financial assets by basing interest income on expected cash flows rather than on contractual cash flows. Rather, the credit impairment allowance for such assets would be equal to the change (since acquisition) in the lifetime expected credit losses.
19. Both favorable and unfavorable changes in expectations about the collectability of cash flows after acquisition would be recognized immediately as an adjustment to impairment expense for the period, even if favorable changes exceed the allowance for credit losses.
20. The boards directed the staff to evaluate appropriate disclosure to facilitate analysis and comparability of originated and purchased portfolios. This disclosure might include discrete information for purchased portfolios that allows users to reconcile from (1) the “gross” amounts of contractual cash flows, excluding the discount not attributable to credit, to (2) the net carrying amount.

#### **Application of the Model to Modified Debt Instruments under US GAAP**

21. An entity would recognize lifetime expected credit losses for modified debt instruments in which the lender, for economic or legal reasons related to the

debtor's financial difficulties, grants a concession to the borrower that the lender would not otherwise consider (referred to as troubled debt restructurings under current U.S. GAAP). In these circumstances, a modified debt instrument is a continuation of the existing instrument and would be evaluated for credit deterioration in accordance with the instrument's original terms.

### **Application of the Model to Modified Financial Assets under IFRS**

22. Modified financial assets (that do not result in derecognition) should be considered for transfer in the same way as other (non-modified) assets within the general 'three-bucket' impairment model. In other words, originated and purchased non-credit-impaired financial assets that have been modified should move between buckets according to whether the transfer notion is or is no longer met. Furthermore, purchased credit-impaired financial assets that have been modified should remain outside Bucket 1 throughout their lives.
23. When an entity evaluates the transfer in or out of Bucket 1 for an asset that has been modified, it should:
  - (a) evaluate the current credit quality against the credit quality at initial recognition in determining whether there has been more than an insignificant deterioration in credit quality, and
  - (b) consider the cash flows of the modified instrument when evaluating whether the likelihood that some or all of the contractual cash flows may not be recoverable is at least reasonably possible.
24. The gain or loss upon modification should be recognised against the gross carrying amount of the financial asset.

### **Application of the Model to Trade Receivables**

25. The decisions relating to trade receivables interact with the Revenue Recognition project. The scope of the decisions are limited to trade receivables with (and without) a significant financing component that result from revenue transactions within the scope of Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers* (the Revenue Exposure Draft).

*Trade Receivables with a Significant Financing Component*

26. An expected loss impairment model would be applied to trade receivables with a significant financing component. An entity could apply a policy election either to fully apply the “general approach” to trade receivables accounted for as having a significant financing component or to apply a simplified approach in which those trade receivables would have an allowance measurement objective of lifetime expected credit losses at initial recognition and throughout the trade receivables’ life. The simplified approach provides relief because an entity would not be required to track credit deterioration through the buckets of the “three-bucket” model for disclosure purposes.

*Trade Receivables without a Significant Financing Component*

27. An expected loss impairment model would be applied to trade receivables without a significant financing component. The credit impairment measurement objective for trade receivables that do not have a significant financing component would be lifetime expected losses. A provision matrix could be used to estimate expected credit losses for trade receivables.
28. In addition to the above, the IASB tentatively decided that, for trade receivables accounted for as not having a significant financing component in accordance with the Revenue ED, the receivable shall be measured at the transaction price as defined in the Revenue ED (ie the invoice amount in many cases) on initial recognition in IFRS 9 *Financial Instruments*.

**Application of the Model to Lease Receivables**

29. For lease receivables recognized as a result of the joint leases project an entity could elect either to fully apply the proposed “three-bucket” model or to apply a simplified approach in which those lease receivables would have an impairment allowance measurement objective of lifetime expected credit losses at initial recognition and throughout the lease receivables’ life.
30. The simplified approach would reduce complexity in practice because an entity would not be required to track credit deterioration through the buckets of the three-bucket model.

31. The cash flows and the discount rate used in the measurement of the lease receivables would be used as the contractual cash flows and effective interest rate when assessing the lease receivables' impairment allowance.
32. To address potential timing differences between the finalization of the proposed leases and impairment standards, the Boards tentatively decided that the same approach described above would apply for lease receivables recognized by a lessor under the existing guidance in IAS 17, *Leases*, and FASB Accounting Standards Codification® Topic 840, Leases.

### **Uncollectibility**

33. A financial asset is considered uncollectible if the entity has no reasonable expectation of recovery. Therefore, an entity would write off a financial asset or part of a financial asset in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).
34. A *write-off* would be defined as “a direct reduction of the amortized cost of a financial asset resulting from uncollectibility.”