STAFF PAPER

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REG FASB | IASB Meeting

Project	**Financial Instruments: Impairment**		
Paper topic	Cover Memo		
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Summary of Agenda Papers

1. In continuing to develop the 'three-bucket' impairment approach, the following papers have been prepared for the May 2012 meeting:

   (a) **IASB Agenda Paper 5A (IASB only)**: Discusses the discount rate that should be used when discounting expected losses in the 'three–bucket' impairment approach.

   (b) **IASB Agenda Paper 5B (IASB only)**: Discusses how modifications on financial assets should be treated in the 'three-bucket' impairment approach.

   (c) **IASB Agenda Paper 5C/FASB Memorandum 155**: Discusses the application of the 'three-bucket' impairment approach to lease receivables.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

2. The following table summarises the staff recommendations for the agenda papers:

Topic	Staff Recommendation
Agenda Paper 5A (IASB only)	
Question Discount rate for measuring expected losses	The staff recommend the IASB permits an entity to use a rate between, and including, the risk-free rate and the effective interest rate (as used for the effective interest method in IAS 39).
Agenda Paper 5B (IASB only)	
Question 1 Symmetry of model	The staff recommend that modified financial assets should be considered for transfer in the same way as other assets, that is: (a) originated and purchased non-credit-impaired financial assets that have been modified should move back to Bucket 1 if the downward transfer notion is no longer met; and (b) purchased credit-impaired financial assets that have been modified should remain outside Bucket 1 throughout their lives.
Question 2 Evaluating the transfer notion	The staff recommend that when evaluating whether a modified asset should be transferred back to Bucket 1 an entity should: (a) evaluate the current credit quality against the original credit quality 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 of default is such that it is at least reasonably possible that some or all of the contractual cash flows may not be

	recoverable.
Question 3 Presentation	The staff recommend that the new requirements should state that the impairment loss for modifications should be recognised against the gross carrying value of the financial asset.
IASB Agenda Paper 5C/FASB Memorandum 155	
Question 1 Application of model to lease receivables recognised under the proposed receivable and residual leases model	The staff recommend that an entity should assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for lease receivables recognised under the proposed receivable and residual leases model.
Question 2 Application of model to lease receivables recognised under existing leases standards	The staff recommend that an entity should: (a) assess and measure the impairment allowance in accordance with the proposed 3 Bucket model for finance lease receivables recognised under IAS 17 and capital lease receivables recognised under Topic 840; and (b) measure the impairment allowance at lifetime expected losses for operating lease receivables recognised under IAS 17 and Topic 840.

Summary of tentative decisions to date

3. Impairment for financial assets at amortised cost would follow a "three-bucket" approach based on deterioration in credit quality. The "three-bucket" approach has not yet been fully developed, but is intended to apply to all debt instruments (including both loans and debt securities).

4. 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").

5. (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

6. 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.

7. 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.

8. 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.

9. 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.

10. 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

11. 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.

12. An entity should consider information that is reasonably available without undue cost and effort in estimating expected credit losses.

The Bucket 1 measurement approach

13. 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

14. 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

15. 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."

16. 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.

17. Purchased credit-impaired assets would be presented in the statement of financial position at the transaction price (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.

18. 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).

19. 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.

20. 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.

21. 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

Application of the Model to Trade Receivables

22. 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

23. 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

24. 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.

Uncollectibility

25. 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).

26. A *write-off* would be defined as "a direct reduction of the amortized cost of a financial asset resulting from uncollectibility."