Impairment of financial assets managed in an open portfolio

Highlights

- Proposed common solution for impairment accounting for open portfolios of financial assets.
- Immediate provision required for losses expected to occur in foreseeable future.
- Separate allowance accounts mandatory.
- Calculation of allowance account for 'good book' and 'bad book' categories.
- Boards still need to deliberate on a number of important impairment issues.

Our forthcoming publication *New on the Horizon: Impairment of Financial Assets Managed in an Open Portfolio* will provide more detail about the supplement and discuss possible application issues. Speak to your usual KPMG contact if you would like a copy of this publication.

Introduction

The IASB[1] and the FASB[2] (the Boards), published Supplement to ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the supplement) on 31 January 2011. The supplement has been issued to obtain views from constituents to assist the Boards in developing a common solution to the accounting for impairment of financial assets prior to issuing final impairment requirements.

The Boards have published differing proposals in this area and have expressed separate preferences in relation to a revised impairment model. A significant area of difference under the original proposals related to the timing of the recognition of estimated impairment losses. The supplement is a step towards developing a common solution for impairment accounting and sets out proposals for accounting for impairment of financial assets such as loans managed in an open portfolio. In addition, the supplement proposes presentation requirements for interest revenue and impairment losses and disclosure requirements for open portfolios of financial assets.

Comments on the revised proposals are due to the IASB by 1 April 2011.

Background

As part of its phased approach to replace IAS 39 *Financial Instruments: Classification and Measurement*, the IASB published Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the exposure draft) in November 2009. The exposure draft proposed to replace the current incurred loss method for measurement of impairment of financial assets with a method based on expected losses. The originally proposed model would require an entity to estimate the expected credit losses on a financial asset upon its initial recognition and include them in arriving at the initial effective interest rate for the asset, which would subsequently be used to recognise interest revenue. This would have an effect of recognising the initial expected credit losses and building up a loss allowance over the life of the instrument. The exposure draft also proposed that entities reassess the expected credit losses at the end of each reporting period and recognise immediately the effects of any changes in credit loss expectations.

At the time of issuing the exposure draft, the IASB formed an Expert Advisory Panel to advise the Board on the operational aspects of the proposals.

The FASB issued their proposals for impairment of financial assets in June 2010 as part of the Proposed Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The proposals would require an entity to estimate cash flows not expected to be collected and recognise related losses immediately. The cash flows would be estimated on an assumption that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset.

The Boards have deliberated jointly on the responses to their respective proposals. The FASB also participated in the IASB meetings with the Expert Advisory Panel. The supplement is a result of these joint deliberations.

A number of aspects of the impairment project have not yet been deliberated by the Boards, including:

- credit impairment for financial assets that are not part of an open portfolio, including short-term receivables, the initial recognition of which is expected to be re-deliberated as part of the revenue project;
- methods for measuring credit losses;
- wider disclosure requirements;
- the objective of amortised cost measurement; and
- interest revenue recognition.

Furthermore, a number of aspects of the impairment project remain to be deliberated by the FASB, including:

- credit impairment requirements for purchased loans and loans modified in troubled debt restructuring;
- the concept of 'non-accrual'; and
- presentation and disclosure.

Summary of key proposals

The supplement consists of two parts:

- the Boards' joint invitation to comment on the recognition of impairment of financial assets managed in an open portfolio; and
- the IASB's request for comments on the scope of IAS 39 and IFRS 9 *Financial Instruments*, and the presentation and disclosures related to the joint impairment proposals.

Part one: Boards' joint invitation to comment

Part one of the supplement discusses the recognition of expected credit losses for financial assets managed in an open portfolio. In open portfolios, assets are added to the portfolio and removed from it through origination, purchase, repayment, sale, transfer or write-off.

Recognition of impairment in open portfolios of financial assets

In developing the proposals, the Boards have considered their primary objectives for the impairment project. The IASB's overall objective is to maintain a link between the pricing of financial assets and expected credit losses. The FASB has continued to place primary importance on making sure that the loss allowance is sufficient to cover expected losses when they occur. The proposals in the supplement have features that partly satisfy each of their primary objectives for the impairment project and that they reflect the Boards' commitment to seeking a common solution to accounting in this area.

The Boards propose that for the purpose of determining the impairment allowance, financial assets that are managed on an open portfolio basis are split into two categories: the 'good book' and the 'bad book'. A financial asset would be included in the bad book category if its collectability becomes so uncertain that the entity's credit risk management objective changes for that asset from receiving regular contractual payments to recovery of the financial asset. The proposals acknowledge that some entities already split their financial assets into good book and bad book categories for internal risk management purposes.

The impairment allowance at each reporting date would be made up of the following two components:

- for financial assets in the good book category, the higher of:
  - time-proportional expected credit losses; and
  - credit losses expected to occur in the foreseeable future, which would be no less than 12 months after an entity's reporting date; and
- for financial assets in the bad book category, the entire amount of expected credit losses.

Loss estimates

The loss estimates would be based on all available information taking into consideration expectations of future changes in economic and market conditions beyond the reporting date. Such expectations would be based on reasonable and supportable information and should be consistent with currently available information.

Time-proportional expected losses

The time-proportional expected losses would be measured using either a straight-line method or an annuity method. If calculations are performed using discounted cash flow techniques, then the discount factor could be any rate between the risk-free rate and the asset's effective interest rate. The FASB has not yet deliberated on these issues.

Credit losses expected to occur within the foreseeable future period (the floor)

The foreseeable future period is the period for which specific projections of events and conditions are possible and the amount of credit losses can be estimated reasonably based on those specific projections. The foreseeable future period may differ for different asset classes according to their characteristics; however, there is a presumption that reasonable and supportable information is available for at least the following 12 months.

Part two: IASB's request for comments

This part of the supplement relates to issues that have only been deliberated by the IASB. The IASB has requested comments on the scope of IAS 39 and IFRS 9, and presentation and disclosure requirements related to the joint impairment proposals. The presentation and disclosure requirements relate only to the open portfolios of financial assets and do not cover all impairment disclosures.

Scope of IAS 39 and IFRS 9

The IASB seeks feedback on whether loan commitments that are not accounted for at fair value through profit or loss should be subject to the proposed impairment requirements and whether such requirements would be operational when applied to loan commitments and financial guarantees. This approach may be appropriate as entities often manage drawn and undrawn loan commitments and financial guarantees using the same business model.

Presentation

The supplement proposes that the statement of comprehensive income includes separate line items for:

- interest revenue, calculated using the effective interest rate; and
- impairment losses, including reversals of impairment losses.

Disclosures

The proposed disclosures relating to the allowance account for credit losses, which will be mandatory under the proposals, and credit loss estimates include:

- a separate reconciliation of the allowance account for the good book and the bad book categories of financial assets;
- a reconciliation of the nominal amount of financial assets included within the bad book category;
- the total amount of assets in the good book category, the related expected losses and the amount of the impairment allowance;
- a description of the key estimates in determining the impairment allowance and any subsequent changes to those estimates, an explanation of the key inputs and assumptions, including the time period used as the foreseeable future and how this determination was made; and
- an analysis of how past estimates of credit losses compare with actual outcomes.

The proposals would also require disclosure of information about the internal credit risk management strategy to enable users of the financial statements to understand the relationship between how financial assets are managed and the estimation of credit losses. This would include disclosure of:

- the nominal amount of assets, the entire amount of the expected credit losses and credit losses for the foreseeable future for each credit grade;
- the criteria used to distinguish assets in the good book and bad book categories; and
- information about internal grades.

Next steps

The Boards plan to deliberate jointly on the responses to the supplement and during the comment period the Boards will continue their discussions on other aspects of the impairment model.

The IASB expects that an IFRS combining all impairment requirements will be issued by June 2011. The effective date and transition requirements of the proposed IFRS are yet to be determined.

The FASB expects that a final update including credit impairment will be issued in 2011.

Abbreviations

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

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