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Supplement to ED/2009/12
Financial Instruments: Amortised Cost and Impairment

Financial Instruments: Impairment

Comments to be received by 1 April 2011

Supplement

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Supplement to Exposure Draft
ED/2009/12

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Introduction

Background

- IN1 In October 2008, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) set up the Financial Crisis Advisory Group (FCAG). The FCAG was asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. In its report, published in July 2009, the FCAG identified delayed recognition of losses associated with loans (and other financial instruments) and the complexity of multiple impairment approaches as primary weaknesses in accounting standards and their application. One of the FCAG's recommendations was to explore alternatives to the incurred loss model that would use more forward-looking information.
- IN2 In April 2009, having considered the views and information received as a result of their work responding to the global financial crisis, and following the G20 leaders' conclusions and recommendations of other international bodies such as the Financial Stability Board, the IASB and the FASB announced accelerated timetables for replacing their respective financial instruments standards. As a result:
- in November 2009 the IASB issued IFRS 9 *Financial Instruments* on the classification and measurement of financial assets.
 - also in November 2009 the IASB published the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the IASB's original exposure draft on this subject), which proposed requirements for amortised cost measurement including the impairment of financial assets. This supplementary document proposes some changes to that exposure draft related to the credit impairment guidance and invites comments.
 - in May 2010 the FASB published a proposed Accounting Standards Update on accounting for financial instruments, including guidance on classification and measurement, credit impairment and hedge accounting requirements.
 - in October 2010 the IASB added to IFRS 9 the requirements for the classification and measurement of financial liabilities.

- in December 2010 the IASB published the exposure draft *Hedge Accounting*, which proposes comprehensive changes to the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. The FASB is preparing to publish these proposals for public comment in the US to assess whether to pursue similar changes in US generally accepted accounting principles (GAAP).
- the IASB is continuing its work to address the complex issue of portfolio hedge accounting.

The FASB began its redeliberations on classification and measurement of financial instruments in December 2010, and expects to continue those discussions in the next few months. Once the FASB has decided what changes, if any, it intends to make to its classification and measurement proposals, the boards will identify any differences that remain and evaluate whether and how they might reduce the differences or otherwise enhance comparability.

IN3 In redeliberating their original impairment proposals each board began to develop a model for impairment accounting that was a variant of its original proposal. However, the IASB and the FASB are committed to enhancing comparability internationally in the accounting for financial instruments. In particular, they are committed to seeking a common solution to the accounting for the impairment of financial assets. The importance of achieving a common solution to this particular issue has been stressed by the boards' constituents. This supplementary document presents an impairment model that the boards believe will enable them to satisfy at least part of their individual objectives for impairment accounting while achieving a common solution to impairment. Comments received on this supplementary document are intended to assist the boards in their continuing joint discussions on the accounting for impairment of financial assets.

The objectives for the original proposals

IN4 Both the IASB and the FASB developed their original proposals on credit impairment in contemplation of their respective decisions on the classification and measurement of financial instruments. The primary objectives of the boards' original impairment proposals are set out below. These primary objectives have remained unchanged by each of the boards during their redeliberations. The paragraphs below discuss the individual views of the boards followed by a discussion of how a common proposal was reached to accommodate part of each board's primary objectives in order to develop a common solution.

IASB views

IN5 The IASB's primary objective in the exposure draft *Financial Instruments: Amortised Cost and Impairment* was to reflect initial expected credit losses as part of determining the effective interest rate, as the IASB believed that this was more reflective of the economic substance of lending transactions. It considered impairment as a part of the measurement of financial assets at amortised cost after their initial recognition. Therefore, the IASB did not believe it was appropriate to recognise all expected credit losses immediately. The IASB's original exposure draft did not look at the allowance for credit losses in isolation. The approach originally proposed by the IASB required an entity to estimate expected cash flows over the life of instruments. The IASB proposed this approach because:

- (a) the amounts recognised in the financial statements would reflect the pricing of the asset (ie the interest rate charged, which considers expected credit losses) when an entity makes lending decisions. In contrast, under the current incurred loss approach, interest revenue (and profitability more generally) is front-loaded because interest revenue ignores initially expected credit losses, which are recognised only later once there is objective evidence of impairment as the result of a loss event.
- (b) the proposed impairment approach generally would result in earlier recognition of credit losses than the incurred loss impairment model in IAS 39 (ie avoid the systematic bias towards late recognition of credit losses). In other words, the requirement for an observable loss event to have occurred before considering the effect of credit losses would be removed.

FASB views

IN6 The FASB's objective in its originally proposed approach was to ensure that the allowance balance was sufficient to cover all estimated credit losses for the remaining life of an instrument. Therefore, the approach originally proposed by the FASB would require an entity to estimate cash flows not expected to be collected over the life of the instruments and recognise a related amount immediately in the period of estimate. The FASB proposed this approach because the FASB believed it resolved the concern with respect to the current guidance on impairment that reserves tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle (the 'too little, too late' concern). By recognising all credit losses immediately the allowance

account would have a balance of estimated credit losses based on cash flows not expected to be collected for the remaining lifetime of the financial assets. This meant that the account would be sufficient to cover all such estimated credit losses regardless of the timing of those losses.

- IN7 The FASB believed that an entity should recognise in net income credit impairment when it does not expect to collect all contractual amounts due for originated financial assets or all amounts originally expected to be collected for purchased financial assets. Furthermore, the FASB believed that it would be inappropriate to allocate an impairment loss over the life of a financial asset. In other words, if an entity expects not to collect all amounts, a loss exists and should be recognised immediately.

Achieving a common solution

- IN8 The boards' constituents have consistently stressed the importance of achieving a common solution to the accounting for impairment. In order to achieve this, the boards have spent significant time discussing their differing objectives, as described in paragraphs IN5–IN7, so as to determine whether a common objective could be achieved.
- IN9 Each of the boards is sympathetic to the other's primary objective for accounting for impairment. However, each board has continued to stress its own primary objective.
- IN10 The IASB has continued to stress the importance of reflecting the relationship between the pricing of financial assets and expected credit losses. As a result of information received in response to its original exposure draft the IASB developed a modified proposal for open portfolios of financial assets with an objective of approximating the outcomes of the original exposure draft in an operational manner. This approach still meets the IASB's overall objective of maintaining a link between the pricing of financial assets and expected credit losses. However, the IASB also acknowledged that in some circumstances, such as when expected credit losses are concentrated in the early part of financial assets' lives, its proposed approach might not recognise an impairment allowance sufficient to cover expected losses at the time those losses occur.
- IN11 The FASB has continued to place primary importance on ensuring that the amount of the allowance for credit losses is adequate to cover expected credit losses before they occur. The FASB concluded, jointly with the IASB, that an entity should, along with considering historical

data and current economic conditions, consider reasonable and supportable forecasts of future events and economic conditions for developing the entity's estimate of expected credit losses. Along with addressing comments regarding an entity's ability to consider forecast events and conditions in developing expected credit losses, the FASB has addressed some other comments it received on its original proposal. The FASB began to develop a model that would require immediate recognition of credit losses expected to occur in the near term, or the foreseeable future rather than over the expected remaining life of the asset. For this purpose, 'foreseeable future' is the future time period for which reasonable and supportable information exists to support specific projections of events and conditions for that period.

- IN12 The common proposal set out in this document has features that partly satisfy each of the boards' primary objectives as described above. It incorporates the model the IASB was developing but introduces a requirement to establish a minimum allowance balance, or 'floor', which addresses the FASB's primary concern about the adequacy of the impairment allowance. The time-proportional approach addresses the IASB's primary concern about reflecting the relationship between the pricing of financial assets and expected credit losses. Therefore the model in this supplementary document reflects a common proposal that both boards agreed to publish to obtain further information for their continuing joint deliberations on impairment.
- IN13 The boards have proposed the model set out in this document in acknowledgement of the importance of reaching a common solution to the accounting for impairment. The boards believe at this point that seeking comments from constituents on the common proposal and the models they were each separately developing is imperative to move forward together and will give the boards the best opportunity of reaching a common outcome. Further information on the models that were being developed separately by the IASB and the FASB is provided in the Basis for Conclusions.

Reasons for publishing this supplementary document

- IN14 The IASB and the FASB invite views on the impairment model described in this document to assist them in developing a common approach that addresses the objectives of both boards. This document primarily addresses the timing of the recognition of expected credit losses. During the comment period of this document the IASB and the FASB will continue their

discussions on other aspects of an impairment model. In addition, they will conduct further outreach to gain information on the operational practicality and usefulness of the common proposal described in this document.

- IN15 Many respondents to the IASB's original exposure draft agreed that a new impairment approach should be more forward-looking and based on expected credit losses, as opposed to the current incurred loss model. While most supported in principle the expected cash flow model proposed in the exposure draft, many thought it was operationally too difficult to apply, especially in the context of open portfolios. In addition, many thought that the impairment of short-term trade receivables should be considered within the broader context of revenue recognition.
- IN16 As a result, the IASB started its redeliberations in July 2010 by discussing how to address the significant operational challenges identified with impairment for open portfolios. The goal of these redeliberations was to develop the main features of an impairment model for open portfolios as the operationally most complex area. Following that, the IASB would then discuss the details of that model and how it could be applied to financial instruments in a context other than open portfolios (eg individual instruments and closed portfolios).
- IN17 The information that the IASB received in response to its original exposure draft identified the use of an integrated effective interest rate (which incorporated expected credit losses) as a source of operational complexity. As part of the IASB-only redeliberations, the IASB decided to exclude expected credit losses when determining the effective interest rate, ie to use a non-integrated effective interest rate ('decoupled' effective interest rate).
- IN18 After the comment period of the FASB's proposals ended in September 2010, the IASB and the FASB began to discuss impairment jointly with the goal of developing a common impairment model. The IASB-only redeliberations have resulted in some decisions that are included in an appendix to this supplementary document but have not yet been formally discussed by the FASB because of the boards' different timetables.
- IN19 This supplementary document addresses the impairment model in the context of open portfolios. Impairment in other circumstances is not addressed. As described below, the boards have received extensive comments on their original exposure drafts. Some of those comments are still to be considered in future deliberations. This supplementary document only addresses the credit impairment model, and not amortised cost or interest revenue recognition, more generally.

Proposals yet to be redeliberated

IN20 The boards have not yet redeliberated all of the proposals in their original exposure drafts because they wanted first to address the operationally most challenging area (ie open portfolios) and to obtain further information on this aspect of the model. As a result, this document focuses on the timing of recognition of expected credit losses for open portfolios. For example, the boards have received many comments on, and have not yet redeliberated, the following:

- (a) the credit impairment requirements for financial assets that are not part of open portfolios or are evaluated individually, other problem loans, purchased loans, short-term trade receivables and any issues specific to investments in debt securities (in particular, whether there should be a single impairment model or whether there is sufficient justification for several different impairment models).
- (b) methods for measuring credit losses. This topic relates to different aspects of measurement, eg whether to use discounted or undiscounted amounts and whether the credit loss estimate should be an expected value.
- (c) for the IASB, the proposed disclosure requirements related to stress testing, origination and maturity (vintage information) and the credit quality of financial assets.
- (d) the proposed definitions of 'write-off' and, for the IASB, 'non-performing'.
- (e) the objective of amortised cost measurement and how the impairment model relates to that measurement.
- (f) interest revenue recognition.

IN21 In the light of current US GAAP and the FASB's original exposure draft, certain additional issues will need to be redeliberated by the FASB. Such issues include:

- (a) the credit impairment requirements for purchased loans and loans modified in troubled debt restructurings, and whether different impairment models are justified for these types of loans.
- (b) whether the concept of 'non-accrual' as it relates to interest revenue recognition should be included in a finalised credit impairment model.
- (c) presentation and disclosure.

IN22 The above lists are not intended to be exhaustive but are provided as context for how this document fits within the overall redeliberations of the impairment project. The boards will use the information received on their original exposure drafts and outreach efforts to redeliberate these issues and for some issues (such as the items described in paragraphs IN20(a) and IN21(a)) additional information obtained in response to this document. The boards believe that completing these redeliberations is not a prerequisite to publishing this supplementary document because this document focuses on the timing of the recognition of impairment losses in the context of open portfolios only. In the boards' view, soliciting views on this particular aspect is the most targeted and efficient way to progress this project. The boards do not request additional comment on the issues that are not included in this document but which the boards intend to redeliberate on the basis of their original exposure drafts.

Contents of this supplementary document

IN23 In addition to the guidance proposed in this joint supplementary document, the IASB has redeliberated guidance related to presentation and disclosure affected by the impairment model. The FASB has not yet redeliberated those topics. Therefore, the introduction, invitation to comment, proposals, application guidance and Basis for Conclusions related to presentation and disclosure are included in a separate IASB-only Appendix Z to the supplementary document. Although included as an appendix to the joint supplementary document, Appendix Z has equivalent status to the joint supplementary document for the IASB.

IN24 The proposals in this supplementary document would be part of the IASB's and FASB's projects to revise the requirements in IFRSs and US GAAP for accounting for financial instruments. For IFRSs, these proposals will be combined with the proposals on amortised cost measurement that were included in the IASB's original exposure draft after redeliberations on this second phase of the project to replace IAS 39 are completed. For US GAAP, these proposals will be combined with the proposals on the remaining portions for accounting for financial instruments that were included in the FASB's originally proposed Update. The complete set of proposals would also result in consequential amendments to other IFRSs and to the *FASB Accounting Standards Codification*TM (including the guidance on those IFRSs and US GAAP). For the convenience of readers, the joint supplementary document, including the Basis for Conclusions, is set out in this booklet, followed by Appendix Z (which includes IASB-only discussions).

Next steps

- IN25 The boards plan to redeliberate jointly the proposals in this document with an objective of achieving common requirements on accounting for impairment of financial assets. While this supplementary document is open for comment, the boards will continue to use comments received on their original exposure drafts for redeliberations that do not affect the proposals in this supplementary document.
- IN26 The IASB expects that the IFRS combining both the impairment proposals herein (including those within this supplementary document and Appendix Z) and the amortised cost measurement proposals from the IASB's original exposure draft will be issued by June 2011. However, the IASB has not yet redeliberated when the IFRS would become mandatory or whether early application would be available. On the basis of the comments received on the IASB's original exposure draft, the IASB acknowledges that implementing the proposals might require substantial lead-time. The IASB will also consider comments received on its Request for Views *Effective Dates and Transition Methods*.
- IN27 The FASB expects that a final Update including the credit impairment model will be issued in 2011.

Joint invitation to comment

The boards invite comments on all matters in this supplementary document, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated
- (b) indicate the specific paragraph or paragraphs to which the comments relate
- (c) contain a clear rationale
- (d) describe any alternatives the boards should consider.

The boards are not seeking comments on aspects of IAS 39, IFRS 9 or US GAAP not addressed in this supplementary document.

Comments should be submitted in writing so as to be received no later than **1 April 2011**.

General

An important weakness that has been identified with respect to the current impairment models under IFRSs and US GAAP is delayed recognition of credit losses associated with financial assets.

This supplementary document proposes a revised approach for an impairment model for financial assets in open portfolios that would recognise credit losses from initial recognition of a financial asset. The timing of recognition would vary according to the differentiation of financial assets into two groups as described in paragraphs 2, 3 and B2–B4 of the supplementary document.

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

Scope – Open portfolios

The scope of this document is limited to financial assets managed in an open portfolio. However, the boards expect to use the comments received on this supplementary document and the original proposals published by the IASB and the FASB to determine whether a single impairment model should be applied to all financial assets or whether there are differences that justify multiple impairment models. Therefore, the boards are asking for views on whether the proposals outlined in this document could be applied to closed portfolios, single instruments and any other types of instruments.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Differentiation of credit loss recognition (paragraphs 2, 3 and B2–B4)

This document proposes that financial assets managed on an open portfolio basis should be placed into two groups, based on their credit characteristics, for the purpose of determining the impairment allowance. For one group the entire amount of expected credit losses would be recognised in the impairment allowance (this group is often referred to as the ‘bad book’). For the other group (often referred to as the ‘good book’), expected credit losses would be recognised on a portfolio basis over a time period at the higher of the time-proportional expected credit losses (depending on the age of the portfolio) and the credit losses expected to occur within the foreseeable future period (being a minimum of twelve months).

Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

The principle for how to determine whether a financial asset should be in the group for which the entire amount of expected credit losses would be recognised (ie the 'bad book') is described in paragraph 3 as follows:

It is no longer appropriate to recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.

Therefore, financial assets would be included in and transferred between the two groups (ie the 'good book' and the 'bad book') in accordance with an entity's internal risk management.

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Minimum impairment allowance amount (paragraph 2(a)(ii))

This document proposes to differentiate the recognition of credit losses depending on the classification of a financial asset into two groups (often referred to as the 'good book' and the 'bad book'). For the 'bad book' the allowance amount would always be equal to the lifetime expected credit losses for the financial assets in that group. Paragraph 2(a)(ii) would require the time-proportional impairment allowance (ie in relation to the 'good book') never to be less than a minimum allowance amount ('floor'). This would ensure that this allowance amount would at least cover the expected credit losses over the near term. The floor is proposed to be the amount of credit losses expected to occur within the foreseeable future (required to be no less than twelve months after an entity's reporting date). The model that was being developed by the FASB is consistent with this 'floor' approach but the FASB did not propose the minimum of 'no less than twelve months'.

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

continued...

...continued

Question 9

- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Flexibility related to using discounted amounts (paragraphs B8(a) and B10)

Paragraph B8(a) permits an entity to use a discounted or undiscounted estimate when calculating the time-proportional allowance amount in accordance with that paragraph.

When using a discounted expected loss amount, paragraph B10 permits an entity to use as the discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate (as used for the effective interest method in IAS 39). This flexibility is intended to make discounting operationally feasible. Requiring the use of the effective interest rate would give rise to operational complexity similar to that identified in the comments received by the IASB in relation to an integrated effective interest rate approach. (Note: the FASB did not deliberate this issue. This was a decision reached by the IASB only; however, comment is requested in this joint document because this is an integral component of the time-proportional approach.)

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Approaches developed by the IASB and FASB separately

As mentioned in the Introduction and in the Basis for Conclusions, the model described in this document is being proposed by the IASB and FASB because both boards are committed to reaching a common solution to impairment accounting. However, the IASB and the FASB had been developing models that would address their differing primary objectives. Components of these models are reflected in the common proposal. In summary the approaches are:

Model	Recognition of credit losses (when appropriate to recognise over life - ie 'good book')	Recognition of credit losses (when NOT appropriate to recognise over life - ie 'bad book')
Common proposal	Higher of: (a) time-proportional amount of remaining lifetime expected credit losses; and (b) all expected credit losses for the foreseeable future (being a minimum of twelve months)	Full amount of remaining lifetime expected credit losses
IASB approach	Time-proportional amount of remaining lifetime expected credit losses	Full amount of remaining lifetime expected credit losses
FASB approach	Recognise expected credit losses for the foreseeable future (no minimum period specified)	

The approach that was being developed by the IASB for open portfolios of financial assets measured at amortised cost took into account comments received in comment letters, the advice from the Expert Advisory Panel (EAP) and other outreach activities. For financial assets for which it is appropriate to consider credit losses over their life (commonly called the ‘good book’) the credit losses expected to occur for the remaining life of the financial assets would be recognised using a time-proportional approach. For all other financial assets, credit losses expected to occur for the remaining life would be immediately recognised. In other words, the model being developed by the IASB was the model described in this document without consideration of a ‘floor’ amount.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

The approach that was being developed by the FASB addressed the comments on its original exposure draft and other outreach activities. That model being developed would have required an entity to recognise immediately all credit losses expected to occur in the foreseeable future (not explicitly set at a minimum of twelve months). As described in paragraphs B11 and B12, the foreseeable future time period is the period for which reasonable and supportable information exists to support specific projections of events and conditions. In other words, the approach being developed by the FASB applied a similar concept to the ‘floor’ included in this document to recognise credit losses expected to occur within the foreseeable future at or after the first reporting date after initial recognition for all financial assets within the scope of this document.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

This supplementary document is set out in paragraphs 1–4 and Appendices A and B. All paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the supplementary document. Definitions of other terms are given in the Glossary for International Financial Reporting Standards or the Master Glossary of the *FASB Accounting Standards Codification*TM.

An IASB-only appendix, Appendix Z, to this supplementary document proposes presentation and disclosure requirements.

Joint supplementary document

Financial Instruments: Impairment

Scope

- 1 For the IASB, the proposals in this supplementary document would be applied to *financial assets* that are measured at *amortised cost* if they are managed on an open *portfolio* basis, except short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial. For the FASB, the proposals in this supplementary document would be applied to open portfolios of loans and debt instruments that are not measured at fair value with changes in value recognised in net income.

Impairment of open portfolios (pools) of financial assets

- 2 At each reporting date, an entity shall recognise an impairment allowance that is the total of:
- (a) for assets for which it is appropriate to recognise expected credit losses over a time period, the higher of:
 - (i) the time-proportional expected credit losses; and
 - (ii) the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity's reporting date); and
 - (b) for all other assets, the entire amount of expected credit losses.
- 3 Whether it is appropriate to recognise expected credit losses over a time period depends on the degree of uncertainty about the collectibility of a financial asset. It is no longer appropriate to recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.
- 4 Expected credit losses referred to in paragraph 2 are estimated for each portfolio (or group of portfolios) for the remaining expected weighted average life of the portfolio, or the foreseeable future, as applicable. All estimates of expected credit losses shall be updated, at a minimum, at the time an entity prepares its annual or interim financial statements (reporting date).

Appendix A Defined terms

This appendix is an integral part of the supplementary document.

For entities applying IFRSs, the following terms are defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation*, paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* or Appendix A of IFRS 7 *Financial Instruments: Disclosures* and are used in this supplementary document with the meanings specified in those IFRSs:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method
- (d) financial asset.

For entities applying US GAAP, the following terms are defined in the Master Glossary of the *FASB Accounting Standards Codification*TM and are used in this supplementary document with the meanings specified in the Master Glossary of the *FASB Accounting Standards Codification*TM:

- (a) effective interest method
- (b) financial asset.

For entities applying either IFRSs or US GAAP:

portfolio A grouping of financial assets with similar characteristics that are managed by a reporting entity on a collective basis. In an open portfolio, assets are added to the portfolio through its life by origination or purchase, and removed through its life by write-offs, transfer to other portfolios, sales and repayment. In a closed portfolio, assets are not added to the portfolio through its life, and are removed by write-offs, transfer to other portfolios, sales and repayment.

Appendix B

Application guidance

This appendix is an integral part of the supplementary document.

Scope

Open portfolios

- B1 Some entities manage financial assets using portfolios for which financial assets are grouped on the basis of similar characteristics but irrespective of the time of their origination (open portfolios). In an open portfolio, financial assets are added through origination or purchase and removed through transfers to other portfolios, sales or transfers to external parties, repayment and write-offs each period. The characteristics used in defining a portfolio include asset type, industry, credit risk ratings, geographical location, collateral type and other relevant factors.

Impairment of financial assets

Differentiation of credit loss recognition

- B2 In accordance with paragraph 2, financial assets that are managed on an open portfolio basis are differentiated into two groups for the purpose of determining the impairment allowance. The differentiation depends on whether the uncertainty about the collectibility of an asset has taken precedence over its profitability from the interest charged. For one group, time-proportional credit losses expected to occur for the remaining lifetime are recognised, unless the minimum amount of credit losses expected to occur in the foreseeable future period applies. For the other group, the entire amount of expected credit losses for the remaining life is recognised in the impairment allowance.
- B3 An entity shall differentiate the two groups on the basis of its internal credit risk management. Some entities use a credit risk management approach for financial assets that has different objectives depending on the entity's assessment of the degree of uncertainty about the collectibility of the financial asset. As the credit quality of a financial asset, or group of financial assets, deteriorates its collectibility reaches a degree of uncertainty that results in the entity's credit risk management objective changing from receiving the regular payments from the debtor

to recovery of the financial asset. If the objective is the recovery of the financial asset(s), the management of the financial asset(s) typically becomes more active. Depending on the type of financial asset, examples are evaluating or taking actions such as the enforcement of security interests (eg foreclosure on real estate or seizing assets under collateral agreements), debt restructuring in order to avoid or resolve non-performance of the asset, exercise of a call option that becomes exercisable depending on breach of debt covenants that relate to credit risk or attempting to recover cash flows from an uncollateralised financial asset by making contact with the debtor by mail, telephone or other methods. Entities often manage those financial assets on an individual basis and separately from the financial assets for which the credit risk management objective is receiving the regular payments from the debtor.

- B4 Entities that do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility in a way similar to the principle in paragraph 3 must still differentiate their financial assets into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2. For example, an entity might comply with that principle using criteria such as days past due, whether the expected return is below the risk-free interest rate, or when management identifies loans as doubtful (sometimes also considered by an entity as ‘problem loans’).

Loss estimates

- B5 An entity shall develop its estimate of expected credit losses for the remaining lifetime or the foreseeable future as required by paragraph 2, considering all available information. Entities should consider both internal data (ie entity-specific information) and external data. All available information includes historical data, current economic conditions, and supportable forecasts of future events and economic conditions. Expectations of future conditions should be based on reasonable and supportable information to substantiate those inputs used in the expected loss estimate. Those expectations should be consistent with currently available information.

- B6 Depending upon the expected life of the open portfolio of financial assets, two loss estimates may be required to apply the credit impairment model set out in this document. The time-proportional expected loss estimate is based on the expected losses for the remaining life of the pool of financial assets. The floor, based on expected credit losses for the foreseeable future, may encompass a shorter time period than the remaining expected life of the pool of financial assets.
- B7 This supplement does not mandate a specific approach for developing loss estimates for the expected life of an open pool of financial assets. As a practical matter, for pools of financial assets with longer expected lives, determining the time-proportional allowance amount would involve developing expected loss estimates for both shorter-term and medium-term time periods and for time periods that are farther into the future. For example, for shorter-term and medium-term time periods, entities may develop projections of expected losses on the basis of specific inputs, such as forecast information. At the end of that period for which specific projections of events and conditions can be developed, an entity could then revert to a long-term average loss rate for the more distant time periods.

Time-proportional expected credit losses

- B8 An entity shall determine the time-proportional expected credit losses in accordance with paragraph 2(a)(i) either:
- (a) by multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio's age to its expected life (ie a straight-line approach using either a discounted or undiscounted estimate); or
 - (b) by converting the entire amount of the credit losses expected for the remaining life of the portfolio into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolio's age (which includes accruing notional interest on the balance of the allowance account) (ie an annuity approach, which by definition, uses a discounted estimate).

Note: the FASB did not deliberate this issue. This issue was a decision reached by the IASB only.

- B9 For the purpose of determining the time-proportional expected credit losses, the age and the total expected life of the portfolio are weighted averages. At each reporting date, those weighted averages are updated. The age of a portfolio is based on the time that the financial assets within

the portfolio have been outstanding since they were initially recognised by the entity. The total expected life of a portfolio is based on the time that the financial assets within the portfolio are expected to be outstanding from inception to maturity (for example, considering prepayment, call, extension and similar options and defaults).

- B10 When using a discounted expected credit loss amount, an entity may use as the discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate (as used for the *effective interest method* in IAS 39). (Note: the FASB did not deliberate this issue. This was a decision reached by the IASB only.)

Credit losses expected to occur within the foreseeable future period

- B11 For the purpose of paragraph 2(a)(ii), an entity would make its best estimate of credit losses expected to occur in the future time period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections. That future period is referred to as the 'foreseeable future' for the purpose of this guidance.
- B12 As discussed in paragraph B5, an entity would use all available information to develop its estimate of expected credit losses for the remaining life or foreseeable future, as applicable. In doing so, an entity uses all reasonable and supportable information to develop its forecasts of future events and conditions. The process of developing specific projections includes consideration of past events, historical trends, existing conditions, and current and forecast economic events and trends to evaluate and project the set of circumstances that will prevail in the future. Then, the estimate of credit losses for the foreseeable future is the estimated amount of losses that an entity expects as a consequence of those specific projections of future events and conditions.
- B13 Similarly to developing a remaining lifetime expected loss estimate, in developing the estimate of expected credit losses for the foreseeable future an entity would generally consider historical data, including loss occurrence patterns, and current and forecast economic events and trends. While historical data and trends are considered, development of the estimate relies heavily on an entity's ability to forecast events and conditions that will exist in the foreseeable future period.

- B14 As the period over which the entity can develop specific projections of events and conditions, the foreseeable future would be a fairly constant period that would not be expected to change significantly from period to period for a particular portfolio. However, the foreseeable future period may differ for different asset classes according to the characteristics of those asset classes. For some, but not necessarily all, asset classes, the estimate of expected credit losses in the foreseeable future period may correspond to historical loss occurrence patterns. The emphasis is not on the loss occurrence pattern but instead on the losses expected to occur within the foreseeable future period.
- B15 The foreseeable future period may be the same as or shorter than the remaining average expected life of a portfolio of financial assets. For classes of financial assets with a shorter-term expected life, the foreseeable future may encompass the full remaining average expected life of the portfolio, to the extent that the time horizon for which management can develop specific projections of events and conditions captures that full remaining average expected life. For other asset classes, the foreseeable future might be shorter than the remaining average expected life of the portfolio. If the foreseeable future is shorter than the remaining average expected life, then no further consideration is given to the time period outside the foreseeable future period to determine losses for the foreseeable future.
- B16 For the purpose of estimating credit losses in accordance with paragraph 2(a)(ii), there is a presumption that entities can develop specific projections of events and conditions for at least a twelve-month future period. Therefore, a period of at least twelve months after the reporting date shall be used for the purpose of estimating credit losses in the foreseeable future (unless the weighted average life of the portfolio of assets is less than twelve months). It is expected that for many portfolios of financial assets, the foreseeable future period will be a period greater than twelve months after the reporting date.

Illustrative examples

These examples accompany, but are not part of, the supplementary document.

Examples of mechanics

Calculation of time-proportional and floor amounts

- IE1 For assets for which it is appropriate to recognise expected credit losses over a time period, paragraph 2(a) requires an entity to perform a 'higher of' test to determine the appropriate allowance amount. An entity will recognise the 'higher of' the time-proportional amount and the amount of credit losses expected to occur within the foreseeable future period (the 'floor' amount).
- IE2 Paragraph B8 permits an entity to use either a straight-line approach or an annuity approach when determining the time-proportional expected credit losses in accordance with paragraph 2(a)(i).
- IE3 As described in paragraphs B11 and B12, the foreseeable future period is the future time period for which reasonable and supportable information exists to support specific projections of events and conditions over that period. The foreseeable future period must be a period of at least twelve months (unless the remaining expected life is less than twelve months in which case the foreseeable future period will equal the remaining expected life).
- IE4 The supplementary document does not describe how to measure expected losses. Nor does it define how to calculate a weighted average age or a weighted average life of a portfolio as these are commonly understood concepts.
- IE5 The following tables illustrate the mechanics of how an entity would use its expected loss estimates and weighted average age and life of a portfolio in order to calculate a time-proportional amount of credit losses expected over the remaining life. An entity would also determine the foreseeable future period and calculate expected losses for that period.
- IE6 The following table illustrates the mechanics of calculating a time-proportional amount using a straight-line approach and illustrates the 'higher of' test for the purpose of determining the impairment allowance account. This example uses an undiscounted amount, but paragraph B8(a) permits an entity to use either a discounted or undiscounted amount.

Impairment allowance — straight-line approach and 'higher of' test								
Portfolio	Expected credit losses over remaining life	Weighted average age	Weighted average life	Annual amount	Time-proportional amount (TPA)	Foreseeable future period (FFP)	FFP expected credit losses (Floor)	Impairment allowance
	A	B	C	$D = A / C$	$E = A \times (B/C)$ $= B \times D$	F	G	H = greater of E and G
Z	100	3 years	5 years	20	60	2 years	100	100 (Floor)
Y	100	2 years	5 years	20	40	2 years	70	70 (Floor)
X	100	2 years	5 years	20	40	1 year	35	40 (TPA)
W	100	3 years	5 years	20	60	1 year	55	60 (TPA)
V	100	2 years	10 years	10	20	3 years	40	40 (Floor)
U	100	5 years	10 years	10	50	3 years	35	50 (TPA)

IE7 The table above illustrates a series of portfolios of financial assets. Columns A-E relate to the computation of the time-proportional amount of expected credit losses. Columns F and G relate to the floor amount, which is the amount of expected credit losses for the foreseeable future period. Column H shows which computation is higher and therefore would be used to establish the allowance for the particular portfolio.

IE8 The time-proportional aspect of the model seeks to approximate the credit-adjusted effective interest rate, which would allocate initially expected credit losses for a financial asset to each period in its life, as proposed in the IASB's original exposure draft, by recognising a time-proportional amount of expected credit losses. The expected credit losses for the remaining weighted average expected life (column A) is the amount of credit losses expected by the entity for the remaining expected life of the portfolio. For example, for portfolio Y, the remaining expected life is 3 years (the difference between the weighted average age and weighted average life of the portfolio) and the entity estimates expected credit losses of 100 for that 3-year period. In column D, that amount of expected credit losses for the remaining weighted average expected life is converted to an annual amount by apportioning the amount in column A to each time period in the weighted average expected life on a straight-line basis. For example, for portfolio Y, the amount of expected credit losses for the remaining expected life of 100 is apportioned on a straight-line basis over a 5-year period to arrive at an annual amount of 20. This amount is then converted to a time-proportional amount in column E based on the weighted average age of the portfolio of 2 years.

Alternatively, the time-proportional amount can be computed by applying the ratio of the weighted average age of the portfolio to the weighted average life to the expected losses for the remaining weighted average expected life of the portfolio.

- IE9 The objective of the time-proportional aspect of the model for the 'good book', as noted in paragraph 2, is to recognise expected credit losses for a portfolio of loans over a time period. More specifically, the objective is to recognise those expected credit losses over the time periods in which interest revenue is recognised (ie the life of the portfolio). This provides a link between the pricing of financial assets and expected credit losses (as described in paragraph BC70). In an open portfolio, impairment expense is determined by replenishing the allowance for credit losses based on the time-proportional amount, or floor, as applicable, after considering the effects of any activity through the allowance account for the period (eg charge-offs or reversals).
- IE10 Expected credit losses for the foreseeable future period (column G) are the estimate of expected credit losses as described in paragraphs B11–B16. In certain instances, the foreseeable future may equal the full remaining weighted average expected life of the portfolio. For example, for portfolio Z, the estimate of expected credit losses for the foreseeable future period of 2 years is 100, which is equal to the estimate of credit losses for the remaining expected life of the portfolio used for determining the time-proportional amount for that portfolio.
- IE11 For the time-proportional approach, changes to the allowance balance would occur because of changes in loss expectations reflecting the balance and composition of the portfolio as of the reporting date as well as changes in the weighted average age and weighted average life of the portfolio as a result of new loans being added to the portfolio and existing loans being removed. For the foreseeable future approach, changes to the allowance balance would occur because of changes in loss expectations for the foreseeable future period reflecting the balance and composition of the portfolio as of the reporting date.
- IE12 The following table illustrates the mechanics of calculating a time-proportional amount using an annuity approach as described in paragraph B8(b) of the supplementary document. In an annuity approach, an entity would first determine the present value of the expected credit losses using the discount rate and the timing of the expected losses (see column B). That amount is then converted into an annuity using the appropriate annuity factor (see column D) obtained from a Table of Present

Value Annuity Factors. In this example, the calculations assume that all losses are expected at the end of the weighted average life, and the annuity factors are based on an ordinary annuity.

IE13 The 'higher of' test would still be required when using an annuity approach, but it is not re-illustrated in this table.

Impairment allowance — annuity approach									
Portfolio	Expected credit losses over remaining life	Present value of expected credit losses	Discount rate	Ordinary annuity factor	Annuity	Weighted average age	Weighted average life	Notional interest (see paragraph IE14)	Time-proportional amount (TPA)
	A	B = PV of A (using C and G*)	C	D (using C and G)	E = B / D	F	G	H	I = (E × F) + H
Z	100	71.30	7%	4.1002	17.39	3 years	5 years	3.74	55.91
Y	100	74.73	6%	4.2124	17.74	2 years	5 years	1.06	36.54
X	100	78.35	5%	4.3295	18.10	2 years	5 years	0.90	37.10
W	100	71.30	7%	7.0236	7.24	3 years	10 years	1.56	23.28
V	100	55.84	6%	7.3601	7.59	2 years	10 years	0.45	15.63
U	100	61.39	5%	7.7217	7.95	5 years	10 years	4.15	43.90

* In this example, the annuity calculation used the weighted average life because of the simplifying assumption that all losses occur at the end of the life.

IE14 Notional interest is calculated on the basis of the sum of all previous years' annuities and interest amounts multiplied by the discount rate. Total notional interest is calculated by adding together the appropriate number of periods based on the weighted average age. For example, for portfolio Z, notional interest is the sum of the interest amounts for years 1-3. The following table illustrates how the notional interest would be calculated for portfolio Z. Note that the amount shown in each individual year is not necessarily the amount recognised that year. Rather, the amounts are shown so that the sum for years 1-3 can be calculated to tie to the amounts in the table above.

	Year 1	Year 2	Year 3	Years 1 – 3	Year 4	Year 5	TOTAL
Annuity for Z	17.39	17.39	17.39	52.17	17.39	17.39	86.95
Interest (7%)	0	1.22	2.52	3.74	3.91	5.40	13.05
				55.91			100.00

Basis for Conclusions on the supplementary document *Financial Instruments: Impairment*

This Basis for Conclusions accompanies, but is not part of, the supplementary document.

Introduction

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in developing the proposals in the supplementary document *Financial Instruments: Impairment*. It includes the reasons for accepting particular views and for rejecting others. Individual IASB and FASB members gave greater weight to some factors than to others.
- BC2 The proposals in the supplementary document are the result of joint discussions of the IASB and FASB about an impairment model for credit losses in order to reach a common solution that addresses part of each of the boards' individual primary objectives. An appendix to the supplementary document reflects additional decisions made by the IASB in separate redeliberations of its exposure draft *Financial Instruments: Amortised Cost and Impairment*.
- BC3 In response to requests from interested parties that the accounting for financial instruments should be improved quickly, and the G20 leaders' recommendation that the IASB should take action by the end of 2009, the IASB is replacing IAS 39 *Financial Instruments: Recognition and Measurement* in several phases. As the IASB completes each phase, it will delete the relevant portions of IAS 39 and add new chapters to IFRS 9 *Financial Instruments*.
- BC4 In October 2010 the IASB completed the first phase of its project to replace IAS 39 by finalising the classification and measurement requirements in IFRS 9. IFRS 9 requires all financial instruments to be measured either at fair value or amortised cost. Only financial assets measured at amortised cost would be subject to impairment accounting.
- BC5 The IASB decided to address the impairment of financial assets as part of the second phase of the replacement of IAS 39 because the classification and measurement decisions from the first phase form the foundation for the measurement basis (including impairment). Following a Request for Information that was posted on the IASB's website in June 2009, the IASB published, in November 2009, its original exposure draft *Financial*

Instruments: Amortised Cost and Impairment, proposing requirements for the impairment of financial assets and also for amortised cost measurement as a whole. The IASB's original exposure draft proposed introducing an impairment model based on accounting for expected losses.

- BC6 The FASB published proposals for credit impairment as part of its comprehensive approach to replacing US GAAP on the accounting for financial instruments. Those proposals were included in the proposed accounting standards update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED), published in May 2010. The main objective of the FASB ED was to provide users of financial statements with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments.
- BC7 The FASB believed that classification and measurement and the accounting for impairment are interrelated and that a comprehensive approach results in requirements that are more coherent. The FASB considered various impairment models and selected the concept of cash flows expected to be collected as the basis for its proposed impairment model. The FASB believed a single impairment model should apply for both loans and investments in debt securities.
- BC8 A panel of credit risk experts, the Expert Advisory Panel (EAP), was established to advise the IASB on the operational implications of applying the proposals in the IASB's original exposure draft. Comments received on that exposure draft and information from the EAP and from other outreach activities indicated support for the concepts in the exposure draft but highlighted the operational difficulties of applying the original proposed approach (the expected cash flow model). The operational complexities were most pronounced for open portfolios for which financial assets are added and removed during the life of the portfolio. As a result, the IASB decided to refine the impairment model so that it could be applied in a more operational manner while retaining the concepts from the original exposure draft as much as possible. As it is the most complex scenario operationally, the IASB decided to focus first on developing a model for open portfolios that could be applied generally and to consider later whether that model should be applied to other scenarios, such as for closed portfolios or single instruments. The FASB received limited views from the EAP on the impairment guidance in its exposure draft given that the exposure draft was issued late in the EAP process. In particular, the EAP focused on the information used to determine the amount of expected credit

losses, recommending that the FASB should allow an entity to incorporate reasonable and supportable forecast period assumptions consistent with its risk management practices when estimating cash flows it does not expect to collect. The EAP also provided advice on the FASB's proposed guidance for the recognition of interest revenue and the guidance for purchased credit-impaired loans.

- BC9 Both the IASB and the FASB agree with those who have advised them repeatedly that achieving a common outcome for impairment accounting is highly desirable. As a result, over the past several months the boards have developed a proposed impairment model for open portfolios that attempts to incorporate the original objectives of both boards. For this reason they decided to publish the supplementary document to obtain further input from their respective constituents on the proposed common solution.
- BC10 It is important to note, however, that a minority of members of the IASB and some members of the FASB still prefer the models that were being developed separately by the IASB and FASB, respectively (see paragraphs BC66–BC86). By seeking comments on this proposed common solution as well as on the approaches they were separately developing, the boards believe they will have the greatest opportunity to reach a common high quality solution to accounting for impairment.

Scope

- BC11 For the IASB, the proposals in the supplementary document are limited to open portfolios of financial assets that are measured at amortised cost, excluding short-term trade receivables. The purpose of limiting the proposal and the proposed guidance to open portfolios is to attempt to obtain views particularly on the operational implications and relevance of the refined proposals for accounting for credit impairment. For the FASB, the proposals in the supplementary document would apply to loans and debt instruments that would not be measured at fair value with changes in value recognised in net income and that are managed on an open portfolio basis. However, the boards are also taking the opportunity to seek views on the operational practicality of the proposed approach for other types of financial instruments. In addition, the proposals in the supplementary document reflect a modified objective for the impairment model developed with a view to seeking a common solution for accounting for impairment.

- BC12 The boards have not yet redeliberated all of the proposals in their original exposure drafts because they wanted first to address the operationally most challenging area (ie open portfolios) and to obtain further input on this aspect of the model. As a result, the supplementary document focuses on the timing of recognition of expected credit losses for open portfolios. A list of topics that the boards are yet to discuss is included in paragraphs IN20 and IN21 of the joint document.
- BC13 Many respondents to the IASB's original exposure draft and the joint exposure draft *Revenue from Contracts with Customers* disagreed with the proposed accounting for expected credit losses that would have required revenue to be recognised net of initial expected credit losses. For the IASB, the proposals in the supplementary document exclude short-term trade receivables from its scope pending the proposals in the *Revenue* exposure draft being redeliberated. The impairment proposals for financial assets determine the accounting for expected credit losses as part of the subsequent measurement of financial assets at amortised cost. The IASB thought that the starting point for amortised cost measurement for short-term trade receivables should be aligned with and follow from the measurement of the related revenue. In the IASB's view, whether the measurement of revenue should include the effect of initially expected credit losses is a question that should be redeliberated during the discussion of the revenue proposals. Once the boards reach a conclusion on the measurement of revenue, they will consider how to recognise impairment for short-term trade receivables. (Note: the FASB did not deliberate this issue. This was a decision reached by the IASB only.)

The objectives of the original impairment proposals

IASB

- BC14 After considering alternative impairment approaches, the IASB decided to propose in its original exposure draft an approach that integrates impairment on an expected loss basis into amortised cost measurement. Those proposals would require an entity to include the initial estimate of the expected credit losses for a financial asset in determining the effective interest rate (an integrated effective interest rate). Therefore, the initial estimate of the expected credit losses would be allocated over the expected life of the financial asset depending on the cash inflows still expected from that asset. That proposed approach would not result in an

impairment loss immediately after initial recognition. Instead, under that proposed approach impairment losses (gains) would result only after initial recognition of the financial asset from an adverse (favourable) change in the estimate of expected credit losses.

- BC15 The proposals in the IASB's original exposure draft would not include any indicators or triggering events as a threshold for credit loss estimates or changes in those estimates. The IASB believed that this would reflect lending decisions more faithfully than existing requirements that use indicators or triggering events as a threshold for considering estimates of credit losses (and changes in those estimates) for financial reporting purposes. The IASB's original proposals would enable the relationship between expected credit losses and the pricing of financial assets to be reflected. Under that approach the carrying amount of financial assets at amortised cost would always equal the cash flows expected from the asset over its expected life (updated for changes in expected credit losses) discounted at the original effective interest rate.
- BC16 The IASB noted that eliminating the incurred loss model's recognition threshold for impairment losses would remove some significant weaknesses of that impairment model. While the primary objective of the IASB's original exposure draft was to reflect the relationship between expected credit losses and the pricing of financial assets, those proposals would also result in earlier recognition of credit losses than the incurred loss impairment model in IAS 39. The original proposed impairment approach with appropriate presentation and disclosures would also provide transparency that would allow users of financial statements to distinguish the effect of initial estimates of credit losses (which affect the economic return) and the effect of later changes in estimates (which provide information about a change in the credit quality of a financial asset). In addition, by eliminating the recognition threshold the original proposed approach would also avoid the problems associated with applying that threshold and the resulting diversity in practice.
- BC17 The original proposed approach would measure an impairment loss (gain) as the difference between the carrying amount of the financial asset before the change in estimate and the present value of the expected cash flows of that asset after including the change in estimate. An entity would be required to revise its cash flow estimates, including the effect of credit losses, on each measurement date. The effect of a change in estimate would be recognised in profit or loss in the period of the change.

- BC18 By including the initial estimate of expected credit losses in determining the effective interest rate the original proposed approach would also avoid the systematic overstatement of interest revenue in periods before a loss event occurs and use a subsequent measurement that is internally consistent with the initial measurement.

FASB

- BC19 The FASB's original impairment proposal would have required recognition in net income of a credit impairment loss when an entity determines that it does not expect to collect all contractual amounts due for originated financial asset(s) or all amounts originally expected to be collected for purchased financial asset(s). The objective of that proposed impairment model was to recognise at the balance sheet date (end of the reporting period) the full amount of credit impairment losses based on an assessment of cash flows not expected to be collected over the remaining life of its financial assets. This objective would result in earlier recognition of credit losses relative to the current impairment guidance in US GAAP. The FASB decided that the impairment model should not be based on a notion of incurred losses and that a credit loss need not be deemed probable of occurring to recognise a credit impairment. The FASB believed that removing the probable threshold would result in an entity recognising credit impairments in net income earlier on the basis of its expectations about the collectibility of cash flows.
- BC20 In determining the amount of cash flows not expected to be collected under the proposed guidance, the FASB decided that an entity's expectations of collectibility of cash flows would consider all available information about past events and existing conditions but would not consider potential future economic events beyond the reporting date. The FASB believed that entities could not feasibly forecast macroeconomic factors and economic cycles through the life of the financial assets with a sufficient degree of reliability. Therefore, the FASB decided to limit the information considered in the impairment analysis to past events and existing conditions and the implications of that information on the collectibility of cash flows.
- BC21 With respect to the measurement of credit impairment losses, the FASB's original proposed guidance would have provided latitude for entities to select appropriate measurement techniques to estimate the amount of credit impairment losses for financial assets. This included using historical loss rates, adjusted for qualitative factors to reflect existing conditions, to measure credit impairment for pools of similar financial assets. Such a technique results in recognition of a rate of loss on a pool

of financial assets, even if the assets that will default cannot be specifically identified. Therefore, under the original proposed guidance, the FASB acknowledged that an entity could recognise a credit impairment for a pool of financial assets in the first reporting period after an asset is originated or purchased.

- BC22 The original proposed guidance would have permitted entities to choose to evaluate financial assets for impairment on an individual basis. In such situations, if no past events or existing conditions indicate that the individual financial asset is impaired (for example, when a financial asset is originated), the FASB decided that an entity should not automatically conclude that no credit impairment loss should be recognised. Instead, the FASB originally proposed that an entity should determine whether assessing the financial asset together with other financial assets with similar risk characteristics indicates that a credit impairment exists. In other words, the FASB decided that evaluation on an individual basis should not avoid recognition of credit impairment if evaluation of that same financial asset as part of a pool of similar assets would have resulted in recognising a credit impairment loss.
- BC23 The FASB originally proposed that when a financial asset is individually identified as impaired, the amount of credit impairment should be measured as the difference between the amortised cost of the financial asset and the present value of cash flows expected to be collected, with the interest rate used to discount the cash flows being the same rate that is used to calculate interest revenue. In addition, the FASB originally proposed expanding the practical expedient in existing US GAAP loan impairment guidance to allow an entity to measure impairment on the basis of the fair value of the collateral for all collateral-dependent financial assets for which repayment is expected to be provided primarily or substantially through the operation or sale of the collateral.
- BC24 The FASB's original proposed guidance on impairment would have applied the same model to originated loans and debt securities. The FASB decided that there are insufficient reasons for prohibiting the evaluation of debt securities in a pool if they have similar risk characteristics. However, the FASB believed that debt securities will more often have unique risk characteristics that will result in their being evaluated individually.

Comments received on the FASB's original exposure draft

- BC25 Many respondents, excluding users, opposed recognising total credit losses expected to occur over the life of a financial asset 'immediately' or at the first reporting date at or after financial assets are originated or purchased. However, some preparers supported recognising total expected credit losses immediately while others supported recognising immediately a portion of credit losses expected to occur over the life of a financial asset.
- BC26 Users responding to the FASB generally supported immediate recognition of expected credit losses. Many preferred that a portion of total expected losses should be recognised at an entity's reporting date as they felt that, at least for asset classes with longer-term expected lives, the amount of credit impairment recognised would be excessive under an approach that would recognise all expected losses immediately. They requested that robust disclosures surrounding the approaches for measuring credit impairment by asset class should be provided to enhance the understandability of the amount of credit impairment recognised and the sufficiency of an entity's allowance for credit losses. See paragraph BC86 which discusses this recently issued guidance.
- BC27 The vast majority of respondents did not support the limitations in the FASB's exposure draft to preclude entities from forecasting future economic events and conditions for the purpose of estimating expected impairment losses. The majority of users were concerned that limiting the inputs into the credit impairment calculation to current conditions would limit the usefulness of the impairment measurement because it would restrain management's ability to reflect expected credit losses fully. Some investors supported incorporating only past events and current conditions. Most investors responding to the FASB agreed that it is difficult, and some think impossible, to forecast total credit losses and the timing of those credit losses over long periods of time. Therefore, they supported allowing forecasts of macroeconomic events and conditions for shorter time periods (for example, two to three years) as they believed that predicting events over shorter time horizons is more reliable. They also questioned the ability to obtain transparent information on these inputs and assumptions at a sufficiently detailed level.
- BC28 Other respondents, such as preparers and auditors, asserted that consideration of future events and forecasting should be limited to a period within a predictable time horizon, as opposed to forecasting for the full life of financial assets. The boards were also presented with information that indicated that for many asset classes held by US banking

institutions, losses tend to occur early in their expected lives. This trend reinforced the FASB's view that the impairment model should currently reflect the losses that are expected to occur rather than recognise those amounts over time.

- BC29 Over the past several months, the FASB has deliberated various questions jointly with the IASB, resulting in the publication of the supplementary document. In the joint redeliberations, the boards concluded that forecasting of future events and conditions should be required for the purpose of developing estimated credit impairment losses expected to occur. Additionally, the FASB concluded that immediate recognition of total expected credit losses of a financial asset or a pool thereof would not be required but, rather, the FASB preferred that an entity recognise credit losses expected to occur in the foreseeable future.

IASB redeliberations

- BC30 While many respondents, including users that responded to the IASB, supported the concepts in the IASB's original exposure draft, a majority of respondents and the EAP said that the proposed approach would be a significant operational challenge and would entail substantial costs and lead-time to implement. These operational challenges were most pronounced for open portfolios of financial assets (where assets are added and removed from the portfolio over its life) and relate to the allocation mechanism for credit losses (ie the integrated effective interest rate). In particular, respondents highlighted that as a result of operating separate accounting and credit risk systems there were strong operational challenges associated with:
- (a) applying an integrated effective interest rate to net cash flow estimates; and
 - (b) maintaining information about the initial estimate of expected losses.
- BC31 Users responding to the IASB supported recognising impairment based on lifetime expected credit losses. Many of these users supported recognising initial estimates of lifetime expected credit losses over the life of a financial asset (as opposed to recognising the entire amount in the period of initial recognition of the financial asset). Those users did not support making an expected loss estimate over a shorter time period, because they thought that a shorter time period would be an arbitrary cut-off and would not be applied consistently across entities. Although these users acknowledged that an expected loss model would require many estimates,

they accepted that with the proposed robust disclosure requirements, it was appropriate to require lifetime expected losses to be estimated. Furthermore, they believed that a remaining lifetime expected loss approach with recognition of expected losses over the life of a financial asset would reflect the economic reality and interaction with interest revenue recognition.

BC32 For the reasons described above, the IASB believes that the model proposed in its original exposure draft faithfully represents the underlying economics included in the pricing of financial instruments and is consistent with amortised cost measurement in accordance with IFRSs. However, the IASB also believes the original proposed approach requires modification for open portfolios to address the significant operational challenges that were identified. The IASB started the redeliberations at the end of the comment period for its original exposure draft with discussions about an operationally simpler impairment model for open portfolios that would retain some of the outcomes of applying the original exposure draft to the maximum extent possible (ie the link between pricing of financial assets and expected credit losses, the recognition of the effects of changes in loss estimates, and not recognising a loss for the expected loss estimate upon initial recognition of the financial asset). The IASB's primary objective was thus unchanged from that underlying its original exposure draft (ie to reflect the underlying economics in a lending transaction by maintaining a link between the pricing of the financial assets and the expected losses). The time-proportional model as described in the supplementary document, before the inclusion of a floor, was designed only to provide simplifications giving operational relief for open portfolios while maintaining this original objective. It was as a result of the boards' joint deliberations that the concept of a floor was later inserted into the proposed model (see paragraph BC62).

BC33 In the supplementary document the IASB has addressed some of the main concerns of respondents to its original exposure draft. The IASB's decisions were based on responses to their exposure draft and in particular the suggestions made by the EAP to address the main operational challenges that were identified for open portfolios. Specifically, the IASB decided for open portfolios:

- (a) to 'decouple' the computation of the effective interest rate from the consideration of credit losses;

- (b) to determine the timing of recognition of expected losses according to the characteristics of the financial assets in a manner consistent with many credit risk management systems;
- (c) to remove short-term trade receivables from the scope of the supplementary document because the relevant revenue recognition proposals have not yet been redeliberated; and
- (d) to provide for the recognition of expected credit losses on a time-proportional basis using the weighted average age and weighted average life of the portfolio.

Separately determining effective interest rate and considering expected credit losses (decoupling)

- BC34 As described above, the IASB's original exposure draft proposed that the effective interest rate should be calculated after considering all expected cash flows including expected credit losses. Respondents to that exposure draft and the EAP told the IASB that this approach introduces operational complexity because accounting systems currently calculate effective interest rates whereas expected loss information is contained in credit risk systems. Currently, those systems are not integrated, so the original proposed integrated approach would be very costly and time-consuming for entities to implement.
- BC35 The EAP suggested that a broadly similar result could be achieved in a less operationally challenging manner by continuing to calculate the effective interest rate as required by IAS 39 today and then using a separate approach for allocating expected credit losses over the life of financial assets. This is consistent with the IASB's original exposure draft in that it requires an allocation approach for the initial estimate of expected losses.
- BC36 In order to simplify the allocation mechanism for credit losses, the supplementary document proposes that financial assets managed on an open portfolio basis would be differentiated into two groups for the purpose of determining the impairment allowance. For one group expected credit losses would be recognised depending on the age of the portfolio, ie a time-proportional amount (this group is often referred to as the 'good book') whereas for the other group the entire amount of expected credit losses would be recognised in the impairment allowance (this group is often referred to as the 'bad book'). Note that the financial

assets in the 'bad book' do not always have an allowance that represents 100 per cent of their nominal amount, rather the allowance represents 100 per cent of the expected credit losses on those financial assets. This approach was also based on suggestions from the EAP.

- BC37 The IASB considered that allocating expected losses using a time-proportional approach would be operationally feasible. A time-proportional approach allocates remaining expected credit losses on the basis of the ratio of the portfolio's age to its expected life, when using a straight-line approach. This is intended to approximate the IASB's original proposals for the allocation of the initial estimate of expected credit losses that was achieved through the integrated effective interest rate. The IASB noted that because the pricing of financial assets includes a component for expected credit losses, (at least initially) some mechanism to allocate expected credit losses is most appropriate.
- BC38 Therefore, the supplementary document proposes that for the group of financial assets for which expected credit losses are allocated over time (ie the 'good book'), an entity should estimate the expected credit losses for the remaining life of a portfolio of financial assets and determine an allowance for credit losses equal to a time-proportional amount of those expected credit losses. That time-proportional amount is based on the weighted average age and the weighted average life of that portfolio.
- BC39 The IASB discussed two alternative approaches for recognising expected credit losses over the life of such financial assets: a straight-line approach and an annuity approach.
- BC40 The IASB considered whether it would be more appropriate to mandate a single approach to allocating expected losses to improve comparability or to allow entities to choose between those allocation approaches. On balance the IASB decided to propose that entities should be permitted to apply either a straight-line approach or an annuity approach to allocate expected losses over the life of a portfolio. The IASB observed that different entities have different systems and levels of sophistication. Therefore, the IASB thought it appropriate to allow those with sophisticated systems to make use of such systems to better approximate the outcomes of the original exposure draft. The IASB also noted that the annuity approach is a present value calculation that is more consistent with amortised cost as a measurement category, and that it allows a closer approximation of the outcomes in the IASB's original exposure draft than simpler methods. However, the IASB also acknowledged that a simpler solution for entities with less sophisticated systems or simple expected loss scenarios is needed.

- BC41 The IASB also considered whether straight-line allocation should be applied to discounted or undiscounted expected losses. Again, in order to allow for different levels of sophistication, the IASB proposes that either discounted or undiscounted amounts could be used. The IASB also noted that it had yet to redeliberate the measurement of impairment. Therefore, for the purposes of the supplementary document, which focuses on the timing of credit loss recognition, the IASB thought it inappropriate to limit the amount that is allocated on a straight-line basis to either a discounted or an undiscounted amount.
- BC42 The IASB considered what discount rate might be appropriate if an entity uses discounted amounts for expected credit losses. The IASB noted that conceptually, the discount rate for cash flows of an asset cannot be below the risk-free rate. The IASB further noted that the discount rate used in its original exposure draft is conceptually appropriate for calculations in connection with amortised cost measurement. The IASB thought that those two rates and any rate between them could be broadly regarded as reasonable. However, the IASB acknowledged that any approach that would specify the effective interest rate in accordance with its original exposure draft as the upper limit would have the effect of requiring the complexity of determining this rate for the purpose of ascertaining whether a more readily obtainable rate could be used. The IASB noted that the operational complexity of determining that effective interest rate would not be avoided, which would defeat the purpose of providing operational relief. For this practical reason the IASB proposes that any rate between the risk-free rate and the effective interest rate determined in accordance with IAS 39 can be used as the discount rate.
- BC43 The IASB also noted that the decoupled approach proposed in this supplementary document would only approximate the outcome that would have resulted from applying the proposals in the IASB's original exposure draft. The IASB noted that permitting an entity to use any reasonable rate between (and including) the risk-free rate and the effective interest rate as currently determined in accordance with IAS 39 would encourage the use of discounted amounts. The IASB concluded that in the context of amortised cost as a present value measurement, the use of discounted amounts, even if the discount rate provided some flexibility, was preferable to the use of undiscounted amounts.

- BC44 The IASB rejected using a financial asset's contractual interest rate as a reference rate. The IASB noted that a general assessment of whether the financial asset's contractual interest rate might be an appropriate discount rate was impossible. For example, for an instrument acquired at a significant discount or an instrument with uneven coupons, the contractual rate could differ significantly from an effective interest rate.
- BC45 The IASB acknowledged that a straight-line approach would not exactly replicate the outcomes of its original exposure draft. The IASB also acknowledged that an annuity approach would not result in exactly the same outcome unless the effective interest rate proposed in the IASB's original exposure draft was used. However, the IASB concluded that the allocation notion of both alternative methods would still better reflect the objectives of its original exposure draft than an immediate recognition model.

Differentiation of credit loss recognition

- BC46 The IASB also concluded that because the time-proportional approach would treat initially expected credit losses and later changes in estimates the same, that approach needed to be complemented by an approach that resulted in the immediate recognition of expected credit losses for those financial assets for which, owing to the uncertainty about their collectibility, it is no longer appropriate to allocate expected credit losses over a time period.
- BC47 The fundamental complexity for open portfolios is that it is not operationally feasible (at least under consideration of costs and benefits) to distinguish between the credit losses associated with financial assets that were newly originated or purchased in the current period, and those that were also outstanding in the previous period. Therefore, the IASB's original proposals that distinguished between initial expected credit losses (that were included in the effective interest rate calculation) and changes in expected credit losses (that resulted in impairment losses or gains) were problematic and would have required significant changes to credit risk systems.
- BC48 The IASB considered whether it should set a 'bright line' to differentiate which financial assets should be subject to an allocation mechanism for expected credit losses and those for which expected credit losses should be immediately recognised.

- BC49 The IASB learned from its outreach activities that the criteria for determining when to transfer financial assets between two groups that are managed differently for credit risk (eg what banks often refer to as the ‘good book’ and ‘bad book’) differ across entities and are dependent on the risk management practices or framework of each entity. The IASB also learned that the credit risk management criteria for transferring financial assets between the two groups typically involve less judgement (and are therefore more objective) for large volume low value financial assets that are typical of consumer lending (eg number of days past due). In contrast, for large wholesale items (eg large corporate loans), there is usually more management judgement and subjectivity involved in assessing whether the financial assets should be transferred between those groups. In this case the facts and circumstances are often assessed case by case. Therefore, the IASB concluded that requiring specific detailed criteria or a bright line for transferring a financial asset between those groups would not be appropriate.
- BC50 Instead, the IASB concluded that an approach that differentiates the two groups of financial assets on the basis of an entity’s internal credit risk management would be operationally simpler and better reflect how the asset is managed. The IASB proposes specific disclosures related to internal credit risk management policies and the two groups.
- BC51 The IASB also observed that some might be concerned that the proposed approach could create opportunities for earnings management because of the effect of transferring financial assets between the two groups on the timing of the recognition of expected credit losses. However, the IASB noted that the differentiation between the two groups inevitably involves significant management judgement, even if a specific bright line were set (eg 90 days past due). Although no bright line is provided, the IASB noted that a bright line would only be the last point in time when a financial asset would have to be considered impaired, but the assessment would still involve the evaluation of whether there are other circumstances that result in an earlier determination of the financial asset as impaired.
- BC52 Furthermore, the IASB considered that using criteria on the basis of internal credit risk management is directionally consistent with the other phases of the project to replace IAS 39 (ie classification and measurement and hedge accounting). One of the classification criteria for financial assets in IFRS 9 is based on the entity’s business model for managing the financial asset. The IASB’s proposals on hedge accounting also aim to improve financial reporting by enabling entities to reflect more closely their own risk management.

BC53 However, the IASB also tentatively decided that for entities without an internal credit risk management that makes such a distinction, and in order to ensure entities understand the objective of the distinction, it should set out a principle that explains when allocation of expected credit losses over a time period would no longer be appropriate. The supplementary document proposes that it is no longer appropriate to recognise expected credit losses over a time period if uncertainty about the collectibility of an asset has taken precedence over its profitability from the interest charged, for example, when management identifies a loan as doubtful (sometimes also considered by an entity as a ‘problem loan’). In the IASB’s view, this would broadly signal that the focus shifts from managing the return from the interest charged to that of managing the recovery of the financial asset.

Overall approach

BC54 Overall, the proposed approach would measure an impairment loss (or its reversal) as the difference between the total of the allowance amounts recognised for all financial assets (within the scope of the supplementary document) at the current reporting date and the previous reporting date, taking into account any activity in the allowance account during the period (eg charge-offs). The IASB noted that, for financial assets for which expected credit losses are recognised over time, the allowance account at the end of each reporting period is based on the time-proportional amount of expected remaining credit losses at that reporting period. Therefore, within a particular reporting period, the timing of when a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance would not affect the allowance amounts or profit or loss. The ending allowance balance and period impact on profit or loss would not differ simply because of the timing of the transfer within that period.

BC55 An entity would be required to revise its expected credit loss estimates on each measurement date.

Joint redeliberations

BC56 As described above, the IASB and the FASB were pursuing different objectives for their impairment proposals, which caused them to favour different proposals for the recognition of expected credit losses and as a result different allowance amounts. Because of the importance of reaching a common solution to the accounting for impairment of financial assets, the boards undertook joint redeliberations.

- BC57 The boards began their joint redeliberations by revisiting the high level components of an impairment model, primarily the information set to determine the amount of the credit loss to be recognised, and the timing of credit loss recognition. The boards considered a variety of models with differing combinations of components.
- BC58 The IASB continued to support an impairment model that would reflect the link between the pricing of a financial asset and the underlying economic activity (ie lending), while providing operational relief for entities. Thus, with regard to the timing of recognition of expected credit losses, the IASB continued to support a method that would recognise credit losses over time for the ‘good book’.
- BC59 The FASB continued to advocate an impairment model that would recognise expected credit losses at the reporting date rather than over time. However, the FASB received specific advice, including from investors and the EAP, that immediate recognition of expected losses for the remaining effective lives of financial assets was potentially recognising an amount of impairment that is ‘too much, too soon’. The FASB decided that an approach that requires immediate recognition of foreseeable future losses sufficiently addresses the problems with the current impairment guidance. Most investors that responded to the FASB’s original proposals supported recognition of the entire credit loss for the foreseeable future in the period estimated. The FASB therefore continued to prefer an approach with an objective of ensuring that the allowance for credit losses is always at least equal to expected credit losses when they occur.
- BC60 While the IASB’s original impairment proposals would have ensured that all expected credit losses are provided for when they occur, the modifications to those proposals (outlined in the previous section) necessary to provide operational relief result in a ‘catch-up’ effect when financial assets are transferred between the two groups that are differentiated for the purpose of determining the impairment allowance.
- BC61 During the joint redeliberations, some members of each board expressed concern that recognising expected credit losses over time under the IASB’s modified approach might result in an insufficient allowance for credit losses at certain points in time for some fact patterns. For example, for the IASB’s time-proportional method, concerns were raised that the allowance balance might be inadequate for asset classes with losses that tend to occur early in the lives of the financial assets. This led the boards to focus in particular on the adequacy of the allowance balance for different loss experience profiles.

- BC62 In order to bridge the gap between the two models, the boards proposed to require that the model developed by the IASB should be modified to introduce a minimum allowance amount (or 'floor') for the group for which expected credit losses are recognised over time, or allocated using the time-proportional method (ie the 'good book'). This modification would set the total allowance for impairments (for both groups, ie the 'good book' and the 'bad book') at an amount that would always at least equal expected credit losses at the time they are expected to occur for those credit losses expected to occur within the foreseeable future (being a period of no less than twelve months). On the basis of the scenarios that the boards considered, they believe that for many asset classes, it is likely that the foreseeable future will be a period greater than twelve months. However, in periods where the time-proportional amount is the higher amount, this approach would still enable the relationship between expected credit losses and the pricing of financial assets to be considered for the 'good book'. As this common solution reflected the primary objectives of both boards, the boards agreed to publish the supplementary document jointly proposing that approach for credit impairment.
- BC63 Under the new joint proposals, an entity would be required to calculate the time-proportional allowance amount for the 'good book' at each reporting date and to compare that with the minimum allowance amount (ie the 'floor') to determine whether the time-proportional amount is adequate. The boards wanted the minimum allowance amount to be equal to the expected credit losses over a period of time to ensure that the allowance balance is always at least equal to those credit losses when they are expected to occur.
- BC64 The boards discussed whether the minimum allowance amount should equate to the expected credit losses for a fixed period of time (such as one year) or whether a more principle-based period should be used. The boards considered that a fixed time period would have the benefit of improving comparability between entities as well as being clearer, and if set at one year it would have the benefit of coinciding with the period for regulatory calculations of expected losses for some regulated banks. However, some were concerned that a 'bright line' would prevent entities from considering expected losses that in the entity's view were foreseeable but beyond the defined time horizon. In the boards' view, that might inappropriately require entities to delay recognition of some expected credit losses.

BC65 On balance, the boards tentatively decided that the floor amount for the minimum allowance amount (ie the minimum target amount for the allowance of the ‘good book’) should represent the amount of credit losses expected to occur within the foreseeable future, which would be required to be a period of no less than twelve months. The boards believe that every entity is able to forecast expected credit losses for at least twelve months, and therefore required that entities must at least consider that future period when determining the minimum allowance amount. However, an entity would forecast losses for a foreseeable future that is greater than twelve months for the purpose of calculating the minimum allowance amount if the entity considers a longer period ‘foreseeable’.

Approaches based on primary objectives before convergence discussions

- BC66 As discussed in the introduction to the supplementary document, the IASB and FASB had different objectives for impairment accounting in their original exposure drafts, which were reflected in the approaches described in those proposals. Because the boards have different primary objectives, they had begun to develop different approaches during redeliberations. A proposal combining these two approaches is set out in the supplementary document in order to request views. The boards propose the approach set out in the supplementary document, even though it does not align perfectly with the original objective of either board, in acknowledgement of the importance of the boards reaching a common solution to the accounting for impairment.
- BC67 The table in the ‘Approaches developed by the IASB and FASB separately’ section of the supplementary document summarises the three approaches.
- BC68 A minority of IASB members and some FASB members still prefer the models that were being separately developed to the common proposal described in the supplementary document. This section summarises the preferred approaches of those board members and the reasons for those views.

IASB

- BC69 A minority of IASB members prefer the approach for impairment developed by the IASB during the IASB-only redeliberations of the exposure draft. This approach is detailed in paragraphs BC30–BC55. Essentially, this approach would recognise a time-proportional amount of the lifetime

expected credit losses for the 'good book' (ie a time-proportional model without a 'floor'). For financial assets where it is not considered appropriate to recognise expected credit losses using that approach, the full amount of lifetime expected credit losses would be immediately recognised. While the common approach proposed in the supplementary document includes the time-proportional approach, a minority of IASB members do not support the inclusion of a minimum impairment amount (or 'floor' amount) for the foreseeable future period. In support of their view, those IASB members cite the reasons in the following paragraphs.

- BC70 The IASB members who prefer the impairment approach developed during the IASB's redeliberations believe that the approach more appropriately reflects the economics of lending transactions. Financial assets are priced so that the interest rate being charged compensates for the initial estimate of future expected credit losses. Therefore, those IASB members prefer this approach because it maintains a link between the pricing of financial assets and the expected losses. Actual losses occur over the expected life of a portfolio of financial assets; therefore, recognising expected credit losses over that expected life better reflects the economics of the lending transactions. These IASB members believe this results in useful information for users of the financial statements.
- BC71 The IASB members supporting the impairment approach developed during the IASB's redeliberations believe it provides an approximation of the outcomes in the IASB's original exposure draft. It is based on work undertaken by the EAP. Although the approach was designed to make the model proposed in the IASB's original exposure draft simpler to apply, the IASB members who prefer this approach acknowledge that some operational complexity may still exist, including the need to change systems in order to calculate weighted averages of the age and life of open portfolios. However, the IASB received information that such operational challenges should be manageable and is requesting additional views from constituents in order to verify that information.
- BC72 In the approach being developed by the IASB during its redeliberations, some expected credit losses (ie those in the 'good book') are recognised using a time-proportional approach based on the weighted average age and weighted average life of the portfolio and the remaining expected credit losses for the portfolio. There would not be an immediate charge to profit or loss for the entire amount of credit losses expected to occur. However, if financial assets are added to an open portfolio on the reporting date, a portion of the remaining expected losses would be reflected in the time-proportional amount recognised at the reporting date. Some argue that, because some amount of loss would be recognised

in the first reporting period under the IASB approach, unless an entity determines weighted average ages and weighted average lives on the basis of expected loss amounts, both the models being developed by the IASB and FASB have an impact on profit or loss immediately after a new loan enters a portfolio. Thus, some believe that the results can be viewed as similar since the model being developed by the FASB would require all credit losses expected to occur in the foreseeable future to be recognised in the period of estimate and the IASB model would require recognition of the time-proportional amount in the period of estimate.

- BC73 However, it is important to note that these loss amounts are viewed by the IASB as conceptually different. The premise for the time-proportional approach is different from the premise for the foreseeable future approach, and the objectives of each approach indicate they were designed to achieve different loss recognition patterns. Under the time-proportional approach, the expected credit losses and changes in loss estimates are not fully recognised in the first period of estimate. The amount recognised is a portion of the remaining expected credit losses for the portfolio, and when new loans enter the portfolio, the amount of loss that would be recognised is viewed by the IASB as one day's worth of the future expected credit loss. In contrast, the FASB's approach was intended to recognise currently the full amount of expected credit losses for the foreseeable future period.
- BC74 When appropriate, expected losses for the remaining life of financial assets are immediately recognised (ie in the 'bad book'). The IASB members who prefer this approach acknowledge that for financial assets for which expected credit losses are recognised over time in an early loss pattern scenario, the time-proportional approach may not create an allowance balance sufficient to cover the expected losses before they occur. However, they do not necessarily believe that the foreseeable future floor in the proposed model is the only way to deal with this issue. For example, the floor amount as set out in paragraph 2(a)(ii) could be required *only* for portfolios that have an early loss pattern. Alternatively, another way of addressing situations in which there is an early loss pattern could be to recognise an amount in addition to that determined using paragraph 2(a)(i) being the excess, if any, of (a) the expected credit losses in the foreseeable future period over (b) the expected credit losses that would be recognised using a time-proportional approach that considers both the current age of the portfolio and the foreseeable future period (ie by using the sum of the foreseeable future period and the weighted average age of the portfolio to calculate the time-proportional amount). This method would have the advantage that a time-proportional approach would always be used while ensuring the allowance balance considers expected losses for the near term.

- BC75 As with any impairment approach, the proposed approach being developed by the IASB would involve judgement when deciding what assumptions to use, as well as when to transfer assets between the two differentiated groups (ie the 'good book' and the 'bad book'). As a result, the IASB members who prefer this approach acknowledge that some are concerned about the lack of comparability between entities that may have similar portfolios, but use different judgement. Also, they acknowledge that because of the judgement involved, some are concerned that the approach creates the potential for earnings management. These IASB members believe that these concerns equally apply to any impairment approach involving judgement (including an approach that recognises losses expected to occur in the foreseeable future).
- BC76 Responses to the IASB's original exposure draft largely supported the use of forward-looking information when calculating expected credit losses. In addition, many agreed that expected losses should be estimated over the lifetime of the financial assets. Other respondents believed that lifetime estimates are not reliable and suggested a shorter time frame for estimating expected losses. The IASB believes that estimating lifetime expected credit losses is similar to other guidance in IFRSs which requires estimates of lifetime amounts (eg projected benefit obligations and cash flow projections for calculating impairment on non-financial assets). Furthermore, the IASB believes that making lifetime expected credit loss estimates should be no more difficult than making a Level 3 estimate in accordance with the fair value measurement guidance, which both boards believe can be made reliably. Finally, the IASB believes that an impairment allowance that would be derived from a time period other than the expected lifetime would not be consistent with accounting frameworks because the resulting information would be neither relevant nor a faithful representation of the economic activity it was meant to depict. Accordingly, the IASB confirmed its support for estimating lifetime expected credit losses.
- BC77 Some IASB members believe that an approach that focuses solely on losses expected over a period shorter than the life of the asset is more susceptible to earnings management. In that case the allowance is entirely dependent on management's estimate of the time period to be used, as well as the amounts of expected losses. In contrast, those IASB members believe that if the losses recognised are on the basis of lifetime expected losses because the pricing of the loan provides a reference for those estimates, there is less room for earnings management.

FASB

- BC78 Some FASB members prefer the approach for impairment discussed by the FASB as part of the joint deliberations. With regard to the timing of recognition of expected credit losses, the preferred approach of those FASB members is an impairment model that would always recognise expected credit losses for the foreseeable future period at the reporting date. Those FASB members believe that an approach that requires immediate recognition of credit losses expected in the foreseeable future sufficiently address the problems with the current impairment guidance and that the time-proportional component of the model provides no incremental benefit. Those FASB members note that the FASB has not yet sufficiently deliberated the aspect of the common proposal regarding whether financial assets should be classified as being in the ‘good book’ or ‘bad book’ or, viewed another way, whether there should be a different impairment approach for individual financial assets when credit quality has deteriorated to a level that requires an entity to analyse them separately.
- BC79 Those FASB members note that many believe that the fundamental problem with the current impairment model under both US GAAP and IFRSs is that reserves for credit losses tend to be at their lowest level before an economic cycle turns downward and actual losses begin to occur (‘too little, too late’). They believe that the basic elements of the FASB approach that was being developed—the elimination of the ‘probable’ threshold and recognising losses expected to occur in the foreseeable future at a given reporting date—achieve the objectives of earlier loss recognition of credit losses and provide a more accurate reflection of management’s estimate of credit losses expected to occur in the allowance balance.
- BC80 The objective of the approach that was being developed by the FASB is for an entity to create and maintain a credit impairment allowance level that represents the total amount of all credit losses expected to occur in the foreseeable future at a given reporting date. The FASB members who prefer this approach would not include a minimum of twelve months as proposed in paragraph 2(a)(ii). The responses to the FASB’s original exposure draft and its outreach activities indicated that, typically, entities are able to make reliable estimates of macroeconomic events and expected conditions over a period greater than twelve months.

- BC81 The FASB members believe this approach would provide useful information to users of financial statements regarding management's expectations about losses on financial assets that an entity expects to occur during the foreseeable future at the entity's reporting date. They believe the approach appropriately reflects earnings resulting from recognition at the first reporting date at or after initial recognition of changes in the point-in-time expectation of credit losses as far out as management can foresee. Those board members believe that the economics of lending are captured by their preferred approach as actual impairment losses do not occur ratably over time and often arise as discrete amounts early in the expected lives of many asset classes.
- BC82 The FASB learned from many constituents through outreach efforts that forecasting and recognising impairment losses for the twelve months after their reporting date may not significantly change current allowance balances.
- BC83 Those FASB members acknowledge that the time-proportional component of the common proposal attempts to align credit impairment with interest income. However, they believe that an objective of recognising credit impairment over time to achieve this alignment is extremely difficult to achieve in an open pool setting. Also, the FASB members believe that the objective of linking credit losses of financial assets to the original pricing, while conceptually appealing, does not recognise that there is often no direct relationship between the two. Thus, those FASB members believe that unless recognition of the time-proportional amount of estimated credit losses coincides with the timing of recognition of actual credit losses (and replenishment of the allowance) profit and loss would not be aligned.
- BC84 The FASB members who prefer this approach understand that some are concerned that the approach would result in a 'day 1 loss' for newly originated financial assets. Those FASB members disagree with this assertion for an open portfolio because an open portfolio is fluid. In other words, in an open portfolio, no beginning or ending date exists unless the pool is being liquidated, in which case the pool would then become a closed pool and impairment recognition for closed pools has yet to be deliberated. Those FASB members point out that in an open pool setting, the time-proportional approach requires a proportion of remaining lifetime expected future credit losses (for the 'good book') to be recognised at the end of the reporting period. In this way, the time-proportional amount is similar to the foreseeable future amount, because both represent some proportion of the remaining lifetime expected credit losses for the open pool being recognised at the reporting date.

- BC85 Those FASB members also believe that this approach can be applied by banks and other organisations without significant systems and process changes and does not pose significant operational challenges in application for constituents. Regarding the loss estimation process, those FASB members believe that limiting the period for which losses are expected to occur to a portion of the full expected life for longer-term financial assets will increase the reliability of the estimate. They believe this is responsive to the comments from most US users of financial statements who opposed recognition of a life loss for all classes of financial assets primarily because of concerns about the reliability of life loss estimates.
- BC86 The FASB members who support this approach acknowledge the concerns expressed by some that the foreseeable future period may not be defined with enough specificity and the application may be subjective, thereby decreasing comparability. Some have pointed out that although judgement is necessary in any impairment methodology, the lack of any clear articulation of what the foreseeable future period means is likely to result in significant divergence in practice. It may also facilitate artificial smoothing of earnings, thus changing the allowance for factors that have no bearing on economic events in the period. These FASB members believe that, on balance, the concerns about subjectivity are greater under the time-proportional approach for longer-term assets, because constituents expressed significant concern about the ability to estimate losses for years far into the future. The FASB members understand the concerns about the challenges of determining the foreseeable future period and expect to receive comments on the operational practicality of this approach, including whether additional guidance or parameters should be placed around the term 'foreseeable future'. However, those FASB members believe the recently issued guidance on disclosures for financing receivables address concerns about the transparency of judgements made in connection with the allowance for credit losses. Those FASB members will also consider the development of additional disclosures of the assumptions used for various types of asset classes, which would allow users to evaluate the rigour with which the estimates are developed.

Supplement
Financial Instruments: Impairment

IASB-only Appendix Z
Presentation and Disclosure

Comments to be received by 1 April 2011

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IASB only Appendix Z

Presentation and disclosure

Introduction

Background and reasons for publishing this appendix

- INZ28 As discussed in the separate supplementary document on impairment, the IASB and the FASB are seeking a common solution to the accounting for the impairment of financial assets. That supplementary document is being published by the boards following their separate initial impairment proposals with the intention of assisting them in their joint discussions on the accounting for impairment of financial instruments. That supplementary document primarily addresses the timing of the recognition of expected credit losses in the context of open portfolios. This appendix proposes related presentation and disclosure requirements. These proposals have been deliberated only by the IASB at this time. The FASB may separately deliberate presentation and disclosure requirements related to proposals in that supplementary document.
- INZ29 The proposed presentation and disclosure requirements have been issued by the IASB as part of the supplementary document in order to facilitate understanding of the proposals as a whole. Constituents should also read the background information in the introduction to the supplementary document to further understand the overall project approach. The disclosure requirements below are solely related to the impairment model proposed in that supplementary document. If a different model is developed, then these disclosure requirements may need to be revisited.
- INZ30 The disclosure requirements in the IASB's original exposure draft that were not related to the impairment calculation (ie stress testing, vintage information and credit quality of financial assets) are not addressed in this document. The IASB will redeliberate those disclosure proposals in the light of the information already received in response to the original exposure draft.
- INZ31 This appendix also includes in the invitation to comment IASB-only questions that are not necessarily related to presentation and disclosure. The additional questions in this appendix relate to the IASB-only redeliberations of impairment in the context of open portfolios. The IASB believes it is important to receive views on those questions, which discuss topics not deliberated jointly with the FASB.

INZ32 The IASB has assessed whether the matters set out in the supplementary document would, in accordance with its respective due process requirements, need to be re-exposed. Because the common model is an expected loss model which incorporates the time-proportional approach, the IASB concluded that it could have finalised the requirements without re-exposure. Accordingly, the IASB is publishing the supplementary document, including Appendix Z, primarily to benefit from additional information on operational practicality but regards this additional consultation as beyond that required by its due process requirements.

Next steps

INZ33 The IASB expects that the IFRS combining both the impairment proposals in the supplementary document, the related presentation and disclosure requirements in this appendix and the amortised cost measurement proposals from the IASB's original exposure draft will be issued by June 2011 after redeliberations are completed. However, the IASB has not yet redeliberated when the IFRS would become mandatory or whether early application will be available. On the basis of responses to its original exposure draft the IASB acknowledges that implementing the proposals might require substantial lead time. The IASB will also consider the responses to its Request for Views *Effective Dates and Transition Methods*.

INZ34 In finalising the proposals in this appendix with the proposals from the IASB's original exposure draft, the IASB may treat the presentation and disclosure requirements as amendments to IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*, respectively.

Invitation to comment

The IASB invites comments on all matters in this appendix to the supplementary document, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated
- (b) indicate the specific paragraph or paragraphs to which the comments relate
- (c) contain a clear rationale
- (d) describe any alternatives the boards should consider.

The boards are not seeking comments on aspects of IAS 39 or IFRS 9 not addressed in this appendix to the supplementary document.

Comments should be submitted in writing so as to be received no later than **1 April 2011**.

Impairment of financial assets

This document proposes that the credit loss estimate does not affect the cash flows used to determine the effective interest rate (ie a non-integrated, or 'decoupled' approach). In contrast, the IASB's original exposure draft proposed an integrated approach that would have included the initial estimate of expected losses in the cash flows used to determine the effective interest rate.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

Scope – Loan commitments and financial guarantee contracts

The scope of IAS 39 (and thus IFRS 9) includes some loan commitments that are not accounted for at fair value through profit or loss (ie commitments to provide a loan at a below-market interest rate) and financial guarantee contracts. Loan commitments that are not included within the scope of IAS 39 are included within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, loans that result from the exercise of loan commitments are subject to the requirements of IAS 39.

Loan commitments and loans are often managed using the same business model and information systems irrespective of whether the credit exposure is accounted for in accordance with IAS 39 or IAS 37. Constituents have urged the IASB to align the impairment requirements for all credit exposures irrespective of their type (ie whether loans or loan commitments) and locate them in a single standard. This could be accomplished by applying the proposed impairment requirements to all loan commitments (that are not accounted for at fair value through profit or loss).

In the exposure draft *Insurance Contracts*, the IASB asked whether all financial guarantee contracts should be brought within the scope of the proposed IFRS on insurance contracts (and hence excluded from the scope of IAS 39 and IFRS 9). The IASB has not yet redeliberated the responses to this question and acknowledges the uncertainty about which requirements will apply to financial guarantee contracts. Since these contracts are currently within the scope of IAS 39, the IASB encourages constituents to consider the proposed requirements in this document in the light of the present scope of IAS 39 (and thus IFRS 9).

Views on whether the impairment model should be applied to commitments to provide a loan at a below-market interest rate are also relevant for any decisions on financial guarantee contracts because IAS 37 applies (by reference from IAS 39) to both types of credit exposures.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Presentation (paragraph Z5)

This document proposes the following line items to be presented separately in the statement of comprehensive income:

- (a) interest revenue (calculated using an effective interest rate that excludes expected credit losses); and
- (b) impairment losses (including reversals of impairment losses).

As a result of the proposed impairment approach (the decoupled approach) in the supplementary document, unlike the proposal in the IASB's original exposure draft, interest revenue would be calculated using an effective interest rate that *excludes* the effect of expected credit losses. Accordingly, impairment would be recognised as a separate line item.

The IASB's original exposure draft would have required an entity to take into account the full initial estimate of expected credit losses when calculating the effective interest rate. The presentation requirements proposed in that original exposure draft reflected that proposed measurement approach and were designed to provide transparency about the different factors that affect interest revenue, interest expense and experience adjustments from revising cash flow estimates. Concerns regarding the operational complexity of the impairment model proposed in the IASB's original exposure draft have resulted in proposing a different impairment model. However, this also means that the information that would be available when applying the impairment model proposed in the IASB's original exposure draft would not be available when applying the impairment model proposed in this document.

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

Disclosure (paragraphs Z6–Z15)

This document proposes to require:

- (a) mandatory use of an allowance account to account for credit losses with disclosure of reconciliations separately for the two groups of financial assets that are differentiated for the purpose of determining the impairment allowance (often referred to as the 'good book' and the 'bad book'), disclosure of information about the minimum allowance amount and disclosure of a reconciliation of the nominal amount of financial assets in the group for which the entire amount of expected credit losses would be recognised (ie the 'bad book').
- (b) disclosure of information about the impairment allowance that depends on the age of the portfolio compared with its expected life (ie that in relation to the 'good book') for five years, including the nominal amount of the financial assets, the total of expected credit losses, the amount of the credit loss allowance and effects of the minimum allowance amount.
- (c) disclosures about expected credit loss estimates, including:
 - (i) information about inputs and assumptions used in determining expected credit losses;
 - (ii) analyses of significant effects on impairment losses resulting from a particular portfolio or geographical area; and

- (iii) information that compares previous estimates of expected credit losses with actual outcomes.
- (d) disclosures related to internal credit risk management, including:
 - (i) the nominal amount of financial assets and information about expected credit losses and the minimum allowance amount differentiated by credit rating grades;
 - (ii) information that describes the criteria used to determine in which of the two groups (the 'good book' or the 'bad book') a financial asset is included; and
 - (iii) information about internal credit rating grades, if used by an entity.

The proposed disclosure requirements reflect that the amounts in the statement of financial position and the statement of comprehensive income, in isolation, are not sufficient to allow users of financial statements to evaluate the credit risk exposures arising from financial assets.

Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Paragraph BZ24 proposes that when a financial asset is moved between the two groups of financial assets (the 'good book' and the 'bad book'), an amount of the related allowance reflecting the age of the financial asset would be transferred together with that financial asset. The reconciliation proposed in paragraph Z7(c) would require disclosure of the amount transferred.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

The IASB-only appendix to the supplementary document is set out in paragraphs Z5–Z15 and Appendices AZ and BZ. All paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix AZ are in *italics* the first time they appear in Appendix Z. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. Paragraph references without a ‘Z’ refer to paragraphs in the main supplementary document.

In finalising the proposals in this appendix to the supplementary document with the proposals from the IASB’s original exposure draft, the IASB may treat the presentation and disclosure requirements as amendments to IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*, respectively.

Presentation and disclosure

Presentation

- Z5 The statement of comprehensive income shall include separate line items that present the following amounts for the period:
- (a) interest revenue (calculated using the *effective interest method*).
 - (b) impairment losses (including reversals of impairment losses).

Disclosure

Classes of financial instruments and level of disclosure

- Z6 When this appendix to the supplementary document requires disclosures by class of *financial asset*, an entity shall group financial assets into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those *financial instruments* (including their grouping into portfolios). An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Allowance account

- Z7 **For financial assets measured at *amortised cost* an entity shall use an allowance account to account for credit losses. An entity shall disclose for each class of financial assets:**
- (a) **separate reconciliations of changes during the period in the allowances determined in accordance with paragraph 2(a) and (b);**
 - (b) **if the amount determined in accordance with paragraph 2(a)(ii) is higher than that determined in accordance with paragraph 2(a)(i), the difference between those amounts; and**
 - (c) **a reconciliation of the nominal amounts of the financial assets for which the impairment allowance is determined in accordance with paragraph 2(b). That reconciliation shall include disclosure of the nominal amount of financial assets for which the impairment allowance is no longer determined in accordance with paragraph 2(b) but instead in accordance with paragraph 2(a) and where the change is a consequence of a modification of contractual term(s).**

- Z8 For financial assets for which the impairment allowance is determined in accordance with paragraph 2(a) an entity shall disclose in a tabular format for the current annual period and the previous four annual periods:**
- (a) the total nominal amount of the financial assets;
 - (b) the total amount of expected credit losses;
 - (c) the amount of the impairment allowance; and
 - (d) if applicable, the amount determined in accordance with paragraph Z7(b).

Expected credit loss estimates

- Z9 An entity shall disclose information that explains the estimates and changes in estimates that are required to determine the impairment allowance.**

Z10 An entity shall explain the inputs and assumptions used in determining the entire amount of expected credit losses and the amount of credit losses expected to occur within the foreseeable future (which shall be at least twelve months), including the time period used as the foreseeable future and how that determination was made (see paragraph 2(a)(ii)). For this purpose an entity shall disclose, separately for both amounts:

- (a) the basis of inputs (eg internal historical information or rating reports) and the estimation technique;
- (b) an explanation of the changes in estimates and the cause of the change (eg loss severity, change in portfolio composition); and
- (c) if there has been a change in estimation technique, disclosure of that change and the reason for the change.

Z11 An entity shall disclose quantitative and qualitative analyses of significant positive or negative effects on impairment losses that are caused by a particular portfolio or geographical area.

Z12 An entity shall disclose information about how previous estimates of expected credit losses compare with actual outcomes:

- (a) when an entity performs back testing, it shall disclose a quantitative analysis that compares the actual outcomes and the previous estimate of expected credit losses. The analysis shall enable users to understand the difference between the actual outcomes and the previous estimate. For that purpose, a qualitative explanation may

be necessary in some instances (eg when the actual outcome is higher than previously expected for mortgages because of a worse than expected development in house prices).

- (b) when an entity does not perform back testing, it shall disclose a qualitative analysis of expected credit losses and the actual outcomes to enable users of its financial statements to understand the differences between the actual outcomes and the entity's previous estimate (eg when credit losses are more severe than previously expected for mortgages because of a worse than expected development in house prices).

Credit risk management

Z13 An entity shall disclose information about its internal credit risk management processes in order to enable users of its financial statements to gain a better understanding of the relationship between how financial assets are managed and how expected credit losses are estimated.

Z14 An entity shall disclose by credit risk rating grades:

- (a) the nominal amount of financial assets in a grade; and
- (b) other information including:
 - (i) the entire amount of expected credit losses for a grade; and
 - (ii) the amount of credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity's reporting date) (see paragraph 2(a)(ii)) for a grade.

The number of credit risk rating grades used for this disclosure shall be sufficient to enable users of the entity's financial statements to evaluate the extent of credit risk. The number of grades shall not exceed the number that the entity uses for internal credit risk management purposes. However, at a minimum the grades must allow differentiation between financial assets for which impairment allowances are determined in accordance with paragraph 2(a) and (b). Information about expected credit losses could include, for example, information about loss given default (amount expected to be impaired given a default), exposure at default and probability of default.

Z15 An entity shall also disclose:

- (a) a qualitative analysis that describes the criteria used to determine how financial assets are managed to distinguish between those for which impairment allowances are determined in accordance with paragraph 2(a) and (b), including the criteria that determine whether the entity applies paragraph 2(a) or paragraph 2(b);
- (b) when an entity uses internal credit rating grades, information about those rating grades. An entity could meet that requirement by providing, for example, the following information:
 - (i) a comparison with external ratings, if available;
 - (ii) a description of the credit rating grades used; and
 - (iii) if an entity uses a *watchlist*, a description and the criteria for including or no longer including financial assets in the watchlist;
- (c) how the internal credit rating grades are assigned to financial assets for which impairment allowances are determined in accordance with paragraph 2(a) and (b); and
- (d) when applicable, how the watchlist relates to the criteria that determine whether the entity applies paragraph 2(a) or paragraph 2(b).

Appendix AZ

Defined terms

This appendix is an integral part of Appendix Z.

The following terms are defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation*, paragraph 9 of IAS 39 or Appendix A of IFRS 7 and are used in this appendix to the supplementary document with the meanings specified in IAS 32, IAS 39 or IFRS 7:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method
- (d) financial asset
- (e) financial instrument.

watchlist A list that comprises financial assets or debtors for which information has indicated increased uncertainty about a financial asset's collectibility to such a degree that the entity considers the asset needs to be monitored more closely.

Appendix BZ

Application guidance

This appendix is an integral part of Appendix Z.

Presentation and disclosure

Disclosure

BZ17 The disclosures required in this appendix to the supplementary document shall be either given in the financial statements or incorporated by cross-reference from the financial statements to other statements that are available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Classes of financial instruments and level of disclosure

BZ18 Paragraph Z6 requires an entity to group financial assets into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial assets. These classes are determined by the entity and are, thus, distinct from the measurement categories of financial assets (which determine how financial assets are measured and where changes in fair value are recognised).

BZ19 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this appendix to the supplementary document, how much emphasis it places on different aspects of the requirements, how it aggregates information to display the overall picture without combining information with different characteristics and whether users of financial statements need any additional information to evaluate the quantitative information disclosed. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. However, when an entity determines the level of aggregation or disaggregation, it shall consider the level of aggregation or disaggregation it uses for other disclosure requirements in IFRS 7. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

BZ20 As an example for a financial institution, financial assets might be grouped into classes based on the following characteristics:

- (a) government and central banks (further disaggregated into countries with AA ratings (or equivalent) and above, and countries with A ratings (or equivalent) and below);
- (b) financial institutions;
- (c) corporate;
- (d) retail (further disaggregated into secured by real estate collateral, qualifying revolving retail, retail loans to small and medium-sized entities and other);
- (e) securitised financial assets; and
- (f) below investment-grade.

BZ21 As an example for a non-financial institution, financial assets might be grouped into classes based on the following characteristics:

- (a) collateralised wholesale;
- (b) non-collateralised wholesale;
- (c) collateralised retail;
- (d) non-collateralised retail; and
- (e) credit card business.

Allowance account

BZ22 The disclosure requirements in paragraph Z7(a)–(c) shall be presented by asset class in tabular format:

Allowance for financial assets for which credit losses are recognised over a time period (paragraph 2(a)) [Column A]		Allowance for financial assets for which the entire amount of credit losses is recognised (paragraph 2(b)) [Column B]		Total allowance account [Column C]		Total profit or loss [Column D]	Nominal amount of the financial assets for which the entire amount of credit losses is recognised (paragraph 2(b)) [Column E]	
Opening balance	XX	Opening balance	XX	Opening balance	XX		Opening balance	XX
							Add: purchases	XX
Less: transfers to Column B	(XX)	Add: transfers from Column A	XX				Add: transfers from Column A	XX
Add: transfers from Column B	XX	Less: transfers to Column A	(XX)				Less: transfers to Column A	(XX)
Less: write-offs	(XX)	Less: write-offs	(XX)	Less: write-offs	(XX)		Less: write-offs	(XX)
Less: reversals	(XX)	Less: reversals	(XX)	Less: reversals	(XX)			
Less: disposals	(XX)	Less: disposals	(XX)	Less: disposals	(XX)		Less: disposals	(XX)
Additions / releases	XX	Add: additional credit losses	XX	Additions / releases and additional credit losses	YY	(YY)*		
Additional provision for minimum allowance amount (see paragraph 2(a)(ii) (if applicable))	XX			Additional provision for minimum allowance amount (see paragraph 2(a)(ii) (if applicable))	ZZ	(ZZ)*		
Closing balance	XX	Closing balance	XX	Closing balance	XX	(YZ)**	Closing balance	XX

* Amount represents sum of corresponding amounts in columns A and B.

** Amount represents total of amounts in column D.

- BZ23 An entity shall include all write-offs in the reconciliation of changes in the allowance account (ie on a gross basis as both an addition to and a use of the allowance account). This applies even if a financial asset becomes impaired and is written off in the same period. Hence, direct write-offs against the contractual amount of financial assets without using an allowance account are prohibited.
- BZ24 When a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance in accordance with paragraph 2, the amount that is transferred between the impairment allowances for the two groups shall be determined in accordance with paragraph 2(a)(i).
- BZ25 When a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance in accordance with paragraph 2 because it is no longer appropriate to recognise expected losses immediately, an entity shall disclose as part of the reconciliation in paragraph Z7(c) the nominal amount of those financial assets transferred if the contractual terms were modified in relation to that transfer. A modification of contractual terms is related to the transfer if it is the cause for transferring the asset. However, sometimes it is not obvious that the modification of contractual terms was the cause because the transfer might result from multiple factors (eg an improving economic outlook for the sector in which the debtor operates, a rise in the value of collateral, raising of equity by the debtor, restructuring of the debtor's debt by other creditors or a takeover of the debtor by another party). In such circumstances the modification shall be considered related to the transfer. Conversely, if for example the contractual terms of a financial asset were modified several years before the transfer while the financial asset had a high credit grade, that modification of contractual terms would not be related to the transfer of the financial asset. Hence, an entity does not need to track and evaluate all modifications of contractual terms that were ever made from the date of entering into the contract.

Illustrative examples for Appendix Z

These examples accompany, but are not part of, the supplementary document.

Example of mechanics

Transfer between ‘good book’ and ‘bad book’

- IEZ15 The supplementary document would require an entity to place its financial assets into two groups (the ‘good book’ and the ‘bad book’) depending on the entity’s assessment of the degree of uncertainty about the collectibility of the financial asset. At each reporting period, an entity must estimate expected credit losses for the remaining average expected life and the foreseeable future period, and determine the time-proportional allowance balance needed to be recognised based on the weighted average age and weighted average life of the portfolio for financial assets in the ‘good book’. For the ‘bad book’ the entire amount of expected credit losses is recognised. Paragraph BZ24 of Appendix Z to the supplementary document requires the impairment allowance to be transferred between the two groups to be determined in accordance with paragraph 2(a)(i) of the supplementary document (ie the time-proportional amount).
- IEZ16 Therefore, an entity would determine the time-proportional amount for the allowance on the financial asset, or group of assets, that are being transferred to the ‘bad book’. The weighted average age and weighted average life of the transferred financial assets should be used to determine the time-proportional amount. However, the age and life of the transferred financial assets may not be equal to the weighted average age and weighted average life of the portfolio.
- IEZ17 After the financial asset, or group of financial assets, is transferred between the ‘good’ and ‘bad’ book with the time-proportional allowance balance (based on the weighted average age and weighted average life of the transferred financial asset, or group of financial assets), the amount of expected credit losses is re-estimated for both the ‘good’ and ‘bad’ books. On the basis of those estimates, the allowance amount is adjusted (using the ‘higher of’ test set out in paragraph 2(a)).
- IEZ18 The following table illustrates the mechanics for transferring the time-proportional amount from the ‘good book’ to the ‘bad book’ and how the allowance balance for the ‘bad book’ is determined. The same concept would be used to transfer from the ‘bad book’ to the ‘good book’.

Impairment allowance — transfer to 'bad book'						
Portfolio	Nominal amount to transfer to 'bad book'	Expected loss over remaining life on transferred amount	Weighted average age of transferred amount	Weighted average life of transferred amount	Allowance transferred from 'good book'	Additional allowance needed for 'bad book'
	A	B	C	D	$E = B \times C / D$	$F = B - E$
T	300	50	4 years	5 years	40	10
S	200	40	2 years	5 years	16	24
R	250	50	2.5 years	5 years	25	25
Q	400	75	3.5 years	5 years	52.5	22.5
P	150	100	1.5 years	10 years	15	85
O	500	80	4 years	10 years	32	48

Basis for Conclusions on Appendix Z to the supplementary document *Financial Instruments: Impairment*

This Basis for Conclusions accompanies, but is not part of, Appendix Z.

Introduction

- BCZ87 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in developing the proposals in the appendix to the supplementary document *Financial Instruments: Impairment*. It includes the reasons for accepting particular views and for rejecting others. Individual IASB members gave greater weight to some factors than to others.
- BCZ88 As discussed in the separate supplementary document on impairment, the IASB and the US Financial Accounting Standards Board (FASB) are seeking a common solution to the accounting for the impairment of financial assets. That supplementary document is published by the boards following their separate initial impairment proposals with the intention of assisting them in their joint discussions on the accounting for impairment of financial instruments. That supplementary document primarily addresses the timing of the recognition of expected credit losses in the context of open portfolios. The appendix to that supplementary document proposes related presentation and disclosure requirements. At this time, these presentation and disclosure proposals have been deliberated only by the IASB. The FASB may separately deliberate presentation and disclosure requirements related to proposals in that supplementary document.
- BCZ89 The proposed presentation and disclosure requirements have been published by the IASB as part of the supplementary document in order to facilitate understanding of the proposals, as a whole. Constituents should also read the background information in the introduction to the supplementary document, as well as the basis for conclusions in the supplementary document, to further understand the overall project approach.

Scope

- BCZ90 The IASB-only invitation to comment asks whether the proposals should also apply to loan commitments that are not accounted for at fair value through profit or loss. Although many loan commitments are outside the scope of IAS 39 and IFRS 9 the IASB wants to hear views on whether only one standard should apply to the accounting for impairment of loans (both before and after a drawdown). This may be appropriate because entities often manage both drawn and undrawn loans using the same business model and accounting systems irrespective of whether the credit exposure is accounted for in accordance with IAS 39 or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- BCZ91 In the exposure draft *Insurance Contracts*, the IASB asked whether financial guarantee contracts should be brought within the scope of the proposed IFRS on insurance contracts (and hence excluded from the scope of IAS 39 and IFRS 9). The IASB has not yet redeliberated the responses received and it acknowledges the uncertainty about which requirements will apply to financial guarantee contracts. However, the IASB decided that the invitation to comment should ask whether the impairment model proposed in this document would be operational for financial guarantee contracts. Responses to this question would inform the IASB whether applying that impairment model might be an alternative to other proposals for how to account for financial guarantee contracts. The IASB also decided that it would use this document to seek views on whether to apply the proposed impairment model to commitments to provide a loan at a below-market interest rate and that IAS 37 applies (by reference from IAS 39) to both types of credit exposures. Hence, the IASB believed that its proposals might also be relevant for any decisions on financial guarantee contracts.

Presentation

- BCZ92 The proposed presentation requirements in the IASB's original exposure draft provided information about interest revenue before including the effect of expected credit losses, the effect of allocating the initial estimate of expected credit losses over the expected life of financial instruments and the net (credit loss adjusted) economic return. In addition, the effect of changes in estimates of expected credit losses (both improvements and deteriorations) was required to be presented as a separate line item. When using a simplified approach that does not differentiate between initial estimates of credit losses and changes in those estimates it is no longer possible to present separately the effect of allocating the initial

credit loss estimates and changes in those estimates. As a result the IASB decided to require two separate line items in the statement of comprehensive income: interest revenue and impairment losses (including reversals).

Disclosure

- BCZ93 Appendix Z proposes that disclosures should be required about amounts presented in the statement of comprehensive income, inputs and assumptions used for determining credit loss estimates, information about an entity's internal credit risk management, and how the two groups of financial assets that are differentiated for the purpose of determining the impairment allowance (eg what banks often refer to as the 'good book' and 'bad book') are managed.
- BCZ94 The IASB noted that the amounts in the statement of financial position and the statement of comprehensive income, in isolation, are not sufficient to allow users of financial statements to evaluate the effects of the credit risk of financial instruments on an entity's financial position and performance. The original exposure draft proposed disclosures about the credit quality of financial assets that are relevant irrespective of the impairment model (such as disclosure about non-performing assets). This document does not specifically address those disclosures as they will be redeliberated while this document is open for comment.

Allowance account

- BCZ95 Consistently with the IASB's original exposure draft, this document proposes mandating the use of an allowance account. This is in response to feedback from users of financial statements that direct write-offs against the contractual amount of financial assets without use of an allowance account would conceal useful information about the credit quality of the financial asset.
- BCZ96 The IASB decided to propose a reconciliation of changes in the allowance accounts separately for the two groups that are differentiated for the purpose of determining the impairment allowance in order to provide transparency about the development of that account. Furthermore, the IASB decided that requiring more detailed information about the composition of, and the inflows and outflows of, the group for which all expected credit losses are recognised immediately (ie the 'bad book') would be useful because credit risk is more intensely managed and monitored owing to the higher risk of credit losses.

- BCZ97 The IASB considered different alternatives for how the amount should be determined that would be transferred with a financial asset between the two groups that are differentiated for the purpose of determining the impairment allowance (ie what some institutions often refer to as the ‘good book’ and ‘bad book’). The IASB concluded that when an entity transfers a financial asset between the two groups, the allowance amount for credit losses that would be transferred with that asset should reflect the age of the asset (ie the time-proportional amount) rather than the full amount of the allowance amount or no amount at all. The IASB noted that all three approaches would result in the same effect on profit or loss and the amount in the allowance for the two groups. However, the IASB believed that presenting an amount related to the age of the financial asset would provide useful information in a reconciliation of the allowance accounts as well as improve comparability in the measurement of transfers between the two groups.
- BCZ98 The IASB also proposes to require disclosure in tabular format for the past five years for the group for which expected credit losses are allocated using the time-proportional expected credit losses (ie the ‘good book’). That disclosure would comprise the estimate of lifetime expected credit losses (as updated for each reporting date), the balance of the outstanding nominal amounts, the time-proportional allowance amount and any additional impairment loss recognised to reach the minimum allowance amount (if applicable).
- BCZ99 The IASB believes that this historical time series disclosure would provide information about the development and relationship between lifetime expected credit losses, the growth or decline of the portfolio and the allowance balance. In the IASB’s view, disclosing the time-proportional allowance amount alongside lifetime expected credit losses would give users of financial statements an indication of the approximate maturity of the portfolio.

Expected credit loss estimates

- BCZ100 The IASB noted that determining expected credit loss estimates requires significant judgement. Hence, similarly to the proposed disclosures in the IASB’s original exposure draft, the IASB decided in order to enhance transparency to propose disclosures about inputs and assumptions including changes in estimates and estimation techniques.

BCZ101 The IASB also noted that in another area of financial reporting—insurance contracts—disclosure that compares the development of provisions with actual outcomes is used to provide information about difficult estimates. In order to enhance disclosures about estimates, this document proposes a disclosure that compares the expected credit loss estimates with actual outcomes of credit losses. Some entities already perform this sort of testing, called ‘back testing’. The IASB proposes requiring quantitative analysis and disclosure only if an entity already performs this type of testing. The IASB concluded that it might be unduly onerous to require all entities to perform such a type of testing for all types of financial assets.

Credit risk management and differentiation of credit loss recognition

BCZ102 This supplementary document proposes using entities’ internal credit risk management to determine whether expected credit losses should be allocated over time or be recognised immediately. Therefore, in order to assist users of financial statements, the IASB proposes various disclosures about entities’ internal credit risk management.