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HKFRSs/IFRSs UPDATE 2011/04

UPDATE ON IAS 39 REPLACEMENT PROJECT PHASE 2 - FINANCIAL INSTRUMENTS: IMPAIRMENT

The objective of IAS 39 Replacement Project Phase 2 is to improve the decision-usefulness of financial statements for users by improving the amortised cost measurement, in particular the transparency of provisions for losses on loans and for the credit quality of financial assets.

STATUS
Supplement to Exposure Draft and subsequent IASB redeliberations

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Significant changes proposed

Background

Following the receipt of comments on its exposure draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* and its subsequent redeliberations, the International Accounting Standards Board (IASB) issued for comment a Supplement to Exposure Draft to ED/2009/12 (SED). The SED includes joint proposals from the IASB and the US Financial Accounting Standards Board (FASB) on accounting for the impairment of financial assets in open portfolios (ie a portfolio of financial assets that is continually changing as new balances are originated and existing ones are settled or are written off).

The SED was issued by the IASB as part of its three phase project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Phase I: *Classification and measurement* was completed with the issue of IFRS 9: *Financial Instruments*. The scope of IFRS 9 is currently limited to the classification and measurement of financial assets and liabilities. The Exposure Draft *Amortised Cost and Impairment* was issued in November 2009 as part of Phase II: *Amortised cost and impairment of financial assets*. The proposals set out in the SED also relate to Phase II. An Exposure Draft *Hedge Accounting* was issued in December 2010 as part of Phase III of the project.

The IASB and FASB had been working separately to develop models for the impairment of financial assets. The models developed by the boards differed significantly as they were working towards developing models based on their own distinctly different primary objectives.

The IASB's primary objective was to reflect initial expected credit losses as part of determining the effective interest rate (ie to recognise credit losses over the life of the asset) as the IASB believe this reflects the economic substance of a lending transaction. This is based on the view that a lender includes a margin in the interest rate charged to cover expected credit losses arising on a portfolio basis on loans advanced. Under this model a day one loss would never be recognised. Respondents to the IASBs initial proposals agreed in principle that the impairment model should be forward looking and based on expected credit losses. However many respondents thought the proposals would be difficult to apply because accounting systems calculated effective interest rates whereas credit loss information is derived from other systems; systems integration would prove difficult.

The primary objective of the FASB was to ensure that the allowance balance was sufficient to cover all estimated credit losses for the remaining life of an instrument. As a result, the approach taken by the FASB in their initial model was to recognise expected losses immediately (ie a day one loss). Many respondents to the FASB's initial proposals opposed recognising immediately, or in the first reporting period, the losses expected to occur over the life of the financial asset.

The SED sets out joint IASB and FASB proposals for a common solution, for accounting for the impairment of financial assets, that will at least partly satisfy the primary objectives of both boards. The SED amends the proposed model in ED 2009/12 such that it is based on the IASBs 'expected loss impairment approach' set out in ED 2009/12, but also introduces a minimum allowance for credit losses expected to arise in the foreseeable future (which is a period not less than 12 months from the reporting date).

The SED includes an IASB only Appendix Z covering proposals on the presentation and disclosure of impaired financial assets in open portfolios. The FASB may separately deliberate the proposals on presentation and disclosure in the SED.

The IASB plans to develop an IFRS from the proposals in both the SED and ED 2009/12, and expects to publish the IFRS in the second half of 2011. The IASB has not redeliberated when the proposals will become mandatory or whether early application would be permitted. However, it has been acknowledged that a substantial lead time may be necessary based on comments received on its original exposure draft *Amortised Cost and Impairment*.

Proposals

Scope

The proposals in the SED are limited to financial assets measured at amortised cost (under IFRS 9) that are managed on an open portfolio basis, with the exception of short-term trade receivables.

Definitions

Open portfolios

In an open portfolio, financial assets in the portfolio are continually changing through origination or purchase, sales or transfers to external parties, and repayments and write-offs.

Closed portfolios

Financial assets in a closed portfolio are not added to during the life of the portfolio, and are removed through sales or transfers to external parties, repayments and write-offs.

Calculating impairment of open portfolios of financial assets

The SED proposes that financial assets measured on an open portfolio basis should be separated into one of two groups, commonly referred to as the 'good book' and 'bad book' based on the degree of uncertainty about the collectability of the financial asset.

Financial assets in an open portfolio where management does not consider collectability to be uncertain would be placed into the 'good book'. An impairment allowance would be recognised for assets in the 'good book' on a time proportionate basis, based on the losses that are expected to occur over the life of the portfolio, unless that amount was lower than the credit losses expected to occur within the foreseeable future. This approach is intended to ensure that an entity has sufficient provisions for expected credit losses based on current market conditions and, when a downturn in the market occurs, additional provisions would be recognised quickly. Financial assets would be transferred from the 'good book' to the 'bad book' when the recovery of contractual cash flows becomes uncertain to the extent that management's objective changes from receiving those cash flows to the recovery of all, or a portion of, the financial asset.

An impairment allowance would be recognised immediately for assets included in the 'bad book'. This allowance would be calculated as the entire amount of expected credit losses.

The impairment allowance for each portfolio or group of portfolios would be required to be updated at each reporting date (or interim reporting date).

Calculation of time-proportional expected credit losses

The SED provides two methods for calculating the time-proportional expected credit losses, as follows:

Straight line approach	=	Entire amount of expected credit losses for remaining life of portfolio	X	Portfolio age / Portfolio expected life

Under the straight line approach, an entity would have an accounting policy choice of whether to use discounted or undiscounted expected losses. Where an entity discounted its expected credit losses, it would be permitted to use any discount rate between (and including) the risk-free rate and the effective interest rate.

Annuity approach	=	Convert the remaining lifetime of expected credit losses of the portfolio into annuities based on the expected life of the portfolio, and accumulate the annuities based on the portfolios age

Credit losses expected in the foreseeable future

The SED proposes that management's estimate of credit losses expected to occur in the foreseeable future would be based on historical data, including loss occurrence patterns, and current and forecast events and trends. It is expected that the foreseeable future for many portfolios will be greater than twelve months, although this may differ across portfolios depending on the characteristics of the classes of asset.

Presentation and disclosure

IASB only Appendix Z includes proposals for the presentation and disclosure of financial assets.

The proposals in the SED would require an entity to present the following line items in its statement of comprehensive income:

- interest revenue (calculated using the effective interest rate);
- impairment losses (including reversals of impairment losses).

The proposals in the SED would require an entity to provide a number of disclosures, including:

- An allowance account to account for credit losses on financial assets measured at amortised cost which discloses, for each of the two groups of financial asset (the 'good book' and 'bad book' financial assets), a reconciliation of changes during the period;
- A reconciliation of the nominal amounts of the financial assets included in the 'bad book', including disclosure of the nominal amount of financial assets for which the impairment allowance is no longer based on them being included in the 'bad book' where that change is a consequence of a modification of the contractual term(s);
- For financial assets where the impairment allowance is determined on the basis of them being included in the 'good book', tabular disclosure of the following is required:
    - the total nominal amount of the financial assets;
    - the total amount of expected credit losses;
    - the amount of the impairment allowance; and
    - if applicable, if the expected credit losses over the foreseeable future are higher than the time-proportional expected credit losses, the difference between the amounts.
- Information that explains the estimates that are used to determine the impairment allowance, and changes that have been made to those estimates;

- Information about the entity's 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.

The Appendix to the SED also contains additional guidance on the information to be included in the disclosures.

Effective date and transition

The IASB has not redeliberated when the IFRS will become mandatory or whether early application will be available, although it has been noted that the standard may need a significant amount of lead time to implement. The IASB will also consider the responses received on the *Request for Views on Effective Dates and Transition Methods* when deciding on the effective date and transition.

Recent joint board redeliberations on the impairment project

February 2011

- The boards tentatively decided that the definition of 'write-off' will be 'a direct reduction of the amortised cost of a financial asset resulting from uncollectibility'.
- The boards discussed disclosures proposed in the original ED in relation to:
  - Write-off policy – the boards tentatively decided that an entity should disclose its write-off policy, including whether written-off assets are still subject to enforcement activity and disclosing the nominal amount of previously written-off assets where the entity is still pursuing collection.
  - Stress testing – the boards tentatively decided that no disclosures will be required in the final standard in relation to stress testing information where it is prepared by an entity.
  - Credit quality of financial assets - the boards tentatively decided to require disclosure of a reconciliation of changes in financial assets measured at amortised cost that are included in the 'good book' that are greater than 90 days past due. The boards also tentatively decided to remove the definition of 'non-performing' included in the original ED.
  - Vintage information – the boards tentatively decided to remove the requirement to disclose vintage information (year of origination and year of maturity) included in the original ED.

March 2011

- The boards discussed methods for estimating expected credit losses. The boards tentatively decided that the expected credit losses should be estimated using expected value as an objective. The final standard will clarify that an expected value identifies possible outcomes (ie estimate likelihood of possible outcomes, or representative sample of possible outcomes, and calculate a probability weighted outcome).
- The boards discussed the accounting for purchased debt instruments subject to impairment accounting. The boards tentatively decided that an entity should account for impairment on purchased financial assets that are included in the 'good book' on acquisition (including loans acquired as part of a portfolio rather than individual asset level) in the same way as for originated loans. The boards will look at the appropriate impairment accounting model for these assets as part of redeliberations on the SED.
- The boards also discussed the accounting for impairment on purchased financial assets that are included in the 'bad book' on acquisition. The boards tentatively decided that interest income on these assets should be based on the expected collectible cash flows at the acquisition date. As a result, a separate impairment expense would not be recognised at the date of acquisition for such assets.

April 2011

- The boards discussed feedback from the comment letters received on the jointly issued SED as well as results of the recent outreach activities.
- The boards discussed interest income recognition and the definition of amortised cost. Current US GAAP and IFRS define amortised cost differently, with the key difference being that IFRS subtracts an allowance for credit losses in the calculation of amortised cost, while US GAAP does not. The boards tentatively decided that interest income would be determined using an effective interest rate that would be applied to an amortised cost balance that does not include an allowance for credit impairment (ie to decouple the presentation of impairment losses from interest revenue).
- The boards discussed discounted verses undiscounted expected losses. The SED proposed that an entity would be permitted to use either discounted or undiscounted expected losses when calculating an impairment allowance under the time-proportional approach. The boards tentatively decided that the measurement of expected losses should include the effect of discounting. Finalised guidance will clarify methods that can be used to measure this amount and that the unit of account does not have to be an individual loan.
- The boards discussed whether to unwind any discount on expected losses through interest revenue or through impairment losses. The boards tentatively decided that the unwinding of the discount should be included in the impairment loss line item.

May 2011

At this meeting, the boards discussed the approach that should be taken going forward, given the inconsistent feedback received from comment letters and outreach activities. The staff proposed four alternatives:

1. Finalise the impairment model based on the approach developed by the IASB (a time proportionate approach for the ‘good book’ and full lifetime expected losses for the ‘bad book’);
2. Finalise the impairment model based on the approach developed by the FASB (recognise losses expected to occur in the ‘foreseeable future’);
3. Finalise the impairment model based on the proposals in the SED; or
4. Task the recently formed impairment subgroup to develop a variation of the previous proposals, taking into account the feedback already received.

Almost all members of both boards agreed that a decision was needed, and that it needed to be a joint decision. It was noted that constituents had consistently said that there needed to be a converged solution for impairment.

During the discussion, one of the FASB members suggested that a modified incurred loss model might be an appropriate approach. However, other members of both boards disagreed and felt that it was essential to move to an expected loss model.

It was agreed that the impairment subgroup should be asked to develop an impairment model, based on the feedback received.

BDO’s support and assistance on HKFRSs/IFRSs

For any support and assistance on HKFRSs/IFRSs, please talk to your usual BDO contact or Stephen Chan, Partner and Head of Technical & Training at +852 2853 5820 or email StephenChan@bdo.com.hk

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