FINANCIAL ACCOUNTING SERIES

SUPPLEMENTARY DOCUMENT

Issued: January 31, 2011
Comments Due: April 1, 2011

Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Impairment

This Supplementary Document is issued by the Financial Accounting Standards Board for public comment as a step preceding the development of an Exposure Draft of a proposed Accounting Standards Update.

Written comments should be addressed to:

Technical Director
File Reference No. 2011-150

Financial Accounting Standards Board
of the Financial Accounting Foundation

Supplementary Document

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Financial Instruments: Impairment

Financial Accounting Standards Board
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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 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 amortized 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 proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, which included 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 the 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 of the 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 because 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 amortized cost after their initial recognition. Therefore, the IASB did not believe it was appropriate to recognize 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 recognized 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 recognized 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 recognize 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 recognizing 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 recognize 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 recognized 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 recognize 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 board's 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 now believe 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 in principle most supported 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 amortized 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 amortized cost measurement and how the impairment model relates to that measurement.

(f) interest revenue recognition.

IN21 In 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 finalized 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 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 that 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.

IN24 The proposals in this supplementary document would be part of the IASB's and the 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 amortized 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*® (including the guidance on those IFRSs and US GAAP).

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 and the amortized 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 on Effective Dates and Transition Methods.*

IN27 The FASB expects that a final Update that includes 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; and

(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 **April 1, 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 recognize 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 proposed 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 recognized 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 recognized 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 recognize the impairment allowance using the proposed 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 recognized (ie the 'bad book') is described in paragraph 3 as follows:

> It is no longer appropriate to recognize 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 proposed 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 proposed 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 proposed 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?

(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 recognized 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 proposed 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 the 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 recognize over life – ie 'good book')	Recognition of credit losses (when *not* appropriate to recognize 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	Recognize 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 amortized 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 recognized using a time-proportional approach. For all other financial assets, credit losses expected to occur for the remaining life would be immediately recognized. In other words, the model being developed by the IASB was the same as the model described in this document without consideration of a 'floor' amount.

Question 12

Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (ie to recognize 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 would have required an entity to recognize immediately all credit losses expected to occur in the foreseeable future (not explicitly set at a minimum of twelve months). As described in paragraph B11, 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 recognize 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's 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 approach, do you prefer the general concept of the FASB's approach (ie to recognize 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®*.

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

Joint supplementary document *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment*

Scope

1 For the IASB, the proposals in this supplementary document would be applied to *financial assets* that are measured at *amortized 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 recognized in net income.

Impairment of open portfolios (pools) of financial assets

2 At each reporting date, an entity shall recognize an impairment allowance that is the total of:

(a) **for assets for which it is appropriate to recognize 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 recognize 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 recognize 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: Disclosure* and are used in this supplementary document with the meanings specified in IAS 32, IAS 39 or IFRS 7.

(a) amortized 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*® and are used in this supplementary document with the meanings specified in the Master Glossary of the *FASB Accounting Standards Codification*®.

(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 recognized, 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 recognized 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 on 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 supplementary 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 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 recognized 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.

Basis for Conclusions

Introduction

BC1 This Basis for Conclusions summarizes 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 *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—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 the FASB about an impairment model for credit losses in order to reach a common solution that addresses part of each of the board's 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 finalizing the classification and measurement requirements in IFRS 9. IFRS 9 requires all financial instruments to be measured either at fair value or amortized cost. Only financial assets measured at amortized 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 amortized 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 proposed guidance for purchased credit-impaired loans.

BC9 Both the IASB and the FASB agree with those that 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 this 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 amortized 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 recognized 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 seek 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, this 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 recognized net of initial expected credit losses. For the IASB, the proposals in this 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 amortized cost. The IASB thought that the starting point for amortized 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 recognize 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 amortized 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 (favorable) 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 amortized 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 recognized 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 recognize 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 recognize a credit impairment. The FASB believed that removing the probable threshold would result in an entity recognizing 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 recognize 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 recognized. 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 recognizing 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 amortized 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 opposed recognizing 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 recognizing total expected credit losses immediately while others supported recognizing 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 recognized 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 recognized would be excessive under an approach that would recognize 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 recognized 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 recognize 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 recognize 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 recognizing impairment based on lifetime expected credit losses. Many of these users supported recognizing initial estimates of lifetime expected credit losses over the life of a financial asset (as opposed to recognizing 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 amortized 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 recognizing 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 this 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, this 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 recognized 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 recognized 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 percent of their nominal amount, rather the allowance represents 100 percent 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, this 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 recognizing 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 amortized 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 this 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 amortized 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 amortized 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 recognized .

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. This supplementary document proposes that it is no longer appropriate to recognize 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 recognized for all financial assets (within the scope of this 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 recognized 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 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 favor 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 of 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 recognized,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 recognize credit losses over time for the 'good book'.

BC59 The FASB continued to advocate an impairment model that would recognize 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 recognizing 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. Therefore. the FASB 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 recognizing 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 recognized 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 this 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 this supplementary document, the IASB and the 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 this 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 summarizes 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 this supplementary document. This section summarizes 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 recognize 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 for which it is not considered appropriate to recognize expected credit losses using that approach, the full amount of lifetime expected credit losses would be immediately recognized. While the common approach proposed in this 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, recognizing 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 providees 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 recognized 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 recognized at the reporting date. Some argue that, because some amount of loss would be recognized in the first reporting period under the IASB's 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 the 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 because the model being developed by the FASB would require all credit losses expected to occur in the foreseeable future to be recognized in the period of estimate and the IASB's 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 recognized in the first period of estimate. The amount recognized 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 recognized 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 recognize

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 recognized (i.e. in the 'bad book'). The IASB members who prefer this approach acknowledge that for financial assets for which expected credit losses are recognized 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 recognize 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 recognized 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 (e.g. 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 recognized 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 recognize 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 recognizing 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 recognizing 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 recognizing 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 recognize 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 recognized 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 recognized at the reporting date.

BC85 Those FASB members also believe that this approach can be applied by banks and other organizations 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 rigor with which the estimates are developed.

Illustrative examples

Examples of mechanics

Calculation of time-proportional and floor amounts

IE1 For assets for which it is appropriate to recognize 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 recognize 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 × (B/C) = B × 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 recognizing 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 recognize expected credit losses for a portfolio of loans over a time period. More specifically, the objective is to recognize those expected credit losses over the time periods in which interest revenue is recognized (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 this 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 recognized 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