March 1, 2011

Questions & Answers

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 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?

Answer

Para IN5 gives IASB views as follows: -

In other words, the requirement for an observable loss event to have occurred before considering the effect of credit losses would be removed.

As per para 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.

As per para 2 of the supplementary document, for assets for which it is appropriate to recognize expected credit losses over a time period, the higher of:

A combined reading of all the above suggest that loss is assessed after an event has happened. This is not the objective of IASB, hence, the proposed approach does not deal with the weakness of delayed recognition of expected credit losses.

Hence, irrespective of the assets, a percentage should be recognized even for standard assets, for which normally, no provision will be required. This is the practice in India and as a third point in para 2, this should be provided.

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.

Answer

The definition of portfolio appearing in appendix A includes both open and closed portfolio. In a normal situation, when a portfolio is closed, that means, there is no further business in the portfolio and only collection to be done on the remaining portfolio. This means the "growing concerns" concept is affected for a closed portfolio. Business attention is also not the same compared to a open portfolio. In other words, the valuation of a closed portfolio will always be less than the open portfolio leading to higher requirement of provisioning.

It is highly difficult to have a single impairment approach for all relevant financial assets. Impairment model should take into account all available information as per para B12.

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

This document proposes that financial assets managed on an open portfolio basis should be placed into two groups, based on their credit characteristics, for the purpose of determining the impairment allowance. For one group the entire amount of expected credit losses would be recognised in the impairment allowance (this group is often referred to as the 'bad book'). For the other group (often referred to as the 'good book'), expected credit losses would be 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 recognise the impairment allowance using the approach described above? Why or why not?

Answer

For the classification of "good book", it is enough, if expected credit losses over the time period in proportion to the expected credit losses. A financial asset cannot remain as a good book, if the credit losses are expected to occur within a foreseeable future. If this can be predicted, then it becomes a bad book and no more it can remain as a good book. Further, an asset to be classified as a good book, should be flawless and hence, the present classification of good book and bad book is not at all correct.

Question 4

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

Answer

If it is a good book, then provision should be based on percentage of outstanding. Once a loss is estimated, entire amount of expected credit losses to be provided for either in full or based on a percentage as per the practice followed by Reserve Bank of India (RBI).

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Question 5

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

Answer

The proposed approach does not provide information useful for making decision. The best way should be to classify the advances into standard assets and non-confirming asset. For standard asset, there should be a general provision, as 1 day, it may become bad. On the other hand, for the non-confirming asset are bad book, provision should be made based on percentage or in full depending upon the stage on the bad book.

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 recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.

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

Question 6

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

Answer

The requirement to differentiate between the two groups "good book" and "bad book" is not clearly described. Once an asset for which it is appropriate to recognize expected credit losses over a time period happens, it is a bad book. Hence, guidelines given is not correct and clear.

Question 7

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

Answer

The guidelines that is given is available in para B12 and most of the points mentioned in that para are based on estimates. Many a time, this amount may or may not be auditable.

On the other hand, Reserve Bank of India (RBI) has classified an asset as non-performing asset, if income generation is stop. If the income is regularly generated, it is called a standard asset. This kind of income generation should be the basis for good book and bad book.

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?

Answer

The requirement to differentiate between two groups is well appreciated. But however, the definition of the group is not proper. A good book can be a good book only if there is no impairment. Even for such asset, a general provision should be made. Then only, it satisfied the expected loss method. For the bad book, there should be different yardsticks and gradation to determine the requirement of provision.

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

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

Question 9

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

Ouestion

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

Answer

The proposal to require a floor for impairment allowance related to good book is a welcome feature. But the definition of a good book has not come out well in the proposed handout. A good book is a good book only when there is not even a doubt of collectability.

Question

(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?

Answer

No. Good book also should suffer impairment allowance as one day, these good book only become bad book.

Question

(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?

Answer

The minimum allowance should be separately calculated for good book and bad book. For good book, this should be general provision and for a bad book, this should be a graded provision or over the period of expected credit losses or based on credit losses expected to occur within the foreseeable future.

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Question

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

Answer

It is advisable to have foreseeable future based on time period, say 12 months, rather than making changes based on economic conditions as these are subject to many variables.

Question

(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.

Answer

The foreseeable future period should normally be a period of 12 months. 12 months indicates a year for which normally, a financial statement is prepared. Further, on each balance sheet date, the estimates are revisited. Further, the "growing concerns" concept is based on 12 months period. Hence, it is advisable to keep the foreseeable future to a period of 12 months.

Question

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Answer

Foreseeable period should normally be 12 months otherwise a ceiling should be established.

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.

Answer

This will depend on facts and circumstances of each 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:

Question

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

Answer

Normally, it is not advisable to permit flexibility in an accounting policy. This will make comparison unreliable. It is better to provide based on the undiscounted basis, as this is only a provision, which is liable for change on each balance sheet date that means undiscounting is a better option.

Question

(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?

Answer

Instead of stating a range, a midpoint can be suggested.

Approaches developed by the IASB and FASB separately

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

Model	Recognition of credit losses (when appropriate to	Recognition of credit losses (when NOT appropriate to
	recognise over life	recognise over life
	- ie 'good book')	- ie 'bad book')
IASB	Time-proportional amount of	Full amount of remaining
Approach	remaining lifetime expected credit loss	lifetime expected credit losses
FASB	Recognise expected credit losses for the foreseeable future	
Approach	(no minimum period specified)	

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

Question 12

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

Answer

IASB approach is more correct except the fact that the definition of good book and bad book is not clear.

Question 13 - Preamble

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

Question 13

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

Answer

The concept of FASB that there should be a floor provision is correct to that extent that even on good book provision need to be made in order to satisfy the expected loss method.

Impairment of financial assets

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

Question 14Z

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

Answer

It is preferable that determination of effective interest rates should be separate from the consideration of expected losses. As per the present proposal, the expected credit losses is likely to be provided even on good books.

Scope - Loan commitments and financial guarantee contracts

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

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

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

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

Question 15Z

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

Answer

Loan commitments are in the nature of executory contract. So long it is an executory contract, impairment will not apply to such contracts. Only if it is become a onerous contract, then impairment to be tested and provision should be made as per IAS 37.

Below market rate interest contracts should not impaired, as this is a part of an executory contract and knowing well contract has been entered into for various business decision purposes like, complying with the government order or corporate social responsibilities etc.

Question 16Z

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

Answer

It need not be apply to loan commitments. However, financial guarantee contracts, IAS 37 will apply and provision will be made accordingly.

Presentation (paragraph Z5)

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

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

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

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

Question 17Z

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

Answer

The proposed presentation requirement is in order.

Disclosure (paragraphs Z6-Z15)

This document proposes to require:

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

- (ii) information that describes the criteria used to determine in which of the two groups (the 'good book' or the 'bad book') a financial asset is included; and
- (iii) information about internal credit rating grades, if used by an entity.

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

Question 18Z

Question

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

Answer

The requirement as per Z8 requiring for current and previous four annual periods is totally unwarranted. Normally it should be given only for one year. Further disclosures of expected credit loss estimate is meant for management and not for common shareholders. Hence, the economic benefit arising out of disclosure will be very less compare to the cost involved. Similarly, the disclosure on credit risk management is normally a business secret and should not be disclosed in such a great detail. Similarly, the requirements of Z15 is also very much internal and should not be disclosed.

Question

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Answer

The disclosures can only be general policy and not a very detailed one.

Question 19Z - Preamble

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

Question 19Z

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

Answer

When assets are transferred normally, allowance is also transferred. However, no amount should be credited to P&L a/c from the allowance account.

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