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IFRS bulletin from PwC

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IASB publishes exposure draft on impairment of financial instruments

What is the issue?

Following several years of discussions and two previously published proposals, the IASB has issued an exposure draft (ED), 'Financial Instruments: Expected Credit Losses'. It proposes an expected loss impairment model that will replace the current incurred loss model of IAS 39. The ED addresses the criticisms of 'too little, too late' that arose during the recent financial crisis. So it is expected that impairment losses will not only be larger but will also be recognised earlier.

Key provisions

General model
Under the proposed model, an entity should recognise an impairment loss equal to 12-month expected credit loss; or, if the credit risk on the financial instrument has increased significantly since initial recognition, it should recognise a lifetime expected credit loss.

12-month expected credit losses are all cash flows not expected to be received over the life of the financial instrument ('cash shortfalls') that result from those default events that are possible within 12 months after the reporting date.

Lifetime expected credit losses are cash shortfalls that result from all possible default events over the life of the financial instrument.

Calculation of the impairment
Expected credit losses are determined using an unbiased and probability-weighted approach, and they take into account the time value of money. The calculation is not a best-case or worst-case estimate; rather, it should incorporate at least the probability that a credit loss occurs and the probability that no credit loss occurs.

Assessment of credit deterioration
When determining whether lifetime expected losses should be recognised, an entity should consider the best information available, including actual and expected changes in external market indicators, internal factors and borrower-specific information.

Where more forward-looking information is not available, delinquency data can be used as a basis for the assessment. But, in this case, there is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are 30 days past due.

An entity does not recognise lifetime expected credit losses for financial instruments that are equivalent to 'investment grade'.

Interest income
Interest income is calculated using the effective interest method on the gross carrying amount of the asset. But, once

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there is objective evidence of impairment (that is, the asset is impaired under the current rules of IAS 39), interest is calculated on the net carrying amount after impairment.

Purchased or originated credit impaired assets

Impairment is determined based on full lifetime expected credit losses for assets where there is objective evidence of impairment on initial recognition. Lifetime expected credit losses are included in the estimated cash flows when calculating the asset's effective interest rate ('credit-adjusted effective interest rate'), rather than being recognised in profit or loss. Any later changes in lifetime expected credit losses will be recognised immediately in profit or loss.

Trade and lease receivables

The ED includes a simplified approach for trade and lease receivables. An entity should measure impairment losses at an amount equal to lifetime expected losses for short-term trade receivables resulting from transactions within the scope of IAS 18, 'Revenue'. For long-term trade receivables and for lease receivables under IAS 17, 'Leases', an entity has an accounting policy choice between the general model and the model applicable for short-term trade receivables.

The use of a provision matrix is allowed, if appropriately adjusted to reflect current events and forecast future conditions.

Scope

The ED should be applied to: financial assets measured at amortised cost under IFRS 9; financial assets measured at fair value through other comprehensive income under draft 'Classification and Measurement: Limited amendments to IFRS 9'; loan commitments when there is a present legal obligation to extend credit, except for loan commitments accounted for at fair value through profit or loss (FVPL) under IFRS 9; financial guarantee contracts within the scope of IFRS 9 that are not accounted for at FVPL; and lease receivables within the scope of IAS 17.

Disclosures

Extensive disclosures are proposed, including reconciliations of opening to closing amounts and disclosure of assumptions and inputs.

Effective date and transition

The proposal does not specify its effective date, but it refers to IFRS 9 that currently sets it as 1 January 2015. The IASB is seeking comments on the appropriate mandatory effective date for all phases of IFRS 9.

The proposal is to be applied retrospectively; but restatement of comparatives is not required.

Is convergence achieved?

Convergence is not yet achieved, because the IASB and the FASB are proposing different impairment models. The FASB issued an exposure draft on 'Financial Instruments – Credit Losses' in December 2012. The major difference between the IASB's proposed model and the FASB's 'Current Expected Credit Loss' model is that, under the FASB's proposal, a full lifetime expected loss is recorded on initial recognition, whereas the IASB requires a significant increase in credit risk before recognising full lifetime expected losses.

Am I affected?

The ED will affect all entities; but financial institutions will be most significantly impacted.

What do I need to do?

The comment deadline is 5 July 2013. The IASB expects to finalise the impairment requirements by the end of 2013.

Management should assess the impact of the proposals and consider commenting on the exposure draft to ensure its views are considered.