

To the Point

FASB – proposed guidance

Impairment – a major step toward convergence

The Boards are committed to developing a single impairment model for financial assets in their continuing attempt to achieve convergence between US GAAP and IFRS on this issue.

What you need to know

- ▶ The FASB and the IASB have made significant progress on their “three-bucket” credit impairment approach.
- ▶ The approach would apply to various types of financial assets (e.g., loans, debt securities, receivables) and would affect financial and nonfinancial institutions.
- ▶ The Boards plan to issue a new exposure draft on impairment in the first half of 2012. An effective date for US GAAP has not yet been proposed.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have made significant progress on their “three-bucket” expected loss approach to the impairment of financial assets. At their joint meeting in December, they made several tentative decisions, including:

- ▶ How impairment for financial assets in Bucket 1 should be measured
- ▶ When the transfer of items out of Bucket 1 is appropriate
- ▶ How to distinguish between items categorized in Bucket 2 versus Bucket 3
- ▶ When grouping financial assets for impairment evaluation is and is not appropriate

In addition, the Boards discussed general and specific indicators that entities would need to consider when assessing whether to recognize lifetime expected losses. These indicators can be found in the Appendix to this publication.

The 'three-bucket' approach

The guiding principle of this approach is the general pattern of the deterioration in the credit quality of financial assets. Under this approach, all financial assets would initially be classified in Bucket 1, regardless of credit quality.

Impairment allowance for Bucket 1

The Boards had previously agreed that the allowance for Bucket 1 would be less than remaining lifetime expected credit losses, while the allowance for Bucket 2 and Bucket 3 would represent the full remaining lifetime expected credit losses.

At their December meeting, the Boards clarified that the allowance for financial assets in Bucket 1 would focus on losses expected over the next 12 months (e.g., the probability of default in the next 12 months multiplied by the loss given default). These expected losses refer to shortfalls in all cash flows related to loss events expected over the next 12 months, not simply the cash shortfalls expected in the next 12 months.

How we see it

The bright-line outlook period of 12 months would simplify the approach and provide more consistency in application and better comparability among entities.

Recognition of lifetime expected losses

The Boards tentatively decided that financial assets would be transferred out of Bucket 1 based on two criteria: (1) when there has been a more than insignificant deterioration in credit quality since initial recognition **and** (2) when the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable.

The assessment of when to recognize lifetime expected losses would generally be based on the probability of default, rather than whether a loss would actually be realized or the magnitude of the loss. Hence, the assessment would not take into account the value of collateral, although it is reflected in the estimate of lifetime expected loss.

In addition, the Boards have asked the staff to develop examples to clarify the meaning of "reasonably possible" by considering both of the following:

- ▶ The differences in practice between US GAAP and IFRS when interpreting the term "reasonably possible"
- ▶ The likelihood that cash shortfalls begin to increase at an accelerated rate as an asset deteriorates (e.g., this may be the dividing line between investment-grade and non-investment-grade financial assets, which is equivalent to greater than 10% probability of default)

Under this approach, higher-quality assets would not transfer as quickly as lower-quality assets to the other buckets.

Financial assets would move into buckets 2 or 3 when two criteria are met: (1) there has been a more than insignificant deterioration in credit quality and (2) it is at least reasonably possible that cash flows are not recoverable.

How we see it

Because no bright line has been prescribed, management would need to exercise judgment, and there could be diversity in application.

Because loss given default would not be considered in determining when to transfer assets between buckets, collateralized financial assets could move to buckets 2 or 3 when credit deteriorates, even though the collateral may be sufficient to avoid a loss (i.e., no impairment may need to be recorded).

Differentiating factor between Bucket 2 and Bucket 3

The Boards tentatively decided to retain Bucket 3 because it would provide valuable information and that the “unit of evaluation” would be the differentiating factor between Bucket 2 and Bucket 3.

If the determination that the financial assets should transfer out of Bucket 1 was made on a collective basis, the assets would move to Bucket 2. If the determination was made on an individual basis, the assets would be transferred directly to Bucket 3. An entity would transfer assets from Bucket 2 to Bucket 3 if it starts to assess these assets individually.

Grouping of financial assets for impairment evaluation

The Boards agreed with the staff’s proposals that “shared risk characteristics” should be used as a basis for when and how entities aggregate individual financial assets into groups in assessing whether transfer out of Bucket 1 is appropriate as follows:

- ▶ If there are shared risk characteristics for a subgroup that would indicate whether recognition of lifetime expected losses is appropriate, entities may not group these assets at a more aggregated level.
- ▶ If a financial asset cannot be grouped with other assets that have shared risk characteristics or if a financial asset is individually significant, entities would be required to perform an individual assessment.
- ▶ If a financial asset shares risk characteristics with other assets, entities would be permitted to choose either an individual or collective assessment.

The use of an ‘expected value’ in estimating losses

The Boards agreed that clarification and guidance is needed regarding appropriate methods for estimating expected values. As such, they asked the staff to further analyze the following:

- ▶ Practicality and the need to identify practical expedients (e.g., the use of fair value of collateral for collateral-dependent instruments)
- ▶ Inappropriate avoidance of undesirable outcomes because the expected loss is not necessarily the same as the most likely outcome (e.g., when there is a low probability of default with high-loss outcomes, the most likely outcome when looking at an individual instrument or a small number of instruments could be no loss, even though an allowance would be required based on probability-weighted cash flows)

Financial assets would be evaluated on a collective basis in Bucket 2 and individually in Bucket 3. The allowances for both buckets would be lifetime expected losses.

Application to debt securities, retail and commercial loans

The Boards decided that no bright line would be prescribed when applying the credit deterioration model.

For debt securities, there would be no rebuttable presumption for recognizing lifetime losses when the fair value of the security is less than a specified percentage of the amortized cost basis for some specified period of time. While fair value information should be used as one of the indicators when assessing whether it is appropriate to recognize lifetime expected losses for debt securities, it would not be the sole indicator.

For retail and commercial loans, there would be no bright lines for the recognition of lifetime expected losses on the basis of delinquency, such as a specified number of days past due.

Items that remain to be discussed

The Boards still need to address the following issues:

- ▶ The applicability of the model to financial assets that may improve in credit quality and may warrant a transfer back into Bucket 1 (i.e., whether the approach is symmetrical)
- ▶ Application of the model to purchased financial assets (including those acquired in a business combination), trade receivables, lease receivables, commitments and guarantees
- ▶ Specific disclosures (although the Boards have emphasized that robust disclosures will be critical to ensure comparability among entities)

Next steps

We encourage entities to participate in the FASB and IASB staff outreach activities and to provide feedback to the Boards.

Entities would likely be required to gather additional information to apply the proposed impairment model and provide the necessary disclosures. This may entail changing current systems and processes.

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Appendix: Proposed indicators

The Boards proposed the following indicators to help entities identify when recognition of expected lifetime losses is appropriate.

| General indicators | Specific indicators | |
|--|---|---|
| <ul style="list-style-type: none"> ▶ Change in general economic conditions ▶ Change in industry conditions ▶ Change in market indicators of credit risk ▶ Change in re-origination rates ▶ Change in management approach ▶ Change in company performance ▶ Change in company prospects ▶ Change in collateral values ▶ Change in credit quality enhancement/support ▶ Change in the loan documentation ▶ Change in expected performance of the borrower ▶ Others | Retail loans | |
| | <p><i>Economic indicators</i></p> <ul style="list-style-type: none"> ▶ Unemployment rates ▶ National and local economic and business conditions ▶ Declining collateral values | <p><i>Credit profile of individual borrower</i></p> <ul style="list-style-type: none"> ▶ Delinquency ▶ Credit / FICO scores ▶ Data on borrower's ability to pay ▶ Bankruptcy filings |
| | Commercial loans | |
| | <p><i>Economic indicators</i></p> <ul style="list-style-type: none"> ▶ National and local economic and business conditions ▶ Industry trends ▶ Collateral values | <p><i>Credit profile of corporate borrower</i></p> <ul style="list-style-type: none"> ▶ Operating results ▶ Management expertise ▶ Operational risks ▶ Asset quality ▶ Leverage and liquidity ▶ Financial support from parent and/or affiliate ▶ Pending litigation |
| | Debt securities | |
| <ul style="list-style-type: none"> ▶ Fair value information | | |