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Straight away

Impairment model for financial assets takes a new course

What's new?

In a joint meeting this week, the IASB and FASB (the "boards") decided to change course on their proposed model for impairment of financial assets. The new approach attempts to address constituents' feedback on previous proposals. Instead of splitting the debt investment portfolio into two categories (the "good book" and the "bad book") as proposed earlier this year, the new approach would divide a portfolio into three categories, which will ultimately determine the timing and amount of the credit losses to be recognized. The assets allocated to each category will be based on their credit risk and any credit deterioration since their origination.

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It is important to note that the boards' decisions are tentative and subject to change, as the boards have not yet concluded their redeliberations or issued a final standard.

Key Provisions

The intent of the new model is to reflect the general pattern of credit quality deterioration of debt investments. As the credit quality of the debt investment deteriorates over its life cycle, the proposed accounting model is intended to capture this change. The new approach would segregate the portfolio into three categories (referred to as "buckets" by the Boards).

Bucket #1: Assets not affected by observable events

This category would consist of debt investments that have been unaffected by observable events that provide direct evidence of a possible future default. It is possible that credit loss expectations of instruments in this bucket may have changed due to macroeconomic events that are not specific to an individual or group of assets. The allowance at each period for this category will be equal to 12 months worth of expected losses.

Bucket #2: Assets affected by observable events (but credit issues are not evident on specific assets) — This category would consist of portfolios of debt investments that have been affected by observable events that provide direct evidence of a possible future default, however, there is no evidence that is attributable directly to individual assets in the portfolio. An allowance for credit impairment would be recognized immediately in current earnings equal to the full expected lifetime losses. Since expected credit losses cannot be specifically identified for individual assets, the allowance amount would be determined at a portfolio level.

Bucket #3: Individual assets expected to default or that have defaulted — This category would consist of debt investments where information is available that specifically identifies that credit losses are expected to, or have, occurred on individual assets. No default needs to have occurred for assets to be included in this category. An allowance for credit impairment would be recognized based on the full lifetime expected losses for the individual assets.

While the Boards conceptually agreed on the proposed approach described above, they will continue to address and deliberate key points regarding factors and events that may trigger reclassifications between buckets as well as whether the proposed model is operational.

Am I affected?

All companies that have debt investments that are not classified and measured at fair value with fair value changes recognized in net income could be impacted.

What do I need to do?

The boards have yet to decide on an effective date, but it likely will not be before 2014. The boards will continue to develop the revised impairment model over the next few months. An exposure draft with a new proposed model is targeted to be issued in September of 2011. We will continue to keep you informed of the significant redeliberation decisions.

If you have questions about this issue, please contact the PwC IFRS team or your engagement partner.