

Reporting Impairment of Financial Assets

Application of FRS 26 (IAS 39)



By Patrick Connolly, ACA

Whilst fair value accounting has been extremely topical in recent months as measuring fair value in illiquid markets becomes increasingly more difficult, an important accounting requirement that should not be overlooked and will undoubtedly require particular attention this year is the impairment test. New rules for impairment testing of financial assets were introduced in 2005 by FRS 26 (IAS 39). Although there is scope for exercising judgement, accountants must be careful that they do not ignore the detailed guidance and principles set out in this accounting standard. This article explains the main principles and highlights some of the issues that may arise.

Impairment testing is required for all financial assets not carried at fair value through profit or loss (i.e. those carried at cost or amortised cost and available for sale securities). Banks and credit institutions have a high proportion of assets in this category. A recent study by the US Securities and Exchange Commission (SEC) reported that only 22% of bank assets were reported at fair value through profit or loss, a further 9% were measured at fair value with changes in fair value not affecting income (available for sale classification) and the remaining 69% measured at cost or amortised cost. The potential to affect reported income significantly is huge, so particular care must be taken in performing impairment reviews.

In the current economic environment there is an expectation among many that higher impairment losses will be reported and that auditors will rigorously examine such calculations. However, the standard setters acknowledge that in some cases observable data required to estimate the amount of an impairment loss may be unavailable or not relevant to current circumstances. In such cases

‘experienced judgement’ should be used to estimate impairment. The principles in the standard should nevertheless be followed.

Loss events

Impairment is assessed individually for financial assets that are individually significant, and either individually or collectively for other financial assets. The standard provides considerable guidance for assessment of impairment for groups of financial assets. However, in both instances the starting point is to identify whether there has been a loss event. Impairment is only assessed if there is evidence of a loss event having occurred by the balance sheet date. Losses expected as a result of future events (no matter how likely) are not recognised. FRS 26 gives examples of loss events, including:

- ▶ a breach of contract, such as a default or delinquency in interest or principal payments;
- ▶ lender granting to the borrower, for reasons related to the borrower’s

financial difficulty, a concession that the lender would not otherwise consider;

- ▶ for a group of financial assets, conditions that correlate with defaults, e.g. increase in unemployment rate or a decrease in property prices in the relevant area.

Given current economic conditions it is likely that a significantly greater number of loss events will be identified for the 2008 year end than in prior years, requiring additional effort to test for impairment. It is not necessary to identify a single loss event that caused impairment; the combined effect of several events may together be considered a loss event. For equity investments, a significant or prolonged decline in fair value below cost constitutes a loss event, the significance of which is to require reclassification of losses on available for sale securities, that previously would not have gone through the income statement, so as to include their impact in the calculation of profit or loss for the period.

Measuring Impairment

Once a loss event is identified, the amount of the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. It must be possible to reliably estimate the impact on estimated future cash flows in order to record an impairment loss. The standard distinguishes between losses expected as a result of future events and incurred losses. Losses expected as a result of future events should not be taken into account in estimating future cash flows. Such losses include future credit losses. Incurred losses are those that can be linked to a loss event before the balance sheet date. Estimated cash flows from collateralised financial assets should reflect cash flows that may result from foreclosure.

In reality a considerable amount of judgement is likely in estimating future cash flows. Where the analysis identifies a range of possible impairment loss amounts, the reporting entity should recognise an impairment loss equal to the best estimate within the range taking into account all information available before the financial statements are issued about conditions existing at the balance sheet date.

Groups of Financial Assets

Financial assets with similar credit risk characteristics may be grouped together and collectively assessed for impairment. However, financial assets

that are individually significant (this term is not defined in FRS 26) must first be assessed individually for impairment and if impairment is found they should be excluded from the collective assessment. Future cash flows are estimated on the basis of historical loss experience for similar assets. This experience must be adjusted to reflect current conditions that did not affect the period on which the historical loss experience is based (or remove the effect of prior conditions that do not exist currently). This last point is important as it indicates that historical loss rates may not necessarily be indicative of future losses and should be adjusted where relevant information is available. The standard specifically identifies factors that should be considered for adjusting future cash flows. These factors include changes in unemployment rates, property prices or other factors that are indicative of incurred losses in the group. The standard retains the distinction between future losses and incurred losses, with only incurred losses being recognised.

Disclosures

The disclosure requirements for impairment are contained in FRS 29 (IFRS 7) and are quite brief compared to the extensive disclosure requirements surrounding fair value. The amount of impairment loss for the period for each class of financial asset must be disclosed. The standard also requires an analysis of financial assets that are individually determined to be impaired, including the factors the entity considered in determining that they are impaired. Finally details of collateral held as

security must be disclosed. However, the standard does not require any detailed disclosures of how the impairment loss has been measured or assumptions made in estimating cash flows. Preparers of IFRS financial statements must in addition comply with the requirements in IAS 1, which compel an entity to disclose information about the key assumptions concerning the future that have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year.

Conclusion

Measuring impairment is clearly an area involving the exercise of considerable judgement. IAS 1 contains requirements for the disclosure of information surrounding these judgements. Under FRS 29, sensitivity analysis showing the effect on profit or loss is required in relation to assumptions that are not supported by observable market data which affect fair value. However, no such sensitivity analysis is required in relation to assumptions that underpin the assessment of impairment. A reader of the financial statements should look for the relevant disclosures outlined above and be prepared to make an informed assessment of the impact of uncertainties on reported amounts. In this regard it should be remembered that the impairment model is not aimed at predicting future losses but instead focuses on measuring those already incurred. A fine distinction at times, but an important one!

Patrick Connolly, ACA is a Manager (Financial Services) with Deloitte in Dublin.

IFAC launches new guide on development and training of accounting technicians

As part of its strategy to develop the accountancy profession worldwide, the International Federation of Accountants' (IFAC) Developing Nations Committee has released a new good practice guide entitled *The Education, Training and Development of Accounting Technicians*. The new guide is designed to raise awareness of the role and value of accounting technicians in both the public and private sectors.

The guide promotes the importance of having accounting technician-level programs in both developed and

developing economies so that individuals have access to education and training. The guide also encourages professional accountancy organisations to support the development of accounting technicians by offering technician programs that lead to certification and membership in the organisation.

The guide can be downloaded free-of-charge from the IFAC online bookstore (www.ifac.org/store).

For more information on IFAC's work to support developing nations, visit www.ifac.org/developingnations.

IFAC Sustainability Framework Supports Professional Accountants in Creating Sustainable Value

The Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC) has developed a comprehensive Sustainability Framework to support professional accountants and their organisations in integrating a sustainable way of thinking and working in all business processes.

The recognition governments and many organisations have given to sustainability are changing business culture and society. The global challenge is to ensure that organisations remain profitable at the same time as improving their environmental and social performance. This requires radical changes in the way organisations do business and presents opportunities for professional accountants to take a significant role in helping organisations to focus on the key drivers of long-term success.

The new Sustainability Framework, developed by the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC), highlights the issues organisations must address to make sustainability an integral part of their business model. For example, it offers guidance on how to inject sustainability leadership into the management cycle, from making and executing strategic decisions to reporting on performance to stakeholders.

Four Perspectives

Designed from four different perspectives – business strategy, internal management, financial investors, and other stakeholders – the web-based Framework allows professional accountants to easily navigate those sustainability issues that are most important to their



immediate roles. It will also allow them to select and use those examples of good sustainability practice that are most relevant to their organisations.

The business strategy perspective emphasises the importance of adopting a strategic approach, so that sustainable development is a part of strategic discussions, objectives, goals, and targets. This will help to integrate sustainable development governance and accountability arrangements, as well as risk management, and foster support by leadership.

The internal management perspective focuses on achieving integrated management systems, introducing sustainability, and environmental accounting as an extension of existing accounting/information systems to accommodate organisational plans for sustainable development and enhancing performance evaluation and measurement. This section of the

guidance also includes advice on how organisations can relatively simply and quickly improve energy efficiency and reduce waste; this, in turn, can help them improve environmental performance while reducing their costs, all in a relatively short time frame.

The financial investors' perspective is about telling the story to investors. It offers advice on both incorporating environmental and other sustainability issues into financial statements in a way that supports an organisation's stewardship role. It also encourages broader-based and forward-looking reporting to investors in financial reporting by management commentary.

The other stakeholders' perspective considers achieving wider transparency with non-financial reporting against a broader set of stakeholder expectations. Such