# The Treatment of Impaired Financial Assets in the National Accounts

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1. In December 2003, the International Accounting Standards Board (IASB) published the final statement of IAS 39 – Financial Instruments, which included standards for determining impairment and measuring impairment loss. Mr. Anthony Cope of the IASB has provided us with the text of the standard related to impairment. The standard appears compatible in key respects to national accounts standards, but applying the IAS rationale for impairment implies that the national accounts should treat changes in the value of financial assets caused by impairment as a change in the volume of assets.

2. The section *Impairment and Uncollectibility of Financial Assets* of IAS 39 describes the relevant standards. Several different treatments are needed to cover the different types of accounting for the different classes of financial assets covered under IAS 39 – financial assets carried at amortized cost, financial assets carried at cost, and available-for-sale financial assets.[1]

3. Paragraph 58 states that "An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset is impaired." Paragraph 59 explains that the determination that an asset (or group of assets) is impaired must be based on objective evidence that a loss-causing event or events has occurred, and examples of such events are listed. Paragraph 59 states the following:

> "A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several

[1] IAS 39 also covers financial assets carried at fair value, under which no separate treatment for impairment is required because current fair value directly reflects losses in value due to diminished collectability for the asset. Thus, the market/fair value of an asset exchanged in liquid, arms-length sales transactions is assumed to already incorporate loss of value due to impairment and the carrying value entered on the balance sheet at the time of purchase reflects the estimated realizable value of the asset (that is, the discounted value of all future cash flows generated by the asset).

events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of financial assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

a) significant financial difficulty of the issuer or obligor;
b) a breach of contract, such as a default or delinquency in interest or principal payments;
c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
d) it becoming probable that the borrower will enter bankruptcy or other financial reorganization;
e) the disappearance of an active market for that financial asset because of financial difficulties; or
f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including;
    (i) adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
    (ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

4. The guidelines in paragraph 59 appear directly relevant to the national accounts and its accrual accounting framework. Specifically, an initial economic transaction occurs that results in the creditor and debtor recording a financial asset on their balance sheet at the transaction value. Subsequent to that, a specific economic event must occur that diminishes the value of the asset. In accordance with accrual accounting principles, that change in value must be recorded within the period in which it occurs. Moreover, the IAS position that "Losses expected as a result of future events, no matter how likely, are not recognised" suggests that the guidelines of IAS 39 are compatible with SNA principles for accrual, valuation, recognition of a flow, and balance sheet recognition. It is important to mention that the trigger for considering impairment is not based on unilateral accounting actions, but on economic events recognised on an accrual basis that affect the effective value of the financial asset (the actual recovery by the creditor and payment by the debtor), and thus appear to be precisely the type of economic event that should be captured within the national accounts. Therefore, it is recommended that the revised version of the IAS 39 related to the impairment

of financial assets be incorporated into the revised SNA as an element of guidance on the definition of flows and balance sheet valuations of financial assets. *Restated in a more concise form, the revised IAS 39 definition of impairment focuses on actual economic events that have flow and stock consequences that should be recognized in the national accounts. The definition focuses on events that reduce the actual collectability of the asset, which is an economic concept applicable to both the creditor and debtor units.*

5. The assessment of impairment also extends beyond individual assets to groups of assets. Paragraph 59 subsection (f) covers situations in which impairment losses affect a group of assets, but which cannot be allocated at the time to specific assets. A two-step process described in paragraph 64 is used, beginning with a review of individual assets, followed by a review of groups of assets within the portfolio including (i) those not reviewed individually and (ii) those reviewed individually and found to be not individually significant or not impaired on that basis. An impairment loss can be estimated for the group, possibly using models of incurred but not yet reported loss or relevant aggregate or macro information.[2] Different degrees of loss might be estimated for assets that have been reviewed individually and those that have not.[3]

6. When objective evidence of impairment is found to exist, paragraph 58 directs the reporting entity to apply specific procedures described in paragraphs 63 (for financial assets carried at amortized cost), 66 (for financial assets carried at cost), or 67 (for available-for-sale financial assets) to determine the amount of impairment loss and recording in the income statement and balance sheet.

- ¶ 63 "If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss."

- ¶ 66 "If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be

[2] IAS39 describes both model-based procedures for estimating such losses, as well as cases for use of macroeconomic information that affects the collectability of assets, such as unemployment or property prices as cited in paragraph 59(f)(ii), or changes in the technological, market, economic, or legal environment as cited in paragraph 61.

[3] IAS 39 provides extensive commentary on the rationale for this two-step procedure. See, for example, their Application Guidance paragraphs AG90-92, and Board Considerations paragraphs BC111-124.

settled by delivery of such an unquoted equity instrument, the amount of impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial instrument (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed."

- ¶ 67 "When a decline in the fair value of an available-for-sale financial asset has been recognized directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that has been recognised directly in equity shall be removed from equity and recognised in profit and loss even though the financial asset has not been derecognised."

7. A common element of the procedures above is that losses are to be incurred on an accrual basis whenever impairment is determined. Losses are reflected in the income statement. Carrying values are reduced, either directly or through use of an allowance account. This formulation thus permits provisioning as one possible method to account for impairment loss on an accrual basis when objective evidence of impairment occurs.

8. The formulation in the previous paragraph also supports the recognition of provisions constructed in this manner within the national accounts as a reflection of the economic reality that a loss event has occurred that requires a reduction in balance sheet carrying values.[4] That is, such provisions should not be viewed as merely a reflection of financial accounting practice affecting only the books of creditors (which is the current SNA formulation), but as a reflection of an underlying economic reality – the realization of a loss of economic value. The IAS have attempted to apply modern economic criteria for the evaluation of impairment losses and in the process have fleshed out principles that appear to be largely compatible with the underlying standards of the national accounts.

9. Within the national accounts losses due to impairment should be captured symmetrically for creditors and debtors. There appear to be two options for the balance sheet treatment.

- Retain the gross carrying value of the asset and use allowances to reflect the effect of the reduction in the value of the asset due to impairment. This option permits the debtor to continue to record on its balance sheet the full legal liability for debt instrument issued and to maintain consistency with the gross valuation of the instrument recorded on the creditor's books. Many statisticians may find this method intuitive and appealing due to the close correspondence of the debtor's valuation with traditional financial accounting and SNA standards.

[4] Provisions can be used for many purposes, and not all provisions on financial accounting balance sheets are designed to cover impairment losses as described in IAS 39. Those that are provide a method for measuring OCVA-type losses in the national accounts.

- Record the decrease in value due to impairment symmetrically for creditors and debtors, and carry both the asset and liability at a reduced value reflecting impairment. This is equivalent to fair valuation of both the asset and liability position. The rationale is that the recognition of impairment constitutes a realized loss of economic value and an actual reduction in the effective resource flows that received by the creditor, and paid by the debtor, for the financial instrument. Thus, it provides a suitable representation in the national accounts of the value and resource flows associated with an impaired financial instrument.

10. At the present time, balance sheets of corporations reflect a variety of valuation and recognition methods. A key issue related to the possible adoption of the guidance in revised IAS 39 in the national accounts is how to integrate the accounting for financial instruments recorded at market value/fair value and those accounted for using different valuation and recognition methods – amortized cost, cost, or available for sale. Some elements of this integration are described below.

- Instruments carried on the balance sheet at fair value are subject to price change caused by factors such as changes in market interest rates and changes in the risk premium for particular instruments. Impairment of a fair value instrument is reflected as a drop in the market/fair value of the instrument. Although *in concept* it is possible to distinguish between changes in current general market interest rates and changes in the risk premium for instruments issued by specific debtors, in practice it may not be possible to distinguish between changes in the value of holdings of fair value instruments caused by general market price changes and those caused by deterioration in the condition of debtors.[5] Thus, as a practical matter, impairment of fair value instruments may often be reflected in the national accounts as valuation changes.

- As described earlier in this memorandum, impairment losses for assets carried on the balance sheet using valuation methods other than market/fair value[6] should be reflected by using provisions or making direct charges to the carrying value. As the IAS 39 definition for impairment of such assets focuses on specific economic events affecting income and carrying values, it is appropriate to treat such impairment losses as OCVA.

[5] Similarly, IAS 39 paragraph BC130 notes that the IASB was not able to find acceptable methods to distinguish between reversals of impairment value for available-for-sale equity instruments and other increases in fair value.

[6] As an aside, IAS 39 paragraph AG84 notes that the measurement of impairment loss on assets carried at amortized cost implies use of the asset original effective interest rate because use of current market rates would impose fair value measurement on the financial asset. Conversely, it could be argued that the national accounts valuation of securities or other instruments carried at market/fair value would necessarily imply the application of market interest rates to estimate interest accruals on the instrument.

- The two bullet points above provide rationales for different treatments. They can be bridged if compilers can identify the portion of the change in market/fair value stemming from impairment of securities or other financial instruments held at fair value; those impairment losses should be treated as OCVA. For examples of such an identification process, national accountants might be able to identify extraordinary losses of mortgage banks as a result of a decline in mortgage servicing receipts, or models of accrued losses affecting portfolios of assets might be used. In the absence of such information, impairment losses that cannot be separately identified would be captured as price changes within financial accounts and national accounts.

- The collection of data on impairment losses for instruments not carried at fair value should be feasible given the specific IAS 39 requirements for their measurement and recognition in the income statement and balance sheet. Where such losses are intermixed with other provisions or loss items, the specific importance of information on impairment justifies imposition of requirements for their separate reporting to supervisors and government statisticians, or public disclosure. Such information would also contribute to the compilation of financial soundness indicators.

## Appendix.

Full text of the relevant paragraphs.

- ¶ 58 “An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset is impaired. If any such evidence exists, the entity shall apply ¶ 63 (for financial assets carried at amortized cost), ¶ 66 (for financial assets carried at cost), or ¶ 67 (for available-for-sale financial assets) to determine the amount of impairment loss.

- ¶ 59 “A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of financial assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:
  a) significant financial difficult of the issuer or obligor;
  b) a breach of contract, such as a default or delinquency in interest or principal payments;
  c) the lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
  d) it becoming probable that the borrower will enter bankruptcy or other financial reorganization;
  e) the disappearance of an active market for a financial asset because of financial difficulties; or
  f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including;
     (i) adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
     (ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

- ¶ 63 “If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.”

- ¶ 66 “If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial instrument (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed.”

- ¶ 67 “When a decline in the fair value of an available-for-sale financial asset has been recognized directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that has been recognised directly in equity shall be removed from equity and recognised in profit and loss even though the financial asset has not been derecognized.”