

To the Point

FASB – proposed guidance

A new proposal for recognizing credit losses

The new joint proposal differs significantly from what the FASB proposed last year.

What you need to know

- ▶ The FASB and IASB have proposed a new model for determining when credit losses should be recognized on certain financial assets.
- ▶ Assets would be split into a “good book” and “bad book” based on a company's internal credit risk management policies.
- ▶ For the good book, credit losses would be recognized on a new time-proportional basis. The full amount of the expected loss would be recognized immediately for assets in the bad book.
- ▶ To estimate credit losses, companies would use all available information, including supportable forecasts of future events and economic conditions.
- ▶ The FASB and IASB are also seeking comments on their separate approaches. Comments are due by 1 April 2011.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have jointly proposed a model for determining when credit losses should be recognized on certain loans and other financial assets.¹

The Supplementary Document outlining the proposal focuses on when to recognize losses on open portfolios. After they receive feedback, the Boards will determine the impairment model for financial assets that are not part of open portfolios, how to measure credit losses and the required disclosures.

The proposal represents a big change from current practice under both US GAAP and IFRS. It also differs significantly from what the FASB proposed last year.

Background

Coming out of the financial crisis, the FASB and IASB had separately proposed significantly different models for accounting for impairment. Constituents have consistently stressed that the Boards need to achieve a converged solution.

Under the IASB's original proposal, credit losses would have to be recognized over the life of the financial asset (or group of financial assets) by computing an effective interest rate based on the cash flows expected to be collected. Many companies indicated this approach would be too difficult to apply in practice.

In contrast, the FASB had originally proposed eliminating the probable threshold and instead recognizing the full amount of lifetime expected credit losses immediately in net income. To estimate these losses, only past events and current conditions could be considered, not expectations of future events or conditions. Many opposed this upfront approach to recognizing losses and considering only current conditions.

Joint impairment model

The proposal would apply to financial assets in open portfolios except those measured at fair value with changes in value recognized in net income.² The Boards started with open portfolios because they believe this area is the most challenging.

Under the proposal, an asset would be put into either a good book or a bad book. This distinction is important because expected losses on the good book would be recognized over time while all expected losses on the bad book would be recognized immediately.

For assets in the good book, the portion of the lifetime expected losses to be recognized would be based on the weighted average age and the weighted average life of the portfolio. That amount is the time-proportional loss. For example, 20 percent of the lifetime expected credit losses would be recognized for a portfolio that has a weighted average age of one year and a weighted average life of five years.

The proposal would require a minimum allowance (or floor) for the good book to be established at each reporting date. That floor would be the amount of credit losses that are expected to occur in the foreseeable future, which is defined as a period of no less than 12 months. The greater of the time-proportional loss or the floor would be recognized as the allowance for the good book. The allowance for the bad book would be added to that amount to arrive at the total allowance for credit losses.

How we see it

Determining the floor would be subjective because it would require an assessment of credit losses for the "foreseeable future," which is not clearly defined. As a result, companies may determine this period differently, making it harder to compare financial statements.

Use of assumptions

Companies would use all available information to estimate expected credit losses for the remaining life of the portfolio or the foreseeable future. All available information includes historical data, current economic conditions, and, in a change from the FASB's original proposal, supportable forecasts of future events and economic conditions.

The Boards expect the period that companies use to reflect the foreseeable future to remain fairly constant for a particular portfolio, but it may differ by asset class.

Allocating losses

The IASB has proposed that lifetime expected losses can be recognized either on a straight line basis or using an annuity approach. In addition, estimated expected losses may either be discounted or undiscounted. The discount rate can be any rate between the risk-free rate and the effective interest rate.

The FASB has yet to deliberate how lifetime expected losses should be allocated over the average life of the portfolio and the discounting of expected credit losses.

Good book/bad book split

The Boards did not provide any "bright line" guidance to differentiate the good book from the bad book. The determination should be based on the company's internal credit risk management policies. In general, the quality of the asset and not the method of calculation (i.e., portfolio level versus individual asset level) determines whether the asset goes in a good book or a bad book.

For example, if a company's credit risk management objective for a financial asset is to receive regular payments from the borrower, that asset would likely be in the good book. On the other hand, if the uncertainty about the collectibility of a financial asset rises to a level where the risk management objective is to recover the financial asset, the financial asset would likely be allocated to the bad book.

Approaches developed separately

The FASB and IASB have continued to develop their own credit loss models, components of which are included in the joint proposal. While stressing the importance of reaching a converged solution, the Boards are also seeking feedback on their respective approaches.

FASB approach

The FASB's separate approach is similar to what it proposed last year, with two important differences. First, an entity would be required to immediately recognize all credit losses expected to occur in the foreseeable future instead of over the entire lifetime of the financial assets.

Second, supportable forecasts of future events and economic conditions would be considered when estimating future credit losses. Under the FASB's original proposal, companies could consider only past events and current conditions.

IASB approach

This IASB's approach is essentially the same as the joint approach but does not incorporate a floor.

The Boards are also seeking comments on their separate approaches.

How we see it

The joint approach, as well as the IASB's and FASB's separate approaches, would generally result in a higher allowance for credit losses compared to current practice. This was one of the primary objectives of both Boards.

Effective date and transition

The Boards are requesting comments by 1 April 2011. The FASB and IASB have not decided on effective dates. The Boards would like to field test the model(s) before issuing final guidance.

The FASB expects to finalize its credit impairment guidance sometime in the second half of 2011. The IASB expects to issue final guidance by June 2011.

Next steps

Companies should focus on whether the proposed model would be operational. Given the relatively short period of time until the final guidance is expected to be issued, companies should take this opportunity to provide comments to the Boards.

Endnotes:

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- ¹ Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, 31 January 2011.
 - ² An open portfolio is one in which assets are added and removed through the portfolio's life due to reasons such as origination, purchase, sales, repayments, etc.

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