

# Technical Line

FASB – Proposed guidance

## Proposed impairment approaches: a closer look

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### What you need to know

- ▶ The FASB and IASB are seeking input on a joint model for recognizing credit losses on certain financial assets and their own separate approaches.
- ▶ The joint model would require assets to be split into a “good book” and “bad book.” Credit losses on the good book would be recognized as the greater of a time-proportional allowance or losses expected in the foreseeable future. Lifetime expected losses on the bad book would be recognized immediately.
- ▶ Two big challenges are where to draw the line between the good book and bad book and how to determine losses expected in the foreseeable future.
- ▶ Final guidance is expected later this year. Companies should provide their views to the standard setters by 1 April 2011.

### Overview

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

The Boards are striving to converge on improvements to accounting for impairment, which has been criticized for delaying the recognition of losses at the outset of the global financial crisis (i.e., too little, too late). The FASB and the IASB also have continued to develop separate approaches, taking into account feedback they received on proposals they issued in 2010<sup>2</sup> and 2009<sup>3</sup>, respectively.

The joint approach, described in a Supplementary Document (SD) the Boards issued last month, would mark a big change from current practice under both US GAAP and IFRS. It combines key elements of the Boards' separate approaches (on which they are also seeking comment) and differs from what the FASB and the IASB had initially proposed.

The joint approach focuses only on the timing of recognizing losses in open portfolios, which the Boards believe is the most operationally challenging area. Using the feedback they receive, the Boards will revisit the impairment model for financial assets that are not part of open portfolios and for individual financial assets.

## Background

The FASB and the IASB initially took vastly different approaches to improving the accounting for impairment.

The FASB had proposed removing the probable threshold and requiring an entity to recognize losses immediately based on the estimate of cash flows not expected to be collected over the life of the financial asset. Constituents criticized this approach as "too much, too soon," because an entity would have been required to recognize lifetime expected losses on assets when they were originated.

Constituents also criticized the FASB proposal to limit consideration of information in forecasting expected losses to past events and current conditions, saying future forecasts of economic conditions should also be permitted. These constituents noted, however, that any future forecasts would have to be reliable.

The IASB, meanwhile, had also proposed removing the threshold for impairment recognition under IFRS and instead would have required credit losses to be recognized over the life of the asset. Under this approach, an entity's initial expectation of credit losses would have to be included in the determination of the effective interest rate of the asset. Subsequently, impairment losses would be recognized immediately based on adverse changes in the estimate of expected credit losses.

The IASB believed this approach better reflected the economic substance of lending transactions, but constituents said that distinguishing between the initial estimates of credit losses and the subsequent changes in those estimates would be too challenging for open portfolios, in which assets are added and removed regularly. Critics also indicated that the IASB approach may not result in losses being recognized timely enough.

Both Boards received strong opposition to their proposed changes to recognizing interest income. Many indicated that interest income and the net interest margin should continue to be reported separately from credit losses and any changes would confuse financial statement users.

Before developing their joint model, the FASB and IASB had been separately redeliberating their own approaches. Some FASB and IASB board members still prefer these separate approaches. As described in more detail later, the IASB's separate model is essentially the joint proposal without the minimum amount that would have to be recognized for losses expected on the good book.

The FASB's separate model would recognize expected credit losses only for the foreseeable future period at the reporting date. No time-proportional approach would be used. It would permit the use of supportable forecasts of future events and economic conditions when estimating future credit losses.

The IASB has reached tentative decisions on some issues the FASB has yet to deliberate. The SD includes an IASB-only appendix that requests feedback on several issues (primarily presentation and disclosure) that have not yet been deliberated by the FASB.

## Joint impairment approach

### Scope

The joint proposal would apply only to loans and debt instruments managed in an open portfolio that are not measured at fair value with changes in value recognized in net income. A portfolio is a group of financial assets with similar characteristics that are managed on a collective basis. In an open portfolio, assets are added to and removed from the portfolio for originations, purchases, write-offs, transfers, sales and repayment.

While the joint proposal addresses only open portfolios, the Boards are looking for comments on whether the model should also be applied to closed portfolios and individual loans and debt securities, as well as whether there should be only one impairment approach for all financial assets. Equity investments are outside the scope of the joint proposal.

Only for IFRS, the joint model would not apply to short-term trade receivables because the IASB has not yet decided how the revenue recognition project will affect the measurement of these assets. The FASB has yet to deliberate this issue.

The joint proposal does not address individual loans and debt securities.

### How we see it

The joint approach does not address loans and debt securities that are credit impaired at acquisition. Troubled debt restructurings are also not addressed in the SD. The FASB has not determined how loan commitments should be addressed. However, the IASB has asked for views on whether the joint approach should be applied to loan commitments not accounted for at fair value through net income and to financial guarantee contracts.

### Overview

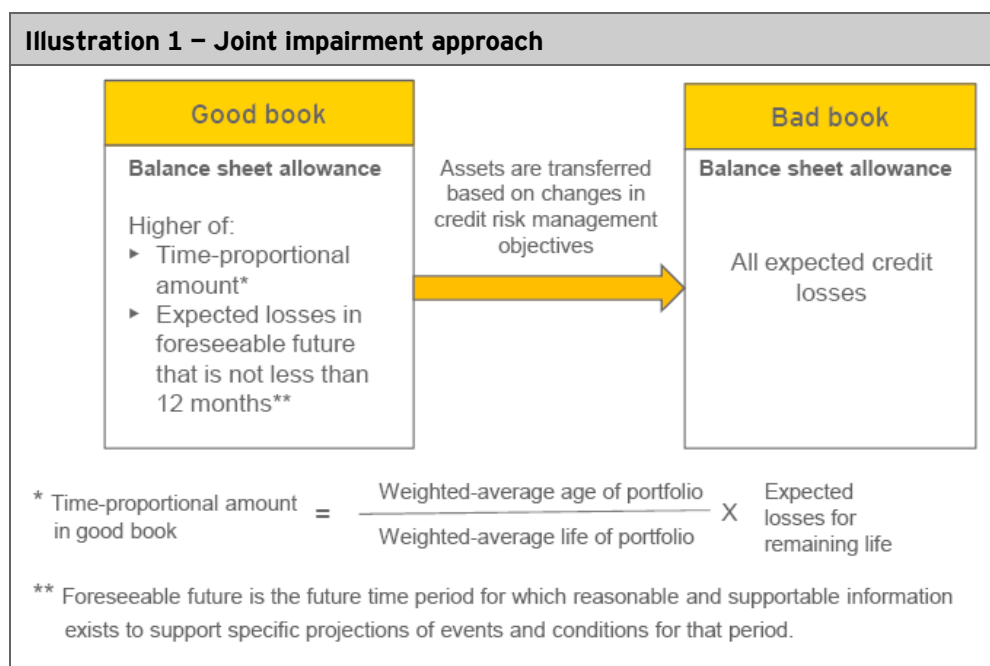
Under the joint approach, an asset would be put into either a good book or a bad book, based on the company's credit risk management policies. The distinction would depend on management's view of the degree of uncertainty relating to the collectibility of cash flows.

The distinction is important because expected credit losses over the life of the assets in the good book would be recognized over time (subject to a floor) while expected lifetime losses for the bad book would be recognized immediately. The total allowance on any reporting date would be a combination of the allowances for the good and bad books.

To address concerns that the time-proportional approach could result in an inadequate allowance for portfolios with losses that tend to occur early in their lives, the proposal would require a minimum allowance (or floor) to be set for the good book at each reporting date. That floor would be the amount of credit losses that are expected to occur within the foreseeable future, which is defined as a period of no less than 12 months.

The expected credit losses for the good book would be estimated at each reporting date to reflect changing experience and circumstances, including assets added to or removed from the book. The time-proportional allowance would then be adjusted to reflect the proportion of the weighted-average life of the portfolio that has elapsed. For example, if on average, two years have elapsed on a portfolio with an average expected life of five years when the lifetime expected loss estimate is revised, the cumulative allowance would represent two-fifths of the revised lifetime expected losses. This is referred to as the time-proportional amount.

Illustration 1 summarizes the components of the joint approach for the allowance for credit losses.



### Good book/bad book split

The SD does not provide any “bright line” guidance to differentiate the good book from the bad book, but instead indicates that the determination should be based on the credit quality of the financial assets and the company’s credit risk management policies.

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 the point where the risk management objective is to recover the financial asset, the asset would likely be allocated to the bad book.

The SD provides examples that would indicate a bad book classification:

- ▶ Management is evaluating or taking actions to enforce security interests
- ▶ Debt is restructured to avoid nonperformance
- ▶ Contingent call option is exercised, based on breach of debt covenants
- ▶ Attempts are made to recover cash flows through collection efforts

The good book and bad book split is meant to mirror how financial institutions manage and assess credit risk in their lending businesses. Some entities assign internal risk grades to loans based on factors such as credit quality of the borrower, probability of default and the loan's "loan-to-value" ratio (for loans secured by collateral). Others manage credit risk based on days past due or a simple "performing" versus "nonperforming" split.

Judgment would be necessary to split the good book and bad book and the level of subjectivity might differ by asset class. For example, while the decision to transfer an asset from the good book to the bad book might be very subjective for high-value, low-volume loans such as commercial real estate loans, the decision might be more objective for low-value, high-volume loans such as credit card balances.

The credit risk management objective for a financial asset would be critical in determining the good book/bad book split.

While there is little guidance on splitting the good book and the bad book, the SD does not imply that the bad book should be comprised only of loans that are nonperforming or impaired pursuant to ASC 310-10.<sup>4</sup> For example, an entity would have to consider whether special mention loans or loans on a watch list – even if performing – would have to be moved to the bad book. The Boards do not want entities to wait until a default occurs before transferring an asset to the bad book. We believe that more guidance will be needed in this area.

### How we see it

In practice, judgment would be needed to draw the line between the good book and bad book and that split would likely vary by entity. Entities would need to establish policies and procedures to ensure consistent application. In the absence of additional guidance, the FASB would likely require companies to disclose information about these policies and procedures, given the subjectivity involved and the potential for diversity in practice. Another issue is how well the good book/bad book split would work with consumer loans (e.g., credit cards and auto loans) because some banks may not manage small balance loans in a way that is consistent with the proposed requirements.

### Allowance for the good book

To determine the allowance for the good book, the joint approach would require two separate calculations.

First, entities would be required to calculate the time-proportional expected credit losses by multiplying the amount of credit losses expected to occur over the remaining life of the portfolio by the ratio of the portfolio's age to its expected life. (The calculation would use weighted averages to measure how long the assets have been outstanding and how long they are expected to be outstanding considering

prepayment, call, extension and similar options and defaults.) Lifetime expected losses would be updated at each reporting date and the apportioned expected losses would be determined as if the updated expected loss estimate had been known and used from the beginning of the portfolio's life.

Second, entities would be required to determine an amount that represents losses expected in the foreseeable future, which cannot be less than 12 months. For assets with an expected life shorter than 12 months, the foreseeable future would equal the remaining life of the portfolio.

At each reporting date, these two amounts would be compared and the greater of the two would be recognized as the allowance for the good book.

### How we see it

Requiring calculations of two potential allowances for the good book every reporting period would add operational complexity. This outcome would seem to conflict with the Boards' other important objective of reducing complexity in accounting.

### Allowance for the bad book

The bad book allowance would be the full amount of lifetime expected losses and would be recognized when a financial asset is moved from the good book to the bad book. As a result, the key issue is determining when a loan should be moved from the good book to the bad book because expected lifetime losses in the good book would be allocated over the portfolio's life while they would be fully recognized in the bad book.

In transferring a loan from the good book to the bad book, entities wouldn't have to separately account for the transfer of the allowance because lifetime expected losses would be fully recognized in the bad book and the allowance for the good book would be adjusted based on the new estimate of lifetime expected losses and the portfolio's weighted-average age and life.

### How we see it

It would be generally expected that the aggregate allowance for credit losses would increase when a loan is transferred from the good book to the bad book. However, there may be circumstances where a loan is considered impaired but has sufficient collateral and thus no loss is expected. This might not have been fully considered when the asset was in the good book because impairment is based on a pool concept. But once the asset is individually evaluated for impairment, as would likely be the case for assets in the bad book, it may be determined that no allowance is necessary. This may result in a decrease in the overall allowance, all else remaining equal.

### Estimating credit losses

The Boards have not yet deliberated in detail all aspects of estimating and measuring credit losses. The SD does not propose any specific approach for developing loss estimates, but rather provides some high-level principles-based guidance.

The joint approach would require companies to use all internally and externally available information to develop estimates of expected credit losses for the remaining lifetime or for the foreseeable future. All available information includes historical data, current economic conditions and, in a change from the FASB's original proposal, reasonable and supportable forecasts of future events and economic conditions (e.g., unemployment rates, housing or other collateral values and economic growth rates). However, any assumptions about future conditions would have to be consistent with available information.

While short-term estimates would be based on specific inputs and forecasts that are based on current information, companies may need to rely on long-term average loss rates in developing loss estimates for time periods further out in the future.

### How we see it

We believe the determination of what is a reasonable and supportable forecast of future events and economic conditions would be very subjective. Entities would likely apply different interpretations of what is reasonable and supportable information when coming up with projections. This would make it difficult to compare financial information from one entity to another and would present auditing challenges. To reduce diversity in application, the Boards should provide additional guidance in this area.

Developing a foreseeable future forecast that is reasonable and supportable is one of the most challenging aspects of the model.

### Foreseeable future

The foreseeable future is defined as the period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those projections. The SD does not provide detailed guidance on how the "foreseeable future" would be determined, other than to say it is a period no less than 12 months. The determination would depend on an entity's ability to forecast events and conditions.

The expected credit losses for the foreseeable future would be the amount of credit losses an entity is able to estimate as a consequence of the specific projections of future events and conditions. Once an entity could no longer estimate credit losses based on specific projections of future events and conditions, it would likely have gone beyond the foreseeable future.

The Boards did not prescribe a fixed period for the foreseeable future, even though many believe that would improve comparability between entities. They also considered that, if the fixed period were set at one year, it would be similar to the period for regulatory calculations of expected losses for some banks (e.g., under Basel requirements). The Boards were concerned, however, that setting a fixed period would prevent entities from considering foreseeable expected losses that were beyond the defined time horizon, potentially inappropriately delaying loss recognition.

In some cases (e.g., a portfolio with a short-term average expected life), the foreseeable future may be the entire remaining expected life of the portfolio, while in other cases (e.g., a portfolio with a long-term average expected life) this period would likely be only a portion of the remaining expected life. The foreseeable future

period could differ by asset class, but the expectation is that this period would not change significantly from one reporting period to another for a given asset class.

## How we see it

Coming up with the foreseeable future forecast is one of the most challenging aspects of the model. Since sophisticated entities may have better access to data and models to forecast future events and conditions than less-sophisticated entities, the foreseeable future period would vary between entities, making it harder to compare financial statements. Regulators would likely weigh in on this issue.

The following example illustrates the application of the joint impairment approach.

### Illustration 2 – Applying the joint impairment approach

Assume that Bank X manages its commercial mortgage loans in an open portfolio. Each loan is assigned a risk rating, based on a combination of factors. Bank X decides that loans that exceed a certain risk rating should be transferred to the bad book.

To determine the allowance for credit losses, Bank X would gather the following information:

	Good book Example A	Good book Example B	Bad book
Notional amount of loans	\$ 1,000,000	\$ 1,000,000	\$ 100,000
Lifetime expected losses (A)	\$ 60,000	\$ 60,000	\$ 70,000
Weighted-average age (B)	5 years	5 years	
Weighted-average life (C)	15 years	15 years	
Foreseeable future period	2 years	2 years	
Expected losses – foreseeable future	\$ 18,000	\$ 35,000	
Time-proportional amount (D=A*B/C)	\$ 20,000	\$ 20,000	

In Example A, the time-proportional amount is greater than the expected losses for the foreseeable future (or floor). Therefore, Bank X would recognize an allowance equal to the time-proportional amount for the good book (\$20,000) plus the lifetime expected losses for the bad book (\$70,000) for a total allowance of \$90,000.

In Example B, however, expected losses for the foreseeable future are greater than the time-proportional amount. Therefore, Bank X would recognize an allowance equal to the expected losses for the foreseeable future (\$35,000) plus the lifetime expected losses for the bad book (\$70,000) for a total allowance of \$105,000.

### Allocating losses and discount rate

To allow for different levels of sophistication, the joint proposal would provide a choice of either a straight-line approach or an annuity approach to allocate expected losses over the life of a portfolio (good book). When using the straight-line approach, discounted or undiscounted expected losses could be used.

The annuity approach is the more complicated of the approaches. It would require performing a discounted cash flow calculation on the expected losses to determine the present value amount. This present value amount would then be converted into an annuity that would be allocated over the life of the portfolio and recognized in profit or loss as a periodic charge. The target allowance under the time-proportional approach would be the accumulated annuity including the interest component.

The straight-line undiscounted approach would be operationally simpler. But this approach would not capture the time value of money or consider timing of losses. Under the straight-line discounted approach, lifetime losses would be calculated every period and then discounted to arrive at the present value of the expected losses, which would be allocated over the remaining life of the portfolio. This approach would essentially be a crossover between the annuity approach and the straight-line undiscounted approach, as it would consider the time value of money in a less complex way.

In determining discounted expected credit losses, the SD would permit as a discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate.

When estimates of expected remaining lifetime credit losses change, a catch-up adjustment would be recognized for the time-proportional amount of the change in expected losses, in the period that the estimate changes.

### How we see it

The choice of approach would mainly depend on the nature of the loan portfolio and sophistication of systems available. Once an approach is selected, consistent application would be required.

Given the relative simplicity of the straight-line approaches (either undiscounted or discounted), we would not expect many entities to choose the annuity approach.

The straight-line undiscounted approach is operationally the easiest of the three allocation approaches proposed in the SD.

## The Boards' separate approaches

While stressing the importance of a converged solution, the Boards are also seeking feedback on their separate models.

### FASB alternative impairment approach

The FASB's separate model is similar to its original proposal, with two important differences. It would require an entity to immediately recognize all credit losses expected to occur in the foreseeable future and would permit the use of supportable forecasts of future events and economic conditions when estimating these losses.

The FASB members who support this approach believe that constituents would be better off focusing on estimating credit losses expected in the foreseeable future rather than making additional efforts to come up with a time-proportional amount that may be vague and provide no incremental benefits. They believe many companies can forecast, with reasonable accuracy, events and conditions over a shorter time horizon.

The FASB members who support this approach also believe it would provide an adequate allowance before a downward economic cycle when actual losses begin to occur. Those members also believe that, by eliminating the “probable” threshold, the FASB approach would recognize credit losses sooner and provide a better reflection of management’s estimate of credit losses expected to occur.

The FASB has not yet discussed whether it would require a good book/bad book split. Under its approach, a split may not be necessary because losses on nonperforming or uncollectible assets would generally be expected to occur in the foreseeable future.

The following example illustrates the application of the FASB approach.

**Illustration 3 – Applying the FASB impairment approach**

Assume that Bank Y splits its portfolio into a good book and a bad book for credit risk management purposes. Assume further that lifetime expected losses for the bad book also represent losses in the foreseeable future for those loans.

Bank Y would determine its allowance for credit losses as follows:

	Good book	Bad book
Notional amount of loans	\$ 1,000,000	\$ 100,000
Foreseeable future period	2 years	2 years
<b>Example A</b>		
Expected losses – foreseeable future	\$ 18,000	\$ 70,000
Total allowance for credit losses	\$ 88,000	
<b>Example B</b>		
Expected losses – foreseeable future	\$ 35,000	\$ 70,000
Total allowance for credit losses	\$ 105,000	

In Examples A and B, the allowance represents the estimated losses for the foreseeable future.

**IASB alternative impairment approach**

The IASB’s separate approach is essentially the same as the joint approach without the floor. That is, the total allowance would be equal to the time-proportional amount for the good book and the full lifetime expected losses for the bad book.

A minority of the IASB members support this approach because they believe that it appropriately reflects the economics of lending transactions by aligning interest income with credit loss expense. In their view, actual losses occur over the expected life of a portfolio of financial assets and therefore expected credit losses should be recognized over that expected life.

The IASB approach is a pure time-proportional approach. It does not include a floor.

The following example illustrates the IASB approach.

**Illustration 4 – Applying the IASB impairment approach**

Assuming the same facts as in Illustration 2, Bank Y would calculate its allowance for credit losses as follows:

	Good book	Bad book
Notional amount of loans	\$ 1,000,000	\$ 100,000
Lifetime expected losses (A)	\$ 60,000	\$ 70,000
Weighted-average age (B)	5 years	
Weighted-average life (C)	15 years	
Time-proportional amount (D=A*B/C)	\$ 20,000	
Allowance	\$ 20,000	\$ 70,000
Total allowance for credit losses	\$ 90,000	

The allowance under the IASB approach represents the time-proportional amount for the good book plus the full amount of lifetime expected losses for the bad book.

### Details that have not yet been deliberated by the FASB

Although the joint approach was developed by both Boards, the FASB still needs to deliberate certain aspects of the model, including the following:

- ▶ Impairment approach for assets that are not in the scope of the SD (e.g., closed portfolios, single financial assets and short-term receivables)
- ▶ Credit impairment requirements for purchased loans and loans modified in a troubled debt restructuring
- ▶ Methods for measuring credit losses
- ▶ Presentation and disclosure requirements
- ▶ Interest revenue recognition
- ▶ Objectives of amortized cost measurement
- ▶ Certain aspects of the joint approach (e.g., good book/bad book classification and allocation approach for losses)

It is unclear when the FASB will begin redeliberations on these issues.

### Effective date and transition

The Boards are requesting comments by 1 April 2011. The FASB will determine an effective date in connection with its broader financial instruments project and the IASB will determine an effective date after it considers the feedback received. The Boards would like to field-test the model(s) before issuing final guidance.

The IASB expects to issue final guidance by June 2011. The FASB expects to issue comprehensive final guidance for all parts of its financial instruments project later in 2011.

## Our views

We support a converged approach for recognizing credit impairment and are encouraged by the Boards' joint proposal. However, we believe these proposals need to be field tested in order to determine if they are operational. As described earlier, to promote comparability we believe additional guidance is needed for splitting the good book and bad book and for determining the foreseeable future period.

In order to reduce complexity, we believe it is preferable to have a single impairment model for debt instruments, where appropriate.

## Next steps

Entities should review the SD and provide comments to the Boards by 1 April 2011. Companies should consider both the joint approach to impairment and the FASB and IASB alternative approaches.

We believe entities should focus on the operational aspects of implementing a new model, which could have wide-ranging implications for an entity's resources. We believe the Boards will need to carefully consider this feedback as well as the results of any field testing, in determining whether the model can be implemented by entities of different sizes and sophistication.

## Endnotes:

- <sup>1</sup> FASB and IASB Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the SD), 31 January 2011
- <sup>2</sup> FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*
- <sup>3</sup> IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*
- <sup>4</sup> ASC 310-10, *Receivables* (formerly FASB Statement 114)

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