

Heads Up

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On January 31, 2011, the FASB and IASB (the “boards”) jointly issued a supplementary document for comment as a follow-up to the FASB’s proposed ASU and the IASB’s exposure draft on credit impairment.

Supplementary Angles

Boards Propose Changes to Impairment; FASB Tentatively Changes Measurement Approach for Financial Assets

by Magnus Orrell, Adrian Mills, Shahid Shah, and Stephen McKinney, Deloitte & Touche LLP

Introduction

After the comment period ended on its proposed Accounting Standards Update (ASU) on financial instruments (the “proposed ASU”),¹ the FASB began redeliberations of key components of the proposal. The FASB tentatively agreed on January 25, 2011, to revise its approach to classifying and measuring financial assets by narrowing the circumstances under which financial assets would be subject to fair value accounting. On January 31, 2011, the FASB and IASB (the “boards”) jointly issued a [supplementary document](#) for comment as a follow-up to the FASB’s proposed ASU and the IASB’s exposure draft (ED) on credit impairment.²

This *Heads Up* focuses on the following key areas:

- The supplementary document, under which:
 - The determination of expected losses would be based on all available information, including forward-looking information. This represents a significant change from the proposed ASU, which required entities to determine expected losses on the basis of information about past and current conditions.
 - To determine an impairment allowance, an entity would differentiate financial assets that are managed in a “bad book” or “good book,” depending on the degree of uncertainty about the collectability of the cash flows of the financial asset.
 - Immediate recognition of lifetime expected losses would be required for the assets in the bad book. For assets in the good book, an entity would recognize the higher of (1) a loss estimate based on the amount of credit losses expected to occur within a period that can be reliably estimated (no less than 12 months) or (2) the expected lifetime loss estimate apportioned to the period passed, calculated by using a time-proportional ratio (i.e., weighted-average age to weighted-average life).

¹ Proposed FASB Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (issued May 2010).

² IASB ED/2009/12, *Financial Instruments: Amortised Cost and Impairment* (issued November 2009).

The supplementary document focuses on when and how credit impairment should be recognized and does not address other issues related to impairment, which have yet to be deliberated.

- The FASB’s tentative decisions related to classification and measurement of financial assets:
 - Amortized cost will be an alternate primary measurement category for certain financial assets that meet the FASB’s revised business activity criterion. This represents a significant change from the proposed ASU, under which amortized cost was subject to restrictive criteria.
 - Reclassification is prohibited between categories and gains and losses on financial assets classified as fair value through other comprehensive income would be recognized in net income when such gains and losses are realized from sales or settlements.

In addition, this *Heads Up* contains the following appendixes:

- [Appendix A](#) — compares the supplementary document’s proposed impairment model with models that were previously exposed.
- [Appendix B](#) — outlines each board’s alternative approach to the supplementary document’s joint impairment model.
- [Appendix C](#) — illustrates a good book allowance calculation.
- [Appendix D](#) — summarizes similarities and differences between the proposed ASU, IFRS 9,³ and the FASB’s redeliberations on the classification and measurement approach.
- [Appendix E](#) — compares the hedging model in the proposed ASU and in the IASB’s ED on hedge accounting.⁴

Editor’s Note: For more information about the FASB’s proposed ASU and the IASB’s ED on credit impairment, see Deloitte’s [May 28, 2010](#), and [November 10, 2009](#), *Heads Up* newsletters. For more information on the feedback received by the FASB on its proposed ASU, see Deloitte’s [November 5, 2010](#), *Heads Up*.

Supplementary Document

The supplementary document proposes to replace the incurred loss impairment models under U.S. GAAP and IFRSs with an expected loss impairment model. The document focuses on when and how credit impairment should be recognized and does not address other issues related to impairment, which have yet to be deliberated (see discussion below).

The proposal is limited to open portfolios of assets (i.e., portfolios that are constantly changing through originations, purchases, transfers, write-offs, sales, and repayments) because the boards consider the application of an impairment model to such portfolios to be the most operationally challenging. The boards have asked constituents to submit comments on the supplementary document by April 1, 2011, and have specifically asked whether potential issues exist in the application of the proposals to individual items or closed portfolios. The boards will consider these responses when they address closed portfolios and individual assets.

Editor’s Note: The IASB’s version of the supplementary document contains a separate appendix that proposes presentation and disclosure requirements. Because the FASB has not yet deliberated such requirements, its version of the supplementary document does not contain such an appendix.

A Brief History

The incurred-loss impairment models in U.S. GAAP and IAS 39⁵ were criticized during the financial crisis for delaying recognition of losses and not incorporating more forward-looking information.

³ IFRS 9, *Financial Instruments*.

⁴ IASB ED/2010/13, *Hedge Accounting*.

⁵ IAS 39, *Financial Instruments: Recognition and Measurement*.

The supplementary document proposes that, in determining an impairment allowance, an entity differentiate between financial assets managed in a “good book” and those managed in a “bad book,” depending on the degree of uncertainty about the collectability of the cash flows of the financial asset.

To address these concerns, the boards issued proposals on impairment. Because the boards’ objectives differed, the proposals differed. The FASB’s objective was to ensure that in accounting for the impairment of financial assets, an entity maintained a sufficient allowance to adequately cover all estimated credit losses for the life of a financial asset. The FASB therefore proposed that in determining whether a credit loss exists, an entity should not apply a probability threshold. That is, in assessing credit impairment, the entity would not wait until a loss is probable before recognizing an impairment loss. Although the entity would not forecast future events or economic conditions that do not exist as of the reporting date in assessing a financial asset for credit impairment, the entity would consider the impact of past events and existing conditions on the current and future collectability of the cash flows associated with the financial asset.

Most respondents to the FASB’s proposed ASU supported the elimination of a probability threshold in the determination of whether an impairment loss should be recognized. However, views were mixed on the possibility of recognizing initially expected losses on a portfolio of assets in net income in the reporting period that those assets were purchased or originated. Some favored this outcome, whereas others preferred the IASB’s proposed approach, under which entities would use a systematic and rational method to allocate such initially expected losses over the life of the related assets (see discussion below). Further, most respondents opposed the ED’s prohibition against forecasting future events or economic conditions that did not exist as of the reporting date in the recognition and measurement of credit impairment. Many believed that it is appropriate for entities to consider reasonable and supportable assumptions about future conditions and events within a predictable forecasting period.

Under the proposals in the IASB’s ED, the amortized cost of a financial asset would be the present value of the future expected cash flows from the asset as adjusted for expected lifetime credit losses. Entities would recognize initially estimated credit losses by reducing the amount of interest revenue recognized on the financial asset by adjusting the effective interest rate of the asset to reflect the initially expected lifetime credit losses. However, any subsequent changes to the estimate of lifetime credit losses would be immediately recognized in profit or loss.

The rationale for different treatment of initial estimates and subsequent changes in estimates of expected credit losses resulted from the view that credit risk is a key input into the pricing of the asset and that therefore initial estimates of lifetime credit losses should be a component of interest revenue recognition. Subsequent changes in credit risk that were not part of the consideration in the pricing of the asset should be recognized in profit or loss immediately.

Although many respondents acknowledged the conceptual merits of the IASB’s proposals, they identified operational concerns and questioned whether the potential improvement in financial reporting would justify the potentially significant costs and effort associated with implementation of the proposals. Many financial statement preparers also questioned whether the proposals could be applied to open portfolios of financial assets, which is the basis on which credit risk is managed for many entities.

Scope

The proposals in the supplementary document would apply to (1) loans and debt instruments under U.S. GAAP that are managed on an “open” portfolio basis provided they are not measured at fair value with changes in fair value recognized in net income and (2) financial assets measured at amortized cost under IFRS 9 and managed on an open-portfolio basis.

Good Book Versus Bad Book

The supplementary document proposes that, in determining an impairment allowance, an entity differentiate between financial assets managed in a “good book” and those managed in a “bad book,” depending on the degree of uncertainty about the collectability of the cash flows of the financial asset. An asset would be transferred to the bad book when the entity’s credit risk management objective changes for that asset

from receiving payments from the debtor to recovery of all or a portion of the financial asset. The lifetime expected losses for assets in the good book would be recognized over time, while the lifetime expected losses for assets transferred to the bad book would be recognized immediately in profit or loss to the extent that the losses were not already recognized in profit or loss.

Impairment — the Good Book Approach

The supplementary document proposes that for financial assets for which it is appropriate to recognize expected credit losses over time (i.e., the good book), the allowance amount would be determined as the higher of (1) a portion of lifetime expected credit losses determined under a time-proportional approach and (2) credit losses expected to occur in the foreseeable future (defined in the supplementary document as no less than 12 months after the reporting date).

Editor’s Note: The boards had different objectives for this project. The FASB’s goal was to ensure that the allowance was sufficient to absorb all expected credit losses. The IASB’s was to recognize initially expected lifetime credit losses over the life of the asset in accordance with the view that credit loss considerations are a component in the pricing of the asset. In other words, the FASB focused more on the statement of financial position, and the IASB focused more on earnings.

The recognition of credit losses expected to occur in the foreseeable future represents the FASB’s adaptation of its original proposals by shortening the window of time over which an entity would forecast expected losses for immediate recognition.

The time-proportional approach represents the IASB’s adaptation of its original proposals after making modifications to address the operational complexities. Those modifications included “decoupling” the effective interest rate and the estimate of credit losses (so that credit losses are no longer a component of the effective interest rate). Decoupling is generally viewed as more operational because credit risk and interest revenue calculations are typically managed from separate computer systems.

The time-proportional approach, with a minimum floor allowance of credit losses expected to occur in the foreseeable future, is the result of compromising by both boards on their original proposals while attempting to preserve both of their respective objectives. However, the supplementary document summarizes approaches that were separately developed by the boards to achieve their respective objectives. For further information on the separate approaches, see Appendix B.

A minimum floor allowance equal to the credit losses expected to occur in the foreseeable future (but no less than 12 months from the reporting date) was included so that a sufficient allowance is recognized for asset classes that experience higher default rates early in the asset’s life.

A minimum floor allowance equal to the credit losses expected to occur in the foreseeable future (but no less than 12 months from the reporting date) was included so that a sufficient allowance is recognized for asset classes that experience higher default rates early in the asset’s life.

Upon the transfer of an asset from the good book to the bad book, all remaining lifetime expected credit losses would be recognized immediately.

Editor’s Note: While the time-proportional approach is addressed in the supplementary document, the FASB did not participate in discussions on its application. The supplementary document proposes that entities would determine the amount of expected credit losses to be recognized under the time-proportional approach by either (1) multiplying the remaining lifetime expected credit losses of the portfolio by the ratio of the portfolio’s current age to the portfolio’s expected life (a straight-line approach using either a discounted or undiscounted estimate) or (2) converting the remaining lifetime expected credit losses of the portfolio into annuities on the basis of the portfolio’s expected life (an annuity approach using a discounted estimate).

Under the time-proportional approach, entities determine both the age and expected life of the portfolio on the basis of a weighted average. The age of the portfolio is the length of time the financial assets have been outstanding since initial recognition, while the expected life of the portfolio is the period the assets in the portfolio are expected to be outstanding since initial recognition.

While requiring a single approach may have improved comparability, the IASB ultimately agreed that entities should be permitted to use any of the three approaches (straight-line undiscounted, straight-line discounted, or the annuity approach), indicating that this would allow entities with more sophisticated systems and processes to achieve a “more precise allocation” of expected losses.

Impairment — the Bad Book Approach

Upon the transfer of an asset from the good book to the bad book, all remaining lifetime expected credit losses would be recognized immediately. Entities that do not manage their credit risk by differentiating assets on the basis of the good book versus bad book criteria outlined in the supplementary document would still be required to differentiate their assets to determine an impairment allowance.

Editor’s Note: The FASB did not deliberate how an entity transfers assets from the good book to the bad book; however, the IASB did address this issue, and its approach is noted in the supplementary document. The supplementary document proposes that for transfers between the good book and the bad book, the allowance balance should be transferred in accordance with the time-proportional approach. Under this approach, a portion of the portfolio’s good book allowance account, based on the weighted-average age and weighted-average life of the asset being transferred, would be transferred to the bad book allowance account when the asset is transferred. The good book allowance account would be reduced, and a new target allowance balance for the good book would be established. The asset being transferred to the bad book would recognize an impairment loss for the remaining lifetime expected loss that is not already covered by the amount transferred from the good book allowance account.

Expected Credit Loss Estimates

The boards have clarified that the expected credit loss estimate should take into account all information available, including internal and external information (e.g., historical data and current economic conditions as well as reasonable and supportable forecasts of future events and future economic indicators). The estimate of future conditions should be consistent with both currently available information and management’s internal forecasts. The estimate of expected credit losses should be updated at least as of each reporting date.

Editor’s Note: The boards converged their proposals on developing expected loss estimates. As previously discussed, under the FASB’s proposed ASU, entities would have been required to consider all available information on past events and current conditions in developing estimates on expected losses, but they would not have been allowed to consider potential future economic events beyond the reporting date. In contrast, the IASB’s ED permitted the use of various sources of data, including both internal and external data, in the estimation of the effect of credit losses on future cash flows but included little guidance on how to develop estimates of future events.

The appendix to the supplementary document proposes presentation and disclosure requirements related to credit impairment that were discussed by the IASB only.

Entities will need to develop two separate expected-loss estimates: one for the lifetime expected losses under the time-proportional approach and a second for losses expected to occur in the foreseeable future period (at least 12 months after the reporting date) in determining the minimum floor for the allowance under the good book approach. The foreseeable future period is a constant period and would not change from period to period, but it may vary in length between different asset classes depending on the characteristics for each asset class.

Proposals Not Redeliberated

The boards have not yet redeliberated all of their original proposals. Instead, the boards have chosen to first request additional feedback on the most challenging aspects of impairment (e.g., application to open portfolios). The boards will then redeliberate the remaining topics while considering the feedback received on the proposals in the supplementary document. For example, items yet to be discussed by the FASB include:

- Impairment considerations for individual financial assets, assets held in a closed portfolio, other problem loans, purchased loans, loans modified in troubled debt restructurings, investments in debt securities, and trade receivables.
- Methods for measuring credit losses.
- Definition of the term “write-off.”
- The objective of amortized cost measurement.
- Interest revenue recognition and whether the concept of “nonaccrual” should be included in the final model.
- Presentation and disclosure.

Presentation and Disclosure

As previously mentioned, the appendix to the supplementary document proposes presentation and disclosure requirements related to credit impairment that were discussed by the IASB only. The appendix notes that impairment losses would be presented as a separate expense line item in profit or loss. This represents a significant change from the IASB’s original proposals, under which the allocated initial estimate of credit losses would have been presented as a reduction of interest revenue.

The appendix proposes that entities sufficiently disaggregate their disclosures related to impairment to reflect the credit characteristics of the portfolio. The appendix also proposes to permit incorporation by reference to other publicly available statements when the required disclosures are already included in other documents, as might occur with banks that file reports with regulators that include similar disclosure requirements.

The proposed disclosures would give financial statement users information about:

- Allowance account activity.
- Factors that could affect credit losses for the good book.
- Significant gains or losses from changes in expected loss estimates, particularly arising from specific portfolios or geographic areas.
- The credit risk management process and how the good book and bad book distinction has been made.
- Management’s assessment of expected losses.
- Inputs and assumptions used in estimating credit losses.
- Performance of expected loss estimates with actual outcomes (e.g., backtesting).

Next Steps

While awaiting constituent feedback on the supplementary document, the boards plan to redeliberate issues in their originally exposed documents that are independent of the proposals in the supplementary document. The FASB expects to issue a final standard with a credit impairment model in 2011, and the IASB expects to issue a final credit impairment model by June 2011.

An Update on Other FASB Deliberations on Financial Instruments

Classification and Measurement

In December 2010, the FASB began its formal redeliberations of the classification and measurement component of its project on accounting for financial instruments. The FASB has reached the following tentative decisions in this area to date⁶ (note that they are subject to change as a result of the FASB's redeliberations):

- *Redeliberation plan* — The Board tentatively plans to first address the classification and measurement model for **financial assets** and then redeliberate the proposal for financial liabilities.
- *Classification criteria* — The FASB has tentatively agreed that in determining the classification and measurement of a financial asset, an entity should evaluate both the instrument's cash flow characteristics and the entity's business strategy. Although the FASB has yet to redeliberate the cash flow characteristics test for classification and measurement of financial assets, the Board tentatively agreed to redefine the business strategy criteria of the proposed ASU.⁷ Under the Board's revised approach, the characteristics of a financial asset and an entity's business strategy will affect the classification of financial assets as follows:
 - The FV-NI category will encompass an entity's trading or held-for-sale activities (e.g., financial assets that are bought and sold for short-term profit-taking and loans held for sale in the near future).
 - The FV-OCI category will apply to financial assets that are being managed in accordance with an investing activity with a focus on managing risk exposures (interest rate risk and liquidity risk) and maximizing total return. The primary purposes of an entity's investing activities are to manage and invest excess capital and, simultaneously, maximize returns on the related financial assets.
 - The amortized cost category will apply to financial assets for which an entity's business strategy is managing the assets for the collection of the contractual cash flows through a lending or customer financing activity. This is a significant change from the proposed ASU, under which amortized cost was available only to financial assets that are short-term trade receivables.

The amortized cost category will apply to financial assets for which an entity's business strategy is managing the assets for the collection of the contractual cash flows through a lending or customer financing activity.

Editor's Note: The inclusion of amortized cost as an alternative primary measurement attribute is in response to comments received by the FASB on the proposed ASU. Many respondents raised concerns about the requirement for loans to be measured at fair value and suggested that carrying loans at fair value would increase the subjectivity of financial statements. In addition, many users believed that amortized cost is a better starting point for financial analysis when supplemented by information about assets' quality and risk exposures. See Deloitte's November 5, 2010, *Heads Up* for a discussion about feedback received on the proposed ASU.

The FASB directed its staff to (1) further refine the business activity criterion and assess how various financial assets would be classified under the revised criterion and (2) discuss the analysis for further deliberation at a future board meeting.

⁶ As of the FASB's January 25, 2011, meeting.

⁷ The proposed ASU defines the business strategy criterion as an approach to "collect or pay the related contractual cash flows rather than to sell the financial asset or settle the financial liability with a third party."

The FASB has tentatively agreed that (1) reclassification between classification categories will not be permitted and (2) subsequent sales of financial assets in the amortized cost category would not “taint” the financial asset’s classification.

- *Reclassification and sales* — The FASB has tentatively agreed that (1) reclassification between classification categories will not be permitted and (2) subsequent sales of financial assets in the amortized cost category would not “taint” the financial asset’s classification. However, at future meetings the Board plans to discuss presentation and disclosure requirements for financial assets classified as amortized cost that the entity subsequently sells.
- *Recycling* — The Board has reaffirmed its previous decision that gains and losses on financial assets classified as FV-OCI would be recognized in net income (i.e., “recycled”) when such gains and losses are realized from sales or settlements.
- *Disclosures* — Although the Board has not specifically redeliberated the disclosure requirements, it has asked the staff to analyze and discuss at a future meeting disclosures about financial instruments that would provide transparency about the risks inherent in financial instruments and how an entity manages those risks.

Hedge Accounting

The FASB has not yet outlined its plan to redeliberate hedge accounting; however, we expect the Board to consider hedge accounting after it completes its redeliberation of the classification and measurement model for financial assets and financial liabilities. Later this month, the FASB also expects to issue the ED on hedge accounting originally issued by the IASB⁸ to seek feedback from its own constituents.

⁸ See Deloitte’s December 22, 2010, *Heads Up* on the IASB’s proposed hedge accounting model.

Appendix A — Impairment Model

The following table summarizes the similarities and differences between the credit impairment approaches described in (1) the FASB’s proposed ASU, (2) the IASB’s ED on credit impairment, and (3) the FASB’s and IASB’s supplementary document.

Subject	FASB’s Proposed ASU	IASB’s ED on Credit Impairment	FASB’s and IASB’s Supplementary Document
Scope	Financial assets classified as FV-OCI and short-term receivables accounted for at amortized cost.	Financial assets accounted for at amortized cost.	<i>FASB</i> — Loans and debt instruments managed on an “open” portfolio basis, provided they are not measured at fair value with changes in value recognized in net income. <i>IASB</i> — Financial assets measured at amortized cost and managed on an open-portfolio basis.
Probability threshold for recognition of impairment	No.	No.	No.
Consideration of future events in loss estimates	No. Entities consider all information related to past events and existing conditions, but they are precluded from considering information about future economic events and conditions.	Yes.	Yes. Estimate of expected credit losses is based on all available information, including “reasonable and supportable forecasts of future events and economic conditions.”
Measurement of impairment	Entities measure impairment of financial assets that are individually identified as impaired by using the present value of expected future cash flows, except that they may use the fair value of collateral as a practical expedient to measure impairment of collateral-dependent assets. Entities measure impairment of financial assets that are assessed as a group by using a historical loss rate that is adjusted for current conditions.	Entities measure impairment of financial assets by using the present value of expected future cash flows.	Measurement of impairment differs depending on whether assets are managed in a “good book” or a “bad book.” <i>Bad book assets</i> — the impairment allowance equals the total of “remaining lifetime expected credit losses.” <i>Good book assets</i> — the impairment allowance equals the higher of (1) a “portion of the remaining lifetime expected credit losses” calculated by using a time-proportional ratio (i.e., the assets’ weighted-average age to weighted-average life) or (2) a floor equal to all credit losses expected to occur within a period that can be reliably estimated (no less than 12 months).
Effective interest rate (EIR)	At initial recognition, the EIR is not adjusted for initially expected future credit losses, except in the case of purchased financial assets for which credit losses are expected at the time of purchase.	At initial recognition, the EIR is adjusted to exclude a margin for initially expected future credit losses over the life of the financial asset. This adjustment has the effect of reducing reported interest income and gradually building up an allowance for credit losses over the life of an asset before actual losses occur.	The IASB has decided “to ‘decouple’ the computation of the [EIR] from the consideration of credit losses” for “open” portfolios.
Interest recognition	Interest income is calculated by applying the EIR to the amortized cost basis, net of any related allowance for credit impairments.	Interest income is calculated by applying the EIR to the amortized cost basis, net of any related allowance for credit impairments.	Not addressed.
Ongoing reassessment	Yes. Changes in expected cash flows typically result in recoveries (gains) or losses.	Yes. Changes in expected cash flows result in recoveries (gains) or losses.	Yes.

Appendix B — Alternative Approaches to the Impairment Model

The following table compares the proposals in the supplementary document and the alternative approaches being considered by the FASB and the IASB (as discussed in the supplementary document).

Subject	Supplementary Document	FASB's Alternative Approach	IASB's Alternative Approach
Primary objective	To achieve a common solution to impairment by combining aspects of both the FASB's and the IASB's approaches.	Ensure that the allowance balance is sufficient to cover expected credit losses.	Reflect the relationship between the pricing of financial assets and initially expected credit losses by allocating initially expected credit losses over the life of assets.
"Good book" versus "bad book" approach	Yes. Measurement of impairment differs depending on whether assets are managed in a good book or a bad book.	No.	Yes.
Recognition of credit losses expected over the foreseeable future	Yes. All expected credit losses for at least 12 months are recognized.	Yes. All expected credit losses for the foreseeable future (no minimum period specified) are recognized.	Yes for bad book assets but not necessarily for good book assets. In the good book, credit losses equal the time-proportionate amount of remaining lifetime expected credit losses, which could be less than credit losses expected for the foreseeable future.
Recognition of remaining lifetime expected credit losses	Yes for bad book assets; no for good book assets.	No.	Yes for bad book assets; no for good book assets.

Appendix C — Example of a Good Book Allowance Calculation

Assume that an entity manages two portfolios of performing loans (i.e., “good books”). Portfolio A comprises auto loans with a nominal balance of CU 1,000,000 and Portfolio B comprises prime mortgage loans with a nominal balance of CU 50,000,000. The table below indicates the information the entity would use in calculating its impairment for the two portfolios under a straight-line⁹ undiscounted time-proportional approach as illustrated in the supplementary document.

Portfolio	Remaining Lifetime Expected Credit Losses A	Weighted Average Age B	Weighted Average Expected Life C	Time-Proportional Amount D = A × (B ÷ C)	Foreseeable Future Period (FFP) E	Expected Credit Losses During FFP F	Impairment Allowance Higher of D or F
A	3,000	1 year	3 years	1,000	1 year	2,500	2,500
B	75,000	3 years	12 years	18,750	1 year	12,000	18,750

The portfolio of auto loans expects losses in the foreseeable future that are greater than the amount calculated under the time-proportional approach; therefore, the entity records an allowance amount equal to those losses anticipated in the foreseeable future. In contrast, the amount for the portfolio of mortgage loans as calculated under the time-proportional approach exceeds those losses expected in the foreseeable future; therefore, the entity records an allowance amount equal to the allowance as calculated under the time-proportional approach.

⁹ The supplementary document proposes that an entity determine the time-proportional expected credit losses on the basis of (1) a straight-line approach (by using a discounted or undiscounted estimate) or (2) an annuity approach (by using a discounted estimate). This example illustrates the calculation of the time-proportional expected credit losses under a straight-line approach (ignoring the effects of a discount rate).

Appendix D — Classification and Measurement

The following table summarizes similarities and differences between the FASB’s proposed ASU, IFRS 9, and the FASB’s redeliberations on the classification and measurement of financial assets and financial liabilities (including a summary of tentative decisions reached by the FASB through January 25, 2011, as part of its redeliberations on classification and measurement of financial assets). Note that the FASB has yet to redeliberate the classification and measurement of financial liabilities.

Subject	FASB’s Proposed ASU	IFRS 9	FASB’s Redeliberations
Categories of financial assets and financial liabilities	<p>Effectively, six categories of financial assets and financial liabilities:</p> <ol style="list-style-type: none"> 1. FV-NI (default category). 2. FV-OCI (elective for qualifying debt instruments). 3. Amortized cost (elective for qualifying liabilities and short-term payables and receivables). 4. Redemption value (required for certain redeemable investments). 5. Remeasurement approach for core deposits through net income (default category for core demand deposit liabilities). 6. Remeasurement approach for core deposits through OCI (elective for qualifying core demand deposit liabilities). 	<p>Effectively, three categories of financial assets:</p> <ol style="list-style-type: none"> 1. Fair value through profit or loss (FVTPL). 2. Amortized cost (required for certain debt instruments). 3. FV-OCI; (elective for equity investments). <p>Effectively, three categories of financial liabilities:</p> <ol style="list-style-type: none"> 1. FVTPL (required for trading and derivative liabilities). 2. Fair value, with changes attributable to an entity’s own credit risk recognized in OCI, and other changes recognized in profit or loss (also required for financial liabilities elected under the fair value option). 3. Amortized cost (required for certain debt instruments). 	<p>FASB’s redeliberations so far have focused on financial assets only.</p> <ul style="list-style-type: none"> • FV-NI (required for financial assets for which an entity’s business activity is “trading” or “holding for sale”). • FV-OCI (financial assets for which an entity’s business activity is “investing”). • Amortized cost (financial assets in lending and customer financing activities that meet certain criteria; see below). <p>Note that the FASB has not yet redeliberated the remeasurement attribute for core deposit liabilities and the redemption value category for certain redeemable instruments.</p>
Criteria for amortized cost measurement	<p>An entity has the option to elect to carry the following financial instruments at amortized cost:</p> <ol style="list-style-type: none"> 1. Short-term receivables and payables (other than short-term lending arrangements, such as credit card receivables) arising in the normal course of business, and due in customary terms not exceeding one year, that meet the criteria for classification as FV-OCI (see below). 2. Financial liabilities that meet the criteria for classification as FV-OCI (see below), provided that measuring the financial liability at fair value would create or exacerbate an accounting mismatch. 	<p>A financial asset must be carried at amortized cost if it meets both of the following criteria:</p> <ol style="list-style-type: none"> 1. <i>Business model</i>— The objective of the entity’s business model is to hold assets to collect the contractual cash flows. 2. <i>Cash flow characteristics</i>— The asset’s contractual cash flows represent payment of principal and interest. <p>A financial liability must be carried at amortized cost if it is not held for trading and the entity has not elected the fair value option.</p>	<p>A financial asset is carried at amortized cost if the business activities that an entity employs in acquiring and managing those financial assets are for the collection of contractual cash flows through a lending or customer financing activity.</p> <p>Note that the Board has not yet redeliberated the cash flow characteristics test or the criteria that should apply to financial liabilities.</p>
Criteria for FV-OCI classification	<p>An entity has the option to classify a financial asset or financial liability as FV-OCI if it meets all of the following criteria:</p> <ol style="list-style-type: none"> 1. <i>Cash flow characteristics</i>— A “debt instrument [that] cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initially recorded investment, other than through its own choice.” 2. <i>Business strategy</i>— “[B]usiness strategy for the instrument is to collect or pay the related contractual cash flows.” 	<p>Upon initial recognition, an entity has the option to irrevocably elect to classify an equity investment as FV-OCI. For this category, both unrealized and realized gains and losses are recorded in OCI; dividend income is recorded in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment.</p>	<p>Financial assets for which an entity’s business activity is investing with a focus on managing risk exposures and maximizing total return are classified as FV-OCI.</p> <p>Note that the board has yet to redeliberate the cash flow characteristics test.</p>

Subject	FASB's Proposed ASU	IFRS 9	FASB's Redeliberations
Criteria for FV-OCI classification (continued)	<p>3. <i>No embedded derivative required to be separated</i>— It is not a hybrid instrument for which an embedded derivative is required to be separated under existing U.S. GAAP.</p> <p>For instruments in this category, current-period interest accruals, credit losses, and realized gains or losses are recognized in earnings.</p>		
Reclassification of accumulated OCI to net income	Amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment.	Amounts in accumulated OCI are permanently deferred in equity.	Same as the proposed ASU, i.e., amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment.
Equity investments	Carried at fair value, with changes in fair value recognized in earnings, except for certain redeemable investments that are carried at redemption value, with changes in the redemption value recognized in earnings.	Carried at fair value, with changes in fair value recognized in profit or loss, except for investments that an entity irrevocably elects to classify as FV-OCI on initial recognition.	Not yet redeliberated.
Embedded derivatives in hybrid financial contracts	<p>Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC 815,¹⁰ would instead be measured in their entirety at fair value, with changes in fair value recognized in earnings. No embedded derivative would be bifurcated from a hybrid financial asset or liability (except for hybrid financial instruments that are outside the proposed ASU's scope).</p> <p>An entity is permitted to classify as FV-OCI hybrid financial contracts that meet the FV-OCI classification criteria and that contain an embedded derivative that does not require bifurcation under ASC 815.</p>	<p>The embedded derivative guidance is eliminated for hybrid financial assets (except for hybrid financial assets that are outside the scope of IFRS 9). That is, embedded derivatives would never be bifurcated from such assets.</p> <p>The embedded derivative guidance is retained for hybrid financial liabilities. That is, embedded derivatives would continue to be bifurcated from such liabilities if they meet the criteria for bifurcation.</p>	Not yet redeliberated.
Fair value option	No explicit fair value option.	<p>Retained for financial assets but only available when a fair value designation eliminates or significantly reduces an accounting mismatch; irrevocable election at initial recognition.</p> <p>Retained for financial liabilities and available when a fair value designation eliminates or significantly reduces an accounting mismatch or an entity manages and evaluates a group of instruments on a fair value basis or the liability contains certain types of embedded derivatives. Changes in total fair value are recognized in profit or loss, with an entry to reclassify changes attributable to changes in an entity's own credit from earnings to OCI. Recycling of amounts initially recognized in OCI is prohibited.</p>	Not yet redeliberated.
Reclassification	Not permitted.	Required for a financial asset if the business model changes; however, changes in the business model are expected to be infrequent.	Not permitted. Note that the FASB plans to discuss at future meetings the presentation and disclosure requirements for financial assets classified as amortized cost that the entity subsequently sells.

¹⁰ FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

Appendix E — Hedge Accounting

The following table summarizes similarities and differences between the FASB’s hedging model under the proposed ASU and the IASB’s ED on hedge accounting.

Subject	FASB’s Proposed ASU	IASB’s ED on Hedge Accounting
Hedged Items		
Ability to designate as the hedged item an exposure that contains a freestanding derivative	Not permitted.	A combination of an exposure (e.g., a recognized nonderivative asset or liability) and a derivative could be designated jointly as a hedged item.
Risk components	The proposed ASU retains the provision under current U.S. GAAP (ASC 815) that allows an entity to designate hedges of financial items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk). Component hedging of nonfinancial items not permitted (except for foreign currency risk).	ED aligns the requirements for eligible risk components for both financial and nonfinancial items. Risk components of any item would be eligible for hedge accounting provided that the risk component is (1) separately identifiable and (2) reliably measurable.
Groups and net positions	Hedges of net positions not permitted.	Permits groups of individually eligible hedged items to be hedged collectively as a group, provided the group of items is managed together for risk management purposes. Such groups may be net positions (certain conditions apply to cash flow hedges).
Hedging Instruments		
Time value of financial options	No changes to ASC 815. If intrinsic value of the option is designated in a hedge, the time value is recognized in earnings. If option time value is included in the hedged item, an entity can defer time value in OCI when certain conditions are met.	Proposes a two-step approach to accounting for time value of options. <i>Step 1</i> — Defer in OCI an amount of fair value change of the time-value component (on the basis of a hypothetical option that has matched terms to the hedged item). <i>Step 2</i> — Reclassify amounts from OCI to profit or loss on the basis of the hedged item, which could be transaction related or period related.
Nonderivative financial instruments	Not permitted except for certain foreign currency hedges.	Permits nonderivative financial instruments classified as FVTPL as qualifying hedging instruments.
Effectiveness Assessment		
Effectiveness threshold	Reasonably effective.	Hedging relationship must achieve “other-than-accidental offset” and meet the objective of hedge effectiveness assessment (i.e., minimize expected hedge ineffectiveness).
Means of assessing effectiveness (quantitative versus qualitative)	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.	No specific requirement for a quantitative assessment; qualitative assessment may be sufficient in some cases.
Frequency of hedge effectiveness assessments	Inception only, unless reassessment is warranted because of a change in circumstances.	An entity would need to determine that a hedging relationship meets the hedge effectiveness requirements at inception and then on an ongoing basis (at a minimum, each reporting period or upon a significant change in circumstances).
Prospective versus retrospective test	No change to ASC 815 requirements (i.e., test is both prospective and retrospective)	Prospective only.
Ineffectiveness Measurement		
Determination of amounts recorded in OCI for cash flow hedges	Eliminates the “lower of test” in ASC 815. Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction since hedge inception.	Retains the “lower of test” in IAS 39.

Subject	FASB's Proposed ASU	IASB's ED on Hedge Accounting
Cash Flow Hedge — Mechanics		
Basis adjustment	No changes to ASC 815 requirements. Amount is reclassified from OCI to earnings when the hedged transaction affects earnings.	Eliminates the option in IAS 39, which permits an entity to either adjust the basis of the hedged item (when the forecasted transaction is recognized) or reclassify amounts from OCI to profit or loss, when the hedged items affect earnings. The ED requires an entity to apply a basis adjustment when the forecasted transaction is recognized.
Fair Value Hedge — Mechanics		
Changes in fair value of hedged item — balance sheet impact	No changes to ASC 815. Changes in fair value of the hedged item are recorded as an adjustment to the carrying value of the hedged item.	Changes in fair value of the hedged item are reported in a separate line item on the balance sheet. Carrying value of the hedged item is not adjusted.
Changes in fair value of hedged item and hedging instrument — income statement impact	No changes to ASC 815. Changes in fair value of the hedged item and the hedging instrument are recorded in the income statement.	Changes in fair value of the hedged item and the hedging instrument are recorded in OCI, with any hedge ineffectiveness recognized in profit or loss.
Dedesignation		
Voluntary dedesignation of a hedging relationship	An entity cannot voluntarily remove hedge designation after it has been established; however, the entity may enter into an offsetting derivative to effectively terminate the hedge.	An entity cannot voluntarily remove hedge designation after it has been established; however, partial dedesignation and rebalancing may be required.

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