

Heads Up

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The FASB's deliberations are part of its joint efforts with the IASB to simplify and improve the accounting for financial instruments.

FASB Deliberates Approach to Accounting for Credit Impairment and Interest Income.

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Background

At its January 13, 2010, meeting, the FASB reached a tentative decision on how entities should recognize and measure credit impairments and interest income under its proposed new model for accounting for financial instruments. The proposed new model would affect the accounting for credit losses associated with loans and debt securities (see the [Scope of the Credit Impairment Approach](#) section below).

The FASB's deliberations are part of its joint efforts with the IASB to simplify and improve the accounting for financial instruments. As we reported in our [November 10, 2009, Heads Up](#), the IASB recently issued an exposure draft, *Amortised Cost and Impairment*, that proposes radical changes to the manner in which entities recognize and measure credit impairment. Under the IASB's proposal, entities would use an "expected-loss" approach on the basis of their estimates of expected cash flows over the life of financial assets. The FASB is contemplating less significant changes to existing accounting requirements and plans to expose its proposed new model for comments by the end of this quarter.

Despite differences in their timelines and approaches, the FASB and IASB have agreed to jointly consider the comment letters on their respective proposals. The objective of the two standard setters is to converge their approaches to impairment before issuing final guidance on accounting for financial instruments later this year. The two boards have formed a joint expert advisory panel to advise them on resolving operational issues related to their impairment approaches.

See the [appendix](#) of this *Heads Up* for a table summarizing the similarities and differences between the FASB's and IASB's impairment and interest income models.

Scope of the Credit Impairment Approach

As we discussed in our [October 27, 2009, Heads Up](#), financial assets are classified as either at fair value through other comprehensive income (FV-OCI) or at fair value through net income (FV-NI) under the FASB's proposed new model for accounting for financial instruments. Credit impairments are recognized and separately presented within net income for financial assets in the FV-OCI category (e.g., eligible originated and purchased loans, debt securities, and beneficial interests). The FASB is proposing a single approach to accounting for impairment for all financial assets in the FV-OCI category (i.e., unlike current accounting requirements, the FASB's proposed approach would stipulate that the same impairment requirements apply to loans, debt securities, and beneficial interests in securitized financial assets). Financial assets in the FV-NI category would not be assessed for credit impairments.

Recognition and Measurement of Credit Impairments

Under the FASB's tentative approach, an entity would recognize credit impairment when there is information indicating that the entity will be unable to collect all of the contractually promised cash flows. In determining whether a credit loss exists, the entity would not consider a probability threshold for the occurrence of an event (or events) or the effect of specific conditions. That is, the entity would consider all past and current events and existing conditions (e.g., the current unemployment rate) in assessing and calculating the amount of credit impairments without assessing whether it is probable that a loss has been incurred. Although the entity would not consider future expectations (e.g., the projected near-term unemployment rate) 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 collectibility of the financial asset(s).

Under the FASB's proposed approach, entities would have latitude to develop measurement methods that are practical under the circumstances and would not be prevented from evaluating credit losses on a pool or portfolio basis. Applying appropriate historical loss rates, adjusted for current macroeconomic factors, or other methods that are practical for the entity would not be prohibited. However, when the entity has enough information about the amount and timing of cash flows expected not to be collected, the entity would use a net present value technique to determine the amount of impairment. That amount would be based on the entity's estimate of the present value of cash flows not expected to be collected or changes in the net present value amount of cash flows expected to be collected. The discount rate would be the asset's effective interest rate. (See the [Interest Income Model](#) section below for a discussion of how the effective interest rate is determined.)

Under the FASB's proposed approach, entities would have latitude to develop measurement methods that are practical under the circumstances.

Editor's Note: In assessing credit impairments, an entity would consider remaining payment terms, the financial condition of the issuer, defaults, and collateral values. The entity would also consider existing environmental factors, such as industry, geographical, economic, and political data; the existing business climate in a particular industry; the level of delinquencies, bankruptcies, charge-offs, and recoveries; national, regional, or local economic conditions; and effects of credit concentrations, if such concentrations indicate that impairment has occurred.

During the FASB's deliberations, several Board members suggested that an entity should not wait for an event to occur before recognizing credit impairment for financial assets that are aggregated in a pool on the basis of similar risk characteristics, provided that existing conditions or historical statistics indicate that a credit impairment loss exists in the pool. This would mean that an entity might need to recognize an immediate credit impairment loss on new financial assets that are pooled with other financial assets at the end of the reporting period in which the asset was originated or acquired.

Presentation

The FASB's tentative approach would require an entity to present purchased (i.e., not originated) financial assets on a "gross basis" in the statement of financial position. That is, the entity would separately present an allowance related to its expectations of credit losses inherent in the asset at acquisition. Accordingly, if there is a difference between the principal amount and the purchase price of a financial asset, the entity would need to determine how much of that difference is attributable to credit losses (which would be recorded in the allowance account) and how much relates to other factors such as changes in market interest rates (which would be treated as a discount or premium).

Interest Income Model

Under the FASB's tentative approach, an entity would apply an expected cash flow model in recognizing interest income on both originated and purchased financial assets. Under this expected cash flow model, an entity would calculate interest income by applying the effective interest rate to the amortized cost for the financial asset, reduced by any related allowance for credit impairments.

The FASB tentatively agreed that an entity should cease recognizing interest income on a financial asset only if the entity's expectations about cash flows expected not to be collected indicate that the overall yield on the financial asset will be negative.

Editor's Note: On the basis of discussions with the FASB staff, we understand that the effective interest rate to be used for originated fixed-rate financial assets would be the same as that under ASC 310¹ (previously Statement 91²). That is, this rate would be the contractual rate adjusted for any fees, direct costs, premiums, and discounts. Similarly, for purchased fixed-rate financial assets for which no credit losses are expected as of the date of purchase, the effective interest rate would equal the rate that equates the purchase price to the present value of the contractual cash flows (i.e., the contractual rate adjusted for any fees, discounts, and premiums). If credit losses are expected at acquisition, the effective interest rate would be the rate that equates the purchase price to the present value of the **expected** interest and principal cash flows as of the date of purchase (i.e., the contractual rate adjusted for any fees, discounts, and premiums and for the current assessment of credit losses at acquisition).

Cash Receipts in Excess of Accrued Interest Income

An entity that receives cash receipts in excess of accrued interest income would recognize the excess cash by increasing the allowance for credit losses rather than recognizing the excess as interest income (e.g., Dr. Cash \$1,200, Cr. Interest Receivable \$1,080, Cr. Allowance \$120). To the extent that the allowance account exceeds the entity's estimate of expected credit losses, the difference would be recognized in income as a recovery of credit impairment.

Nonperforming Financial Assets and Nonaccrual Status

The FASB tentatively agreed not to define the terms "nonperforming financial assets" and "nonaccrual status." Because, under the proposed approach, interest income is recognized on the basis of amortized cost less any related allowance, the practice of placing loans on nonaccrual status would no longer apply unless an asset has a negative yield (e.g., if the gross cash flows expected to be collected are less than the original principal amount). Said differently, the FASB tentatively agreed that an entity should cease recognizing interest income on a financial asset only if the entity's expectations about cash flows expected not to be collected indicate that the overall yield on the financial asset will be negative.

Direct Write-Off

The FASB tentatively agreed to define the term write-off as "a direct reduction in the carrying amount of a financial asset due to uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery." The FASB previously agreed that the amortized cost of a financial asset under its proposed model should be reduced for any related write-off, but not for any allowance associated with the asset.

¹ FASB Accounting Standards Codification Topic 310, *Receivables*.

² FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* — an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17.

Appendix

The following table summarizes similarities and differences between the FASB's tentative decisions reached as of January 13, 2010, and the IASB's exposure draft (ED) on amortized cost and impairment.

	FASB's Tentative Decisions	IASB's ED on Amortized Cost and Impairment
Scope	Financial assets accounted for at fair value through other comprehensive income.	Financial assets accounted for at amortized cost.
Impairment recognition and measurement	Based on expected future cash flows; all available information relating to past events and existing conditions is considered. A present value technique is used if there is enough information about the amount and timing of cash flows expected not to be collected.	Based on the present value of expected future cash flows adjusted for future credit losses expected throughout the life of the asset or portfolio (on the basis of probability-weighted possible outcomes).
Initial recognition of a loss	Recognition of a loss on initial recognition is generally precluded. However, when impairment is assessed for a pool of assets, a loss may be recognized as of the first reporting date (e.g., by applying a loss rate to the pool balance). Recognition of a loss on initial recognition for an individual asset would generally not occur.	Recognition of a loss on initial recognition is precluded.
Effective interest rate (EIR)	At initial recognition, the EIR is not adjusted for initially expected future credit losses except for purchased financial assets with expected credit losses 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.
Interest recognition	Interest income is calculated by applying the EIR to the amortized cost basis adjusted by any related allowance for credit impairments.	Interest income is calculated by applying the EIR to the amortized cost basis adjusted by any related allowance.
Ongoing reassessment	Yes. Changes in expected cash flows result in recoveries or losses.	Yes. Changes in expected cash flows result in gains or losses.

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