Heads Up

The IASB's proposed expected-loss approach applies to all financial assets measured at amortized cost, such as loan assets, investments in debt securities, and trade receivables that meet the IASB's criteria for amortized cost measurement.

IASB Proposes New Approach to Accounting for Credit Losses.

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Introduction

The global financial crisis has put the spotlight on how banks and other entities that engage in lending activities account for credit losses. It has also raised questions about whether the recognition of credit losses ought to be more forward-looking or take more of a through-the-cycle view of lending activities than under today's accounting requirements.[1] Accordingly, world leaders have asked standard setters to make this topic a priority. In response, the FASB and the IASB are considering, as part of their joint project on the accounting for financial instruments, whether to change the requirements that govern when entities recognize credit losses and how the amount of these losses is determined.

On November 5, 2009, the IASB issued an exposure draft (ED), *Financial Instruments: Amortised Cost and Impairment*, that proposes a fundamentally new approach to accounting for credit losses to replace the existing "incurred-loss" model. The proposed approach, which affects the recognition of both net interest revenue and credit impairment, is designed to result in earlier loss recognition by taking into account future credit losses expected over the life of loans or other financial assets (an "expected-loss" approach). Under this approach, an allowance for expected future losses is gradually built over the life of a financial asset by deducting a margin for future credit losses from gross interest revenue, even if no losses have yet been incurred. If adopted, implementation of the IASB's expected-loss approach would be a considerable undertaking. Many banks and other lending institutions would need a lengthy implementation period that would give them enough time to collect data and develop systems to apply the new approach. Comments on the ED are due by June 30, 2010. The IASB expects to finalize the new requirements in 2010, and to make them effective for 2013 or later.

This *Heads Up* gives an overview of the IASB's proposed approach (including related operational issues). In addition, this *Heads Up* compares the IASB's proposed approach with the FASB's tentative decisions to date about the accounting for credit losses. Appendix A includes an example illustrating the calculation for fixed-rate financial assets under the IASB's proposed approach. Appendix B contains a table comparing the incurred-loss approach under existing IFRSs[2] and the ED's proposed expected-loss approach.

Scope

The IASB's proposed expected-loss approach applies to all financial assets measured at amortized cost, such as loan assets, investments in debt securities, and trade receivables that meet the IASB's criteria for amortized cost measurement. Under the IASB's new IFRS on classification and measurement of financial assets, a financial asset generally must

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1. Under through-the-cycle approaches (e.g., dynamic provisioning), an entity estimates impairment of financial assets by using statistical parameters derived from historical credit loss data that cover a full economic cycle or several economic cycles.
2. See IAS 39, *Financial Instruments: Recognition and Measurement.*

be accounted for at amortized cost if the objective of the entity's business model is to hold its assets to collect the contractual cash flows and the asset's contractual cash flows represent payments of principal and interest.[3] The ED also includes proposed guidance on how to calculate amortized cost and the effective interest rate that applies to both financial assets and financial liabilities.

Key Components of the IASB's Expected-Loss Approach

The IASB's expected-loss approach is based on the manner in which a lender would price a loan or other financial instrument upon origination. That is, the pricing of the instrument includes a risk premium to compensate the lender for future expected credit losses. Under the IASB's expected-loss approach, therefore, an entity would not wait until a loss event (e.g., a default or bankruptcy) has occurred before reflecting expected future credit losses in the accounting for financial assets. Instead, an entity would adjust the recognition of net interest revenue for initially estimated future credit losses by deducting a margin for future credit losses expected over the life of the financial asset (rather than through the cycle).[4] In addition, the entity would continually update its estimate of future credit losses along with other changes in expected cash flows and reflect any changes (both upward and downward) in earnings as those changes occur.

The following are key components of the IASB's proposed expected-loss approach:

- **Upon initial recognition of a financial asset, management estimates credit losses expected over the life of the asset.** Upon initial recognition of a financial asset (or group of financial assets) measured at amortized cost (e.g., a loan or investment in a debt security), the entity estimates the asset's expected cash flows, taking into account expected future credit losses over the life of the asset. This estimate reflects probability-weighted possible outcomes (i.e., even if the most likely outcome is full repayment, the likelihood of the debtor's not repaying all contractual principal and interest is also factored into the estimate). This does not mean, however, that a loss is recognized immediately upon initial recognition of the asset if an entity does not expect to collect all its contractual cash flows. Instead, initial future credit loss expectations are reflected through adjustments to net interest revenue over the life of the asset, as discussed in the next bullet point.

- **Net interest revenue is adjusted by a margin for initially expected future credit losses.** In calculating and recognizing net interest revenue, the entity deducts a margin for future credit losses expected at initial recognition over the life of the financial asset. The entity does this by adjusting the effective interest rate[5] used for accounting purposes to recognize net interest revenue on the financial asset. That approach is applied to financial assets measured at amortized cost that have fixed interest rates, fully floating interest rates, or a combination of fixed and floating interest rates. For floating-rate financial assets, projections of future cash flows would also reflect expectations of future floating interest rates. In calculating the effective interest, the entity solves for the discount rate that equates (1) the initial carrying amount with (2) the present value of the expected future cash flows incorporating initially expected credit losses. This is different from the calculation of the effective interest rate under existing accounting requirements, which typically makes no adjustment for expected future credit losses[6] except for financial assets acquired at a deep discount that reflects incurred credit losses.[7]

[3] For more information, see Deloitte's October 27, 2009, *Heads Up*.

[4] The IASB rejected through-the-cycle approaches (e.g., dynamic provisioning) that rely solely on historical events to determine the amount of credit losses, since they may not be predictive of future credit losses. For example, applying a cycle-average of historical credit losses to a loan with a life shorter than the cycle would not reflect expected losses on that loan. In addition, the IASB concluded that it would be inappropriate to recognize a credit loss on initial recognition of a financial asset.

[5] The effective interest rate is the discount rate that results in a present value of the future cash flows expected upon initial recognition of a financial instrument that equals the instrument's initial net carrying amount (when any fees, points paid or received, transaction costs, and other premiums or discounts are taken into account). For a fixed-rate financial instrument, the effective interest rate is held constant over the life of the financial asset and does not change as market interest rates change. For a floating-rate financial instrument (e.g., a financial asset that pays LIBOR plus a fixed credit spread), the effective interest rate is not a single, constant interest rate. Instead, the IASB proposes that the effective interest rate be determined by combining the spot interest rate curve for the benchmark interest rate (e.g., LIBOR) and a derived initial effective spread.

[6] Paragraph 9 of IAS 39 currently specifies that when an entity calculates the effective interest rate, it "shall not consider future credit losses."

[7] See paragraph AG5 of IAS 39.

> **Example 1 — Calculation of the Effective Interest Rate Under the IASB's Proposed Approach**
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> Assume that the initial carrying amount of a loan is $100,000 and that the loan contract promises one contractual payment of $110,000 in exactly one year. Also assume that on the basis of its experience with a portfolio of loans with similar credit risk characteristics adjusted for the current conditions, the lender only expects to receive, on average, $107,000 and expects to lose $3,000 of the outstanding amount. In this case, under the IASB's proposed approach, the effective interest rate used for accounting purposes to recognize net interest revenue is 7 percent even though the contractual interest rate is 10 percent. During the year, the entity would accrue net interest revenue of $7,000 under the IASB's proposed approach rather than the $10,000 it would accrue under existing accounting requirements.

- **Over time, an allowance is built for expected future credit losses by reducing the amount of net interest revenue recognized to reflect an estimate of expected losses.** The margin for initially expected credit losses that is deducted from gross interest revenue in each period is set aside to gradually build up an allowance for expected future credit losses for the financial asset even if no actual losses have yet been incurred. This differs from existing accounting requirements, under which expected future credit losses are not reflected in the measurement of an asset measured at amortized cost unless the loss has been incurred — that is, if there is objective evidence of impairment as a result of a loss event (e.g., default or bankruptcy) that occurred after initial recognition of the asset.[8]

> **Example 2 — Determining the Allowance for Future Credit Losses Under the IASB's Proposed Approach**
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> Assume that the contractual interest rate in a group of 10-year loans with an initial carrying amount and aggregate principal amount of $10 million is 10 percent payable annually but that the effective interest rate, adjusted for initially expected future credit losses calculated in the manner discussed above, is 8 percent per year. Also assume that at the end of year 1, no actual defaults have occurred. In that case, the entity would accrue an interest receivable of $1 million, but only $800,000 would be reported as net interest revenue (this accounting differs from existing accounting requirements, under which the entity would record $1 million as interest revenue). The entity would account for the remaining $200,000 by using an allowance account to reduce the net carrying amount of the financial assets from $10 million to $9.8 million to reflect the expectation of credit losses at some point in the future. When the entity receives year 1's cash interest receipts, it would debit cash and credit interest receivable for $1 million. The entity would continue to accrue net interest revenue at 8 percent on the net carrying amount in years 2 to 10.

- **Management estimates expected future credit losses on an ongoing basis.** In each period, the entity reassesses the asset's expected cash flows, taking into account expected future credit losses.

- **Any changes in credit loss expectations — both favorable and unfavorable — are recognized immediately on a discounted cash flow basis as a gain or loss in earnings.** In performing this calculation, the entity discounts revised expected future cash flows at the asset's effective interest rate.

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[8] See paragraph 58 of IAS 39.

> **Example 3**
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> In Example 1, if actual losses at the end of the year reflect the expected losses of $3,000, no additional impairment loss would be recognized in profit or loss, since the losses were already reflected in the recognition of lower net interest revenue during the year. If, however, contrary to initial credit loss expectations, no credit losses occur, the entity would record a gain of $3,000 at the end of the year to reverse expected credit losses recognized in net interest revenue during the year. If losses in excess of initial credit loss expectations occur, the entity would record an impairment loss to reflect those losses.

Practical Expedients

The IASB proposes that an entity be permitted to use practical expedients to calculate the amortized cost of the asset if the overall effect is immaterial. For example, an entity may wish to use simplified approaches for trade receivables and other non-interest-bearing assets. Examples of practical-expedient approaches include:

- Measurement of trade receivables at their invoice amount less the initial estimate of undiscounted expected credit losses, if the effect of discounting is immaterial.

- The use of a "provision matrix" that defines fixed provision rates on the basis of the number of days a receivable is past due (e.g., 3 percent if less than 90 days, 20 percent if 90 to 180 days).

- Use of a method other than adjustment of the effective interest rate to allocate and amortize initially expected future credit losses over the life of a financial asset.

The IASB proposes that a practical expedient needs to be consistent with the following principles:

- It should consider the time value of money unless the effect of discounting is immaterial.

- The calculation should reflect all expected future cash flows of the financial instrument (e.g., not just expected losses over a one-year horizon).

- The calculation should not give rise to a loss upon initial recognition.

Presentation and Disclosure

The ED proposes separate presentation of the following line items in the statement of comprehensive income:

- Gross interest revenue (calculated by using the effective interest method **before** expected losses are taken into account).

- The effect of allocating initially expected credit losses[9] (i.e., the margin deducted from gross interest revenue over the life of a financial asset for initially expected credit losses).

- Net interest revenue (i.e., "economic" or "credit-cost-adjusted" interest revenue).

- Gains and losses resulting from changes in loss expectations.

The ED proposes that entities be required to use an allowance account to account for credit losses.

The ED also proposes that an entity provide the following disclosures about financial assets measured at amortized cost:

- A reconciliation of changes in the allowance account, showing at a minimum:

  o Increases from the allocation of initial expected credit losses (i.e., the margin deducted from gross interest revenue over the life of a financial asset for initially expected credit losses).

  o Losses recognized because of adverse changes in the estimate of expected future credit losses.

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[9] The effective interest method would be used to allocate initially expected credit losses over the life of the financial asset.

> The IASB proposes that an entity be permitted to use practical expedients to calculate the amortized cost of the asset if the overall effect is immaterial.

- o Gains recognized because of favorable changes in the estimate of expected future credit losses.
- o Write-offs.
- The entity's write-off policy.
- Information about estimates and changes in estimates used in determining credit losses, including:
  - o The basis of inputs (e.g., internal historical data or rating reports) and estimating techniques used to determine initial expected credit losses.
  - o Sensitivity analysis of inputs for which reasonably possible alternative inputs would significantly change the initial expected credit loss.
  - o Explanation of any changes in estimates, the cause of the change, and the new inputs and assumptions used.
  - o Any change in estimation technique and the reason for the change.
  - o Disaggregation (and, if significant, further analysis) of gains and losses resulting from changes in estimates:
    - Amount attributable to changes in the estimate of credit losses.
    - Amount attributable to other factors (e.g., changes in prepayment rates).
  - o A comparison between the development of the credit loss allowance over time and cumulative write-offs and, if significant, a qualitative analysis of the effect of changes in credit loss estimates on this comparison.
- Stress testing information (e.g., ability to withstand stress scenarios) if the entity prepares stress tests for internal risk management purposes.
- Credit-quality information, including:
  - o A reconciliation of changes in nonperforming financial assets (defined as more than 90 days past due or considered uncollectible) during the period.
  - o A qualitative analysis of the interaction between changes in nonperforming financial assets and changes in the allowance account if that interaction is significant.
- Vintage information (i.e., information showing the year of origination and the year of maturity for each class of financial assets).

Effective Date and Transition

The IASB expects to finalize the new requirements in 2010 and to make them effective for 2013 or later; early adoption would be permitted.

On transition, an entity would need to adjust the effective interest rate on financial assets measured at amortized cost to approximate the rate that the entity would have determined at inception by using an expected-loss approach.

Benefits of an Expected-Loss Approach

Proponents of the IASB's expected-loss approach believe it is superior to the incurred-loss model under current accounting requirements (i.e., to defer recognition of losses until a loss event has occurred) for the following reasons:

- Current accounting requirements overstate ("frontload") interest revenue for loans and other financial assets measured at amortized cost in the periods before a loss event has occurred (i.e., before the incurrence of a loss) because lenders do include a risk premium intended to cover expected future credit losses in the interest rate charged. In addition, the incurred-loss model is inconsistent with how entities price loans (i.e., they include a margin for expected future credit losses).
- Current accounting requirements create a systematic bias toward late recognition of credit losses that is inconsistent with management's cash flow expectations, because incurred losses lag expected losses.

- Under the incurred-loss model, it is not always clear when a loss event has occurred. This reduces comparability.

- The incurred-loss model is misleading because a loss may be recognized even if original loss expectations have not changed. This occurs when an initially expected loss becomes incurred.

Operational Issues

The IASB has acknowledged that implementation of its proposed expected-loss approach may prove operationally challenging and costly and may require significant lead time to implement. Operational issues include:

- The need for management to create models and develop systems to compute estimates of future cash flows and credit losses over the life of a financial asset or group of financial assets.

- The need for management to consider whether impairment should be assessed and measured at an individual asset level or at a group (portfolio) level.

- The need for management to collect or obtain historical loss data or ratings information for assets with similar credit risk characteristics in estimating future cash flows.

- Estimation uncertainty and the need for management to make difficult, subjective, and complex judgments in estimating future cash flows.

- The need for management to create systems that incorporate initially expected credit losses in the application of the effective interest rate method (or other allocation mechanisms for credit losses) over the life of a financial asset.

- The need for management to periodically update credit loss and other cash flow estimates.

- Interaction with regulatory requirements. Banks may wish to consider the extent to which they are able to leverage data collected to comply with Basel II capital requirements.

The IASB is establishing an expert advisory panel to advise it on operational issues related to the implementation of its expected-loss approach.

The FASB's Tentative Approach

The FASB is also deliberating changes to its existing accounting model for impairments. Unlike the IASB's proposed approach, the FASB's tentative approach would apply to financial assets whose changes in fair value are recognized in other comprehensive income, including loans, receivables, and investments in debt securities that meet the FASB's proposed criteria for such accounting. As discussed in Deloitte's October 27, 2009, *Heads Up*, no financial assets would be measured at amortized cost under the FASB's tentative approach.

Like the IASB, the FASB has tentatively decided that an entity should measure credit impairment losses by using a discounted cash flow approach. Under the FASB's approach, an entity would recognize a credit impairment loss in earnings if there is a decrease in the net present value of cash flows expected to be collected. In estimating the amount of future cash flows, an entity would consider all available information relating to past events and existing conditions that are relevant to the collectibility of the financial asset(s), such as the remaining payment terms, the financial condition of the issuer, expected defaults, and collateral values, as well as existing environmental factors such as industry, geographical, economic, and political data that indicate that some contractual cash flows are not expected to be collected.

The FASB has tentatively rejected the "expected-loss" approach that the IASB is proposing in its ED. The FASB believes that an entity should not consider possible future scenarios in estimating future cash flows.

The IASB has acknowledged that implementation of its proposed expected-loss approach may prove operationally challenging and costly and may require significant lead time to implement.

Appendix A

The table below includes an example illustrating the calculation for fixed-rate financial instruments under the IASB's proposed expected-loss approach.

This example illustrates a pool of 100 loans with a principal amount of $10,000 per loan, a contractual interest rate of 5 percent, and a maturity of five years. At the end of year 2, the originally expected cash flows were revised to reflect higher expected per annum defaults than originally expected. Therefore, the net carrying amount is adjusted against profit or loss at the end of year 2 to reflect the revised cash flow estimate. The amount of the adjustment is the difference between (1) the net carrying amount at the end of year 2 before the revision of the cash flow estimate and (2) the present value of the expected future cash flows (after the estimate is revised) over years 3 to 5, discounted at the originally expected effective interest rate (EIR).

No further adjustments are made in years 3 to 5 because there are no further revisions of estimates.

Example: Fixed-Rate Loans

$	(10,000)	Principal amount
	5.00%	Contractual (coupon) interest rate (payable annually)
	100	Number of loans
	5.00%	Original EIR (not adjusted for future losses)
	4.20%	Original EIR (expected-loss approach)

Initially Expected Cash Flows

Year	Contractual Cash Flows	Expected Loss Rate	Recoverable	Expected Cash Flows
20X0	$ (1,000,000)			$ (1,000,000)
20X1	$ 50,000	0%	100%	$ 50,000
20X2	$ 50,000	0%	100%	$ 50,000
20X3	$ 50,000	1%	99%	$ 49,500
20X4	$ 50,000	2%	98%	$ 49,000
20X5	$ 1,050,000	4%	96%	$ 1,008,000
				$ 1,206,500

Updated Expected Cash Flows at the End of Year 20X2

Year	Contractual Cash Flows	Expected Loss Rate	Recoverable	Expected Cash Flows
20X3	$ 50,000	3%	97%	$ 48,500
20X4	$ 50,000	4%	96%	$ 48,000
20X5	$ 1,050,000	5%	95%	$ 997,500

Amortized Cost, Net Interest Revenue, and Gain/Loss From Revision of Estimates

Year	Beginning Amortized Cost	Net Interest Revenue (Beginning Amortized Cost Times Original EIR Under Expected-Loss Approach)	Actual Cash Flows	Amortized Cost Before Reestimate (Beginning Amortized Cost Adjusted for Difference Between Actual Cash Flows and Net Interest Revenue)	Impairment Loss (Difference Between the Present Value of Expected Cash Flows Before and After Reestimate)	Ending Amortized Cost (Amortized Cost Before Reestimate Less Impairment Loss)
20X1	$ 1,000,000	41,985	(50,000)	991,985	–	991,985
20X2	$ 991,985	41,648	(50,000)	983,633	(11,162)	972,471
20X3	$ 972,471	40,829	(48,500)	964,800	–	964,800
20X4	$ 964,800	40,507	(48,000)	957,308	–	957,308
20X5	$ 957,308	40,192	(997,500)	–	–	–

Note: The EIR (not adjusted for future losses) is calculated as the internal rate of return for the series of contractual cash flows, whereas the EIR under the expected-loss approach is calculated as the internal rate of return for the series of expected cash flows. Net interest revenue in each period is calculated as the product of the beginning amortized cost multiplied by the EIR under the expected-loss approach. The amortized cost at the end of each period is the beginning amortized cost plus net interest revenue during the period less actual cash flows received during the period and less any impairment loss recognized during the period. The impairment loss in year 20X2 is the difference between the amortized cost basis and the present value of the updated estimate of expected future cash flows, discounted by the EIR under the expected-loss approach.

Appendix B

The table below summarizes the similarities and differences between the existing incurred-loss approach under IFRSs and the IASB's proposed expected-loss approach.

Approach	Incurred-Loss Approach	Expected-Loss Approach
Initial determination of the effective interest rate (EIR)	Based on the initial net carrying amount and expected future cash flows ignoring expected future credit losses	Based on the initial net carrying amount and expected cash flows that are adjusted for expected future credit losses.
Trigger for impairment	Required; indicator-based (objective evidence of impairment).	No trigger.
Measurement of revised carrying amount	Expected cash flows reflecting incurred losses discounted at the EIR.	Continually updated expected cash flows reflecting expected losses discounted at the original EIR (for fixed-rate instruments) or a combination of the spot curve for the benchmark interest rate and a spread (for floating-rate instruments).
	No fair value adjustments.	No fair value adjustments.
	No reflection of expected future credit losses that have not yet been incurred.	Reflects expected future credit losses.
Recognizing impairment	Profit or loss.	Profit or loss.
Subsequent impairments	If further losses have been incurred.	Recognized automatically through continual reestimation of cash flows.
Revenue recognition after impairment	Based on EIR.	Based on EIR.
	Compatible with cost-based measurement objective.	Compatible with cost-based measurement.
Reversals	Required if triggered by event after recognition of impairment loss.	Automatically by adjusting the expected cash flows (no trigger required).
	Up to amortized cost.	Upper limit is the full contractual cash flows discounted at the EIR.

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