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To Err Is Human; to Impair, Divine

IASB Issues Exposure Draft on Impairment of Financial Assets

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On March 7, 2013, the IASB issued an exposure draft (ED)[1] on its expected credit loss model for accounting for the impairment of financial assets. The proposal applies to financial assets (e.g., both loans and securities) measured at amortized cost or at fair value through other comprehensive income (FV-OCI).[2] Comments on the ED are due by July 5, 2013.

Editor's Note: The ED is part of the IASB's project to improve the accounting for financial instruments. If finalized, the new requirements for impairment accounting would be added to IFRS 9.[3] The proposed model is the third impairment model the IASB has exposed for comment (this proposal and the first model, issued in November 2009, were IASB-only; the second model was a supplementary document published jointly with the FASB in January 2011). Through June 2012, the FASB and the IASB jointly deliberated an impairment model known as the "three-bucket approach."[4] However, as a result of concerns about the feedback it received from U.S. constituents on the joint model, the FASB developed an alternative impairment model (the current expected credit loss (CECL) model) and issued a proposed ASU on the model in December 2012. For more information about the FASB's proposed CECL model, see Deloitte's December 21, 2012, *Heads Up*. The boards may resume joint deliberations after they receive comments on their respective proposals.

Under the IASB's proposed model, entities must recognize expected credit losses before the occurrence of a credit-loss event.

Key Aspects of the Proposal

Recognition and Measurement of Credit Losses

Under the IASB's proposed model,[5] entities must recognize expected credit losses before the occurrence of a credit-loss event. This differs from the incurred-loss model currently applied under IAS 39,[6] which requires recognition of credit losses only when a credit-loss event occurs. While the ED permits some exceptions,[7] reporting entities would estimate the expected credit losses over the life of the asset and recognize a loss allowance equal to **12 months of expected credit losses** at initial recognition.

[1] IASB Exposure Draft ED/2013/3, *Financial Instruments: Expected Credit Losses.*
[2] The ED only applies to assets that must be measured at FV-OCI, not to equity instruments that an entity irrevocably elected to measure at FV-OCI at initial recognition. The proposal also provides guidance on lease receivables, loan commitments, and some financial guarantee contracts.
[3] IFRS 9, *Financial Instruments.*
[4] See Deloitte's January 5, 2012, *Heads Up* for background information about the three-bucket approach.
[5] The IASB's proposed model is often still referred to as the three-bucket approach.
[6] IAS 39, *Financial Instruments: Recognition and Measurement.*
[7] Exceptions are made for (1) trade receivables without a significant financing component, (2) trade receivables with a significant financing component and lease receivables for which an entity elected the simplified approach, and (3) purchased credit impaired assets. For all these exceptions, credit losses are measured only on the basis of lifetime expected credit losses.

After initial recognition, entities would generally measure credit losses differently depending on whether the credit risk of the financial asset has increased significantly since initial recognition:

- If it has,entities would recognize a loss allowance equal to **lifetime expected credit losses**.[8]
- If it has not, entities would continue to recognize a loss allowance equal to 12 months of expected credit losses.[9]

Editor's Note: Under the ED, there is a rebuttable presumption that lifetime expected credit losses should be recognized if payments are more than 30 days past due unless other persuasive information is available indicating that the credit risk has not increased significantly.

Lifetime expected credit losses are an expected present-value measure of credit losses that takes into account the potential for default at any point during the life of the financial asset, whereas 12-month expected credit losses are the lifetime expected credit losses associated with the possibility of a default in the next 12 months.

Editor's Note: The ED highlights that 12-month expected credit losses are **neither** of the following:

- The "the cash shortfalls that are predicted over the next 12 months." Instead, entities must use the entire credit loss on a financial instrument weighted by the probability that the loss will occur in the next 12 months.
- The "lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months." Entities would be required to measure such instruments by using lifetime expected credit losses, which take into account the probability of default, not just a most likely outcome.

Entities would measure credit losses differently depending on whether the credit risk of the financial asset has increased significantly since initial recognition.

While entities would measure credit losses differently depending on whether the credit risk of the financial asset has increased significantly since initial recognition, the information used in the measurement of expected credit losses would generally include past events (such as historical loss experience for similar financial assets), current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial asset's future cash flows. The measurement would also reflect the probability that a credit-loss event might occur and could not be made solely on the basis of the most likely outcome.

Interest Recognition

After the FASB began developing its CECL approach, the IASB made some refinements to its own model. One refinement was to clarify that the "third bucket" in the three-bucket approach refers to interest revenue recognition and not to the evaluation of impairment. Once there is objective evidence of an asset's impairment,[10] interest revenue would be recognized on the net amortized cost (i.e., the effective interest rate (EIR) is applied to the gross carrying amount of the asset reduced by the impairment allowance). For additional information about interest recognition, including recognizing interest for assets that are (1) not objectively impaired or (2) purchased (or originated) credit-impaired financial assets, see the appendix below.

[8] The ED permits an exception to the requirement to change from 12-month expected credit losses to lifetime expected credit losses upon a significant increase in the credit risk for financial assets that still have low credit risk as of the reporting date. Such financial assets would be subject only to the 12-month expected credit loss measurement. The ED notes that an example of a financial asset with low credit risk is one that is "investment grade" as of the reporting date.

[9] Entities would assess whether the credit risk has increased significantly by considering the change in the probability of default rather than the change in the expected losses.

[10] Such an asset is most likely already in the lifetime credit loss category.

The Models Side by Side

The boards' impairment models are similar in many ways. For example, entities would use similar information under both models to measure expected credit losses. In addition, both models remove any threshold for recognizing the expected credit losses (i.e., neither model requires an event's occurrence to be probable as of the measurement date before an entity records a credit loss).

As previously noted, under the IASB's model, an entity's measurement of expected credit losses would generally differ depending on whether there has been a significant deterioration in the credit quality of the financial asset (i.e., the entity would use a dual-measurement approach to calculate impairment: either lifetime expected credit losses or 12-month expected credit losses). Under the FASB's model, entities would use a single-measurement approach (i.e., the CECL model), which we understand is meant to be the equivalent of the lifetime expected credit loss model. Thus, for assets whose credit quality has not significantly deteriorated, the FASB's model does not limit the amount of expected credit losses to only 12 months of expected credit losses.

Editor's Note: The FASB's proposed ASU on the CECL model indicates that concerns by U.S. constituents about the three-bucket approach included the following: (1) the approach is complex and may not be operational (because it potentially requires an entity to track the relative credit standing of the financial asset) and (2) the accounting outcome under the 12-month expected credit-loss measurement could potentially be similar to that under the "incurred" loss model. For example, during the credit crisis, constituents noted that losses under the incurred loss model were recognized "too late" (that is, after a credit loss has already occurred), which was perceived as a weakness in the impairment model.

The IASB's ED suggests that some constituents expressed concerns about using lifetime expected credit losses for **all** financial assets (i.e., a single-measurement approach regardless of whether there has been a significant increase in credit risk). One concern was that such an approach does not fully reflect the economic link between initial pricing (e.g., the interest rate charged) and the initial expectations of credit losses.

Neither the IASB's nor the FASB's model requires an event's occurrence to be probable as of the measurement date before an entity records a credit loss.

The appendix below highlights key similarities and differences between the IASB's and FASB's models.

Effective Date and Transition

The IASB will determine an effective date for the final standard after reviewing feedback from constituents. With certain exceptions (e.g., comparative information is not required to be restated), transition would be retrospective in accordance with IAS 8.[11]

[11] IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

Appendix — Comparison of the IASB's and FASB's Proposed Impairment Models

The table below highlights key similarities and differences between the IASB's and FASB's impairment models.

	IASB's Proposed Model	FASB's Proposed Model	Similarities and Differences
Scope	• Financial assets (including trade receivables) measured at amortized cost or at FV-OCI.[12] • Lease receivables. • Loan commitments not measured at FVTPL.[13] • Financial guarantee contracts within the scope of IFRS 9 and that are not measured at FVTPL.	• Financial assets (including trade receivables) measured at amortized cost or at FV-OCI. • Lease receivables. • Loan commitments not measured at FVTPL. • Reinsurance receivables.	Similar scope, but: • The IASB's proposal includes financial guarantees. The FASB's proposal does not address them. • Unlike the FASB's proposal, the IASB's proposal does not apply to reinsurance receivables.
Credit-loss measurement approach	**Dual**-measurement approach. Generally,[14] the impairment allowance is measured at an amount equal to either of the following: • Twelve-month expected credit losses. • Lifetime expected credit losses if, as of the reporting date, **the credit risk has increased significantly** since initial recognition.[15] For instruments with low credit risk, an allowance equal to 12 months of expected credit losses would be measured regardless of whether there has been a significant increase in credit risk.	**Single**-measurement approach. The impairment allowance reflects the estimate of current expected credit losses (i.e., all contractual cash flows that entities do not expect to collect over the expected term of the asset).	Significant conceptual difference between the two measurement approaches: • The IASB's model limits expected losses to 12 months if credit risk has not increased significantly since initial recognition. • The FASB's CECL model (which is thought to be the equivalent of the IASB's lifetime expected credit loss model) applies to all financial assets as of the reporting date, even if there has not been a significant increase in credit risk since initial recognition.
Credit loss estimation	Estimate of expected credit losses must: • Be based on relevant information that is available without undue cost or effort, including information about past events, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial instrument's future cash flows. • Be based on a probability-weighted assessment of expected contractual cash flows not expected to be recovered. • Include the probability that (1) credit loss results and (2) no credit loss results. • Not be estimated solely on the basis of the most likely outcome. • Reflect the time value of money.	Estimate of expected credit losses must: • Be based on relevant information that is available without undue cost or effort, including information about past events, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial instrument's future cash flows. • Include the probability that (1) credit loss results and (2) no credit loss results. • Not be estimated solely on the basis of the most likely outcome. • Reflect the time value of money.	Similar approaches: • Under the IASB's approach, entities can use a reasonable rate that is between (and includes) the risk-free rate and the EIR when discounting the expected credit loss estimate. If the risk-free rate is used, estimated cash shortfalls would be discounted at a lower rate and thus result in a higher amount of expected credit losses. • Under the FASB's model, entities should use the EIR if a discounted cash flow model is used to estimate expected credit losses.

[12] The model does not apply to equity instruments that an entity irrevocably elected to measure at FV-OCI at initial recognition.
[13] Fair value through profit or loss.
[14] Exceptions are made for (1) trade receivables without a significant financing component, (2) trade receivables with a significant financing component and lease receivables for which an entity elected the simplified approach, and (3) purchased and originated credit-impaired assets. See the discussions about the simplified approach and PCI assets below.
[15] If there is objective evidence of an asset's impairment, such asset would be included in this category.

	IASB's Proposed Model	FASB's Proposed Model	Similarities and Differences
Purchased credit-impaired (PCI) financial assets[16]	• No allowance is recognized for contractual cash flows that are not expected to be collected at initial recognition on the balance sheet (see FASB column). • The cumulative change in lifetime expected credit losses since initial recognition is recognized as a loss allowance. Twelve-month expected credit losses are never used to measure the impairment of such financial assets. • Favorable changes in lifetime expected credit losses are reflected as an impairment gain even if the cumulative changes in lifetime expected credit losses are positive and exceed the amount of expected credit losses that were included in the estimated cash flows at initial recognition.	• An allowance is recognized for contractual cash flows not expected to be collected at initial recognition on the balance sheet (i.e., the initial allowance is relative to the contractual cash flows, not the expected cash flows reflected in the price paid at acquisition). • Subsequent changes in current expected credit losses (including contractual amounts not originally reflected in the purchase price) are recognized in earnings, and the allowance is updated.	The effect on earnings (and net balance sheet amounts) might be similar. However, "gross" balance sheet amounts (i.e., (1) the carrying amount before the impairment allowance and (2) the impairment allowance) would differ. The IASB's impairment allowance (balance sheet) does not include expected contractual losses at acquisition; the FASB's allowance does.
Interest recognition	Entities calculate interest revenue by applying the EIR[17] to the gross carrying amount except in the following cases: • For purchased or originated credit-impaired assets, they calculate interest by applying the credit-adjusted EIR[18] to the amortized cost (gross carrying amount less impairment allowance). • When there is objective evidence of impairment, they calculate interest by applying the original EIR to the amortized cost of the financial asset in the subsequent reporting period.	Entities calculate interest on a gross cost basis (i.e., not reduced for the allowance for expected credit losses); however, nonaccrual of interest may apply (see below).	Similar approaches except for (1) purchased and originated credit-impaired assets and (2) situations in which there is objective evidence of impairment. In those instances, the IASB's model might still result in the recognition of interest while the FASB's model might result in nonaccrual status.
Nonaccrual of interest	Not applicable. Interest is recognized in the statement of profit or loss and other comprehensive income irrespective of the extent of credit losses. See "Interest recognition" above for exceptions to using the gross carrying amount for interest recognition purposes.	Financial assets are placed on nonaccrual status "when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest."	Different approaches. The IASB's model requires accrual of interest unless an asset has a full allowance booked against it.
Practical expedient	No practical expedient. However, for instruments with credit risk that has significantly increased but still remains low, the allowance would be equal to 12 months of expected credit losses (e.g., "investment grade" financial assets).	Entities are not required to record an impairment allowance for an FV-OCI financial asset if both of the following apply: • The asset's fair value exceeds its carrying amount. • The expected credit losses are deemed insignificant.	Different approaches. The IASB's model would be applied and some expected credit losses would be recognized irrespective of the fair value of the asset and the amount of expected credit losses.

[16] The IASB's approach for PCI assets also applies to originated credit-impaired assets.

[17] The EIR is the rate used to exactly discount estimated future cash flows and does not take into account the expected credit losses through the remaining life of the financial asset to its gross carrying amount or amortized cost (for objectively impaired financial assets that are not PCI financial assets or originated credit-impaired financial assets).

[18] The credit-adjusted EIR is used to exactly discount the estimated future cash flows through the remaining life of the PCI financial asset or originated credit-impaired financial asset to its amortized cost. This rate differs from the EIR because it takes into account the expected credit losses in the estimate of future cash flows.

	IASB's Proposed Model	FASB's Proposed Model	Similarities and Differences
Simplified approach	A simplified approach would be used for trade and lease receivables as follows: • For trade receivables with no significant financing, entities would always recognize lifetime expected credit losses (i.e., not a dual-measurement approach). • For trade receivables with a significant financing component and for lease receivables, entities can choose a policy of only applying the lifetime expected credit losses instead of applying the dual-measurement approach.	None. The CECL model is applied in all cases.	Different for trade receivables with a significant financing component and lease receivables for which entities did **not** choose a policy of applying the lifetime expected credit losses (i.e., when entities apply the IASB's dual-measurement approach).
Modifications of debt instruments	For debt restructurings (that do not result in derecognition), entities would adjust the gross carrying amount of the asset to reflect the revised contractual cash flows and recognize a modification gain or loss. Entities would discount the gross carrying amount (by the asset's original EIR) in calculating the present value of the asset's estimated future contractual cash flows.	For a troubled debt restructuring (TDR), entities would consider the new series of contractual cash flows and adjust the cost basis of the asset so that the EIR (post-TDR) is the same as the original EIR. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted by the original EIR). For non-TDR modifications that do not result in derecognition, the EIR would be adjusted prospectively.	Similar results for TDRs.

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