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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting: **March 2009, London**

Project: **Loan Loss Provisioning**

Subject: **Analysis of Alternatives (Agenda paper 7A)**

INTRODUCTION

1. The subject of accounting for loan losses has captured significant attention during the current economic crisis. Many have suggested that the current accounting for loan losses is procyclical and that the accounting should be changed to be less so. In this context, we take the term *procyclical* to mean that changes in the amount of recognized loan losses tend to follow the economy through a cycle of growth and recession. The accounting solutions suggested are sometimes referred to as *dynamic provisioning.* However, we have found that the term has a variety of meanings. This paper focuses on two approaches or models of loan accounting – an incurred loss model and an expected loss model. Because the subject is accounting for loans that

are reported using amortized cost conventions, this paper largely ignores questions about the fair value of loans.

2. This paper discusses the existing accounting for loan losses under International Financial Reporting Standards (IFRS) and our general understanding of proposals to change that accounting. We expect that this paper will have a wide audience, ranging from specialists to lay readers. We hope to engage all of that audience in the discussion, and have started from basic concepts and principles with simple illustrations. We apologize to the specialists.

3. We also see the accounting for loan losses as part of accounting for loans in general, rather than as something detachable. Conclusions about loan losses should be consistent with other conventions in loan accounting.

4. The problem of accounting for a loan is straightforward. A lender advances money to a borrower on 1/1/X1. In exchange, the borrower agrees to pay an amount on 1/1/X2. There are several possible outcomes from this transaction. The borrower might:

    a. Pay the contractual amount on 1/1/X2;

    b. Pay some of contractual amount on 1/1/X2 and default on the remainder;

    c. Pay the contractual amount, or some other amount, on some future date; or

    d. Pay nothing.

5. Loan accounting is simply the process of determining the net carrying amount of the loan between 1/1/X1 and the point at which the loan is either paid or deemed uncollectible. Accountants can determine the beginning state and the end state. The accounting problem occurs between those dates. While many criticize IAS 39 for a lack of principles, those governing loan accounting are straightforward:

    a. At any point in time, the carrying amount of a loan is the present value of expected future cash flows, excluding credit losses, discounted at the original effective rate.

b. The original effective rate is the single rate that equates the expected future cash flows in a. with the original recorded amount.

c. The loan loss is the present value of expected future credit losses that arise as a result of past loss events, discounted at the original effective rate.

THE LOSS INHERENT IN THE PORTFOLIO

6. Most regulators and accountants agree that the objective of loan loss accounting should be to identify and account for the *loss inherent in the portfolio* of loans that a bank holds. They disagree about what that phrase means.

7. Consider a very simple example – a portfolio of 1,000 identical loans for CU 2,500 made on 1/1/X1. Each loan has a contractual interest rate of 16 percent and requires a interest payments of payment of CU 400 on each December 31 for 9 years, followed by a payment of 2,900 on December 31 of the tenth year. The loans are not prepayable. There are no transaction costs, fees, or origination costs. As a result, the effective interest rate as defined in IAS 39 is the same as the contractual rate.

8. That is the entire description of what is **known** about the loans. For purposes of this illustration, we stipulate that the initial fair value of the loan portfolio in the origination market is CU 2,500,000. We assume that the lender, or any other marketplace participant, expects some of the loans to default, and that the contractual interest rate is commensurate with that expectation.

9. Stated differently:

    a. CU 2,500,000 is the present value of 9 annual payments of CU 400 and 1 annual payment of CU 2,900 from 1,000 loans, discounted at an annual rate of 16 percent; or

    b. CU 2,500,000 is the present value of the annual payments of from that portion of the original 1,000 loans *that are not expected to default*, discounted at the

effective rate inherent in the initial amount and the expected cash flows, including credit losses.[1]

10. Neither characterization of the initial recorded amount contemplates any recognition of loan losses on the date the loan is made.

11. The description, and the measurement problem, grows more difficult as it moves away from the contracted amounts. For example, the lender might expect that each year, 5 percent of the loans will default, and that no future payments will be made by those borrowers. If the lender's expectations are realized, it will earn a rate of about 10.2 percent over the life of the loans. Unfortunately, there are many (effectively unlimited) combinations of reasonable cash flow expectations that this portfolio might generate and that would justify the original decision to make 1,000 loans of CU 2,500 with the terms described.

12. The question for accountants and regulators is how and when to recognize interest income and to estimate the losses that arise from defaults. As mentioned earlier, we consider the accounting for loan losses to be part of the complete system of loan accounting. In the language often adopted by accountants and regulators – What is a *loss* (measurement) and when is it *inherent* (recognition)?

13. Several measures of loss have been suggested at one time or another. When applied to a loan in the simple example above:

    a. A loss arises from a failure to collect CU 2,500. As long as the lender expects to collect at least that amount, there is no loss. This was the approach taken in U.S. GAAP (and supported by many bankers and bank regulators) prior to the publication of FASB Statement No 114, *Accounting by Creditors for Impairment of a Loan* (May 1993).

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[1] The term *expected* in IFRS generally refers to the probability weighted average of possible outcomes (the mean) as opposed to the single most likely outcome (the mode). Management's estimate of defaults in an expected loss approach would include the range of possible scenarios and their relative likelihood.

b. A loss arises from a failure to collect the 10 contracted annual payments on the dates specified in the contract, discounted at the original effective interest rate. This is the approach mandated for loans within the scope of FAS 114 and for all loans under IFRS.

c. A loss (or gain) arises from a change in the expected (rather than contracted) cash flows from the portfolio of loans, discounted at the original expected (rather than contractual) interest rate.

d. A loss (or gain) arises from changes in the fair value of the loans.

14. There are two concepts that describe when a loss is inherent in a loan or portfolio of loans.

    a. Credit losses are caused by events, and until loss creating events occur, there is no loss inherent in a loan or portfolio. IAS 39, *Financial Instruments: Recognition and Measurement*, is based on this concept, often referred to as an *incurred loss* concept.

    b. Credit losses are an integral part of lending. Different expectations about losses are reflected in different contractual interest rates. Thus there are always future defaults inherent in a portfolio. This concept is often referred to as an *expected loss* concept.

Two approaches compared

15. The examples that follow build on the portfolio of 1,000 loans of CU 2,500 each. Management estimates that no loans will default in X1 or X2. Beginning in X3, loans will default at an annual rate of about 9 percent. If that expectation is correct, then the rate of return from the portfolio will be approximately 9.07 percent. The examples that follow are presented on a “closed book” approach. That is, they track the accounting for a single cohort of loans through its life, without considering new lending.

Incurred loss approach

16. The incurred loss approach in IFRS requires "objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset" (IAS 39, para 59). There is a common misconception that this postpones loss recognition until the borrower actually defaults. In fact, default is the **latest** date on which impairment should be recognized. IAS 39 requires a cause (the event) and an effect (the measurement). If those can be identified before default, then IAS 39 requires earlier recognition. However, IAS 39 does not permit the practice of recording "general provisions," unless those provisions are an attempt to estimate loan losses for which a triggering event has occurred but the individual loan has yet to be identified (sometimes referred to as an "incurred but not reported" approach).

17. For purposes of illustration only, we will keep the simple illustration and assume that management is unable to identify any event that gives rise to default before the default occurs and that a borrower who defaults makes no future payments. We will also assume that the defaults occur as expected. Selected amounts in the entity's financial statements would be:

Incurred Loss Model					
	Loans, net of allowance	Interest income	Loan loss expense	Interest less Loan loss	Return, net of loan loss
12/31/X1	2,500,000	400,000	0	400,000	16.00%
12/31/X2	2,500,000	400,000	0	400,000	16.00%
12/31/X3	2,275,000	364,000	225,000	139,000	5.56%
12/31/X4	2,072,500	331,600	202,500	129,100	5.67%
12/31/X6	1,887,500	302,000	185,000	117,000	5.65%
12/31/X7	1,720,000	275,200	167,500	107,700	5.71%
12/31/X8	1,567,500	250,800	152,500	98,300	5.72%
12/31/X9	1,427,500	228,400	140,000	88,400	5.64%
12/31/Y0	1,300,000	208,000	127,500	80,500	5.64%
12/31/Y1	0	189,600	115,000	74,600	5.74%

Illustration 1

Expected loss approach

18. There are several ways that an expected loss approach might be implemented. For purposes of this paper we have made two assumptions to fully integrate the approach into the loan accounting. First, the amount reported as interest income should continue to represent the contractual amount from outstanding loans. Second, the objective of the expected loss computation is to report the 9.07 percent expected return described earlier. With those assumptions, the expected loss approach is consistent with the underlying principles of loan accounting in IAS 39, except that it includes expected future credit losses.

19. Assuming again that losses occur as expected, selected amounts in the entity's financial statements would be:

Expected Loss Model						
	Loans, net of allowance	**Interest income**	**Loan loss expense (incurred)**	**Expected loss adjustment**	**Interest less Loan loss**	**Return, net of loan loss**
12/31/X1	2,326,689	400,000	0	173,311	226,689	9.07%
12/31/X2	2,137,662	400,000	0	189,027	210,973	9.07%
12/31/X3	1,967,496	364,000	225,000	-54,834	193,834	9.07%
12/31/X4	1,814,300	331,600	202,500	-49,304	178,404	9.07%
12/31/X6	1,676,812	302,000	185,000	-47,512	164,512	9.07%
12/31/X7	1,553,658	275,200	167,500	-44,346	152,046	9.07%
12/31/X8	1,443,737	250,800	152,500	-42,579	140,879	9.07%
12/31/X9	1,346,248	228,400	140,000	-42,511	130,911	9.07%
12/31/Y0	1,260,320	208,000	127,500	-41,572	122,072	9.07%
12/31/Y1	0	189,600	115,000	-39,680	114,280	9.07%

Illustration 2

Summary for Illustrations 1 and 2

20. In the incurred loss approach:

    a. The carrying amount of the loan portfolio is the contractual amount of outstanding loans, reduced by an allowance for incurred losses.

    b. Interest income is computed at the 16 percent contractual rate, which in the illustration is the same as the IAS 39 effective rate.

c. Loan loss expense is the amount incurred as a consequence of events that happened during the period, and revisions to previous years' estimates.

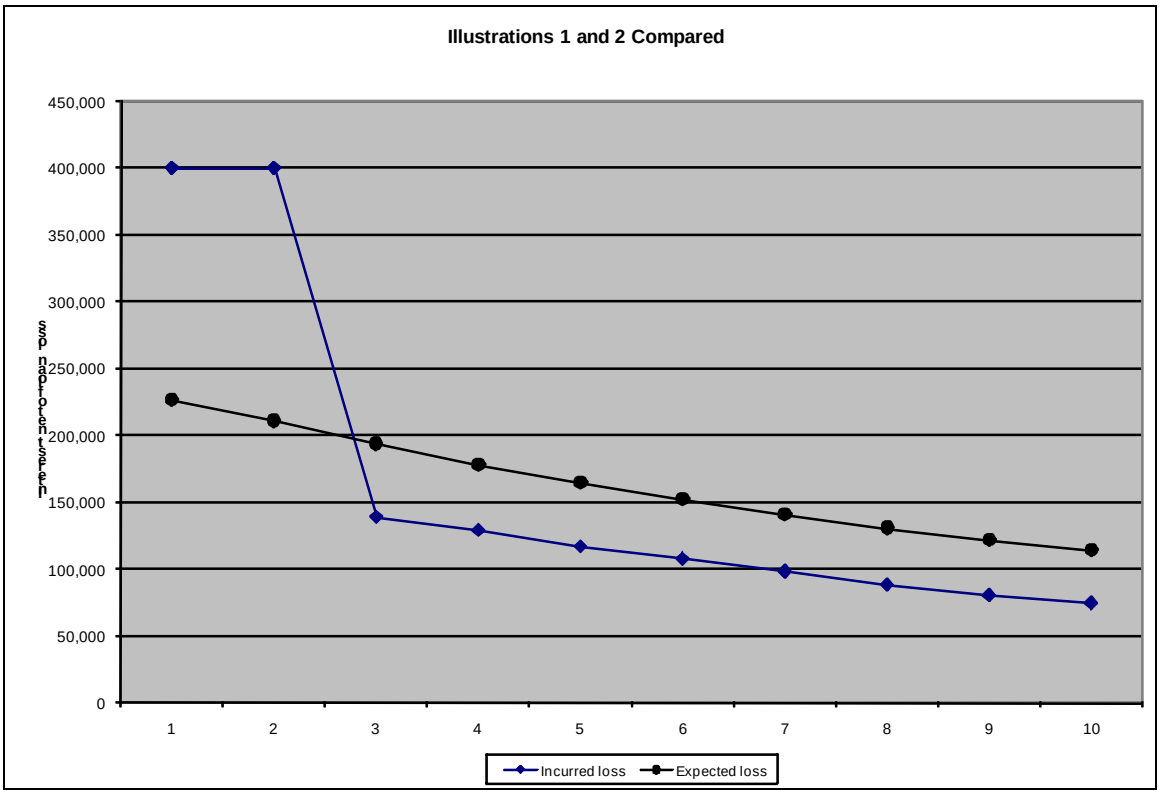
21. In the expected loss approach:

a. The carrying amount of the loan portfolio, net of the allowance for loan losses, is the present value of expected future cash flows discounted at the expected rate of 9.07 percent.

b. Interest income is computed at the 16 percent contractual rate.

c. Loan loss expense is the amount incurred, increased or decreased as necessary to obtain a.

22. Portrayed graphically, the two models produce the following:



Observation: Present value and deferral

23. A comparison of Illustrations 1 and 2 makes the expected loss approach appear more prudent and conservative; deferring income from early years and recognizing it in later years. That appearance is misleading. Consider a slightly different loan portfolio. In this revised portfolio, management expects defaults of about 13 percent in years 1 to 3, and none following that. The expected interest rate over the life of the loans is approximately 8.99 percent.

Expected Loss Model					
	Loans, net of allowance	Interest income	Loan loss expense (incurred)	Expected loss adjustment	Interest less Loan loss
12/31/X1	2,376,650	348,000	325,000	-201,650	224,650
12/31/X2	2,287,415	302,800	282,500	-193,265	213,565
12/31/X3	2,229,361	263,600	245,000	-186,946	205,546
12/31/X4	2,166,091	263,600	0	63,270	200,330
12/31/X6	2,097,136	263,600	0	68,955	194,645
12/31/X7	2,021,984	263,600	0	75,152	188,448
12/31/X8	1,940,079	263,600	0	81,905	181,695
12/31/X9	1,850,814	263,600	0	89,265	174,335
12/31/Y0	1,753,528	263,600	0	97,286	166,314
12/31/Y1	0	263,600	0	106,028	157,572

Illustration 3

24. Illustration 3 shows the other side of an approach designed to produce a smooth pattern of reported income over cash flows that are not smooth. In this case, the expected loss approach defers incurred losses from years 1 to 3 and charges them against years 4 to 10. The net carrying amount of loans remains higher than the contractual amount of those loans over the entire term.

Changing circumstances

25. How do the two models respond to changing circumstances? The next two illustrations return to the case shown in Illustrations 1 and 2. It is now 12/31/X2, and a major employer in the entity's market has announced a plant closing. While there

have been no defaults at year end, management estimates that an additional 100 loans will default in X3. After that, it expects the default rate to continue at 9 percent.

Incurred loss approach

26. The plant closure is a loss event. At 12/31/X2, the entity records an additional loan loss allowance for the 100 loans that it expects to default as a consequence of the plant closure, even though it cannot identify which 100 loans will default.

Incurred Loss Model				
	Loans, net of allowance	**Interest income**	**Loan loss expense**	**Interest less Loan loss**
12/31/X1	2,500,000	400,000	0	400,000
12/31/X2	2,250,000	400,000	250,000	150,000
12/31/X3	2,025,000	324,000	225,000	99,000
12/31/X4	1,845,000	295,200	180,000	115,200
12/31/X6	1,680,000	268,800	165,000	103,800
12/31/X7	1,530,000	244,800	150,000	94,800
12/31/X8	1,392,500	222,800	137,500	85,300
12/31/X9	1,267,500	202,800	125,000	77,800
12/31/Y0	1,155,000	184,800	112,500	72,300
12/31/Y1	0	168,400	102,500	65,900

Illustration 4

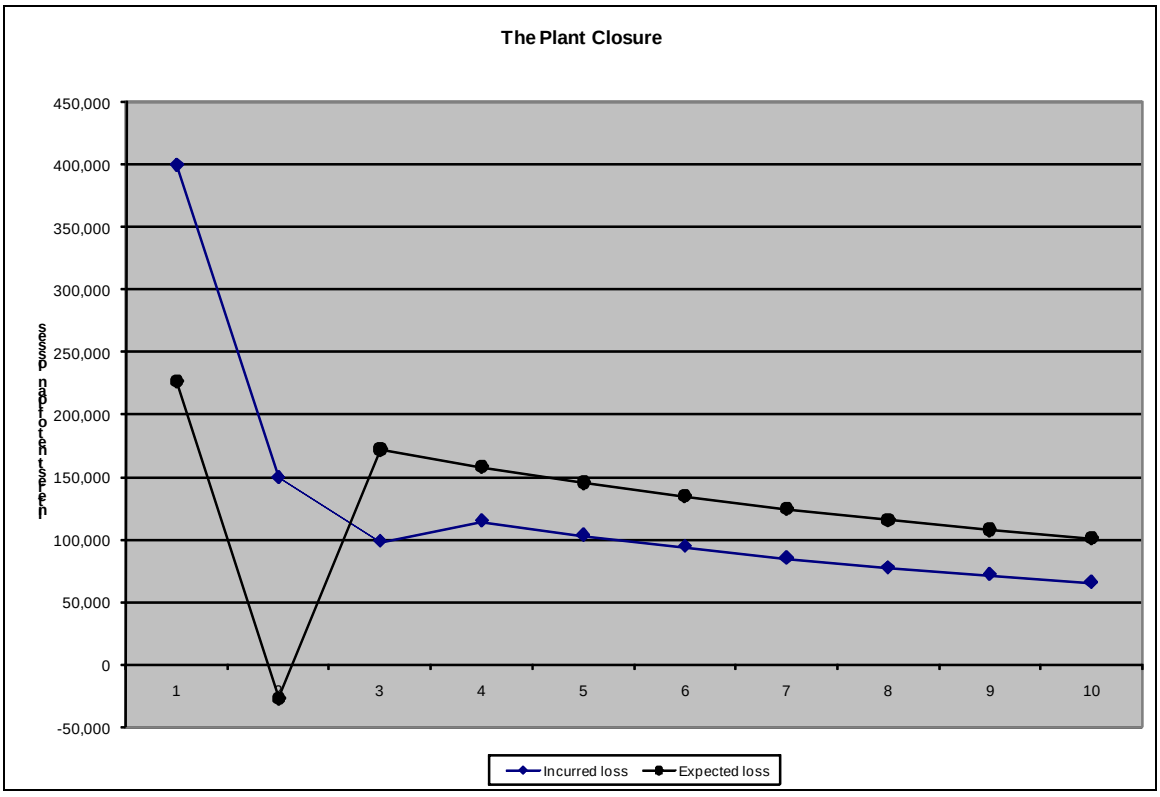
Expected loss approach

27. The change in expectations alters the expected cash flows from the entire portfolio. The additional defaults alter the base for all future cash flows. The entity records an adjustment in X2 necessary to increase its estimate of defaults and restate the net carrying amount of the loans to the new expected cash flows, discounted at the original 9.07 percent.

Expected Loss Model					
	Loans, net of allowance	Interest income	Loan loss expense (incurred)	Expected loss adjustment	Interest less Loan loss
12/31/X1	2,326,689	400,000	0	173,311	226,689
12/31/X2	1,900,576	400,000	250,000	176,113	-26,113
12/31/X3	1,748,911	324,000	225,000	-73,335	172,335
12/31/X4	1,612,295	295,200	180,000	-43,384	158,584
12/31/X6	1,489,690	268,800	165,000	-42,395	146,195
12/31/X7	1,379,969	244,800	150,000	-40,279	135,079
12/31/X8	1,282,298	222,800	137,500	-39,829	125,129
12/31/X9	1,195,771	202,800	125,000	-38,473	116,273
12/31/Y0	1,119,398	184,800	112,500	-36,127	108,427
12/31/Y1	0	168,400	102,500	-35,602	101,502

Illustration 5

28. Portrayed graphically:



29. In this implementation, the expected cash flow approach reports a net loss as a result of the revised estimate, while the incurred loss approach reports a net positive amount. That is a consequence of continuing to discount the revised cash flows at the originally computed 9.07 percent effective rate. If the revised cash flows were discounted at the new inherent rate in the carrying amount and remaining cash flows (about 7.36 percent), the expected cash flow approach would not report a net negative amount in year X2.

ANALYSIS OF THE TWO APPROACHES

Simplifying assumptions and complexity

30. The illustrations used so far are greatly simplified views of loan accounting, designed to show the basic workings of two accounting models. Specialists would criticize them as unrealistic, and they would be right. For example, the illustrations omit the following real-world complications:

    a. Transaction costs, fees, and origination costs that must be capitalized and included in the effective interest rate computation;

    b. Payments at dates other than 12/31;

    c. Partial payments and late payments;

    d. Prepayments.

31. IAS 39 requires an entity to include all of those elements in its computation of the effective interest rate (see IAS 39, paras 9 and AG 5-8). IAS 39 excludes future credit losses from the computation. An expected loss approach would include those future credit losses.

32. Auditors, preparers, and bank regulators tell us that the IAS 39 requirements are a frequent source of questions and difficulties. This is especially true in emerging economies and for nonfinancial entities. The IASB staff continues to receive suggestions that the amount in item a. above should be allocated over the contractual

life of loans (no prepayment assumption) using the straight-line method. Interest income from the loan would be recognized at the contractual rate.

33. The reactions to complexity are understandable, even if the proposed straight-line solution is unacceptable. Bank regulators from emerging economies tell us that their banks' managers lack the information and skills to accumulate the information and make the estimates. Bank regulators from developed economies sometimes say the same thing about small banks in their jurisdictions. Requiring entities to include estimated future credit losses in the computation would increase the complexity of the computation. Requiring entities to recompute the effective interest rate with each change in estimated cash flows would significantly increase system demands.

34. These concerns about complexity have led some to conclude that the expected loss model cannot be implemented at a reasonable cost. The rigorous historical records and estimation required are more common to estimates of insurance companies' liabilities than to banks and nonfinancial entities. Those who reach this conclusion also might observe that the expected loss model is not a sufficient improvement over existing practice unless it can be applied in a rigorous and disciplined manner.

35. The relative complexity of an expected loss model leads some to question whether the effort, if necessary, ought to be extended to fair value the loans. A building block approach to estimating fair value begins with an estimate of expected cash flows, rather than contractual amounts, and then uses current interest rates. Estimating the expected cash flows is the most difficult part of the computation. Why then, they reason, are users well served with an approach that "fair values" the loan loss provision but not the interest rate?

Conceptual rationale

36. The expected loss model is currently prohibited by both IFRS and US GAAP. Incorporating it would require an amendment, and its application probably would not be limited to loans but to all financial instruments that are not reported at fair value through profit or loss. Nor is it likely that such an amendment would be limited to banks. IFRSs apply to specific assets, liabilities, and activities rather than to

industries. This is not to say that an amendment is impossible, but that an amendment targeted on bank lending activity is not consistent with the IASB's approach to principles-based standards.

37. The incurred loss model has a long history in accounting and is based on the proposition that an asset is not impaired until some event happens to make it so. Its earliest and most prominent articulation was developed in FASB Statement No 5, *Accounting for Contingencies.* That FAS was developed in the 1970s in response to concerns that entities were accumulating reserves in good times and releasing them in bad times. The result was a systematic misstatement of assets and income in both.

38. In paragraph 75 of its basis for conclusions, the FASB observed:

> A recurring principle underlying all of these references to asset impairments in the accounting literature is that a loss should not be accrued until it is probable that an asset *has been* impaired and the amount of the loss can be reasonably estimated. As indicated by those references, impairment is recognized, for instance, when a non-temporary decline in the market price of marketable securities below cost *has taken place*, when the utility of inventory *is no longer* as great as its cost, when a commitment, in terms of a formal plan, *has been made* to abandon a segment of a business or to sell a segment at less than its carrying amount, when enterprise assets *are damaged*, and so forth. The condition in paragraph 8(a) is intended to proscribe accrual of losses that relate to future periods, and the condition in paragraph 8(b) further requires that the amount of loss be reasonably estimable before it is accrued. [Emphasis in original.]

39. That general principle of cause and effect can be found in several IFRSs other than IAS 39, most notably IAS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

40. That said, the need to establish cause and effect is a notoriously difficult element of the incurred loss model for loans. The plant closure illustrated in paragraph 25 is a straightforward example. But is the closure indicative of a broader economic downturn? If so, is the downturn a loss event? Paragraph 59 f. of IAS 39 includes the following description of this type of loss event and leaves room for considerable judgement:

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

(i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

(ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

41. Those who favour an expected loss model probably would counter that both approaches are allocation systems. IAS 39 (in conjunction with IAS 18, *Revenue*) already requires entities to defer fees and costs that are considered "an integral part of the effective interest rate." A one-year loan with a fee of 5 percent and a 2 percent interest rate has an effective interest rate of about 7.37 percent. In their view, expected defaults are also integral to the overall accounting for lending activity. No one expects the portfolio illustrated in this paper to actually earn 16 percent. Why then, they reason, should the entity report interest income, net of loan losses, as 16 percent in some periods and 5 percent in others? (See Illustrations 1 and 2.)

42. Proponents of an incurred loss model likely would counter that the cause and effect analysis provides a useful curb on potential earnings management. Expected loss advocates likely would reply that loan loss accounting is already subjective, and that there is no reason to conclude that an expected loss model would be more prone to manipulation than any other accounting estimate.

43. In this regard, we observe that accounting estimates are never completely objective. They often reflect the organizational culture of the entity and its management. Most auditors know that the loan loss provision is one of the most hotly debated elements

of any bank audit. Managers who are under pressure to report earnings are unlikely to be conservative in their estimates of loan losses, regardless of the model employed.

The rationale for the effective interest rate

44. Paragraph 28 alluded to the effect of using the original effective interest rate in loan accounting. We observed that one could recompute a new effective interest rate with each change in loss expectations. Doing so would dampen the effects of changes by spreading them over the remaining life of the portfolio. It would also be bad accounting.

45. Paragraph 5 described the principles of loan accounting in IAS 39. While those principles are expressed in terms of present value, they are similar to the simple inventory of a clothing store. The retailer has an inventory of 100 sweaters that cost CU 15 each. If one of those sweaters is damaged or stolen, the retailer charges off CU 15 and the carrying amount of the inventory is CU 1,485. No successful retailer would think of saying, "Someone stole a sweater, but thankfully the rest are now carried at CU 15.15."

46. In loan accounting, the future cash flows are like the retailer's inventory and the effective interest rate is the original cost of the sweaters. We use present value formulas to apply the cost to the inventory. In historical cost accounting conventions like inventory and loans, we keep the cost fixed and report changes to the quantity.

PROCYCLICALITY

47. Any accounting model that focuses on the characteristics of the particular loans in a portfolio will produce measurements that might be characterized as procyclical. A model that attempts to capture the results of cyclical behaviour – that of borrowers and lenders – will be cyclical. As illustrated earlier, both of the two models respond to changing conditions. The accounting result of that response is governed by the magnitude of the change and the manner in which the model is implemented. Because the expected loss model incorporates future credit losses that are excluded from the incurred loss model, we would expect it to report loan losses sooner in a

cycle. However, given the considerable judgement allowed by IAS 39, we cannot predict how much sooner.

48. As they are described in this paper, both approaches to accounting for loan losses are attempts to account for the characteristics of the portfolio of loans and events that affect the cash flows from that portfolio. Both rely on significant management judgement. The reported amounts will change as that judgement changes. Neither is designed specifically to compensate for the ups and downs of a credit cycle. Neither attempts to build up a "fund" or a "reserve" that can be used to dampen shocks caused by unexpected events.

49. Regulators may seek to incorporate measures that smooth the effects of a credit cycle. But do the resulting amounts report something other than the characteristics of the assets being measured? Stated differently, if the behaviour of the assets is cyclical, then any attempt to make the accounting less so must necessarily measure something other than the assets. For example, regulators might require that the loan loss allowance for the portfolio in our illustrations is the greater of the expected future losses or 11 percent of the contractual amount of the loans. The resulting amounts would certainly dampen the effects of events like the plant closing or a broader economic downturn.

50. However, the financial statements that result from such a system would no longer represent the economic characteristics of the loans in the portfolio. Amounts reported in the allowance for loan losses might or might not report expected losses. Returns on the portfolio would vary significantly, with the highest returns in the final year. The financial statements would represent the results of regulators' desire to (1) dampen the effects of economic cycles and (2) influence the lending behaviour of banks. Those may be valid policy choices, but neither is an objective of financial reporting.

51. We note that economic policy and financial reporting are bad companions. Over time, policymakers have wanted to encourage employee stock options, lending to home buyers, oil and gas exploration, and certain types of postretirement plans. In

each case, some have pressed for accounting treatments that would promote their goals. We take no position on those policy choices, but the role of accounting is to report the effects of choices, not to encourage entities to make them.

52. The objective of financial reporting is to present decision useful information to the users of financial statements. For information to be decision useful, it must be neutral and, to the extent possible, portray real-world characteristics of assets and liabilities. Users should know about the existence of regulatory devices that limit an entity's range of choices, like the one described here, but not at the cost of neutral information. Rather, the regulatory restrictions should be disclosed in notes to the financial statements and, perhaps, as an appropriation of capital reported on the balance sheet.

SUMMARY

53. This paper compares an approach to loan accounting that would incorporate expected future credit losses in the framework of principles found in IAS 39 with the existing incurred loss model. We have not examined the implications of an expected loss approach for assets other than loans that are reported at amortized cost.

54. The expected loss model described in the paper is an allocation system, just as is the effective interest method described in IAS 39. Like any allocation system, it has an element of arbitrariness. It defers the effects of some events and accelerates the effects of others. In some situations, it would necessarily defer the effects of incurred losses. In some situations, the effects of changes in expected losses might be more significant in an expected loss model than in an incurred loss model.

55. We note that an expected loss model would place significant demands on financial statement preparers and auditors. This is especially true in emerging economies and for nonfinancial entities. Given the considerable range of judgement that exists in application of the incurred loss model, it is not clear that the improvement in financial reporting justifies this increased cost.

56. From our examination of simple illustrations, we cannot conclude that an expected loss model is more countercyclical than an incurred loss model. Indeed, in some situations, it would report losses sooner, and of larger amounts, than an incurred loss model. Beyond that, any accounting model that attempts to measure economic characteristics of loans and management expectations will inevitably follow a credit cycle. Borrowers' behaviour is cyclical, and accounting for that behaviour will be likewise.

57. If regulators wish to have banks behave in a manner that is countercyclical, they should do so through restrictions on capital. In this case, financial reporting cannot serve policy objectives and provide decision useful information at the same time.