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Project **Accounting for Financial Instruments**

Topic **Recognition of Credit Impairment Losses**

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## Introduction

1. This paper outlines several models for the recognition of credit impairment losses, which were discussed by the Boards at the Joint meetings held November 10-13, 2010. A more robust introduction and additional alternatives are included in Agenda Papers 13/Memorandum 71 and 13B/Memorandum 71B.
2. For each alternative, this paper describes the recognition of credit impairment, the presentation of amounts in the balance sheet and income statement that would be envisioned resulting from application of the alternative, and summarizes potential issues and operational considerations.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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## Alternative Models

### *Alternative 1: Immediate Recognition of Lifetime Expected Losses*

#### *Description*

3. This alternative would have the following features:
  - (a) *Amount of credit loss estimate:* The amount of the expected credit losses would be the full amount of losses expected by the entity for the portfolio of the loans, regardless of when they occur during the lifetime of the loan portfolio. For open portfolios, the amount of the credit loss would be determined by applying a loss rate to the portfolio balance (which is an undiscounted principal amount) at each reporting date.
  - (b) *Timing of recognition:* An entity would recognize all expected credit losses (and changes in expected credit losses) in the current period.

#### *Financial statement presentation*

4. This alternative would be reflected in the financial statements as follows:
  - (a) From a balance sheet perspective, the allowance for credit losses would represent all expected losses on the financial assets (regardless of when they might occur) that are inherent in its financial asset balance at the reporting date.
  - (b) The allowance would always remain positive and could not carry a negative balance. A change in expectations could not result in reversing credit impairment unless it was previously recognized as a charge in net income.
  - (c) The carrying amount of the financial assets would represent management's best estimate of cash flows that are expected to be realized

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for the financial assets consistent with the objective of holding for collection of cash flows.

- (d) Upon transition, there would be an adjustment to bring the allowance balance to the full lifetime expected credit loss. Thereafter, in each reporting period, the income statement would include an expense that reflects changes in the lifetime expected loss, with a corresponding adjustment of the allowance. Presumably, the life loss rate and the portfolio balance will change at each reporting date, which would drive the changes in the estimate each period.
- (e) Both favorable and adverse changes in expected credit losses would be recognized, so the model would be symmetrical.

*Potential Issues/Operational Considerations*

- 5. The key concerns with this approach are the following:
  - (a) The amount of the allowance under this type of approach reflecting the full expected credit loss for the expected life of the loan portfolio may be excessive.
  - (b) Some are concerned with the reliability of a life loss estimate, noting that entities can reliably forecast expected credit losses in a more near term timeframe but that reliability decreases significantly in the “out” years.
- 6. One operational consideration is the determination and updating of a life loss rate to be used in an immediate recognition model. The staff believes financial institutions could develop different techniques for determining life loss rates. One approach for determining a reserve based on expected credit losses over the life was discussed in Agenda Paper 1B/Memorandum 69. Paragraphs 45-47 of that paper discussed that at the end of the period for which specific projection information is available (that is, when an entity can forecast), an entity would then use a different approach to calculate an expectation of losses to occur in the more distant future. Such a calculation may be based on an average loss rate (as

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opposed to a specific projection which would require estimating specific inputs for periods in the distant future). This approach would be similar to a ‘terminal value’ used in a goodwill impairment calculation.

7. The staff believes further research would need to be conducted to determine what techniques would be used to determine life loss rates. For example, if entities currently determine annual loss rates, one question would be how to convert those rates to lifetime loss rates.

***Alternative 2: Immediate recognition of losses expected to occur in a shorter emergence period***

*Description*

8. This alternative would have the following features:
  - (a) *Amount of credit loss estimate:* The amount of the expected credit losses would be the amount of losses expected by the entity for the portfolio of the loans in a shorter emergence period. For example, this shorter emergence period could correspond to the timeframe used for incorporating into the information set expectations about future conditions. If that timeframe is 2-3 years out, then the coverage period could likewise be 2-3 years worth of losses. For open portfolios, the amount of the credit loss would be determined by applying a loss rate to the portfolio balance (which is an undiscounted principal amount) at each reporting date.
    - (i) Due to the shortening of the coverage period, the recognition of credit losses under this alternative could be described as having an inherent reliability threshold because it could be designed so that the boundaries are the periods for which that management considers future conditions, but not beyond that.

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- (ii) For certain asset classes, the shorter coverage period may not be substantially different from the weighted average expected lives of the financial assets.
- (b) *Timing of recognition:* An entity would recognize all expected credit losses (and changes in expected credit losses) as determined above in the current period.

*Financial statement presentation*

- 9. This alternative would be reflected in the financial statements as follows:
  - (a) From a balance sheet perspective, the allowance for credit losses would represent all expected losses on the financial assets expected to occur in the shorter timeframe (specified as desired, for example, for the foreseeable future, near term, or forthcoming 2-3 years) that are inherent in its financial asset balance at the reporting date.
  - (b) The allowance would always remain positive and could not carry a negative balance. A change in expectations could not result in reversing credit impairment unless it was previously recognized as a charge in net income.
  - (c) The carrying amount of the financial assets would represent management's best estimate of cash flows that are expected to be realized for the financial assets given the shorter-term coverage period.
  - (d) Upon transition, there would be an adjustment to bring the allowance balance to the expected credit loss amount that would provide coverage for the shorter-term period. Thereafter, in each reporting period, the income statement would include an expense that reflects changes in the expected loss, with a corresponding adjustment of the allowance. Presumably, the loss rate and the portfolio balance will change at each reporting date, which would drive the changes in the estimate each period.

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- (e) Both favorable and adverse changes in expected credit losses would be recognized, so the model would be symmetrical.

*Potential Issues/Operational Considerations*

- 10. One operational consideration is the determination and updating of a loss rate that would reflect coverage of a period greater than a single year but for a shorter-term period than the full expected life of the portfolio of financial assets. As in Alternative 1, the staff believes financial institutions could develop different techniques for determining these rates. The staff believes further research would need to be conducted to determine what techniques would be used to determine loss rates for this alternative.

***Alternative 3: Recognition of losses expected to occur in a shorter emergence period over the emergence period***

*Description*

- 11. This alternative would have the following features:
  - (a) *Amount of credit loss estimate:* The amount under this alternative would be consistent with Alternative 2; that is, the amount of the expected credit losses would be the amount of losses expected by the entity for the portfolio of the loans in a shorter emergence period.
  - (b) *Timing of recognition:* Theoretically, an entity would recognize expected credit losses for the shorter emergence period over that emergence period.

*Financial statement presentation*

- 12. This alternative would be reflected in the financial statements as follows:
  - (a) From a balance sheet perspective, the allowance for credit losses would represent a portion of expected losses on the financial assets expected to occur in the shorter timeframe (specified as desired, for example, for the foreseeable future, near term, or forthcoming 2-3 years).

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- (b) The carrying amount of the financial assets would represent amounts expected to be collected on the financial assets *less* an apportioned amount of the full expected losses over the shorter-term coverage period.
- (c) Upon transition, there would be an adjustment to bring the allowance balance to a target balance reflecting a portion of the credit losses expected over the shorter-term period. Thereafter, in each reporting period, the income statement would include an expense that reflects changes in this expected loss, with a corresponding adjustment of the allowance.

*Potential Issues/Operational Considerations*

- 13. Theoretically, under this alternative, for an individual loan or for loans in a closed pool, an entity would recognize expected credit losses (and changes in expected credit losses) for the shorter emergence period over that emergence period. If we assume the loss emergence period is 3 years for capturing impairment losses under this alternative, then the apparent objective of this alternative would be to “build up” to the 3 year expected loss.
- 14. In an open pool setting, the staff believes it is unclear how this would be achieved. The staff believes that the notion of allocation over a particular time period is achievable only for recognition and measurement of credit impairment for individual assets and closed pools as the expected or contractual lives of the financial assets are finite. However, in an open pool, there is no true concept of allocation of amounts over a specified time period because an open pool has no beginning and no specified maturity. Consequently, in any approach that would articulate recognition and measurement of impairment based on an allocated amount, whether it be over the full expected life or a shorter emergence period, the allowance for credit losses must be determined based on a percentage or rate applied to the pool balance at the reporting date to arrive at a target allowance balance.

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15. Therefore, this alternative would require some mechanism for determining the target allowance balance for an open pool at any given point in time. In the decoupled approach discussed in Alternative 4 in Agenda Paper 13B/Memorandum 71B, the mechanism for arriving at this point in time estimate is based on a time-proportionate approach. That is, the approach uses the concept of the weighted average age of the portfolio as a proportion of the average life of the portfolio. However, the staff believes the weighted average age of the portfolio is not relevant for developing the percentage that would be used to compute the target allowance balance under this alternative.
16. Therefore, as a practical matter, the staff believes Alternative 2 is operationally easier. Under that alternative, in the example discussed previously, the entire 3 years of expected losses would be recognized immediately (at transition) and continuously updated for the total expected loss for the forthcoming 3 years.