Project **Financial Instruments: Impairment**

Topic **Estimating the amount of expected losses**

Purpose of this paper

1. The information considered, and how to use that information, when estimating EL has an effect on the amount of EL to be recognised. The staff believe that within the impairment model, there is also a potential interdependence with how to estimate EL (and therefore the EL amount) and the timing of loss recognition. For example, if only the losses expected to occur in the next two years of a five year instruments are to be recognised (either immediately or through allocation), it would not make sense to allocate that short-term EL estimate over 5 year life of the instrument. Likewise, when lifetime expected losses are estimated, if using an allocation approach, it would make sense to allocate over the expected life of the assets. See Agenda Paper 1C / Memorandum 70 for discussion on timing of recognition of EL.

2. This paper first provides analysis and a recommendation for what outlook period should be used for estimating EL (ie estimating EL over the lifetime of the assets, or something shorter) [1].

[1] Note that the IASB tentatively decided at the 24 August 2010 meeting to use a lifetime EL estimate and to permit forecasting when determining the EL. This paper includes several excerpts from agenda papers 1C and 1D of that meeting.

3. One of the areas in which the IASB ED[2] and FASB ED[3] diverged is in the description of how to use the information set available at the measurement date to estimate the amount of expected credit losses (EL).

4. It is important to note that in this paper we use the label 'estimate' as an overall term describing the process by which an entity arrives at an EL amount. The estimate could include specific projections/forecasts of loss amounts for particular time periods if the information available at the measurement date supports such specific projections. For each specific projection, the assumptions underlying the EL are differentiated over time (ie different assumptions for the periods covered by the projection). The estimate could also include amounts that are arrived at based on estimates of longer-term trends at the measurement date. For such amounts, the assumptions underlying the EL amount are not differentiated over time.

5. Some respondents to the IASB ED argued that the proposed guidance was too vague in how EL estimates should be made, and could result in estimates (particularly specific EL projections made for a time period that is far into the future) that were inconsistent with, or that could not be supported by, the current available information.

6. Some respondents to the FASB ED argued that the prohibition of any forecasting was too limiting, was inconsistent with credit risk management practices and would limit the usefulness of the information to users of financial statements.

7. This paper provides analysis and a recommendation on the issue of how the information set available at the measurement date should be used to estimate the amount of EL. However, this part of the paper is only relevant if the Board agrees with the staff recommendation on Question 1.

8. The rest of this paper is structured as follows:

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[2] November 2009 IASB exposure draft *Financial Instruments: Amortised Cost and Impairment* (IASB ED)
[3] May 2010 FASB proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* (FASB ED)

(a) the outlook period for expected losses – short-term versus lifetime expected losses;

(b) staff recommendation and question to the Board on (a);

(c) estimation requirements in current accounting guidance;

(d) how EL estimates should be made;

(e) staff recommendation and question to the Board on (d).

Outlook period for EL estimates

Short-term versus lifetime expected losses

9. Both the FASB ED and IASB ED proposed that entities estimate the cash flows expected to be collected (and, effectively, the EL) over the life of the instrument.

10. Many respondents support an expected loss approach which allows for a long-term outlook period (ie *lifetime* expected losses). They commented that permitting entities to estimate *lifetime* expected losses, the assessment of losses that can be based on the same information that was, presumably, included within the pricing of the assets. Such an assessment also often more closely reflects their internal risk management and reporting systems.

11. However, other feedback from outreach activities and some respondents suggest the impairment approach be based on short-term EL. Some suggested such an approach could be based on the Basel II 1-year expected loss under the Basel II internal ratings based approach. However, many agreed that the Basel II 1-year expected loss is an arbitrary cut-off. In its comment letter to the IASB [CL 148], the Basel Committee have also proposed to use lifetime expected loss[4].

12. Supporters of a short-term EL estimate believe only estimating into the short-term would be more operationally feasible. They also argue that estimating losses beyond the short term would often be less precise, more subjective and less

[4] CL 148; Appendix A

reliable and hence introduce unwarranted volatility in profit or loss. Therefore, when using an immediate recognition model, supporters of a short-term EL estimate prefer to have what they consider a more precise short-term estimate which would have a less severe effect on the financial statements than a lifetime EL estimate immediately recognised.

13. Because of the imprecision in long-term estimates, they believe that the estimates will likely change throughout the life resulting in volatility. In their view, only expected losses in the short term should be considered.

14. However, there is a difference in the volatility in profit or loss that results from short-term and long-term outlook periods:

    (a) Generally, the uncertainty of the credit loss estimate increases with the length of the outlook period. While discounting would have a counter-balancing effect, the overall effect (ie comparing the present values of the changes) can still be that the volatility from changes in estimates is higher for longer term assets with the longer outlook period.

    (b) Given that an outlook period that is shorter than the life of the asset excludes a part of the lifetime expected loss, this would create artificial volatility from the effect of expectations that later crystallise but were ignored in earlier estimates. For example, if it is determined that only losses expected to occur in the next 2 years should be considered in calculating expected losses of a 10-year asset, each year the entity would have to update the expectation for the 2nd year that comes into the 'short term' outlook. Hence, by only considering short-term losses, volatility in profit or loss cannot be avoided.

    (c) Excluding part of the lifetime expected loss can also undermine comparability because the loss patterns of different assets are not the same. For example, financial products with early loss patterns (ie credit losses peak in the earlier part of their life) such as car loans or construction loans would have most of the associated credit losses included in the shorter term expected loss. Conversely, for other

financial products with late(r) loss patterns the expected loss would exclude most of the credit losses until later on. This would systematically distort any comparison of the risk and the profitability of these products. Further, comparability will be further distorted to the extent that different short-term outlook periods were defined for different products.

(d) Using an outlook period that is shorter than the life of the asset means some loss information will only later become available in the external financial reporting, ie once it is taken into account in measuring amortised cost and the allowance balance, thereby affecting profit or loss.

15. Financial reporting that faithfully represents the economic characteristics of any (but especially longer-term) assets would have to reflect the uncertainty on profit or loss associated with its entire term (ie lifetime expected loss). Anything other than a *lifetime* expected loss ignores some credit losses and conveys an incomplete picture of the profitability and the pricing of the financial asset.

16. A short-term expected loss approach does not provide an appropriate link between the future profitability of the portfolio and expected credit losses. The pricing of the financial asset is set for the lifetime at origination and therefore the appropriate link to profitability can only be consistently established by considering lifetime expected losses. Considering short-term expected losses is also inconsistent with the initial measurement of a financial asset (implicit in the initial measurement of a financial asset is pricing for the ***lifetime*** expected losses).

17. The staff further note that identifying any threshold for which losses are 'short term' and which are 'long term' would be an arbitrary cut-off rather than a principles-based approach. This is because time is a *continuous* spectrum, which means it will not be possible to conceptually justify any particular cut-off point (more or less than any other). Also if short-term EL estimates were used, would there need to be a different arbitrary cut-off for different types of products?

18. Moreover, the staff note that any threshold that was not a bright line would be prone to different application by different entities in practice. This is already a

significant problem with the application of the notion of incurred but not reported (IBNR) today, which is similar in this regard (see Appendix).

Staff recommendation

19. For the reasons discussed above the staff recommend to move forward using an expected loss approach based on *lifetime* expected losses.

20. **If the Boards do not agree with the staff recommendation, the rest of this paper is irrelevant and should not be discussed.**

Question 1 – Outlook period
Do the Boards agree with the staff recommendation to move forward using an expected loss approach based on *lifetime* expected losses? If not, what should the outlook period be and why?

Estimation requirements in current accounting guidance

21. Using current information to estimate the future is not a new concept under either IFRSs or US GAAP. The following paragraphs summarise some such areas.

Conceptual framework for financial reporting

22. Paragraph OB2 – OB4 of the IASB's *Conceptual Framework* and FASB's Concept Statement 8, *Conceptual Framework for Financial Reporting* describe the objective for financial reporting. An excerpt from those paragraphs follows:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. …
>
> Decisions…depend on the returns that [users] expect. …expectations about returns depend on [users'] assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. …[users] need information to help them assess the prospects for future net cash inflows to an entity…

23. As it relates to financial assets, the net cash inflows to an entity would be the amount returned over and above the initial capital lent to debtors and any related costs. When deciding what the net cash inflows are, the staff believe that some sort of estimation is necessary to faithfully represent the amount, timing and *uncertainty* of the future net cash inflows. Considering only contractual amounts may not faithfully represent future net cash inflows to an entity, and would ignore the *uncertainty* of future net cash inflows.

Other areas of current accounting guidance

24. IAS 36 *Impairment of Assets* requires that an entity for calculating value in use:[5]

> base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the *range* of economic conditions that *will exist* over the *remaining useful life* of the asset. Greater weight shall be given to external evidence. [*emphasis added*]

25. Topic 360 *Property, plant, and equipment* requires for an entity applying US GAAP that:[6]

> Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider *all available evidence*. … if alternative courses of action to recover the carrying amount of a long-lived asset (asset group) are under consideration or if *a range is estimated for the amount of possible future cash flows* associated with the likely course of action, the likelihood of those possible outcomes shall be considered.
>
> Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall be made for the *remaining useful life* of the asset (asset group) to the entity. [*emphasis added*]

26. Hence, IAS 36 and Topic 360 require cash flow projections that are based on management's estimates of economic conditions that will exist in the future as well as the range of different possible outcomes. The staff note that this estimate of future economic conditions often goes beyond only a short-term assessment because the remaining useful life of the non-financial assets assessed for

[5] IAS 36.33(a).
[6] ASC 360-10-35-30 and 31.

impairment is often long-term (eg for larger machinery, buildings and entire production plants).

27. For time horizons up to five years IAS 36 requires management to use its forecasts to project cash flows. However, if justified by a track record of past estimates, that period can be longer.[7] The staff consider that because cash flows generated by non-financial assets are not contractually pre-set over the life of the asset cash flow projections for them are subject to many more assumptions than for financial assets and hence are more difficult. Therefore, limiting cash flow projections for the purpose of impairment testing financial assets more than for non-financial assets seems unwarranted.

28. For cash flow projections beyond the period covered by forecasts IAS 36 envisages the use of a steady or declining growth rate (including growth rates that turn negative in the future). The staff note that the decision whether to use a declining growth rate (and if so, what decline) means that management has to anticipate future changes (in the growth rate) even for periods beyond that covered by forecasts. IAS 36 also envisages the use of an increase in the rate (future positive changes) if the rate matches objective information about patterns over a product or industry lifecycle[8].

29. Hence, IAS 36 and Topic 360 do not restrict the use of any information but requires entities to consider whether the information used reflects reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset[9].

30. Also, both IAS 19 and Topic 715 require estimating the amount and timing of future events related to the measurement of projected benefit obligations. Neither US GAAP nor IFRSs limit the forecasting period. Topic 715 states[10]:

> The projected benefit obligation is a measure of benefits attributed to service to date assuming that the plan continues in effect and that

[7] IAS 36.33(b). US GAAP does not have this same specific guidance, but practice generally follows a similar approach.
[8] IAS 36.36.
[9] IAS 36.38.
[10] ASC 715-30-35-1A

> *estimated future events* (including compensation increases, turnover, and mortality) occur. [*emphasis added*]

31. The Basis for Conclusions in IAS 19[11] states:

> The Board believes that the assumptions are used not to determine whether an obligation exists, but to measure an existing obligation on a basis which provides the most relevant measure of the estimated outflow of resources. … measurement should take account of estimated future salary increases.

How EL estimates should be made

32. This section of the paper addresses alternatives for how to arrive at estimates for the EL amount. The two alternatives for the Boards to consider when estimating lifetime EL are:

    (a) **Alternative A:** Estimate assumes that conditions existing at the reporting date continue for the entire estimate period;

    (b) **Alternative B:** Estimate based on expectations of future conditions using historical data and other current information.

Background

33. As mentioned above, both the FASB's and IASB's ED proposed that entities estimate the expected cash flows over the remaining life of the instrument. However, the EDs provided different guidance on what conditions to consider. In paragraph 42 of the FASB ED, consideration of future conditions is explicitly prohibited. The IASB ED requires expected cash flows to be based on expected values (which inherently includes consideration of future conditions).

34. Both the FASB's and the IASB's ED would permit an entity to consider both internal data (that is, entity-specific information) and external data.

35. Respondents to the EDs generally stated that they have adequate data and knowledge to determine the relevant historical data to estimate EL at a given

[11] IAS 19.BC36.

reporting date. Many respondents also stated that they believed that they could and should consider current economic data and trends to project future economic conditions (at least over some period) in arriving at an EL amount.

Alternative A: Estimate assumes that conditions existing at the reporting date continue for the entire estimate period

36. This alternative would estimate EL based on the assumption that conditions existing at the reporting date continue for the entire estimate period. That is, the EL estimate would exclude any possibility that future conditions might be different than current conditions.

37. A few respondents support this approach because, in their view, the future cannot be reliably predicted and including such information would be subject to significant management judgement.

38. The staff note that economic and market conditions are dynamic and change over time in cycles[12]. That is, the future is hardly ever the same as today. Changes from conditions today will affect future cash flows. Furthermore, possible changes in economic and market conditions that could impact cash flows are considered in pricing of the financial assets.

39. Today for internal and external risk management purposes, entities have to make assumptions about future conditions to estimate and manage EL. Many respondents commented that EL estimates should include expectations of future changes in economic and market conditions beyond the reporting date. For example, many entities use current information that is forward looking. For example, forward curves and current forecasts of future changes in economic growth rates, unemployment rates and collateral values (eg real estate prices), etc, when estimating future credit losses.

40. Some respondents noted that not factoring in future changes will provide a misleading indication of expected future cash flows. Others pointed out that assuming no change of conditions equates to using a forecast that is certain **not** to

[12] The cycles are not uniform but change themselves, though.

occur as conditions are always changing. As a result, the reasonableness of (implicitly) mandating such a forecast is questionable.

41. Some noted that if cash flow (loss) estimates are restricted so that they do not include the effect of future changes in economic conditions then the expected losses omit or overstate some credit losses. Therefore, expected losses would convey an incomplete picture of the profitability and the pricing of the financial asset.

Alternative B: Use of current information to estimate EL based on expectations of future conditions

42. Alternative B would not assume that the future will be the same as today. Expectations of future conditions would be included within the EL estimate. Those expectations would be based on, and have to be consistent with, currently available information (including historical information). Any assumptions made would have to be internally consistent.

43. Under this approach the EL estimate could include specific projections of loss amounts for particular time periods if the information available at the measurement date supports such specific projections. For each specific projection, the assumptions underlying the EL are differentiated over time. For periods in which the information available does not support specific projections, the EL amount would be arrived at using estimates of longer-term trends expected at the measurement date. For such amounts, the assumptions underlying the EL amount are not differentiated over time.

44. Many respondents are concerned with having to make specific loss estimates (which require differentiated assumptions for each loss estimate made) in time periods that are far into the future. Conversely, many believe that they can make specific projections in the short term, or short to medium term, depending on the type of asset, information available etc.

45. In Alternative B, at the end of the period for which specific projection information is available, an entity would then use a different approach to calculate an

expectation of losses to occur in the more distant future (to estimate total expected losses). Such a calculation may be based on an average loss rate (as opposed to a specific projection which would require estimating specific inputs for periods in the distant future). This would be similar to a 'terminal value' used in a goodwill impairment calculation, for example. Or, to the growth rate required in IAS 36.

46. Another possible way of applying such an approach would be to first determine the average loss rate (or the total lifetime expected losses) based on historical and current information. Then, an entity could deviate from that average rate to the extent that reasonable and supportable information exists to substantiate that deviation. However, when reverting back to the original loss rate determined, consideration should be given to whether that loss rate should be adjusted for the future periods based on the near term estimates.

47. The Expert Advisory Panel (EAP) discussed how best to estimate lifetime EL. The EAP advised that in determining lifetime EL management should be able to use all available information, which may result in a combination of forecasts for shorter term estimates and long run averages for estimates relating to periods in the more distant future (see paragraph 45). For financial products with longer maturities entities may revert to a long-term average loss rate as representing their best estimate of lifetime expected loss including all supportable and reasonable information available at the reporting period.

48. The staff note that any expectations about future conditions would be based on, and have to be consistent with, currently available information (including historical information). Any assumptions made would also have to be internally consistent. The staff expects that specific projection information will be more supportable and reliable over shorter periods than that projected for longer periods.

49. Some respondents suggested that this forecasting approach could use the term 'foreseeable' future for the specific forecast period. However, if using that term, constituents are likely to want guidance as to what is meant by the 'foreseeable' future. Is that 1 year, 2 years, 3 years, etc? Providing such guidance leads to similar issues as those discussed related to identifying an arbitrary cut-off and a

bright line as described in Appendix A in the lifetime versus short-term EL discussion. Therefore, the staff does not believe that 'foreseeable' future nor 'near term' should be defined.

Staff recommendation

50. For the reasons discussed above, the staff consider that the EL estimate should use current information and be based on expectations of future conditions (ie Alternative B).

Question – Estimating the amount of expected losses
Do the Boards agree with the staff recommendation to use current information to estimate EL based on expectations of future conditions (ie Alternative B)? If not, what information should be considered when estimating lifetime EL?

Appendix

A1. The following is an excerpt from agenda paper 1C of the 24 August 2010 IASB meeting.

57. The weakness of using IBNR as a means to differentiate incurred and expected losses is that depending on the loss indicator used, a credit loss that is not yet incurred on the basis of one indicator can be incurred on the basis of another, more leading indicator. Different entities are likely to assess different loss events differently and use different indicators. Hence, IBNR is not selective. That is, it does not provide a consistent, sound differentiation of which losses have been 'incurred'.

58. The Expert Advisory Panel (EAP) also discussed and concluded that it is almost impossible to differentiate what losses have been incurred based on a change in an indicator and what are future credit losses that have yet to be incurred. Part of the problem is that the loss indicators used for IBNR purposes are more continuous *developments* rather than discrete 'events' (eg the change in economic growth or the unemployment rate) while an incurred loss approach is based on identifying loss events.

59. The staff also note that the application of IBNR is a key factor that causes diversity in practice regarding the timing of loss recognition. Because of the weakness of IBNR as a differentiator (see paragraph 57) providing additional application guidance cannot avoid the in diversity in practice regarding what is treated as incurred versus not yet incurred. Because of the complexity of the issue and how it affects the recognition of impairment disclosures could not effectively address the issue. In fact, some have described IBNR as applying an impairment model that is closer to expected than incurred approaches while others have applied IBNR such that it hardly makes a difference because it is considered somewhat of a foreign object in an incurred loss approach (which explains the significant diversity in practice that exists today).