



Financial Accounting Standards Board

Proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (Subtopic 825-15)

Frequently Asked Questions

March 25, 2013

The Board issued proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (Subtopic 825-15), on December 20, 2012 (December 2012 Exposure Draft). The comment period for that proposed Update ends on April 30, 2013.

The Board and staff continue to educate stakeholders about the proposal through participation in various conferences and by conducting outreach with investors, preparers, auditors, and regulators. Through these efforts, the Board and staff have received questions about various aspects of the proposal.

This document provides the staff's clarifications about the proposal by answering common questions received about the proposed guidance. The responses provided in this document represent the views of the staff and are intended to facilitate constituent understanding of the December 2012 Exposure Draft. The questions have been organized as follows:

- a. Project Objectives
- b. Measuring Expected Credit Losses
- c. Other Alternatives Considered.

During the summer of 2013, the Board expects to jointly discuss with the IASB the feedback received on both the FASB's December 2012 Exposure Draft and the IASB's Exposure Draft, *Financial Instruments: Expected Credit Losses* (IASB March 2013 Exposure Draft).

Project Objectives

1. What is the Board's objective as it relates to the recognition of credit losses and interest income?

Within a business model whose objective includes holding debt instruments for the collection of contractual cash flows, the Board believes that the amortized cost measurement objective is consistent with the way an entity expects to realize cash flows from the assets, namely by holding the instrument for the collection of contractual cash flows. That amortized cost objective is to reflect the present value of cash flows that an entity expects to collect. The Board believes

its proposed guidance achieves that objective through the combined effect of (a) the proposed guidance on classification and measurement that would result in measurement of the amortized cost basis of the financial asset at a present value, based on *contractual cash flows* and (b) the proposed guidance on credit losses that would result in an allowance for credit losses at a present value, based on *contractual cash flows not expected to be collected*, both discounted at the effective interest rate. See Question 18 for more information.

Regarding the income statement, the Board believes that the measurement objective of interest income is to reflect the rate of return implicit in a debt instrument (that is, the contractual interest rate adjusted for any net deferred loan fees, premiums, or discounts existing upon initial recognition, which is referred to as the effective interest rate). Importantly, that rate of return includes the compensation that a lender receives for taking on the credit risk inherent in the debt instrument and requires separate presentation of credit losses from interest income (often referred to as a “decoupled” approach for interest income and credit loss recognition). The Board believes its proposed guidance achieves that income statement objective through (a) the existing guidance that measures interest income based on the effective interest rate and (b) the proposed guidance on credit losses that measures credit loss expense based on the period change in expected credit losses.

The Board believes that any alternative approach that *delays* the recognition of some expected credit losses would fail to reflect the present value of cash flows that an entity expects to collect, which is the Board’s desired measurement objective for debt instruments on the balance sheet.

2. Why does the Board believe that the effective interest rate is the best rate for recognizing interest income?

The Board believes that the effective interest rate is the best rate for recognizing interest income because, very simply, investors have indicated this to the Board. Feedback on the proposed FASB 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)* (May 2010 Exposure Draft), and feedback received in more recent discussions with investors have indicated that users prefer to analyze interest income (without adjustment for expected credit losses) separately from their analysis of credit losses (that is, a so-called decoupled approach). Investors have indicated that the effective interest rate provides decision-useful information about the level of credit risk a lender took on when it originated or purchased a financial asset. Furthermore, the Board believes that retaining the current decoupled approach in U.S. generally accepted accounting principles (GAAP) will reduce the cost of implementing a more forward-looking model to credit loss recognition.

3. The FASB's proposed approach has been criticized as having an excessive front loading of credit loss recognition. Why does the Board believe that it is appropriate to recognize all expected credit losses at the first reporting date following the origination of a loan?

The Board believes it is appropriate to recognize all expected credit losses at each reporting date for a number of conceptual and practical reasons:

Conceptual Reasons:

- a. A primary weakness identified with the current accounting model is the delayed recognition of credit losses.
- b. When an entity holds a portfolio of debt instruments, credit losses are reasonably expected in the portfolio even if the entity is unable to specifically identify the individual financial assets upon which a loss is likely to materialize. The Board believes that entities should accrue for their expectation of loss.
- c. Historical information about credit losses for similar assets with similar credit ratings (as updated for current conditions and reasonable and supportable forecasts about the future) is a relevant metric upon which to base an entity's current estimate of credit losses. See Question 12 for more information.
- d. If a lender does not expect to collect contractual cash flows, the Board sees no conceptual reason why an entity should wait to recognize that expected loss. An accounting standard that delays recognition of expected losses fundamentally must determine which losses not to recognize, why those losses should not be recognized, and the period of time for which the unrecognized losses should be delayed. The Board believes that it is extremely difficult to answer those conceptual questions in anything other than an arbitrary manner. See Question 19 for more information.
- e. Within a business model whose objective includes holding debt instruments for the collection of contractual cash flows, the Board believes that the amortized cost measurement objective should be to reflect the present value of cash flows that an entity expects to collect. The Board believes that its proposed guidance achieves that objective through the combined effect of (a) the proposed guidance on classification and measurement that would result in measurement of the amortized cost basis of the financial asset at a present value, based on *contractual cash flows* and (b) the proposed guidance on credit losses that would result in an allowance for credit losses at a present value, based on *contractual cash flows not expected to be collected*, both discounted at the effective interest rate. See Question 1 for more information.
- f. When an entity originates a loan, that entity has increased its exposure to credit losses. Likewise, when a contractual payment is received in full from the borrower, the entity's

exposure to credit loss has decreased. The Board believes that recognizing all expected credit losses in the balance sheet causes the income statement to appropriately reflect the economic phenomenon that has occurred—namely, the extent to which an entity has increased or decreased its exposure to credit risk during the period.

Practical Reasons:

- g. The Board believes that investors desire transparency with regard to management’s *full* estimate of *all* expected credit losses (as opposed to a truncated, arbitrary portion of the credit losses that management expects).
- h. It is impractical, if not impossible, to accurately match the recognition of the part of compensation paid to a lender for taking on the borrower’s credit risk (in the form of interest income) with the recognition of credit losses expected upon initial recognition of the debt instrument, especially because credit losses do not materialize ratably. See Question 20 for more information.
- i. The FASB staff understands that the “significant deterioration” recognition trigger proposed by the IASB may not differ materially from how the incurred loss recognition trigger is applied under current U.S. GAAP. As a result, some are concerned that the approach proposed by the IASB would fail to address concerns about the delayed recognition of credit losses in the United States. See Question 19 for more information.
- j. To varying degrees, the upfront recognition of credit losses is already an element of current U.S. GAAP and also an element of the IASB’s March 2013 Exposure Draft, *Financial Instruments—Expected Credit Losses*.
- k. An expected credit loss model that consistently provides an allowance for *all* expected credit losses results in the simplest expected credit loss model for investors to understand and use in their modeling. For a highly subjective estimate such as the allowance for credit losses, such a model provides the most comparable information to investors by relying on a single measurement objective (as opposed to expecting that investors will be able to make comparisons between entities when each entity uses a model with more than one measurement objective and a subjective threshold for determining when the various measurement objectives are applied by that entity).

4. How does the expected credit loss model fit into the regulatory capital framework?

The mission of the FASB is very different from the mission of banking regulators. Specifically, the mission of the FASB is to establish and improve standards of financial accounting and reporting to provide decision-useful information to *investors* and other users of financial reports. The FASB’s proposed credit loss model would further this mission by providing management’s

estimate of all *expected* credit losses and, in doing so, would address users' concerns about the timely recognition of losses.

Conversely, while the missions of banking regulatory agencies may vary internationally and by agency, their missions often have to do with either (or both) (a) ensuring the safety and soundness of the financial system and/or (b) promoting an environment that facilitates access to credit. As members of the FASB staff understand the regulatory framework, the objective of regulatory capital is to provide a cushion for potential *unexpected* credit losses that could occur if economic conditions worsen, which is an objective that is different from the measurement of *expected* credit losses.

FASB staff and individual Board members continue to discuss the FASB's credit loss proposal with members of the regulatory community to promote consistent and appropriate understanding and interpretation of the Board's proposal.

5. Doesn't the Board really just want entities to record a larger allowance than is recognized under current U.S. GAAP?

No. The Board is seeking to faithfully represent expected credit losses in the financial statements. It is not aiming for a particular size (or directional change) in the allowance for credit losses. This project aims to address the weakness that was identified in current U.S. GAAP by the Financial Crisis Advisory Group (FCAG) regarding the delayed recognition of credit losses. The proposed model accomplishes that goal by requiring the timely recognition of all expected credit losses (as opposed to maintaining a threshold that must be met before all expected credit losses are recognized). Furthermore, the Board believes that the balance sheet under the proposed approach will clearly communicate to investors the present value of cash flows expected to be collected from debt instruments, while also reflecting all changes in expected credit losses (resulting from credit deterioration or improvement) through the income statement.

Measuring Expected Credit Losses

6. What is the allowance for expected credit losses under the FASB's proposed model?

The allowance for expected credit losses reflects management's estimate of all credit losses that management currently expects to realize from the financial assets recognized on the balance sheet (and on loan commitments). The estimate is neither a worst-case scenario nor a best-case scenario, but rather should be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. The Board expects that an entity's estimate of expected credit losses would be informed by historical loss experience for similar assets, coupled with adjustments for current conditions and reasonable and supportable forecasts about the future that inform management's judgment about how the current conditions may differ from its historical experience.

7. Does the expected credit loss estimate represent a *life of loan* estimate?

Yes. Expected credit losses are defined as an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit. As discussed in paragraph BC18 of the December 2012 Exposure Draft, the term *all contractual cash flows* refers to cash flows over the entire contractual term of the financial asset. The Board chose not to characterize the credit loss estimate as *lifetime losses* because that term suggested to stakeholders that projections would be necessary over the entire lifetime of an asset, which is not the case with the proposed model, as described in Questions 10 and 13.

8. Would prepayments be taken into consideration in estimating expected credit losses?

Yes. Expected prepayments shorten the expected life of a loan (relative to the full contractual life) and would be taken into consideration when estimating expected credit losses.

9. Would the value of collateral be taken into consideration in estimating expected credit losses?

Yes. Collateral serves to reduce a lender's exposure to credit losses on a given loan and would be taken into consideration when estimating expected credit losses.

10. How does the Board expect that historical loss experience will be used in developing the current estimate of expected credit losses?

The estimate of expected credit losses should consider current conditions and reasonable and supportable forecasts about the future. As a starting point, however, the Board expects that an entity's estimate of expected credit losses largely will be informed by historical loss information for financial assets of a similar type and credit risk. Once an entity has developed or obtained that historical loss information, the entity will need to evaluate whether and how the historical loss patterns differ from what is currently expected (which would be based on current conditions and reasonable and supportable forecasts). To do so, the Board expects that an entity would consider (a) the economic conditions that existed for the period over which historical statistics were developed and (b) how those conditions differ from what management currently expects will be the economic conditions facing the entity.

11. Why isn't the estimate of expected credit losses characterized as a *best estimate*?

Issued in February 2000, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from “unbiased” to “most likely.”

Similarly, Concepts Statement 7 distinguishes between the terms *estimated cash flow* and *expected cash flow* as follows:

In the past, accounting pronouncements have used the terms *estimated cash flow* and *expected cash flow* interchangeably. In this Statement:

Estimated cash flow refers to a single amount to be received or paid in the future.

Expected cash flow refers to the sum of probability-weighted amounts in a range of possible estimated amounts; the estimated mean or average.

The Board believes that when an entity holds a portfolio of debt instruments, credit losses can reasonably be expected in the portfolio even if an entity is unable to specifically identify the individual financial assets upon which a loss is likely to materialize. That expectation of credit losses is rooted in historical loss experience for groups of similar assets of a similar credit risk. The Board decided that the estimate of expected credit losses should not be based solely upon the statistical mode or most likely outcome. The Board believes the approach proposed in the December 2012 Exposure Draft largely achieves the same result as the pool overlay approach in the May 2010 Exposure Draft. That is, even when the *most likely outcome* (which is a common way to determine *estimated cash flows*) is zero credit loss, an entity would be required to establish an allowance for *expected* credit losses based on the risk of credit loss for similar assets with a similar credit rating. That risk of credit loss exists equally in portfolios and individual assets.

Given that the definition of the term *best estimate* in Concepts Statement 7 refers to a most likely outcome or statistical mode, that term was not selected in characterizing the expected credit loss estimate. In practice, however, the Board does not believe that the prohibition against the statistical mode will conflict with many commonly used approaches to estimating credit losses. Specifically, many measurement methods (such as a loss-rate method, a roll-rate method, a probability-of-default method, and a provision matrix using loss factors) rely on an extensive

population of actual loss data as an input when estimating credit losses. Those methods already typically rely on a statistical mean (that is, the average outcome) as opposed to the statistical mode when estimating credit losses.

12. Why didn't the Board limit the credit loss estimate only to those losses that are expected to occur within a reasonable and supportable forecast period?

The Board does not believe that it is representationally faithful to assign a credit loss estimate of zero to certain periods merely because an entity is unable to precisely estimate future economic conditions for those periods. Rather, the Board believes that historical information about loss is a relevant metric upon which to base an entity's current estimate of credit losses for those periods beyond which the entity believes it is able to develop or obtain reasonable and supportable forecasts.

Furthermore, an approach that does not recognize some expected losses (for example, those that are expected to occur after some prescribed forecast period) would fail to reflect the present value of cash flows that an entity expects to collect, which is the Board's desired measurement objective for debt instruments. Additionally, that approach would introduce noncomparability in expected credit losses across instrument types, time periods, and entities. Finally, the Board believes its proposed approach has the added benefit of removing the need to articulate the length of time into the future over which entities should be required to estimate credit losses.

13. Does an entity need to be able to forecast future economic conditions over the remaining life of the portfolio to estimate expected credit losses?

No. As noted in Questions 7 and 8, the estimate of expected credit losses is intended to represent an estimate of cash flows not expected to be collected over the entire contractual term of the financial asset (recognizing that expected prepayments are considered in estimating expected credit losses). The Board expects that this life-of-loan estimate will largely be informed by historical lifetime loss experience for similar assets.

To develop a current estimate of expected credit losses, the historical loss experience will need to be updated for the entity's current assessment of existing conditions and reasonable and supportable forecasts about the future (and their implications for the entity's current estimate of expected credit losses). However, an entity's ability or inability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan would only affect the entity's analysis of whether (and how) the historical loss experience *is adjusted* for what is currently expected. Furthermore, an entity's ability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan does *not* override the

need to consider historical loss experience for similar assets of similar credit risk as the foundation of the estimate of expected credit losses.

To that end, the Board did not intend to prescribe or prohibit specific approaches or assumptions in how management develops its expectation about the future. In outreach discussions performed to date, the staff has heard preparers describe several different approaches for adjusting historical loss experience for current conditions and reasonable and supportable forecasts about the future, including:

- a. Reverting to unadjusted historical averages for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts, or
- b. Assuming that economic conditions will remain stable for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts (that is, freezing the furthest reasonable and supportable forecast and utilizing that forecast for the remaining future periods).

The staff notes that both approaches are consistent with general valuation theory as to how the so-called terminal value is estimated for valuation purposes. In the absence of reasonable and supportable forecasts that contradict the implicit assumption about the future that is inherent in either approach, the staff does not believe the proposed guidance would preclude an entity from utilizing either approach.

The Board recognizes that the estimation of expected credit losses is highly judgmental. The Board believes that the most representationally faithful estimate of credit losses will, by necessity, incorporate management's expectations about the future. Management may develop those expectations about the future in a variety of ways, and the Board did not intend to require (or preclude) the use of any particular assumptions regarding how management develops its expectations about the future. Rather, the Board decided to provide users with transparency regarding those expectations and their effect on the estimate of expected credit losses, in the form of footnote disclosure (see paragraph 825-15-50-9(b) of the proposed Update on credit losses).

14. Should an entity's assessment of current conditions and reasonable and supportable forecasts about the future always serve to increase the reserve estimate (relative to a reserve based solely on information about past events, including historical loss experience with similar assets)?

No. The Board expects that an entity's estimate of expected credit losses would be informed by historical loss experience for similar assets, coupled with adjustments for current conditions and reasonable and supportable forecasts about the future that inform management's judgment about how the historical experience may differ from what it currently expects. Using historical loss experience as a starting point, an entity will need to evaluate whether and how the historical loss

patterns differ from what is currently expected. As described in Questions 10 and 13, the Board expects that an entity would consider the economic conditions that existed for the period over which historical statistics were developed and how those conditions differ from what management currently expects will be the economic conditions facing the entity. In doing so, an entity could conclude that the current and expected economic conditions facing it are more favorable or less favorable than the economic conditions that existed for the period over which historical statistics were developed. All things equal, when the current and expected economic conditions facing the entity are more favorable than the economic conditions that existed for the period over which historical statistics were developed, the Board expects that the current expected credit loss estimate would be lower than the historical average.

15. Would an entity be required to probability weight a number of forecasts about the future in determining what is expected when it decides how to incorporate or adjust historical statistics to arrive at an estimate of current expected credit losses?

No. In developing the estimate of expected credit losses, the Board expects that an entity would consider the economic conditions that existed for the period over which historical statistics were developed and how those conditions differ from management's expectation of the current and future economic conditions facing the entity as the current credit exposures mature. The proposal would merely require that the entity's expectation about the future be based on reasonable and supportable forecasts. The proposal neither requires nor prohibits management's *adjustment* for current conditions and reasonable and supportable forecasts about the future from being based on a statistical mean, a statistical median, or a statistical mode of reasonable and supportable forecasts. To that end, the prohibition against estimating *expected credit losses* based *solely* on the most likely outcome (see paragraph 825-15-25-5 of the proposed Update on credit losses) was not intended to prohibit an entity from developing its *adjustment to historical loss experience* for current and future economic conditions on the basis of the most likely outcome.

16. Please explain what it means to *implicitly* reflect the time value of money in the estimate of expected credit losses. To utilize an approach that *implicitly* reflects the time value of money, does an entity need to prove that the method provides the same results as a method that *explicitly* reflects the time value of money?

No. Paragraph 825-15-25-4 of the proposed Update on credit losses would require that an estimate of expected credit losses reflects the time value of money. That requirement is satisfied when the method used to estimate expected credit losses either explicitly or implicitly reflects the time value of money. An entity would not be required to prove that a method that *implicitly* reflects the time value of money provides the same result as (or reconciles with) a method that *explicitly* reflects the time value of money.

Most stakeholders acknowledge that a discounted cash flow model is an example of a method that explicitly reflects the time value of money by forecasting future cash flows (or cash shortfalls) and discounting those amounts to a present value using the effective interest rate. To some stakeholders, however, it might be less clear what it means to *implicitly* reflect the time value of money.

The Board believes entities should be permitted to utilize estimation techniques that are based on historical writeoff experience. The Board believes that those approaches implicitly reflect the time value of money, albeit in a different way than when an entity uses an explicit discounted cash flow technique. The amortized cost amount recognized on the balance sheet implicitly reflects the time value of money. As the amortized cost amount reflects the present value of contractual interest and contractual principal, the historical writeoff amount also reflects the present value of contractual interest and contractual principal not expected to be collected. Therefore, in paragraph 825-15-55-3 of the proposed Update on credit losses, the Board indicated that certain methods implicitly reflect the time value of money by developing loss statistics based on historical write offs of the amortized cost amount. Those methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors.

An entity would not be required to prove that a method that *implicitly* reflects the time value of money (as described in paragraph 825-15-55-3 of the proposed Update on credit losses) provides the same result as (or reconciles with) a method that *explicitly* reflects the time value of money. Rather, the Board decided that an entity may use any method that reflects the time value of money explicitly (such as a discounted cash flow technique) or implicitly (as described in paragraph 825-15-55-3 of the proposed Update on credit losses), with no need to reconcile those approaches.

As an aside, the Board recognizes that some individuals view the amount recognized on the balance sheet for a loan to be *principal* as opposed to an amortized cost amount that implicitly reflects the time value of money. While the amortized cost amount may happen to be the same as the principal amount outstanding, the amortized cost recognized on the balance sheet will not equal the principal amount outstanding if the loan is issued at a premium or a discount. As a result, the Board does not believe that it is accurate to suggest that the amount recognized on the balance sheet is *principal* or an *undiscounted* amount. However, in many situations, regardless of whether the amount recognized in the balance sheet for a loan is viewed as principal or the present value of principal and interest, the application of methods that implicitly reflect the time value of money would result in similar, if not the same, outcomes.

17. When an entity uses a discounted cash flow model to estimate expected credit losses, why does the Board believe that the effective interest rate is the appropriate rate for discounting future cash flows?

Within a business model whose objective includes holding debt instruments for the collection of contractual cash flows, the Board believes that the amortized cost measurement objective is to reflect the present value of cash flows that an entity expects to collect. The amortized cost of a debt instrument, prior to adjustment for expected credit losses, reflects the present value of *contractual* cash flows, discounted at the effective interest rate. To be consistent, the Board believes that the effective interest rate also is the best rate for determining the present value of *expected* cash flows. Therefore, when an entity chooses to use a discounted cash flow model to estimate expected credit losses, consistent with the basis for conclusions in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, the Board decided that the effective interest rate is the appropriate discount rate to isolate the measurement of contractual cash flows not expected to be collected.

The Board decided that the discount rate should not be updated to reflect changes in market rates of interest because that would fundamentally change the measurement attribute from *amortized cost* toward something closer to *fair value*.

18. How does the proposed guidance on classification and measurement and the recognition of credit losses achieve the amortized cost measurement objective of reflecting the present value of cash flows that an entity expects to collect?

When a financial asset is initially recognized under the proposed classification and measurement guidance, the asset is recognized at either transaction price or fair value. Conceptually, the Board believes that both of these initial measurement approaches reflect a *present value* as opposed to a *principal amount*. This is easily seen in the case of a bond purchased at a premium in which the purchase price would be the present value of contractual cash flows, discounted at a market rate of interest. For an originated loan, it is ordinarily a more theoretical point because when the stated rate reflects a current market rate, the present value and the principal amount are the same.

Subsequently, when a financial asset is managed within a business model whose objective includes holding debt instruments for the collection of contractual cash flows, amortized cost is utilized as the primary balance sheet measure. If the asset is managed within a business model whose objective is both to hold the asset for the collection of contractual cash flows and to sell the financial asset, then fair value is utilized as the primary balance sheet measure and amortized cost is utilized for purposes of determining the amounts to recognize in net income in each period. The existing guidance on amortized cost for financial assets largely focuses on determining the *effective interest rate* for use in applying the interest method. Generally, the effective interest rate is determined based on (a) the amount initially recorded and (b) the contractual cash flows of the asset.

In drafting its most recent proposals, the Board did not articulate an explicit present value objective in the proposed guidance on amortized cost because it did not intend to change current practices relating to interest income recognition or the related fees and costs. However, the Board has found it helpful to explain the combined effect of (a) the proposed classification and measurement guidance and (b) the proposed impairment guidance in terms of the *present value of expected cash flows*.

Other Alternatives Considered

19. Why didn't the Board propose a model that delays recognition of all expected credit losses until there has been a significant deterioration in the credit quality of the asset?

The IASB's March 2013 Exposure Draft proposes that an entity would only recognize a *portion* of expected credit losses (namely, 12 months of expected credit loss¹) until a specific *recognition trigger* has been met (that is, when there has been significant credit deterioration²). Some have asked the FASB why it did not pursue such a model.

The Board believes that one of the lessons learned from the global financial crisis of 2008 is that investors need timelier reporting of credit losses on loans and other financial instruments. Waiting until significant credit deterioration occurs before recognizing a loss defeats the purpose of moving from an incurred loss model to an expected loss model. Delaying recognition of part of an estimable loss until an event has occurred is akin to an *incurred* loss approach instead of an *expected* loss approach. The FASB's proposed model is intended to fix the problem that the FCAG identified with current U.S. GAAP related to the delayed recognition of credit losses.

Both the FASB model and the IASB model would require that expected credit losses be estimated based on past events, current conditions, and reasonable and supportable forecasts about the future. The amount of credit loss that is ultimately recognized would be the same under both the FASB and the IASB impairment models. The difference relates to when losses that are currently expected would be recognized. Under the FASB model, an entity would record its current estimate of expected credit losses every period. The IASB model would record a

¹ Appendix A of the IASB's March 2013 Exposure Draft defines a *12-month expected credit loss* as "the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date." Furthermore, it defines *expected credit losses* as "the weighted average of credit losses with the respective probabilities of default as the weights, for example, credit losses of CU100 x probability of a default occurring 5 per cent + CU0 x probability of no default occurring 95 per cent is equal to expected credit losses of CU5."

² See paragraph 5 of the IASB's March 2013 Exposure Draft, which indicates that "at the reporting date, the entity shall measure the expected credit losses for a financial instrument at an amount equal to *the lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition."

portion of the expected credit losses until significant credit deterioration has occurred, at which point the full estimate of expected credit losses would be recognized.

While estimating credit losses involves significant judgment under any accounting approach, the FASB believes that using a consistent measurement principle and removing any threshold for recognition reduces management's discretion as to when expected losses should be recognized. Furthermore, the FASB's proposed model would provide investors with a consistent balance sheet objective for debt instruments measured at amortized cost, namely the present value of cash flows that an entity expects to collect (which is not the case for the IASB's Stage One Assets in their March 2013 Exposure Draft).

When the Boards were jointly deliberating the Three Bucket Model, the Boards had tentatively agreed to a *relatively quick* trigger for recognition of lifetime expected credit losses.³ After the FASB decided to develop a model with no recognition trigger, the IASB modified its trigger to be based on *significant* credit deterioration. While the effect of this trigger will ultimately depend on judgments in how the term *significant deterioration* is implemented and interpreted across entities, the FASB staff understands that this trigger may not differ materially from how the *incurred loss* recognition trigger is judgmentally applied under current U.S. GAAP.

As a result, some are concerned that the approach proposed by the IASB would fail to address concerns about the delayed recognition of credit losses, at least in the United States.

20. Why didn't the Board propose a gross-up approach for all originated and purchased debt instruments?

Some individuals (including one IASB Board member who dissented from the IASB's March 2013 proposal⁴) have suggested a potential preference for a gross-up method for all originated and purchased debt instruments. Under that approach, the initial estimate of expected credit losses is recognized as an asset (or, alternatively, as an increase in the cost basis of the asset) and amortized as part of the effective interest rate over the life of the asset. Some may believe that this approach reasonably *matches* the lender's recognition of the compensation for expected credit losses (that is, a subcomponent of interest income) with the recognition of credit losses that were expected upon initial recognition (that is, credit loss expense). The Board's decision on this topic was based on both theoretical and practical considerations, as described below.

Theoretical Considerations:

³ Specifically, the Boards had tentatively decided that lifetime expected credit losses should be recognized when there has been a *more than insignificant* deterioration in credit that makes it at least reasonably possible that some or all of the contractual cash flows will not be collected.

⁴ See paragraph AV11 of the IASB's March 2013 Exposure Draft.

By way of background, the Board recognizes that a lender receives compensation for taking on the credit risk of the borrower. That compensation is one subcomponent of interest income. Other subcomponents of interest income include (a) compensation for the time value of money on a risk-free basis, (b) a premium for the current credit risk environment (the price of credit), (c) compensation for servicing the debt instrument, (d) a discount for the benefit of gaining the customer relationship, and (e) a premium or discount for market factors such as competition and liquidity. Importantly, the current accounting model does not attempt to bifurcate the various subcomponents of interest income and apply a different recognition pattern to each subcomponent. Rather, consistent with investors' preferences, interest income is generally recognized based on the effective interest rate (that is, the overall rate of return implicit in the debt instrument). Importantly, if one were to consider the different subcomponents of interest income separately, one would *not* find the rate of compensation, premium, or discount for each subcomponent to be constant over time. For example, the portion of the overall interest rate that is actually compensating the lender for undertaking the borrower's credit risk would rarely be constant over the life of the asset because credit losses are not expected to occur ratably over the life of a loan. Rather, often credit losses are expected to be very low shortly after origination, rise rapidly in the early years of a loan, and then taper to a lower rate until maturity.

Practical Considerations:

Given current technological capabilities and the multitude of factors that affect pricing, at the moment of initial recognition it is impractical (if not impossible) to reliably isolate and measure, on a by-period basis over the term of the asset, the portion of the interest rate that is actually intended to compensate the lender for undertaking the borrower-specific credit risk. Those capabilities would be necessary if an accounting model were to accurately *match* the recognition of each subcomponent of interest income to the relevant period of time.

Board's Decision:

During its deliberations in the summer of 2012, the FASB considered the gross-up approach. The Board concluded that this approach would not be appropriate for all originated and purchased assets because it would misrepresent the economics by amortizing the asset recognized for the initial estimate of expected credit losses over the life of the asset, despite the fact that credit losses are rarely expected to occur ratably through the life of an asset. As a result, that approach would consistently overstate the net asset position of an entity because the amortization pattern for the expected credit loss asset would be too slow relative to the expected timing of credit losses. In doing so, the approach would violate the Board's balance sheet objective for debt instruments (which is to reflect the present value of cash flows that the entity expects to collect).

However, the Board decided that a gross-up approach was appropriate for purchased credit impaired (PCI) debt instruments because, in that circumstance, the gross up primarily restores the cost basis of the PCI asset so that the balance sheet does represent the present value of cash flows that the entity expects to collect, discounted at the overall rate of return implicit in the debt instrument (recognizing that the market prices such instruments to yield a certain percentage based on expected cash flows at the time of acquisition).

21. Paragraph B29 of the IASB’s March 2013 Exposure Draft generally would permit an entity to utilize any rate between the risk-free rate and the effective interest rate when discounting expected credit losses. Why did the FASB not similarly permit that option?

Paragraph B29 of the IASB’s proposal would allow an entity to consistently choose the risk-free rate when discounting *expected credit losses*. The effect of that option will be to *increase* the allowance for expected credit losses by reducing the discount rate on expected credit losses.

In the December 2012 Exposure Draft, the FASB did not propose an option to utilize any rate between the risk-free rate and the effective interest rate when discounting expected credit losses for the following reasons:

- a. In instances in which an entity uses a discounted cash flow model to estimate credit losses under current U.S. GAAP, the Board has not heard concerns that the use of the effective interest rate for discounting is operationally complex.
- b. The Board believes that such an option may conflict with its objective that, within a business model whose objective includes holding debt instruments for the collection of contractual cash flows, the amortized cost measurement objective is to reflect the present value of cash flows that an entity expects to collect.
- c. The Board believes that the effective interest rate is the best rate for measuring the present value of cash flows that the entity expects to collect. Similarly, the Board believes that the discount rate should not be updated to reflect changes in market rates of interest because that would fundamentally change the measurement attribute from *amortized cost* toward something closer to *fair value*.