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Accounting for Financial Instruments: the FASB and IASB IFRS 9 Approaches

STUDY for the ECON Committee

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Accounting for Financial Instruments: the FASB and IASB IFRS 9 Approaches

Expected-Loss-Based Accounting for the Impairment of Financial Instruments: the FASB and IASB IFRS 9 Approaches

STUDY

Abstract

This paper outlines the work of the FASB and the IASB on the development of expected-loss methods for measuring the impairment of financial instruments arising from credit losses, and describes and compares key features of the different approaches developed by the two standard setters. It also provides information indicative of the possible effect of differences between the two approaches and summarises arguments for and against the main elements of the approaches proposed by the two standard setters.

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AUTHORS

John O'HANLON, Lancaster University
Noor HASHIM, Lancaster University
Weijia LI, Lancaster University

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LIST OF ABBREVIATIONS

DELR	Delayed expected loss recognition
FASB	Financial Accounting Standards Board (in the U.S.)
FSB	Financial Stability Board
FV-OCI	Fair value through other comprehensive income
GAAP	Generally accepted accounting principles
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
LGD	Loss given default
OCI	Other comprehensive income
PCI	Purchased credit impaired
PD	Probability of default

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GLOSSARY OF TERMS

Amortised Cost	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance[1]. Note that FASB (2012) uses the term 'net amortized cost' to refer to this concept, with the term 'amortized cost' denoting the carrying amount before deducting the loss allowance[2].
Credit-adjusted Effective Interest Rate	The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the **amortised cost** of a financial asset that is a purchased or originated credit-impaired financial asset. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset and expected **credit losses**[3].
Credit Loss	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original **effective interest rate** (or **credit-adjusted effective interest rate** for purchased or originated credit-impaired financial assets)[4].
Effective Interest Rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the **gross carrying amount** of a financial asset or to the **amortised cost** of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument but shall not consider the expected **credit losses**[5].
Gross Carrying Amount	The **amortised cost** of a financial asset, before adjusting for any loss allowance[6].
Impairment	The amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount[7].

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[1] IFRS 9, Appendix A.
[2] FASB (2012), p. 6, p. 4, p. 12.
[3] IFRS 9, Appendix A.
[4] IFRS 9, Appendix A.
[5] IFRS 9, Appendix A.
[6] IFRS 9, Appendix A.
[7] IAS 36, paragraph 6.

EXECUTIVE SUMMARY

Both, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have been working on the development of expected-loss methods for measuring the impairment of financial instruments arising from credit losses. This paper describes and compares key features of the different approaches developed by the two standard setters. It also provides information indicative of the possible effect of differences between the two approaches and summarises arguments for and against the main elements of the approaches proposed by the two standard setters.

The financial and banking crisis of the late 2000s drew attention to perceived weaknesses in accounting standards that contributed to loss of confidence in the financial system during the crisis. One of the principal **perceived weaknesses** was **delay** under the incurred-loss approach in **recognition of impairment arising from credit losses until a credit loss is probable or has been incurred**. This is a potentially material issue as loans typically make up 60%-70% of banks' assets. This and other problems were believed to be exacerbated by divergence between (International Financial Reporting Standards) IFRS and U.S. Generally Accepted Accounting Principles (GAAP)[8].

In the wake of the crisis, the FASB and the IASB worked towards replacing the *incurred-loss approach* to accounting for impairment with an *expected-loss approach* that would facilitate more timely recognition of loan losses. Each standard setter initially produced its own set of proposals with deviating objectives.

- The **primary objective of the FASB was to ensure that an entity's loss allowance was sufficient to cover all credit losses expected to be incurred over the remaining life of financial instruments** held by the entity. This gave rise to a proposal for the **immediate recognition of *all* expected credit losses**.

- The **IASB's primary objective was to reflect the economic substance of lending and loan losses**. It was proposed to recognise interest on a credit-adjusted yield basis with subsequent changes to initial expectations of credit losses then being recognised as gains and losses (IASB, 2009). The effect is that initial expectations of losses are recognised over time within credit adjusted interest (i.e. as a reduction to interest) with subsequent changes in expectations being recognised as they occur. (Although it was not the intention in IASB (2009) to 'match' recognition of initial expectations of credit losses against expected credit-spread-inclusive interest, the approach proposed in IASB (2009) might be characterised as leading to that outcome.)

An **attempt by the standard setters to produce a converged approach was unsuccessful**. In light of the perceived importance of the timely implementation of high-quality expected-loss accounting for impairment, the standard setters then proceeded to develop their own non-converged approaches.

The **FASB** approach, described as a *Current Expected Credit Loss (CECL) model*, requires the immediate recognition of all expected future credit losses by an entity in respect of its existing financial instruments, similar to the FASB's initial proposal. The FASB is expected to produce its own standard requiring use of its expected-loss impairment methodology in late 2015.

The **IASB** approach, in its revised accounting standard IFRS 9 Financial Instruments[9] with an adoption date of 2018, aims to approximate the achievement of the IASB's primary objective as described above. Under the IASB approach, for assets for which credit risk has increased significantly since initial recognition, the loss allowance is an amount equal to lifetime

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[8] Financial Crisis Advisory Group.
[9] IFRS 9 (IASB, 2014a), subsequently referred to in footnotes as IRFS 9.

expected credit losses; for assets for which credit risk has not increased significantly since initial recognition, the loss allowance is an amount equal to 12-month expected credit losses. The recognition of 12-month expected losses where credit risk has not increased significantly is an operationally simplified approach to addressing the IASB (2009) objective to recognise initial expected credit losses over time. This dual approach, where the set of losses to be recognised differs depending upon whether credit risk has increased significantly since initial recognition, is referred to by the FASB as combining '*two different measurement objectives*'[10]. See Figure 1 below for an annotated graphical representation of the IFRS 9 approach and the IASB (2009) approach, with reference to the currently proposed FASB approach.

The approaches of the FASB and the IASB both have a reasonable and intuitive basis, with the FASB wishing to ensure loss-allowance adequacy by requiring immediate recognition of all expected credit losses and the IASB wishing to reflect the economic substance of lending and loan losses by always accounting for expected credit losses but reflecting that economic losses arise when loans increase significantly in credit risk relative to initial expectations. However, concerns have been raised about the standard setters' lack of convergence in this important area, including with regard to the **costs that materially different impairment approaches might impose** on the preparers and users of financial statements.

The key difference between the FASB and IFRS 9 approaches to impairment is with regard to whether all expected future credit losses should be recognised at each reporting date (FASB) or whether, on the basis that initial estimates of losses are reflected in lending margins, such losses should be recognised across time to some extent (IFRS 9). The currently proposed FASB approach is likely to give rise to higher loss allowances than the IFRS 9 approach. This might appear preferable in that it is more likely to ensure adequacy of loss allowances and thereby address concerns of bank regulators. However, erring on the upside with regard to loss allowances can be costly in that it could give rise to double counting of initial loss expectations, disincentivise lending to high-credit-risk borrowers, give rise to apparent subsequent gains as excessive loss allowances are reversed, and create incentives for lenders to run down loan books in order to realise accounting gains on 'under-valued' loans. Both standard setters can be expected to succeed in addressing their shared objective to improve accounting for impairment arising from credit losses, in particular with regard to recognising expected losses, albeit in different ways reflecting their partially different focuses.

Particular issues that arise from the contrast referred to above include:

- **Underlying objectives with regard to the measurement of expected credit losses**. The FASB requires that '*at each reporting date, an entity shall recognize an allowance for expected credit losses on financial assets [...]. Expected credit losses are a current estimate of all contractual cash flows not expected to be collected*'[11]. This is a simple aim which is likely to be easily understood by and intuitively appealing to many users of financial statements. The IFRS 9 approach, involving recognition of only 12-month expected losses where credit risk has not increased significantly since initial recognition, is a pragmatic development of the initial proposal in IASB (2009) to reflect the credit adjusted return on financial assets (including recognising initial expected credit losses over time) and to recognise impairment losses for all post-initial-recognition changes in credit loss expectations. It is therefore appealing in that it reflects to some degree an important element of the lending business model and reflects concern with regard to the potential costs of excessive loss allowances.

- **One or two sets of expected losses/One or two 'measurement objectives'**. The issue arises of whether it is appropriate to recognise different sets of expected losses

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[10] FASB (2012), paragraph BC11.
[11] FASB (2012), paragraph 825-15-25-1.

depending on whether or not credit risk on a financial instrument has increased significantly since initial recognition (IFRS 9) or to recognise the same set of expected losses (all contractual cash flows not expected to be collected) irrespective of whether or not credit risk on a financial instrument has increased (FASB). Having two classifications, with *full* recognition of losses for some assets and *partial* recognition for others, could introduce undesirable subjectivity. A transfer from the 12-month category to the lifetime category or vice versa could result in a 'cliff' effect, i.e. a sudden increase or decrease in the loss allowance on transfer from one category to the other. The criteria for transfer from the 12-month-expected-loss category to the lifetime expected-loss category could be seen as introducing something like an incurred-loss recognition trigger, which was one of the main problems that the standard setters' work on impairment was aimed to eliminate. In support of the (IFRS 9) **dual approach**, it could be argued that it provides more opportunity for the communication of information than the (FASB) **uniform approach**.

- **Reserve adequacy**. It is perceived by some that, because the FASB proposes a fuller recognition of expected losses than IFRS 9, it is more likely than IFRS 9 to provide 'reserve adequacy', i.e., full coverage within the loss allowance of all expected credit losses. However, one has to be careful here not to be swayed by arguments that owe more to *prudential regulatory* concerns, which might give rise to bias in loss allowances (i.e. loss allowances that are higher than those that would be given by a neutral faithful representation of the circumstances), than to *financial reporting* concerns.

- **Day-1 losses.** Both the FASB proposal and the IFRS 9 requirement can give rise to 'day-1 losses', i.e., the recognition of loss allowances on initial recognition of assets. These appear counter-intuitive because they immediately bring the net carrying amount of newly-originated/purchased assets to below fair value. As the set of day-1 losses to be recognised is likely to be larger under the FASB proposal than under IFRS 9, this issue is likely to be more pronounced under the former than under the latter.

Evidence on which to base assessment **of the likely impact** on loss allowances of the two standard setters' approaches relative to existing approaches and to each other **is limited**. However, it appears likely that loss allowances

- will rise under both approaches relative to current approaches because a broader set of losses will be recognisable, and

- will rise more under the FASB approach than under the IFRS 9 approach because a broader set of losses will be recognisable under the FASB approach.

Some appreciation of the **potential order of magnitude** of the difference between allowances under the FASB and IFRS 9 approaches is given by observing that, as noted by the Financial Stability Board (FSB), the primary difference between the approaches of the FASB and the IASB could be said to **relate to performing loans**. The performing loans category does not correspond precisely to the IFRS 9 12-month-expected-loss category that gives rise to the difference between the FASB and IASB approaches. However, the fact that the performing loans of a sample of 84 European banks are typically about 90 % of Gross Loans and about seven times larger than Equity suggests that material proportionate differences in allowances could arise from the FASB/IFRS 9 difference in the treatment of financial instruments for which credit risk has not increased significantly since initial recognition.

In our view it is possible that **pressures for a converged approach could re-emerge** once the FASB standard and IFRS 9 become operational side-by-side, as a consequence of costs imposed on preparers and users of financial statements by materially different loss-allowance outcomes of applying the two non-converged approaches. Meanwhile, we believe that the standard setters are right, in the absence of immediate prospects of convergence, to proceed now to higher-quality expected-loss-based standards, even if they are not converged

standards and even if pressures arising from the side-by-side operation of the two approaches could result in the issue of accounting for impairment being re-opened in a few years time.

Figure 1:   Accounting for loss allowances - the IASB approach with reference to the FASB approach

Loss allowance
(% of gross carrying
amount)

Incurred
loss

Significant
deterioration

Deterioration over time in credit
quality from initial recognition

- - - - - - -   Economic expected credit losses (IASB 2009 ED)

....   12-month expected credit losses

————   Lifetime expected credit losses
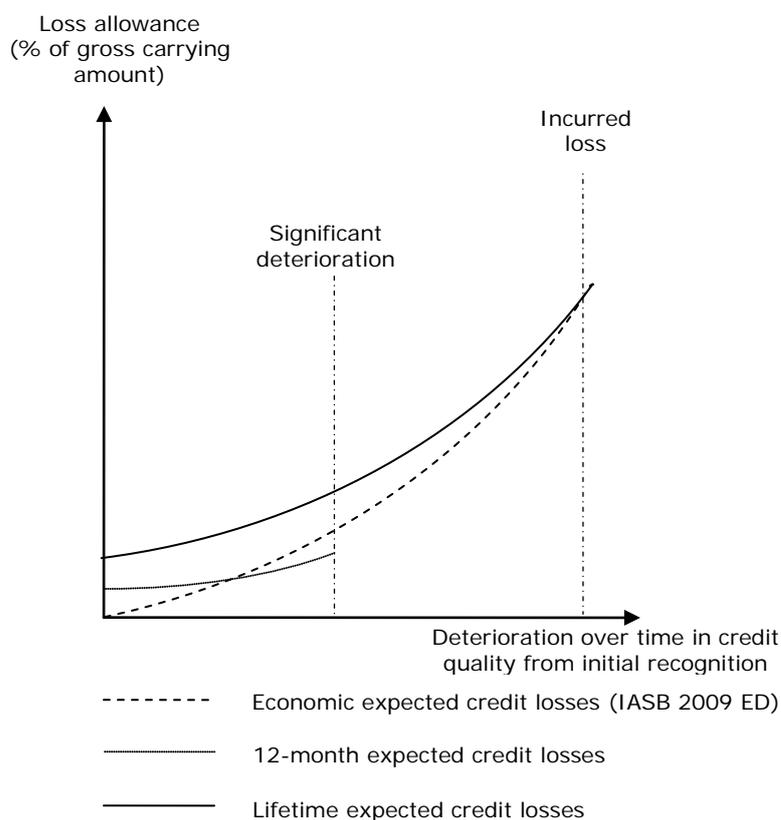
Source: Based on illustration provided by the IASB in its snapshot: Financial Instruments: Expected Credit Losses, (2013), p. 9.

Notes: Figure 1 represents the following. The lines on the graph depict how loss recognition is expected to occur over time such that the losses accumulate to the expected ultimate default.

- The cumulative recognition over time of expected credit losses under IASB (2009) based on expectations at initial recognition of credit losses that will arise over the life of the asset, see the line denoted 'Economic expected credit losses (IASB 2009 ED)'. This line is included in order to facilitate comparison between the IASB (2009) initial approach and the current IASB and FASB approaches. It does not reflect post-initial-recognition changes in credit-loss expectations. If such recognition were depicted, there would be an upward or downward jump in the line at the point at which expectations changed, see Figure 2.

- The cumulative recognition over time of expected credit losses under IFRS 9 for assets for which credit risk has not increased significantly since initial recognition and for which the loss allowance reflects only 12-month expected losses, see the line denoted '12-month expected credit losses'.

- The cumulative recognition over time of expected credit losses where the loss allowance reflects lifetime expected credit losses, see the line denoted 'Lifetime expected credit losses'. Recognition of lifetime expected credit losses occurs under IFRS 9 for assets for which credit risk has increased significantly since initial recognition. The graph uses the point termed 'Significant deterioration' to denote the point at which any transfer from the '12-month expected credit losses' category to the 'Lifetime expected credit losses' category would occur. The recognition of all expected future credit losses occurs under the FASB proposals for all assets within the scope of those proposals. This is represented on the graph by the continuation of the 'Lifetime expected credit losses' line to the left to intersect with the vertical axis. N.B. The FASB does not use the term 'lifetime' in referring to these expected losses.

- The recognition of losses under an incurred-loss approach, where the recognition of losses is delayed until a credit loss is probable or has been incurred, see the point denoted 'Incurred loss'.

1. INTRODUCTION

KEY FINDINGS

- The financial and banking crisis of the late 2000s drew attention to perceived weaknesses in accounting standards, including the incurred-loss approach in the recognition of impairment arising from credit losses.

- The FASB and IASB have produced separate expected loss impairment models.

- This paper compares key features of the different impairment methods now proposed by the IASB and the FASB, starting with an account of key elements of the processes whereby the standard setters developed their approaches.

- The paper also provides our views on prospects for future convergence in this area.

The financial and banking crisis of the late 2000s drew attention to perceived weaknesses in accounting standards that contributed to a loss of confidence in the financial system during the crisis period. One of the principal perceived weaknesses was the delay under the incurred-loss approach in the recognition of impairment arising from credit losses. This is a potentially material issue as loans typically make up 60 %-70 % of banks' total assets.

This and other problems were believed to have been exacerbated by divergence between IFRS and U.S. GAAP[12]. In the wake of the crisis, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) both worked towards replacing the incurred-loss approach to accounting for impairment with an expected-loss approach that would facilitate more timely recognition of loan losses. The IASB (2009) and the FASB (2010a) each initially produced its own set of proposals. They then proposed a converged approach to impairment in a joint supplementary document[13]. **However convergence was not achieved**.

The FASB (2012) and the IASB (2013a) then produced their own proposals and progressed to the issue of their own different impairment standards based on these. **The proposals of the two standard setters differ in an important regard:**

- The **FASB** wishes to require that the current estimate of all contractual cash flows not expected to be collected by an entity in respect of its existing financial instruments should be **recognised immediately**,

- whereas the **IASB** wishes to reflect the economic substance of lending and loan losses to some degree through an approach that does not require immediate recognition of all expected losses, but proposes recognition over time.

The FASB is expected to produce its own standard requiring use of its expected-loss impairment method in the fourth quarter of 2015. The IASB method is now included in a revised accounting standard IFRS 9 Financial Instruments (IASB (2014a)) with an adoption date of 2018. The failure of the FASB and the IASB to achieve convergence in the important area of accounting for credit losses has been a source of some concern, including with regard to the costs that it might impose on the preparers and users of financial statements.

Some terms used in the paper are defined in the Glossary; other terms are introduced and explained within the body of the paper.

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[12] Financial Crisis Advisory Group.
[13] FASB (2011); IASB (2011).

2. HISTORICAL DEVELOPMENT OF THE FASB AND IFRS 9 APPROACHES TO IMPAIRMENT

KEY FINDINGS

- In the wake of the financial and banking crisis of the late 2000s, the FASB and the IASB worked towards the development of expected-loss accounting for impairment of financial instruments arising from credit losses.

- The FASB (2010a) and IASB (2009) each initially produced their own proposals. The FASB proposed immediate recognition of all credit losses. The IASB proposed recognising interest on a credit-adjusted yield basis with changes to initial expectations of credit losses subsequently being recognised as gains and losses (IASB, 2009). The effect of this is that initial expectations of losses would be recognised over time within credit adjusted interest (i.e. as a reduction to interest) with subsequent changes in expectations being recognised when the changes in expectations occur.

- Subsequently, the FASB (2011) and IASB (2011) considered proposals on the basis of which a converged approach might be developed. These involved a 'good-book/bad-book' approach. For the good book, the allowance would be the higher of: (i) the time-proportional expected credit losses; and (ii) the credit losses expected to occur within the foreseeable future (no less than twelve months). For the bad book, the allowance would be the entire amount of expected credit losses. The time-proportional approach was intended to address the IASB's aim to reflect the relationship between the pricing of financial assets and expected credit losses.

- Convergence was not achieved. The standard setters proceeded to the development of their own separate non-converged standards on impairment. The FASB (2012) proposed a Current Expected Credit Loss (CECL) model that required immediate recognition in loss allowances of contractual cash flows not expected to be collected on existing financial instruments. The IASB (2013a) proposed a dual approach under which: (i) for financial instruments that had not deteriorated significantly in credit quality since initial recognition or that had low credit risk, 12-month expected credit losses would be recognised; (ii) for financial instruments that had deteriorated significantly in credit quality since initial recognition (unless they had low credit risk), lifetime expected credit losses would be recognised. The recognition of 12-month expected losses for financial instruments that had not deteriorated significantly in credit quality since initial recognition or that had low credit risk is an operationally simplified approach to addressing the IASB (2009) objective to recognise initial expected credit losses over time.

2.1. Introduction

This section summarises the history of the development of the current IFRS 9 and currently proposed FASB approaches to accounting for impairment arising from credit losses. This history provides useful background for the purpose of understanding the standard setters' current positions.

The financial and banking crisis of the late 2000s drew attention to perceived weaknesses in accounting standards that contributed to a loss of confidence in the financial system during the crisis period. One of the perceived weaknesses was the incurred-loss approach to recognition of impairment arising from credit losses. It was claimed that this approach, which existed under both IFRS and U.S. GAAP, had delayed the recognition of predictable credit losses and that **the consequent late recognition of losses had exacerbated the crisis**.

This and other problems were believed to have been made worse by divergence between IFRS and U.S. GAAP[14]. In response to the perceived problem of delayed recognition of credit losses, the IASB (2009) and the FASB (2010a) each issued exposure drafts. The proposals in the two exposure drafts differed from each other. The principal difference between the two standards was that the IASB proposed that initial expected credit losses be spread over the life of the loan and that all changes in the initial expected credit losses would be recognised immediately, whereas the FASB proposed that all expected losses be recognised immediately.

Within their joint project on Accounting for Financial Instruments, the two standard setters then produced a joint supplementary document that proposed a converged approach to impairment (FASB (2011); IASB (2011)). The two documents dealt identically with the timing of the recognition of losses, and the IASB document also dealt with presentation and disclosure issues that were not addressed in the FASB document. The proposals in these supplementary documents combined elements from the initial IASB (2009) and FASB (2010a) exposure drafts. However convergence was not achieved. This was primarily because of different preferences with regard to the extent to which loss allowances should reflect expected credit losses. The FASB's preference was that they should reflect all expected credit losses for all assets. The IASB's preference was that loss allowances should reflect all expected credit losses for assets for which there had been a significant increase in credit risk since initial recognition but that, since credit-spread-inclusive interest includes a compensation for credit risk, only a subset of expected losses should be recognised in loss allowances where no such significant increase in credit risk had occurred.

The FASB (2012) and the IASB (2013a) then produced their own divergent sets of proposals. Then, each of them progressed to the issue of their own different impairment standards based on these divergent proposals. The IASB published a revised IFRS 9 that included an expected-loss methodology in 2014, with an adoption date of 2018. The FASB is expected to produce its own standard with a different expected-loss impairment methodology in the fourth quarter of 2015.

2.2.   IASB and FASB Proposals: 2009 to 2013

This subsection outlines the key elements of the five documents produced individually or jointly by the IASB and the FASB between 2009 and 2013. It also outlines the so-called three-bucket approach that was considered part-way through the process.

2.2.1.   IASB Exposure Draft ED/2009/12 - Financial Instruments: Amortised Cost and Impairment (November 2009)

This IASB (2009) Exposure Draft '*proposes requirements for how to include credit loss expectations in the amortised cost measurement of financial assets*'[15]. The **key feature of the proposals is the aim to reflect the relationship between the pricing of financial assets and expected credit losses by recognising interest on a credit-adjusted yield basis with changes to initial expectations of credit losses subsequently being recognised as gains and losses. The effect of this is that initial expectations of losses would be recognised over time within credit-adjusted interest (i.e. as a reduction to interest) with subsequent changes in expectations being recognised when the changes in expectations occur.** (Although it was not the intention of the IASB to set up the schedule of recognition of initial expectations of credit losses such as to 'match' them against expected credit-spread-inclusive interest, the proposed process might be characterised as leading to that outcome.) Expected credit losses on financial assets are estimated for accounting purposes when the assets are first obtained. On the premise that the interest

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[14]   Financial Crisis Advisory Group.
[15]   IASB (2009), paragraph IN6.

receivable over the life of the assets includes a credit spread that compensates for initially expected credit losses on the assets, expected losses are scheduled to be recognised gradually within a credit-adjusted return: interest revenue is recognised at the effective interest rate equal to the yield based on net-of-expected-loss cash flows. Expected credit losses are then subsequently re-assessed in each (accounting) period: all changes in credit-loss expectations are recognised immediately by using the initially-calculated effective interest rate to calculate the present value of the revised stream of expected net-of-credit-loss cash flows and recognising any change in carrying amount in profit or loss. Figure 2 depicts graphically the cumulative recognition of losses under IASB (2009) without and with a subsequent revision of initial expectations.

Figure 2:   Accounting for loss allowance - IASB 2009 Exposure Draft without and with revision of initial expectations of credit losses
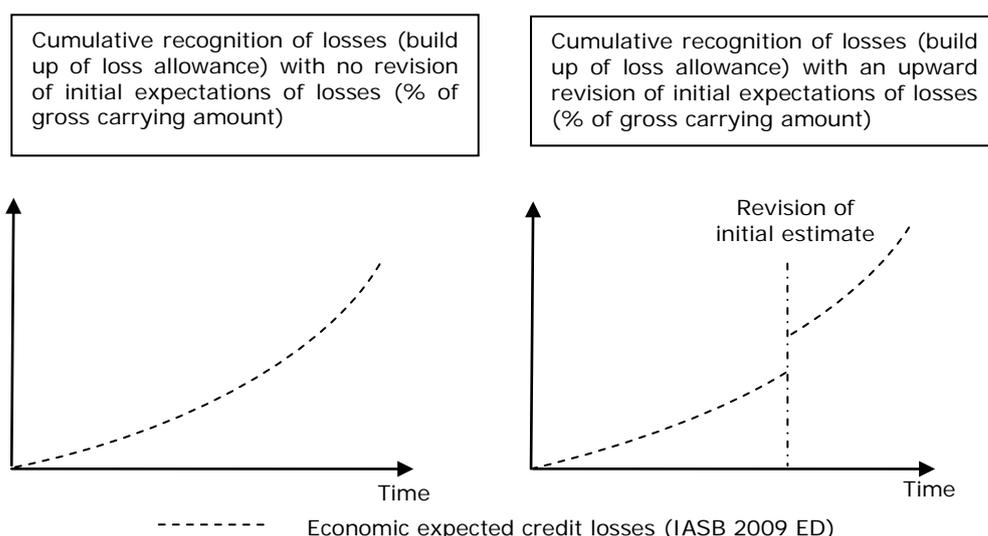
Comments[16] on this Exposure Draft recognised that the proposed approach, with spreading of initially expected credit losses over the life of assets, reflected the economics of lending and loan losses. However, many commentators pointed out operational challenges associated with applying the proposed method, including with respect to the integrated expected-credit-loss-inclusive effective interest rate calculation, arising in part because different parts of the required information set are typically held within different systems.

2.2.2.   FASB Exposure Draft – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (May 2010)

The FASB (2010a) Exposure Draft dealt with all three elements of the Financial Instruments project:

- Classification and Measurement;

- Impairment; and

- Hedge Accounting.

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[16]   References to comments are based in part on the summary of comment letters on the Exposure Draft produced by the standard setter and in part on the authors' review of comment letters themselves. The standard setter's summary can be accessed at http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Impairment/Meeting-Summaries/Documents/FI0710b09Aobs.pdf: the comment letters can be accessed at http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Impairment/ED/Comment-Letters/Pages/Comment-letters.aspx.

N.B. As this paper considers the area of impairment, our discussion of FASB (2010a) is mainly limited to that element of the Exposure Draft. As with IASB (2009), the primary aim was to replace the incurred-loss approach by an expected-loss approach. It was proposed that all expected credit losses should be recognised immediately. Within this approach,

- it was intended to simplify the accounting for impairment by having a single impairment model for all financial assets;

- it was proposed to remove the pre-existing 'probable' threshold for recognising impairments; and

- it was proposed that impairment calculations should be based on economic conditions remaining unchanged for the remaining life of an asset.

One of the other proposals within this Exposure Draft was that loans should be recognised at fair value on the balance sheet, with a reconciliation from amortised cost where amortised cost is relevant, for example where loans are held for collection.

> The **key difference** between the proposals is that
> - IASB (2009) aimed to recognise initial predicted losses by recognising credit-adjusted interest revenue over time, whereas
> - FASB (2010a) aimed to recognise all predictable losses immediately.
> The former IASB (2009) approach could be characterised as giving relatively greater weight to **business-model** considerations; the latter FASB (2010a) could be characterised as giving relatively greater weight to **reserve-adequacy** considerations.
> The contrast between these two initial sets of proposals is relevant to understanding of differences between the current positions of the IASB and the FASB.

Comments on this FASB Exposure Draft largely supported the expected-loss approach and the removal of the 'probable' threshold as a means of facilitating more timely recognition of losses. As this FASB exposure draft was published shortly after IASB (2009), some commentators expressed views on relative merits of this FASB Exposure Draft and the IASB (2009) Exposure Draft. Relevant to the subject matter of this study, some commentators questioned the FASB's proposal for immediate expensing of all predictable losses. Some compare this proposal with the more business-model-focused approach of the IASB which recognised initial expected credit losses by adjusting interest revenue rather than through immediate expensing, with subsequent changes in credit loss expectations being expensed as an impairment. Related to this, there was some concern at the FASB requirement in some cases to recognise losses immediately upon recognition of an asset ('day-1 losses')[17]. There was concern that the requirement to base impairment decisions on an assumption that economic conditions would remain unchanged for the remaining life of the assets could cause loss allowances to be too high (low) in bad (good) times[18].

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[17] The term '**day-1 losses**' refers to the immediate recognition of losses upon recognition of an asset.

[18] References to comments are based in part on the summary of comment letters on the Exposure Draft produced by the standard setter and in part on the authors' review of comment letters themselves. The standard setter's summary can be accessed at http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176158096249: the comment letters can be accessed at http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1810-100.

2.2.3. Seeking convergence: IASB Supplement to ED 2009/12 - Financial Instruments: Amortised Cost and Impairment; **and** FASB Supplementary Document: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Impairment (January 2011)

This Supplementary Document was published by both the IASB (2011) and the FASB (2011). It was presented as a Supplement to IASB (2009) and FASB (2010a), respectively. The two documents dealt identically with the timing of the recognition of losses. The IASB document also dealt with presentation and disclosure issues that were not addressed in the FASB document.

The documents sought to align the objectives of the IASB as reflected in IASB (2009) and those of the FASB as reflected in FASB (2010a) in producing a converged standard on impairment. It is instructive to consider the standard setters' description of the different starting positions from which they sought to achieve convergence, as described in the introductory section of the Supplementary Documents. The IASB's position was described as follows:

'The IASB's primary objective in the exposure draft Financial Instruments: Amortised Cost and Impairment *was to reflect initial expected credit losses as part of determining the effective interest rate, as the IASB believed that this was more reflective of the economic substance of lending transactions. It considered impairment as a part of the measurement of financial assets at amortised cost after their initial recognition. Therefore, the IASB did not believe it was appropriate to recognise all expected credit losses immediately. The IASB's original exposure draft did not look at the allowance for credit losses in isolation. The approach originally proposed by the IASB required an entity to estimate expected cash flows over the life of instruments. The IASB proposed this approach because: (a) the amounts recognised in the financial statements would reflect the pricing of the asset (i.e., the interest rate charged, which considers expected credit losses) when an entity makes lending decisions. In contrast, under the current incurred loss approach, interest revenue (and profitability more generally) is front-loaded because interest revenue ignores initially expected credit losses, which are recognised only later once there is objective evidence of impairment as the result of a loss event; (b) the proposed impairment approach generally would result in earlier recognition of credit losses than the incurred loss impairment model in IAS 39 (i.e., avoid the systematic bias towards late recognition of credit losses). In other words, the requirement for an observable loss event to have occurred before considering the effect of credit losses would be removed*'[19]

The FASB's position was described as follows:

'The FASB's objective in its originally proposed approach was to ensure that the allowance balance was sufficient to cover all estimated credit losses for the remaining life of an instrument. Therefore, the approach originally proposed by the FASB would require an entity to estimate cash flows not expected to be collected over the life of the instruments and recognize a related amount immediately in the period of estimate. The FASB proposed this approach because the FASB believed it resolved the concern with respect to the current guidance on impairment that reserves tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle (the 'too little, too late' concern). By recognizing all credit losses immediately the allowance account would have a balance of estimated credit losses based on cash flows not expected to be collected for the remaining lifetime of the financial assets. This meant that the account would be sufficient to cover all such estimated credit losses regardless of the timing of those losses. [...] The FASB believed that an entity should recognise in net income credit impairment when it does not expect to collect all contractual amounts due for originated financial assets or all amounts originally expected to be collected for purchased financial assets. Furthermore, the FASB believed that it would be inappropriate to allocate an impairment loss over

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[19] IASB (2011) paragraph IN5; FASB (2011), paragraph IN5. The reference to IAS 39 is to IASC (1999 and subsequently amended).

the life of a financial asset. In other words, if an entity expects not to collect all amounts, a loss exists and should be recognised immediately.'[20]

Essentially the contrast was between a business-model-focused approach that sought to adjust interest revenue for initial credit loss expectations and reflect changes in initial expectations as an impairment and a reserve-adequacy-focused approach that sought to expense all predictable losses immediately.

The key element of the proposals in the Supplementary Document was a 'Good-book/bad-book' approach with different treatments of the bad book and the good book. At each reporting date, an entity would recognise an impairment allowance that is the total of:

- for assets for which it is appropriate to recognise expected credit losses over a time period (good book), the higher of: (i) the time-proportional expected credit losses; and (ii) the credit losses expected to occur within the foreseeable future (no less than twelve months); and

- for all other assets (bad book), the entire amount of expected credit losses.

The 'good-book/bad-book' approach had features that partly satisfied the primary objectives of both the FASB and the IASB. For the good book, the time-proportional approach addressed the IASB's aim to reflect the relationship between the pricing of financial assets and expected credit losses, while the foreseeable-loss floor addressed the FASB's aim to recognise sufficient allowance to cover expected credit losses. It was also proposed that impairment should be based on all available information to include supportable forecasts of future events and economic conditions. This was a shift away from the FASB (2010a) position. The proposed method also moved away from IASB (2009) integrated effective interest rate incorporating expected credit losses.

Comments on the Supplementary Document reflected **strong support for proposed convergence** in the face of differing objectives of the standard setters, although some commentators felt that timely improvement of standard(s) was more important than the achievement of convergence. Some commented that the proposals were less conceptually sound in representing the economics of lending than the proposals in IASB (2009) but that they were a pragmatic and operationally feasible way of representing this. Operational difficulties within the IASB (2009) proposals were seen to be addressed.

Some FASB constituents suggested that FASB (2010a) proposals for immediate recognition of all predictable losses were too conservative. The 'good-book/bad-book' approach was seen by most financial institutions as consistent with risk-management procedures, although some highlighted the scope for 'earnings management' provided by this approach.

There was significant comment on the time-proportional and foreseeable-future-loss elements of the proposed method of calculating impairment for the good book, where the former was seen as deriving from IASB's objective and the latter was seen as deriving from the FASB's, with differences of opinion as to whether one or the other or both should be used. Preferences appeared to vary depending on the location of the respondent (U.S. vs non-U.S.). A U.K.-based commentator commented that the foreseeable-future-loss provision for the good book, which would be likely to dominate the time-proportional element in determining impairment, appeared to derive from an inappropriate focus on a *prudential regulatory* objective rather than a *financial reporting* objective. However, it was also noted that such a provision, although undesirable, might be justified on pragmatic grounds to help achieve convergence. Those who agreed with the FASB's objective of ensuring the sufficiency of the

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[20] IASB (2011), paragraphs IN6-7; FASB (2011), paragraphs IN6-7.

allowance to cover all predictable losses were supportive of the foreseeable-future-loss element of the proposed method[21].

2.2.4.   The three-bucket approach (2011 and 2012)

In light of comments on IASB (2011) and FASB (2011), both standard setters continued to work towards a converged approach to impairment. This included consideration of a so-called three-bucket approach.

- **Bucket 1**, to which all originated and purchased assets would be initially allocated, would contain open-portfolio assets evaluated collectively '*that have NOT been affected by observable events which indicate a direct relationship to possible future defaults although they may have suffered changes in credit loss expectations as a result of macroeconomic events that are not particular to a (group of) loan(s)*'[22].

- **Buckets 2 and 3**, into which assets would be transferred from bucket 1 as appropriate, would contain assets which had suffered deterioration in credit quality.

- **Bucket 2** would contain '*assets that have been affected by the occurrence of observable events which indicate a direct relationship to possible future defaults, however the specific assets in danger of default have not yet been identified*'[23].

- **Bucket 3** would contain assets where '*information is available that specifically identifies that credit losses are expected to, or have occurred on individual assets*'[24].

For buckets 2 and 3, lifetime expected losses would be recognised. For bucket 1, there would be partial recognition of expected losses. A number of proposals were made for this, but the key intention was that the allowance should be at least equal to 12 months of expected credit losses. Early proposed alternatives included a time-proportional approach[25], but a later IASB document did not refer to this and referred only to a '*12 months expected loss allowance*'. It appears that, by the end of the three-bucket deliberations, the time-proportional idea that was central to IASB (2009) and featured importantly in IASB (2011) and FASB (2011) had been discounted in favour of proposed recognition of an allowance for 12-months of expected-losses.

The two standard setters failed to agree on the three-bucket approach, and then went their own separate ways with regard to accounting for impairment arising from credit losses. Our understanding of the key issue that impeded convergence is that, as indicated below, the FASB did not feel that it could proceed with an approach that required the application of two measurement objectives, one of which did not involve the immediate recognition of an allowance sufficient to cover all expected future losses, whereas the IASB, in seeking to approximate its preferred representation of the economic substance of lending transactions in light of the fact that carrying values of assets at initial recognition reflect initial expected credit losses, wished to require that loss allowances reflect only part of expected future losses.

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[21] References to comments are based in part on the summary of comment letters on the Supplementary Document produced by the standard setters and in part on the authors' review of comment letters themselves. The standard setters' summary can be accessed at http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176158457166; the comment letters can be accessed at http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2011-150. With regard to the reference to the U.K.-based commentator, see the letter from Barclays (dated 1 April 2011).

[22] IASB/FASB (2011), paragraph 8.

[23] IASB/FASB (2011), paragraph 9.

[24] IASB/FASB (2011), paragraph 10.

[25] IASB/FASB (2011), paragraph 15.

2.2.5.   FASB Exposure Draft – Financial Instruments – Credit Losses (December 2012)

This FASB (2012) Exposure Draft was issued by the FASB after it had worked with the IASB on joint development of the three-bucket approach and the two standard setters had failed to achieve convergence on the basis of that approach. The FASB's objections to the three-bucket approach were summarised in the Exposure Draft as follows:

'Like the proposed amendments, the three-bucket model would eliminate the probable initial recognition threshold and broaden the information set that an entity is required to consider in developing its credit loss estimate. However, unlike the FASB's proposed amendments, the three-bucket impairment model would utilize two different measurement objectives for the credit impairment allowance. For one subset of the portfolio an entity would recognize lifetime expected losses for the financial assets upon which a loss event is expected in the next 12 months (sometimes referred to as "12 months of expected losses"). For another subset of the portfolio, an entity would recognize all lifetime expected losses. An entity would apply certain criteria to decide which measurement objective should be followed for assets held as of the reporting date.

After spending a considerable amount of time and effort developing the three-bucket impairment model, the Board decided not to pursue an Exposure Draft on the three-bucket impairment model given the feedback that the Board had received on using two different measurement objectives. Specifically, U.S. stakeholders expressed concerns about the use of two very different measurement objectives and the ambiguity and operationality of the principle for determining which measurement objective should apply to assets held in a given reporting period. Also, many stakeholders viewed the principle for determining which measurement objective should apply as reintroducing an incurred loss recognition trigger into the model, which was a perceived weakness of existing U.S. GAAP that this project sought to address. Furthermore, users expressed concern about interpreting any model that utilizes two different measurement objectives to arrive at a single recognized allowance for credit losses on the balance sheet, which is a core concept in the three-bucket model. Therefore, the FASB decided to modify its proposal to include only one measurement approach, which is the current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date. The FASB's proposed model carries forward many decisions that were jointly deliberated and agreed upon with the IASB.'[26]

As can be seen from the above extract, the **essential problem was that the FASB did not feel that it could proceed with an approach that required the application of two measurement objectives, one of which did not involve the immediate recognition of an allowance to cover all expected future losses on assets held at the reporting date**. More specific concerns that were cited in the Exposure Draft included:

- that the criteria for transfer out of bucket 1 effectively introduced an incurred-loss approach, which the work of the IASB and FASB was aiming to eliminate;

- ambiguity in criteria for determining which measurement objective to utilise;

- potential for earnings management arising from choices about the timing of the transfers between measurement objectives;

- a potential 'cliff' effect when moving from partial recognition of expected losses to full recognition; and

- potential inconsistency in application that would impede comparability and transparency[27].

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[26] FASB (2012), p. 4-5.
[27] FASB (2012), paragraph BC11.

The **key element** of this FASB (2012) Exposure Draft was the proposal for a **Current Expected Credit Loss (CECL) impairment model**. This '*would require an entity to impair its existing financial assets on the basis of the current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date*'[28]. Also, the 'probable' threshold would be removed, as in the FASB (2010a) proposals, and, in contrast with the FASB (2010a) proposals, the information set for impairment calculations would extend beyond historical experience and current conditions to include supportable forecasts about future conditions.

There was some tendency for comment on the FASB Exposure Draft to vary between investors and preparers:

- **Investors** and some other users had a **strong preference for recognition of all expected losses (CECL)**, as opposed to recognition of only some expected losses. For these commentators, loss-allowance adequacy was seen as important. Some commentators who supported the recognition of all expected losses expressed concern that two models (full recognition and partial recognition) could introduce undesirable subjectivity into the accounting for impairment.

- There was a preference among some **preparers** for **recognition of only some expected losses**, in part based on a preference to reflect the economic substance of lending decisions by matching expected losses with related credit-spread-inclusive interest income.

- Some **financial institutions** raised concerns about the **effect of CECL on regulatory capital**.

- Some strong views were expressed about the **costs of lack of convergence** in such an important area[29].

FASB (2012), as amended by decisions taken subsequently, is the basis for the current FASB proposals on impairment which are described in subsection 3.2. The **essential element of FASB (2012) is the recognition of all expected future credit losses through the Current Expected Credit Loss (CECL)** model.

2.2.6. IASB Exposure Draft ED/2013/3 - Financial Instruments: Expected Credit Losses (March 2013)

This IASB (2013a) Exposure Draft was issued by the IASB after it had worked with the FASB on joint development of the three-bucket approach and the two standard setters had failed to achieve convergence based on this. The Exposure Draft contained the following account from the IASB on the progress from the three-bucket approach:

'*In May 2011, the boards decided to develop a model that would reflect the general pattern of deterioration in the credit quality of financial instruments, the so-called 'three-bucket model'. In the three-bucket model, the amount of the expected credit losses recognised as a loss allowance or provision would depend on the level of deterioration in the credit quality of financial instruments since initial recognition.*

In July 2012, the IASB and the FASB finished deliberating all the joint matters in the development of a general framework for the three-bucket model. However, in August 2012, in response to feedback received from interested parties in the U.S. about that model, the FASB began exploring

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[28] FASB (2012), p. 2.

[29] References to comments are based in part on the summary of comment letters on the Exposure Draft produced by the standard setter and in part on the authors' review of comment letters themselves; see http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162917634 (summary) and http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2012-260 (comment letters).

an alternative expected credit loss model that: (a) did not use a dual-measurement approach; and (b) reflected all credit risk in the portfolio at each reporting date.

Following the FASB's announcement, the IASB conducted outreach to help it decide whether it should continue to develop the three-bucket model. Overall, the majority of participants in the IASB's outreach supported a model that distinguishes those financial instruments that have deteriorated in credit quality from those that have not. However, some noted that their support for the model was dependent on whether the benefits of the information provided outweighed the costs of determining when financial instruments have deteriorated in credit quality. Consequently, the IASB decided to propose the model in this Exposure Draft, which is similar to the three-bucket model. However the IASB clarified and simplified that model to address the views that it had received.'[30]

The **essential feature** of the proposals in this IASB Exposure Draft was the **categorisation of assets in a manner similar to that in the three-bucket approach**:

- For financial instruments for which credit risk **has not** increased significantly since recognition, the allowance should be 12-month expected credit losses, equal to the portion of expected lifetime credit losses from default events possible within next 12 months.

- For financial instruments for which credit risk **has** increased significantly since recognition, the allowance should equal lifetime expected credit losses.

In contrast to IASB (2009), there was a de-coupling of credit losses from the effective interest rate.

Commentators were largely supportive of the proposals as a balance between faithful representation of economic substance with regard to credit losses and practicality. Although some commentators supported full recognition of all lifetime expected losses as proposed in FASB (2012), most did not. Many argued that this would be impracticable and at variance with the economics of lending.

Commentators were largely supportive of the proposed split between assets that have and have not experienced credit deterioration. The proposals were seen as forward looking, without excessive front-loading of recognition of losses. The proposals were seen by some as less conceptually pure than the initial IASB (2009) proposals with regard to the measurement of the effective return on lending, but as a more easily operationalised and pragmatic approach to recognising the economics of lending transactions.

There was some opposition to the fact that the proposals would give rise to 'day-1 losses', which were seen as counter-intuitive on economic-substance grounds. There was some concern about 'earnings management' because of increased reliance on judgement. There was some variance in views depending on the jurisdictional location of commentators.

As with FASB (2012), some strong views were expressed about the costs of lack of convergence in this area[31]. For example, in commenting on IASB (2013a), a major U.K. bank[32] suggested that a material difference between the IASB and the FASB in accounting for credit losses would be costly in that it would confuse investors, give rise to the need for financial statement preparers to provide additional non-GAAP measures, and could affect the relative competitiveness of entities reporting under the two regimes. This commentator did not see additional disclosure as an effective substitute for convergence.

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[30] IASB (2013a), paragraphs BC 11-13.

[31] References to comments are based in part on the summary of comment letters on the Exposure Draft produced by the standard setter and in part on the authors' review of comment letters themselves. The standard setter's summary can be accessed at http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/July/05C-Impairment.pdf; the comment letters can be accessed at http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Impairment/Exposure-Draft-March-2013/Comment-letters/Pages/Comment-letters.aspx.

IASB (2013a) led to the IFRS 9 requirements on impairment which are described in subsection 3.3. An essential element of IFRS 9 is the recognition of 12-month expected credit losses where credit risk has not increased significantly since recognition and of lifetime losses where credit risk has increased significantly since recognition.

2.3.   Conclusion

Summing up the development of the current FASB and IFRS 9 approaches to impairment by reference to the various proposal documents and related documentation produced by the standard setters since 2009:

- The two standard setters started from different positions. The essential element of the initial **FASB position** was the objective to ensure that the loss allowance was sufficient to cover all estimated credit losses for the remaining life of the financial instrument by reflecting immediately in the allowance and in profit and loss the estimate of all cash flows not expected to be collected over the remaining life of the instrument. The essential element of the initial **IASB position** was the objective to represent the economic substance of lending and loan losses by reflecting initial credit loss expectations in adjusted interest revenue and recognising as an impairment expense all changes in credit loss expectations.

- From these initial positions, the two standard setters aimed to reach a converged position but failed to do so. The FASB, after considering an approach that included important elements emanating from the IASB's position, proposed a Current Expected Credit Loss (CECL) model that is very similar in essential respects to its initial position. After its attempt to arrive at a converged approach with the FASB and in light of concerns expressed about the practical implementation of its initial proposals, the IASB eventually produced an amended accounting standard that included requirements on impairment that represented a pragmatic-compromise approach to addressing its initial economic-substance objective.

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[32]   See the letter from Barclays dated 9 July 2013.

3. CORE FEATURES OF THE TWO APPROACHES AND KEY DIFFERENCES

KEY FINDINGS

- The key feature of the current FASB expected-loss proposals is that, at each reporting date, an entity shall recognise the current estimate of all contractual cash flows not expected to be collected as the allowance for expected credit losses in the statement of financial position. Also, the pre-existing 'probable' threshold for recognising credit losses, which is regarded as a significant impediment to the timely recognition of credit losses, is removed. Also, estimates of expected credit losses would be based not only on relevant information about past events and current conditions but also on reasonable and supportable forecasts about the future.

- The key feature of the IFRS 9 expected-loss proposal is that: (i) for assets for which credit risk has increased significantly since initial recognition, the loss allowance should reflect lifetime expected credit losses; (ii) for assets for which credit risk has not increased significantly since initial recognition, the allowance should reflect 12-month expected credit losses. Again, estimates of expected credit losses would be based not only on relevant information about past events and current conditions but also on reasonable and supportable forecasts about the future.

- For banks, loans are a large number on their balance sheet relative to total assets and equity. Performing loans, which are likely to be related to the major source of FASB/IFRS 9 differences in the loss allowance, are about 90 % of loans and are about seven times larger than equity. Even small proportionate differences between the FASB and IFRS 9 regimes with regard to the loan loss allowance for performing loans could cause material proportionate differences in total loan-loss allowances and in equity.

3.1. Introduction

This section summarises the core features of the approaches to accounting for impairment arising from credit losses on financial assets in the currently available proposals of the FASB and in IFRS 9 Financial Instruments (IASB, 2014a). The summary of the FASB approach is based on the most recent FASB Exposure Draft on the topic (FASB, 2012) and other documents available from the FASB. The summary of the IFRS 9 approach is based on the published accounting standard and accompanying documents. The approaches of the FASB and the IASB are presented in the same order as that in which the corresponding Exposure Drafts, FASB (2012) and IASB (2013a), were referred to in Section 2. This section also compares the core features of the two approaches, and provides information relevant to the consideration of possible relative impacts of the two approaches.

3.2. The FASB Approach to Accounting for Impairment

The core features of the FASB approach to accounting for impairment arising from credit losses on financial assets are presented in this subsection. As with the IASB's approach, the FASB's proposals on impairment aim to overcome the weakness of the incurred loss model, which is claimed to have delayed the recognition of credit losses and to have overstated interest revenue in periods before a credit loss event occurs. It also aims to eliminate the pre-existing complexity arising from multiple impairment approaches.

As described in subsection 2.2.5, the FASB (2012) expected-loss approach was developed after the FASB concluded that it did not wish to pursue the three-bucket approach that had been considered by the FASB and the IASB subsequent to deliberation on the 2011 joint

FASB/IASB Supplementary Document (FASB, 2011; IASB, 2011). The FASB felt that the three bucket approach, which is similar to the impairment approach subsequently included in IFRS 9, was inappropriate for a number of reasons.

The **principal objection** was that it involved the combination of two different measurement objectives for different subsets of financial assets. **Claimed potential consequences** of this included ambiguity as to which objective should apply to which asset, opportunities for earnings management, difficulty in interpretation of resultant accounting numbers, and a 'cliff' effect as assets were transferred from the 12-month-expected-loss category to the lifetime-expected-loss category in response to a significant increase in credit risk. Furthermore, the criteria for transferring assets from the 12-month-expected-loss category to the lifetime-expected-loss category felt like the re-introduction of the incurred-loss approach which the standard setters' work since 2009 had aimed to eliminate.

The **main objective** of the approach proposed in FASB (2012) is stated as follows: '*The main objective in developing this proposal is to provide financial statement users with more decision-useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date. This objective would be achieved by replacing the current impairment model, which reflects incurred credit events, with a model that recognizes expected credit risks and by requiring consideration of a broader range of reasonable and supportable information to inform credit loss estimates. These proposed amendments also would reduce complexity by replacing the numerous existing impairment models in current U.S. GAAP with a consistent measurement approach*'[33].

An updated FASB standard on *Financial Instruments – Credit Losses* is due to be published in the fourth quarter of 2015. FASB (2012) proposes the introduction of a **new subtopic** within FASB's Accounting Standards Codification: Subtopic 825-15 Financial Instruments – Credit Losses. Also, it proposes changes to some other **Accounting Standards Codification Topics**, including Topic 310 – Receivables for which some provisions are proposed to be superseded by provisions arising from FASB (2012) and subsequent re-deliberations. A **summary of key elements of the current FASB approach**, based on FASB (2012) and the authors' interpretation of subsequent deliberations by the FASB, is presented in **Table 1** at the end of subsection 3.2.

3.2.1.   Scope

The proposed Current Expected Credit Loss (CECL) model applies to financial assets that are measured at amortised cost. The **financial assets to which CECL applies** include loans, debt instruments (such as held to maturity securities) that are not measured at fair value, trade receivables, reinsurance receivables, net investment in leases, loan commitments, financial guarantees and any other receivables that represent the contractual right to receive cash.

The following **assets are excluded from the application** of the CECL model: debt securities classified as available-for-sale, which continue to be within the scope of FASB Codification Topic 320 – Investments – Debt and Equity Securities; loans made to participants by defined contribution employee benefit plans; policy loan receivables of an insurance entity; promises to give (pledge receivables) of a not-for-profit entity; loans and receivables between entities under common control.

3.2.2.   Recognition and measurement of losses

The allowance for expected credit losses is a measurement to reflect the net asset at the amount an entity expects to collect. At each reporting date (e.g. annually, half-yearly), an

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[33]   FASB (2012), p. 1.

entity shall measure an allowance for expected credit losses. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust for management's current estimate of expected credit losses on financial asset(s). The allowance for expected credit losses shall reflect the amount that the expected cash flows are below the amortised cost basis of a recognised financial asset. In the context of comparison with the IASB proposal, it is notable that the FASB has made a deliberate choice *not* to characterise the requirement to '*estimate credit losses over the entire contractual term of the financial assets*' as a requirement to estimate lifetime expected credit losses. This is because the term 'lifetime' is believed to be capable of being interpreted such as to imply requirements beyond those that are intended[34].The 'probable' threshold for recognition of losses is removed.

Under the FASB's currently proposed CECL model, an entity should evaluate financial assets for expected credit losses on a collective (pool) basis when similar risk characteristics exist; if an entity determines that a financial asset does not share risk characteristics with other financial assets of the entity, the entity could evaluate the financial asset for expected credit losses on an individual basis. Expected credit losses are required to be estimated for the estimated life of the financial assets, which should represent the contractual term of the financial assets, adjusted for expected prepayments but not expected extensions, renewals, and modifications unless the entity reasonably expects that it will execute a troubled debt restructuring with the borrower.

The estimate of expected credit losses should also reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets. In respect of the information set used in making the estimate, information about past events, current conditions, and reasonable and supportable forecasts about the future are all considered relevant in the current proposal.

As mentioned in subsection 2.2.5, the use of supportable forecasts about future conditions is in contrast to the initial FASB proposal in FASB (2010a), which required an entity to assume that existing economic conditions would remain unchanged for the remaining life of the financial assets[35]. The FASB specifies that an entity's estimate of expected credit losses shall start with the historical credit loss experience on financial assets with shared risk characteristics. An entity shall adjust its historical credit loss experience for current expectations based on current conditions and reasonable and supportable forecasts that are not reflected in the historical experience. An entity is not required to develop forecasts for all inputs over the estimated life of the financial asset if those forecasts are not supportable. Rather, for periods in which the entity is unable to make or obtain reasonable and supportable forecasts of expected credit losses for any input, the entity shall revert to unadjusted historical credit loss experience on a straight-line basis for the input.

The FASB proposed approach requires an entity to reflect the time value of money either explicitly or implicitly. This could be through the use of a probability-weighted discounted cash flow model, which reflects the time value of money explicitly. An entity is also permitted to use other methods that implicitly reflect the time value of money, such as loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. An entity is not required to reconcile the estimation technique it uses with a probability-weighted discounted cash flow model. However, if an entity estimates expected credit losses through the use of a discounted cash flow model, the discount rate utilized in that model should be the financial asset's effective interest rate at acquisition or origination.

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[34] FASB (2012), paragraph BC18.
[35] FASB (2010a), paragraph 42.

3.2.3. Financial assets measured at fair value through other comprehensive income

The current U.S. GAAP model (in FASB Codification Topic 320) requires that gains and losses on available-for-sale securities are recognised through other comprehensive income, except for other-than-temporary impairments which are recognised through earnings. The current U.S. GAAP model to recognise credit losses on available-for-sale debt securities, which is an incurred-loss model, will be retained with the following changes:

- An allowance approach would be used for recognising credit losses, which would allow an entity to recognise reversals of credit losses in period in which the improvement occurs. This is different from current GAAP which requires a write down upon occurrence of an other than temporary impairment. Subsequent improvements are recognised prospectively in interest income over the remaining life.

- The requirement to consider the length of time that the fair value of an available-for-sale debt security has been less than its amortised cost basis when estimating whether a credit loss exists will be removed.

- When estimating whether a credit loss exists, an entity would not be required to consider recoveries or additional declines in the fair value of an available-for-sale debt security after the balance sheet date.

3.2.4. Purchased credit-impaired (PCI) financial assets

Purchased credit-impaired (PCI) financial assets are defined by the FASB as acquired financial assets that have experienced a more than insignificant deterioration in credit quality since origination. For such assets, the FASB's proposal requires that the part of the discount in the purchase price attributable to credit losses at the date of acquisition should not be amortised into and recognised as part of the interest income over the life of the asset. Instead, upon acquisition, the initial estimate of credit losses should be recognised as (1) an adjustment that increases the cost basis of the asset and (2) an allowance for credit losses.

3.2.5. Interest revenue recognition

The current U.S. GAAP decoupled approach to recognition of interest revenue would be retained. Interest income would be calculated by applying the effective interest rate to the gross carrying amount of the asset, without any adjustment for expected credit losses. Impairment would be recognised as a separate line item. The current U.S. GAAP for nonaccrual assets would be retained.

Table 1: **Summary of Selected Provisions of the FASB Exposure Draft** *Financial Instruments – Credit Losses (Subtopic 825-15)* **(issued on 20 December 2012)** [36] **and the Current FASB Proposals (as of 20 May 2015)**

Exposure Draft	*Current Proposals*
1.Scope of the Current Expected Credit Loss (CECL) model	
The proposed CECL model applies to '*financial assets that are subject to losses related to credit risk and are not classified at fair value through net income*', including loans, debt instruments classified at amortised cost or at fair value with changes in fair value recognized in other comprehensive income (OCI), trade receivables, reinsurance receivables, lease receivables, loan commitments, and any other receivables that represent the contractual right to receive cash. (825-15-15-2 and pages 1 and 2)	The proposed CECL model applies to financial assets that are measured at amortised cost. The financial assets to which CECL applies include loans, debt instruments (such as held to maturity securities) not measured at fair value, trade receivables, reinsurance receivables, net investment in leases, loan commitments, financial guarantees and any other receivables that represent the contractual right to receive cash. The following are excluded from the application of the

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[36] References in column 1 are to paragraphs in FASB (2012).

Exposure Draft	Current Proposals
	CECL model: Debt securities classified as available-for-sale (which continue to be within the scope of Topic 320 – Investments – Debt and Equity Securities, see Panel 3 of this table); Loans made to participants by defined contribution employee benefit plans; Policy loan receivables of an insurance entity; Promises to give (pledge receivables) of a not-for-profit entity; Loans and receivables between entities under common control.
2. Recognition and measurement of losses	
The 'probable' threshold for recognition of losses is removed. (page 2)	The 'probable' threshold for recognition of losses is removed.
'*At each reporting date, an entity shall recognize an allowance for expected credit losses on financial assets within the scope of this Subtopic. Expected credit losses are a current estimate of all contractual cash flows not expected to be collected.*' (825-15-25-1)	The allowance for expected credit losses is a measurement to reflect the net asset at the amount an entity expects to collect. At each reporting date, an entity shall measure an allowance for expected credit losses. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust for management's current estimate of expected credit losses on financial asset(s). The allowance for expected credit losses shall reflect the amount that the expected cash flows are below the amortized cost basis of a recognized financial asset.
'*An entity shall recognize in the statement of financial performance (as a provision for credit loss) the amount of credit loss (or reversal) required to adjust the allowance for expected credit losses for the current period in the statement of financial position.*' (825-15-25-7)	
'*An entity may estimate expected credit losses for some financial assets on a collective (pool) basis and may estimate expected credit losses for other assets on an individual basis.*' (825-15-55-32)	An entity shall evaluate financial assets for expected credit losses on a collective (pool) basis when similar risk characteristic(s) exist. If an entity determines that a financial asset does not share risk characteristics with other financial assets of the entity, the entity shall evaluate the financial asset for expected credit losses on an individual basis.
'*An estimate of expected credit losses shall always reflect both the possibility that a credit loss results and the possibility that no credit loss results. However, a probability-weighted calculation that considers the likelihood of more than two outcomes is not required. An entity is prohibited from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode).*' (825-15-25-5)	An entity shall estimate expected credit losses for the estimated life of the financial asset(s). The estimated life of a financial asset represents the contractual term of the financial asset(s), adjusted for expected prepayments but not expected extensions, renewals, and modifications unless the entity reasonably expects that it will execute a troubled debt restructuring with the borrower.
'*The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets.*' (825-15-25-6)	The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets.
'*An estimate of expected credit losses shall be based on internally and externally available information considered relevant in making the estimate. That information includes information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses.*' (825-15-25-3)	An entity's estimate of expected credit losses shall start with the historical credit loss experience on financial assets with shared risk characteristics. An entity shall adjust its historical credit loss experience for current expectations based on current conditions and reasonable and supportable forecasts that are not reflected in the historical experience. An entity is not required to develop forecasts for all inputs over the estimated life of the financial asset if those forecasts are not supportable. Rather, for periods in which the entity is unable to make or obtain reasonable and supportable forecasts of expected credit losses for any input, the entity shall revert to unadjusted historical credit loss experience on a straight-line basis for the input.
'*An estimate of expected credit losses shall reflect the time value of money either explicitly or implicitly*' (825-15-25-4). '*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 these amounts to a present value using the effective interest rate. Other methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic (after updating it for current conditions and reasonable and supportable forecasts of the future) to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit*	An entity is not required to utilise a probability-weighted discounted cash flow model to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a probability-weighted discounted cash flow model. However, if an entity estimates expected credit losses through the use of a discounted cash flow model, the discount rate utilized in that model should be the financial asset's effective interest rate at acquisition or origination. In addition to

Exposure Draft	Current Proposals
loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors' (825-15-55-3). '*If an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model shall be the financial asset's effective interest rate*' (825-15-25-4). (The effective interest rate is defined as follows: '*The rate of return implicit in the debt instrument, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the debt instrument. For purchased credit-impaired financial assets, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition*' (pages 12-13).)	using a discounted cash flow model to estimate expected credit losses, an entity is permitted to develop an estimate of credit losses using other methods, such as loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors.

3. Financial assets measured at fair value through other comprehensive income (FV-OCI)

For financial assets measured at fair value through other comprehensive income (FV-OCI), '*the estimate of expected credit losses is a contra-asset that reduces the amortized cost of the asset. The net amortized cost amount for such assets (that is, net of the allowance for expected credit losses) shall be included on the statement of financial position*' (825-15-45-2). An entity may elect not to recognize expected credit losses for FV-OCI if both of the following conditions are met: '*a. The fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset. b. Expected credit losses on the individual financial asset are insignificant*' (825-15-25-2).	The current U.S. GAAP model (in FASB Codification Topic 320) requires that gains and losses on available-for-sale securities are recognised through OCI, except for other-than-temporary impairments which are recognised through earnings. The current U.S. GAAP model to recognize credit losses on available-for-sale debt securities will be retained with the following changes: a) An allowance approach would be used for recognising credit losses, which would allow an entity to recognize reversals of credit losses in period in which improvement occurs. (This is different from current GAAP which requires a write down upon occurrence of an other than temporary impairment. Subsequent improvements are recognised prospectively in interest income over the remaining life.) b) The requirement to consider the length of time that the fair value of an available-for-sale debt security has been less than its amortized cost basis when estimating whether a credit loss exists will be removed. c) When estimating whether a credit loss exists, an entity would not be required to consider recoveries or additional declines in the fair value of an available-for-sale debt security after the balance sheet date.

4. Purchased credit-impaired (PCI) financial assets

Purchased credit-impaired (PCI) financial assets are acquired financial assets '*that have experienced a significant deterioration in credit quality since origination*' (page 14). For PCI financial assets, the discount embedded in the purchase price attributable to the acquirer's assessment of expected credit losses at the date of acquisition shall not be amortized into and recognised as interest income over the life of the asset. Instead, upon acquisition the initial estimate of expected credit losses would be recognised as (1) an adjustment that increases the cost basis of the asset, (2) an allowance for credit losses (825-15-25-9; and see example 6 on pages 33-34).	Purchased credit-impaired (PCI) financial assets are acquired financial assets that have experienced a more than insignificant deterioration in credit quality since origination. For such assets, the discount in the purchase price attributable to credit losses at the date of acquisition is not recognised as interest income over the life of the asset. Instead, upon acquisition the initial estimate of credit losses would be recognised as (1) an adjustment that increases the cost basis of the asset and (2) an allowance for credit losses.

5. Interest Income Recognition

An entity shall apply the existing approach in current	The current decoupled approach in U.S. GAAP would be

Exposure Draft	Current Proposals
U.S. GAAP that recognises interest income and credit losses separately (825-15-25-8, BC44). For PCI assets, *'an entity shall not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition'* (825-15-25-9). For nonaccrual assets, *'an entity shall cease its accrual of interest income when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest'*. In such circumstances, the entity shall apply either the cost-recovery method or the cash-basis method. (825-15-25-10)	retained. Interest income would be calculated by applying the effective interest rate to the gross carrying amount, without any adjustment for expected credit losses. Expense for credit losses would be recognized as a separate line item. Entities will continue to apply current GAAP for nonaccrual assets.

Source: Authors' interpretation of FASB documents.

Note: Column 1 summarises key features of FASB (2012). Column 2 summarises our understanding of the current proposals based on FASB (2012) and the FASB's decisions taken during re-deliberations documented in meeting minutes (from 28 March 2013 to 22 April 2015) and summaries thereof from the FASB web site[37]. Key features of the FASB proposals presented in Table 1. are also described in subsections 3.2.1 to 3.2.5.

3.3. The IASB Approach to Accounting for Impairment: IFRS 9 Financial Instruments (2014)

The core features of the IASB approach to accounting for impairment arising from credit losses on financial assets as described in IFRS 9 Financial Instruments (IASB, 2014a) and accompanying documents are summarised in this subsection. **N.B.** Unless otherwise indicated, all references to paragraphs in subsection 3.3 are to IFRS 9 Financial Instruments (IASB, 2014a), which includes the International Financial Reporting Standard, the accompanying Basis for Conclusions and the accompanying Implementation Guidance.

As with the FASB's approach, the impairment approach in IFRS 9 aims to overcome the delayed-recognition weakness of the incurred-loss model. It also aims to eliminate the pre-existing complexity arising from multiple impairment approaches.

The IFRS 9 model aims to provide users of financial statements with relevant information about the amount, timing and uncertainty of an entity's future cash flows. It is no longer necessary to delay the recognition of credit losses until there is evidence of a credit event. The model requires recognition of expected credit losses at all times and updating of the amount of expected credit losses at each reporting date to provide more timely information.

As described in subsection 2.2.6, the impairment provisions of IFRS 9 were developed from the three-bucket approach after the FASB signalled its unwillingness to proceed with that approach and elected to explore an alternative single-measurement approach that reflected all credit risk in the portfolio at each reporting date. Elements of the three-bucket approach are retained in IFRS 9 in that assets are grouped into three categories. These are referred to in an IASB summary document as 'Stage 1', 'Stage 2' and 'Stage 3'[38], although this terminology is not used in IFRS 9 itself. The categories are as follows:

- *Stage 1* assets for which credit risk has not increased significantly since initial recognition, for which 12-month expected losses are recognised and for which interest is calculated based on the gross carrying amount before deducting the loss allowance;

- *Stage 2* assets for which credit risk has increased significantly and the resulting credit quality is not considered to be low credit risk, for which full lifetime expected credit losses are recognised and interest is calculated based on the gross carrying amount before deducting the loss allowance;

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[37] See http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176159268094.

[38] See the Project Summary for IFRS 9 (IASB (2014b)).

- **Stage 3** assets that are credit-impaired, for which full lifetime expected credit losses are recognised and interest is calculated based on the gross carrying amount of the asset less the loss allowance.

The Stage-1 recognition of 12-month expected losses where credit risk has not increased significantly since initial recognition is an operationally simplified approach to addressing the IASB (2009) objective to recognise initial expected credit losses over time. This can be seen from the following two extracts from IFRS 9: *'entities will be required to recognise a loss allowance at an amount equal to at least 12-month expected credit losses throughout the life of their financial instruments that are subject to impairment accounting. This reduces the systematic overstatement of interest revenue in IAS 39 and acts as a proxy for the recognition of initial expected credit losses over time'*[39]; *'[…] the IASB decided that an entity should measure the loss allowance at an amount equal to 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the earlier recognition of the full lifetime expected credit losses compared to IAS 39, achieves an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledged that this is an operational simplification, and that cost-benefit is the only conceptual justification for the 12-month time horizon'*[40].

Key features of the IFRS 9 approach are outlined in subsections 3.3.1 to 3.3.5.

3.3.1.   Scope

IFRS 9 specifies the scope for its impairment requirements as the following financial assets:

1. A financial asset measured at amortised cost. Such assets are assets that meet the following conditions: (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

2. A financial asset measured at fair value through other comprehensive income. Such assets are assets that meet the following conditions: (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

3. Lease receivables.

4. Contract assets.

5. Loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss[41].

3.3.2.   Recognition and measurement of losses

The key element of the IFRS 9 impairment approach is that two different sets of expected losses would be recognised in impairment allowances depending on whether or not the credit risk on a financial asset has increased significantly since initial recognition. **It is to the two different sets of expected losses to be recognised that the FASB refers when it expresses concern about the IFRS's '*two different measurement objectives*'.**

In respect of assets for which credit risk has increased significantly since initial recognition, the requirement and underlying objective are stated as follows: *'[…] at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to*

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[39] IFRS 9, paragraph BCE.93.

[40] IFRS 9, paragraph BC5.195.

[41] IFRS 9, paragraph 4.1.2, paragraph 4.1.2A, paragraph 5.5.1, paragraph 5.5.2, paragraph BC5.118.

lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition. […] The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.'[42]. In respect of assets for which credit risk has not increased significantly since initial recognition, the requirement is stated as follows: *'an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.'*[43]. Credit losses should be recognised in profit or loss[44].

Note that IFRS 9 also specifies a 'simplified approach' for certain assets, including trade receivables which are likely to have a maturity that is less than one year and for which lifetime expected credit losses and 12-month expected credit losses are likely to be similar. Under this approach, lifetime expected losses should be recognised. This approach is not referred to in further detail on this paper.

Transfer from the 12-month-expected-loss category to the lifetime-expected-loss category is dependent upon assessment of whether the credit risk on a financial instrument has increased significantly since initial recognition. The assessment is based on change in the risk of a default occurring over the expected life of the financial instrument and not on the change in the amount of expected credit losses[45].

The Standard says the following with regard to the measurement of lifetime expected losses and 12-month expected losses: *'For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months'*[46].

As the term '12-month expected credit losses' could denote various things, it is important to emphasize what is denoted by the term in IFRS 9. The meaning is exemplified within the Implementation Guidance in IFRS 9. Based on this, the meaning of '12 month expected credit losses' is explained and exemplified below[47]. 12 month expected credit losses for a loan for which credit risk has not increased significantly since initial recognition is the product of:

- the proportion of the gross carrying amount of the loan that is expected to be lost in the event that the loan defaults (loss given default (LGD));
- the probability of default (PD) over the next 12 months;
- the gross carrying amount of the loan.

For instance: If the gross carrying amount of the loan is Currency Units 1,000,000, the LGD is 25 % (0.25) and the PD over the next 12 months is 0.5 % (0.005), then the loss allowance is

Currency Units 1,250 (= 0.25 × 0.005 × 1,000,000)

The IASB recognises the **conceptual limitations of the requirement** to set a 12-month time horizon for assets for which no significant increase in credit risk has occurred. The IASB

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[42]   IFRS 9, paragraphs 5.5.3.-5.5.4.

[43]   IFRS 9, paragraph 5.5.5.

[44]   IFRS 9, paragraph 5.5.8.

[45]   IFRS 9, paragraph 5.5.9.

[46]   IFRS 9, paragraph B5.5.43.

[47]   IFRS 9, paragraphs IE49-IE50.

decided that an entity should measure the loss allowance at an amount equal to 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the **earlier recognition of the full lifetime expected credit losses compared to IAS 39**[48], achieves an **appropriate balance** between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledged that this is an **operational simplification, and that cost-benefit is the only conceptual justification for the 12-month time horizon**[49].

Assessment of credit risk may be on an individual or collective basis, where 'collective' refers to assessment at the level of a group or sub-group of financial instruments.

Measurement of expected credit losses should reflect the following:

- An unbiased and probability-weighted amount based on evaluating a range of possible outcomes.

- The time value of money. Paragraphs B5.5.44 to B5.5.48 refer in detail to the discounting processes that can be applied. IFRS 9 does not include an equivalent to the FASB provision, referred to in subsection 3.2.2 above, that permits methods that do not explicitly reflect the time value of money but which implicitly reflect it. Therefore, entities must always satisfy the objective of reflecting the time value of money.

- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions[50].

3.3.3. Financial assets measured at fair value through other comprehensive income

As mentioned above, financial assets are measured at fair value through other comprehensive income (FV-OCI)) where

(a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

It should be noted that the available-for-sale category of financial assets that exists in IAS 39 is not present in IFRS 9. In explaining its rationale for this, the IASB states that it believes that the FV-OCI measurement category in IFRS 9 is fundamentally different to the available-for-sale category in IAS 39 because it is based on the criteria of assets' contractual cash flow characteristics and the business model in which they are held rather than being a residual category into which entities could classify assets using significant discretion[51].

Under IFRS 9 expected losses for financial assets measured at fair value through other comprehensive income are calculated using the same model that is used for all other financial assets in the scope of impairment accounting. IFRS 9 states the following with regard to these assets: '*An entity shall apply the impairment requirements for the recognition and measurement of a loss allowance for financial assets that are measured at fair value through other comprehensive income. However, the loss allowance shall be recognised in other comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position*'[52]. This treatment of impairment is noted to be an **exception to the general treatment of gains and losses** on such assets: '*A gain or loss on a financial*

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[48] IASC (1999 and subsequently amended).
[49] IFRS 9, paragraph BC5.195.
[50] IFRS 9, paragraph 5.5.17.
[51] IFRS 9, paragraph BC4.161.
[52] IFRS 9, paragraph 5.5.2.

asset measured at fair value through other comprehensive income […] shall be recognised in other comprehensive income, except for impairment gains or losses […] and foreign exchange gains and losses […], until the financial asset is derecognised or reclassified'[53].

An **example of how the impairment of FV-OCI assets** would be treated is given in the implementation guidance of IFRS 9[54]: A reduction in fair value of (Currency Units/**CU**) 50 from CU 1,000 to CU 950 is deemed to comprise

> (i) an impairment loss of CU 30, and

> (ii) other net-negative valuation effects totalling CU 20.

Item (i) is recognised as an impairment loss in profit or loss. Item (ii) is debited to other comprehensive income. The carrying value of the asset remains at CU 950. The effect of this is that some (CU 30, being the impairment loss) of the fair-value loss of CU 50, which would otherwise be debited to other comprehensive income, is instead debited to an impairment loss in profit or loss. The effect on the relevant accounts is represented in Figure 3.

Figure 3: Debt instrument measured at fair value through other comprehensive income under IFRS 9

To recognise the debt instrument measured at its fair value	Debit CU	Credit CU
Financial asset - FVOCI	1,000	
Cash		1,000
To recognise 12-month expected credit losses and other fair value changes on the debt instrument	**Debit CU**	**Credit CU**
Impairment loss (profit or loss)	30	
Other comprehensive income	20	
Financial asset - FVOCI		50

Source: IFRS 9 (IASB, 2014a), paragraphs IE78-IE79, Example 13.

3.3.4. Purchased credit-impaired (PCI) financial assets

IFRS 9 does not change the requirement of IAS 39 (IASC, 1999 and subsequently amended) that an entity should include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that are credit-impaired on initial recognition. The relevant section of IAS 39 (paragraph AG 5) is as follows: '*In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.*' This implies that, unlike in the FASB proposal, there is no gross-up at acquisition of the amount paid for the asset in order to give (i) a gross carrying amount (before subtracting an initially recognised allowance for credit losses) less (ii) the initially recognised allowance for credit losses. For the reasoning behind the IASB's position on this, see paragraphs BC5.219-BC5.220.

IFRS 9 states that, for purchased or originated credit-impaired financial assets, the entity shall apply the credit-adjusted effective interest rate to the amortised cost of the financial asset from initial recognition[55]. After initial recognition, the entity should *not* consider whether the asset falls into the 12-month-expected-loss category or the lifetime-expected-loss category,

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[53] IFRS 9, paragraph 5.7.10.

[54] IFRS 9, paragraphs IE78-IE81.

[55] IFRS 9, paragraph 5.4.1.a.

and should only recognise the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance[56].

3.3.5. Interest revenue recognition

For financial assets, for which 12-month expected credit losses are recognised, interest revenue is calculated on the gross carrying amount without adjustment for expected credit losses. Assets for which lifetime credit losses are recognised fall into two categories. If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk (Stage 2), full lifetime expected credit losses are recognised. In this case, interest continues to be calculated on the gross carrying amount without adjustment for expected credit losses. If the credit risk of a financial asset increases such that it is considered credit-impaired (Stage 3), interest revenue is calculated based on the amortised cost, which is equal to the gross carrying amount of the asset less the loss allowance, see paragraph 5.4.1.; and also the IFRS 9 Project Summary[57] for a succinct summary of the requirements.

3.4. Key Differences Between the FASB and IFRS 9 Approaches to Accounting for Impairment

In this subsection, we summarise key differences between the FASB and IFRS 9 approaches to impairment, see also Table 2. below.

3.4.1. Scope

Both the FASB proposals and IFRS 9 include within their scope financial assets measured at amortised cost, and also some other instruments that could give rise to credit losses, including lease receivables, loan commitments and financial guarantees. The scope of IFRS 9 also includes financial assets measured at fair value through other comprehensive income (FV-OCI), which include debt securities that are available for sale. The scope of the FASB proposals does not include Debt securities classified as available-for-sale, which continue to be within the scope of FASB Codification Topic 320 – Investments – Debt and Equity Securities.

3.4.2. Recognition and measurement of losses

The key difference between the FASB proposals and IFRS 9 is with regard to which losses are to be recognised. Under the FASB proposals:

- an entity shall recognise the current estimate of all contractual cash flows not expected to be collected as the allowance for expected credit losses.

Under IFRS 9:

- for assets for which credit risk has increased significantly since initial recognition, the loss allowance is an amount equal to lifetime expected credit losses;

- for assets for which credit risk has not increased significantly since initial recognition, the loss allowance is an amount equal to 12-month expected credit losses.

FASB deliberately avoids the use of the term 'lifetime' in referring to losses under its CECL model, as this term is believed to be susceptible to being interpreted as implying requirements beyond those that are intended.

In both the FASB proposals and IFRS 9, credit losses should be calculated by reference to past experience, current conditions and supportable forecasts of future economic conditions.

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[56] IFRS 9, paragraph 5.5.13.
[57] IASB (2014b).

Because of the need to specify how 12-month expected losses are to be calculated, IFRS 9 also includes requirements on this, for which there is no corresponding requirement in the FASB proposals.

Under the FASB proposals, estimates of expected credit losses should reflect the time value of money either explicitly through the use of a discounted cash flow model or implicitly through other methods such as loss-rate methods. IFRS 9 requires that expected credit losses of a financial instrument should be measured such as to reflect the time value of money. IFRS 9 does not contain a provision equivalent to the FASB provision that permits the time value of money to be reflected implicitly rather than explicitly through a discounting process.

3.4.3.   Financial assets measured at fair value through other comprehensive income

The current U.S. GAAP model (in FASB Codification Topic 320) requires that gains and losses on available-for-sale securities are recognised through other comprehensive income, except for other-than-temporary impairments which are recognised through earnings on an incurred-loss basis. Under IFRS 9, financial assets are measured at fair value through other comprehensive income where the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, and the assets give rise on specified dates to cash flows that are solely payments of principal and interest. The available-for-sale category of financial assets that exists in IAS 39[58] is not present in IFRS 9. Impairments arising from credit losses on assets measured at fair value through other comprehensive income are charged to profit or loss (earnings). The effect under both the FASB proposals and IFRS 9 is that impairment losses on such assets are charged to profit or loss (earnings). However, under IFRS 9, impairment is calculated on the basis of expected losses using the same model used for all financial assets in the scope of impairment accounting whereas the FASB impairment continues to be based on an incurred loss model.

3.4.4.   Purchased credit-impaired (PCI) financial assets

The FASB requires that the element of a discount in an acquired asset that is attributable to expected credit losses should be recognized as (1) an adjustment that increases the cost basis of the asset and (2) an allowance for credit losses, with the discount in the purchase price attributable to credit losses at the date of acquisition not being recognised as interest income over the life of the asset. Under IFRS 9, there is no gross-up. The interest rate on the asset is adjusted to reflect all initial expected credit losses and an allowance is recognised for all changes in expected credit losses. Interest at the credit adjusted rate is calculated on the basis of the carrying amount of the asset (net of any allowance).

3.4.5.   Interest revenue recognition

FASB would retain the current U.S. GAAP decoupled approach to recognition of interest revenue. Interest income would be calculated by applying the effective interest rate to the gross carrying amount of the asset, without any adjustment for expected credit losses. Under IFRS 9, for financial assets for which credit risk has not increased significantly since initial recognition (Stage 1) and for financial assets for which credit risk has increased significantly and the resulting credit quality is not considered to be low credit risk (Stage 2), interest revenue is calculated on the gross carrying amount without adjustment for expected credit losses. For financial assets for which credit risk has increased such that they are considered credit-impaired (Stage 3), interest revenue is calculated based on the amortised cost, which is equal to the gross carrying amount of the assets less the loss allowance.

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[58] IASC (1999 and subsequently amended).

Table 2:   Accounting for Impairment of Financial Instruments: the FASB approach versus the IFRS 9 approach

Issue	FASB approach	IFRS 9 approach	Same (√)/ Diffe- rent (✗)	Consequences or impact
Scope	Financial assets measured at amortised cost, including loans, debt instruments, trade receivables, reinsurance receivables, net investment in leases, loan commitments, financial guarantees and any other receivables that represent the contractual right to receive cash	Financial assets measured at amortised cost, financial assets measured at fair value through other comprehensive income, lease receivables, contract assets, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss	✗	The scope of the FASB proposals does not include debt securities classified as available-for-sale, which continue to be within the scope of FASB Codification Topic 320 – Investments – Debt and Equity Securities. The scope of IFRS 9 includes financial assets measured at fair value through other comprehensive income, which include debt securities that are available for sale. We expect that, for this item, IFRS 9 will give more timely recognition of impairment and greater comparability with other financial assets.
Recognition and measurement of losses (a)	The loss allowance reflects the current estimate of all contractual cash flows not expected to be collected.	The loss allowance reflects: (i) lifetime expected credit losses if the credit risk on the financial instrument has increased significantly since initial recognition; (ii) 12-month expected credit losses if the credit risk on the financial instrument has not increased significantly since initial recognition.	✗	We expect that there will be larger loss allowances under the FASB proposal than under IFRS 9.
Recognition and measurement of losses (b)	Expected credit losses should be estimated by reference to past experience, current conditions and supportable forecasts of future economic conditions.	Measurement of expected credit losses should reflect past events, current conditions and forecasts of future economic conditions.	√	
Recognition and measurement of losses (c)	Under the FASB proposals, estimates of expected credit losses should reflect the time value of money either explicitly through the use of a discounted cash flow model or implicitly through other methods such as loss-rate methods.	IFRS 9 requires expected credit losses of a financial instrument to be measured such as to reflect the time value of money. IFRS 9 does not contain a provision equivalent to the FASB provision that permits the time value of money to be reflected implicitly rather than explicitly through a discounting process.	✗	Greater flexibility under the FASB proposal than under IFRS 9 with regard to dealing with the time value of money
Financial assets measured at fair value through other comprehensive	A modification of the existing other-than-temporary impairment model, which is an incurred-loss model, will be applied: other-than-temporary impairments on available-for-sale debt securities will be recognized	The IFRS 9 impairment model will be applied. Impairment will be recognised in profit or loss, and other gains and losses will be recognised in other comprehensive income.	✗	IFRS 9 will give more timely recognition of impairment losses on available-for-sale debt securities, on the basis of expected losses using the same model used for all financial assets in the scope of impairment accounting, than under the FASB incurred-loss procedure.

Issue	FASB approach	IFRS 9 approach	Same (√)/ Diffe-rent (✗)	Consequences or impact
income (FV-OCI)	through earnings; other gains and losses will be recognized through OCI.			
Purchased credit-impaired (PCI) financial assets	The FASB requires that the element of a discount in an acquired asset that is attributable to expected credit losses should be recognized as (1) an adjustment that increases the cost basis of the asset and (2) an allowance for credit losses. The part of the discount in the purchase price attributable to credit losses at the date of acquisition should not be amortised into and recognised as part of the interest income over the life of the asset.	Under IFRS 9, there is no gross-up. The interest rate on the asset is adjusted to reflect all initial expected credit losses and an allowance is recognised for all subsequent changes in expectations regarding credit losses. Interest at the credit adjusted rate, is calculated on the basis of the carrying amount of the asset (net of any allowance).	✗	Under the FASB proposals, PCI assets are shown gross less an allowance, and the discount within the purchase price attributable to expected credit losses at acquisition is not recognized within interest income over the life of the asset. Under IFRS 9, there is no gross up, and the interest rate on the asset is adjusted to reflect all initial expected credit losses.
Interest revenue recognition	The current decoupled approach in U.S. GAAP would be retained. Interest income would be calculated by applying the effective interest rate to the gross carrying amount, without any adjustment for expected credit losses. The current U.S. GAAP for nonaccrual assets would be retained.	For financial assets, for which 12-month expected credit losses are recognised or for which the credit risk has increased significantly and the resulting credit quality is not considered to be low credit risk, interest revenue is calculated on the gross carrying amount without adjustment for expected credit losses. If the credit risk of a financial asset has increased such that it is considered credit-impaired, interest revenue is calculated based on the amortised cost, which is equal to the gross carrying amount of the asset less the loss allowance.	✗	Under the FASB proposals, any interest that is recognised is calculated based on the gross carrying amount. Under IFRS 9, for financial assets considered credit-impaired, interest revenue is calculated based on the amortised cost (i.e. the gross carrying amount of the asset less the loss allowance).

3.5. Possible Relative Impacts of the FASB and IFRS 9 Approaches to Accounting for Impairment

The ability to assess the likely impacts of the implementation of the FASB and IFRS 9 approaches is limited to some extent by the fact that the approaches are new and have not yet been implemented in any regime. However, there are a number of observations that can be made, and summary statistics can provide at least some indication of the potential order of magnitude of any impact.

Relative to an incurred-loss model, the FASB's and the IASB's expected-loss model will tend to **increase the amount of the losses recognised** in the loss allowance accounts in balance sheets. They will not in themselves change the total amount of loss expense recognised in the income statement across the life of an asset, as their effect will be to change the time at which losses are recognised but not to increase the total amount of losses recognised over time.

With regard to the IFRS 9 proposal, there is some evidence on which to base assessment of the likely effect of implementation on loss allowances. Although the EFRAG opinion paper entitled *Adoption of IFRS 9 Financial Instruments*[59] reported that information limitations restricted estimation of the likely impact of the impairment requirements of IFRS 9, it does report some survey-based evidence that loss allowances are expected to rise under IFRS 9 relative to the current incurred-loss model.

Also, an IASB Staff Paper[60] provides some evidence based on a small fieldwork exercise that indicates that **increases in allowances** under IFRS 9 relative to the IAS 39 incurred-loss model could be material. With regard to differences between the **impacts** of the FASB proposals and the IFRS 9 requirements, we are not aware of any specific analysis of this. However, the IASB Staff Paper does suggest that allowances arising from recognition of lifetime losses on all financial assets could be materially greater than those arising from the IFRS 9 requirements to recognise 12-month expected losses on some financial assets and lifetime losses on others. This implies that the **allowances under the FASB proposals could be materially greater than those under the IFRS 9 requirements**.

The principal difference between the FASB and IFRS 9 sets of proposals relates to assets for which credit risk has not increased significantly since recognition. Under the FASB proposals, expected losses beyond the 12-month horizon *would be recognised* for such assets, whereas under IFRS 9 they would *not* be recognised. As a report of the Financial Stability Board of September 2013 put it: '*Under both sets of proposals the provisions for loan losses are based on the same information set of loss expectations and, for poorly performing loans, the provisioning would be the same under both proposals. The difference between the proposals is in the impairment accounting for performing loans*'[61]. This suggests a **potential source of evidence** on the likely order of magnitude of differences in loss allowances that would be recognised for a given set of expectations regarding lifetime losses under the FASB CECL model and under IFRS 9. However any inferences drawn from this approach must be qualified. The category 'performing loans' does not correspond precisely to the IFRS 9 12-month-expected-loss category, for which the FASB CECL model would recognise all expected losses and for which only 12-month expected losses would be recognised under IFRS 9. The lack of direct mapping between the IFRS 9 12-month-expected-loss/lifetime-expected-loss categorisation and the performing/non-performing categorisation is indicated in a PWC paper[62] that refers to (i) the 12-month-expected-loss category (Stage 1) as 'performing loans', (ii)

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[59] EFRAG (2015).
[60] IASB (2013b).
[61] Financial Stability Board, p. 34.
[62] PWC (2014)

assets for which credit risk has increased significantly and the resulting credit quality is not considered to be low credit risk but are not considered to be credit-impaired (Stage 2) as 'under-performing loans', and (iii) assets that are considered to be credit-impaired (Stage 3) as 'non-performing loans'. Also, it should be noted that the criterion for classification out of the 12-month expected-loss category under IFRS 9 is a *relative* criterion rather than an *absolute* criterion in that it requires that credit risk has increased significantly since initial recognition. Furthermore, any attempts to quantify the possible impact of the difference are complicated by the likelihood that, as reported by the IASB based on its fieldwork prior to the issue of IFRS 9, *'lifetime expected credit losses are most difficult to calculate for long-dated financial assets that are fully performing (i.e., the 'good' loans, which are measured at 12-month expected credit losses in accordance with IFRS 9)*[63].

Subject to these qualifications, examination of the magnitude of loans categorised as performing loans relative to total loans and relative to equity provides some indication of the potential order of magnitude of the differences between loss allowances under the FASB and IFRS 9 impairment approaches. Motivated by this, we present statistics on performing loans for European banks derived from data provided by SNL Financial, see Table 3. below.

Table 3. below provides summary statistics for data provided by SNL Financial for 2014 in respect of European Union Member States. Statistics are reported for states for which SNL provides data for five or more quoted banks for all of the variables that we use. It provides the mean and median of the following:

- Total Assets (in millions of U.S. dollars),
- Total Assets as a percentage of Equity,
- Gross Loans as a percentage of Total Assets,
- Gross Loans as a percentage of Equity,
- Loan-Loss Allowance as a percentage of Gross Loans,
- Loan-Loss Allowance as a percentage of Total Assets,
- Loan-Loss Allowance as a percentage of Equity,
- Loan-Loss Expense as a percentage of Net Income Before Tax and Loan-Loss Expense,
- Gross Performing Loans as a percentage of Gross Loans, and
- Gross Performing Loans as a percentage of Equity.

The countries for which data are reported are

- Denmark (18),
- France (16),
- Germany (8),
- Italy (17),
- Poland (7),
- Spain (7),
- U.K. (11).

The total number of banks in the sample is 84.

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[63] IFRS 9, paragraph BCE.155.

Table 3: **Summary Statistics for Banks for Selected European Union Countries 2014**

EU Member State	No. of banks		Total Assets (in USD Mil.)	Total Assets as a % of Equity	Gross Loans as a % of Total Assets	Gross Loans as a % of Equity	Loan-Loss Allowance as a % of Gross Loans	Loan-Loss Allowance as a % of Total Assets	Loan-Loss Allowance as a % of Equity	Loan-Loss Expense as a % of Net Income before Tax	Gross Performing Loans as % of Gross Loans	Gross Performing Loans as % of Equity
Denmark	18	Mean	39,171	1192.4	66.1	804.7	8.3	5.8	77.6	78.3	84.2	658.7
		Median	1,261	1056.2	65.5	620.5	6.7	4.8	34.8	48.9	87.9	559.3
France	16	Mean	199,734	1108.1	69.9	635.9	2.7	1.9	16.9	15.0	96.6	614.1
		Median	20,367	782.9	77.5	602.3	2.7	2.0	16.5	14.5	96.6	581.4
Germany	8	Mean	140,442	1926.4	48.3	905.7	1.5	0.8	14.3	99.2	96.2	864.8
		Median	47,039	1944.1	51.7	998.1	1.2	0.9	16.4	32.8	96.4	956.5
Italy	17	Mean	163,367	1500.0	61.1	898.3	7.0	4.8	78.2	324.7	84.3	724.0
		Median	46,374	1423.2	71.2	882.0	7.1	4.9	69.1	69.2	84.0	739.6
Poland	7	Mean	17,331	906.5	68.0	626.6	4.5	3.1	27.2	29.5	92.4	579.1
		Median	14,040	974.3	74.9	698.8	4.5	2.4	25.2	24.0	93.0	649.9
Spain	7	Mean	472,519	1477.1	62.2	916.4	5.6	3.4	50.8	62.3	86.3	791.2
		Median	282,833	1411.5	60.2	858.9	5.3	3.1	42.0	52.0	89.0	754.0
U.K.	11	Mean	778,201	1507.7	63.6	936.6	1.4	0.8	10.2	17.0	95.9	904.3
		Median	42,363	1553.2	69.3	691.5	1.2	0.5	6.2	29.7	95.8	662.2
Total	84	Mean	235,604	1349.7	63.6	812.8	4.9	3.3	44.9	104.7	90.1	719.6
		Median	26,590	1223.2	68.5	715.7	3.6	2.3	24.4	37.4	93.3	649.0

Source: Authors' own elaboration based on data provided by SNL Financial.

Notes: The banks for which statistics are reported in this table are a sample which was selected as described in the text. Because of a small number of cases where it is negative, the denominator item Net Income before Tax is stated in absolute values. Net income before tax is stated before deducting loan-loss expense.

For European banks, SNL defines non-performing loans to be *'Loans and leases considered to be impaired and potential problem loans that could incur impairment charges in the future and warrant close monitoring'*[64]. Our measure of 'Performing Loans' is equal to Gross Loans obtained from SNL less the SNL measure of non-performing loans.

For Total Assets, the mean sometimes substantially exceeds the median because of the effect of a small number of relatively very large banks. For the percentage measures, the difference between the mean and the median is not usually very large, except for Loan-Loss Expense as a percentage of Net Income before Tax for which a small number of small (net income before tax) denominators can drive up the mean substantially.

We make a number of **observations** based on the statistics in Table 3. that are relevant to the issue of the **potential differences between the loss allowances likely to be produced by the FASB proposal and those likely to be produced by IFRS 9:**

- First, Total Assets are typically well in excess of 10 times the magnitude of Equity.

- Second, Gross Loans are typically about 60 % to 70 % of Total Assets and about seven times larger than Equity.

- Third, the Loan-Loss Allowance as a percentage of Equity ranges from a median value of 6.2 % in the U.K. to 69.1 % in Italy, with an overall-sample median of 24.4 %.

- Fourth, Gross Performing Loans are typically about 90 % of total Gross Loans, ranging from a median value of 84.0 % in Italy to 96.6 % in France, with an overall-sample median of 93.3 %.

- The median value of Gross Performing Loans as a percentage of Equity ranges from 559.3 % for Denmark to 956.5 % for Germany, with an overall sample median of 649.0 %.

The key points from the foregoing are

- that loans are a large number relative to Total Assets and Equity and

- that Performing Loans are about 90 % of loans and

- they are about seven times larger than equity.

Thus, even **small proportionate differences with regard to the loan loss allowance for performing loans could cause material proportionate differences** in total loan-loss allowances and in equity[65]. With the qualification referred to above regarding the extent to which the magnitude of performing loans is indicative of the order of magnitude of the IFRS 9 12-month-expected-loss category, these statistics suggest that the difference between the FASB and IFRS 9 requirements with regard to calculation of the loss allowance could give rise to **material proportionate differences in the loss allowances between the two regimes**.

It should be noted that the magnitude of differences arising from different treatments of assets for which credit risk has not increased significantly is likely to be larger in good economic times than in bad economic times, and that the orders of magnitude indicated in Table 3 relate to 2014 only.

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[64] Based on our selective tracing of the SNL data on non-performing loans data back to the source financial statements, it appears possible that there are some differences across countries with regard to what is included in this category. Interpretation of these results must also be qualified in light of this.

[65] Note that the effect on equity of a difference in the loan-loss allowance is determined to some extent by the tax treatment of recognised loan losses.

3.6.   Conclusion

In sum, the main differences between the key features of the FASB proposals and the IFRS 9 requirements with regard to impairment arising from credit losses is with regard to the set of expected losses that should be recognised. The FASB, under its Current Expected Loss (CECL) Model, requires that an entity should recognise *all* expected losses on its existing financial assets. In contrast, IFRS 9 requires that, for assets for which there has been a significant increase in credit risk since initial recognition, lifetime expected losses should be recognised but, for assets for which there has been no significant increase in credit risk since initial recognition, only 12-month expected losses should be recognised.

It is difficult to foresee with any precision the likely magnitude of the differences in loss allowance given by the FASB proposals and the IFRS 9 requirements for a given set of facts. However, recognising that the source of the differences between the allowances is likely to derive largely from loans for which no deterioration has occurred since initial recognition and taking into account the relative magnitude of performing loans relative to total loans and to equity, some indication of the potential order of magnitude of differences between FASB allowances and IFRS 9 allowances can be obtained. There is reason to believe that the loss allowances given by the FASB proposals could be materially higher than those given by the IFRS 9 requirements for a given set of facts.

4. RESPECTIVE MERITS OF THE TWO APPROACHES

KEY FINDINGS

- The underlying objectives of the FASB and IASB with regard to the measurement of expected credit losses are different. The FASB states that '*at each reporting date, an entity shall recognize an allowance for expected credit losses on financial assets [...]. Expected credit losses are a current estimate of all contractual cash flows not expected to be collected*'[66].

- The IFRS 9 approach involving recognition of only 12-month expected losses where credit risk has not increased significantly since initial recognition is a pragmatic development of its initial proposal to spread the recognition of initial expected losses over the life of the loan by reflecting credit adjusted interest revenue in order to reflect the economic substance of lending.

- The FASB proposal of full recognition of expected losses may be more likely to achieve 'reserve adequacy', but one has to be careful not to be unduly swayed by arguments that owe more to prudential-regulatory concerns, which might give rise to bias in loss allowances, than to financial-reporting concerns. Unduly high loss allowances may be costly in giving rise to double counting of initial expected losses, disincentives to lending to high-credit-risk borrowers, apparent subsequent gains from the reversal of loss allowances, and incentives for lenders to run down loan books in order to realise gains on 'under-valued' assets.

- The issue arises of whether it is appropriate to recognise different sets of expected losses depending on whether or not credit risk on a financial instrument has increased significantly since initial recognition, as required by IFRS 9, or to recognise the same set of expected losses (all contractual cash flows not expected to be collected) irrespective of whether or not credit risk on a financial instrument has increased, as proposed by the FASB. Two classifications could introduce undesirable subjectivity, could introduce a 'cliff' effect, and could look like the introduction of an incurred loss recognition trigger. However, it could also provide opportunities for the communication of better information than a uniform approach.

- In light of the power of bank regulators to adjust accounting-based loss allowances in arriving at regulatory capital and the standard setters' Conceptual Framework, it appears best to judge the relative quality of different impairment approaches not with regard to whether they directly address the concerns of bank regulators but with regard to the quality of information they provide to markets and other stakeholders to promote transparency and market stability.

- Both approaches can be expected to promote high-quality in the provision of the different information that is required to be provided. The FASB's information set might be better because it reflects a larger set of losses; the IFRS 9 information set might be better because it distinguishes explicitly between cases where credit risk has increased significantly and cases where it has not.

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[66] FASB (2012), paragraph 825-15-25-1.

4.1.   Introduction

This section summarises and considers arguments for and against the IFRS 9 and FASB approaches to impairment. It also considers issues to be considered in evaluating the potential contributions of the two approaches to promoting financial stability by helping to avoid future banking crises.

4.2.   Arguments for and against the IFRS 9 and FASB approaches to impairment

The key difference between the FASB and IFRS 9 approaches to impairment is with regard to whether all expected credit losses should be recognised immediately (FASB) or whether, on the basis that initial estimates of losses are reflected in lending margins, such losses should be recognised across time (IFRS 9). As discussed previously, the current FASB approach is likely to give rise to higher loss allowances than the IFRS 9 approach.

Some might argue that the FASB approach is therefore better than the IFRS 9 approach in that it is more likely to ensure the adequacy of loss allowances and thereby avoid costs that bank regulators have in mind related to insufficiency of loss allowances, especially at the onset of bad economic times. However, it has to be recognised that erring on the upside with regard to loss allowances can also be costly. It could be argued that recording unduly high loss allowances would result in double counting of initial loss expectations, could dis-incentivise lending to high-credit-risk borrowers, and would result in apparent subsequent gains as excessive loss allowances are subsequently reversed. Furthermore, it may create incentives for lenders to run down loan books in order to realise accounting gains on 'under-valued' assets.

An argument in favour of the FASB's objective to recognise all foreseeable losses at each reporting date, rather than an objective to approximate a spreading of loss recognition over time to link it with interest, is that credit losses are 'lumpy' (i.e., unpredictable with regard to magnitude and timing) and that the latter approach could be regarded as being based on an assumed greater degree of precision in the ability to allocate future losses over time than can practicably be achieved.

Particular issues that arise from the contrast referred to above are considered below.

4.2.1.   Underlying objectives with regard to the measurement of expected credit losses

In its 2012 Exposure Draft, the FASB states that '*at each reporting date, an entity shall recognize an allowance for expected credit losses on financial assets […]. Expected credit losses are a current estimate of all contractual cash flows not expected to be collected*'[67]. This is a simple aim which is likely to be easily understood by and intuitively appealing to many users of financial statements.

An aim in the IASB's 2009 Exposure Draft on impairment (IASB, 2009) was to reflect the relationship between the pricing of financial assets and expected credit losses by setting up the schedule of recognition of credit losses at initial recognition of the asset such that interest revenue is credit adjusted. This was seen to be a **faithful representation of the economics of lending and associated loan losses**, as it effectively treats initial expected loan losses as being compensated for in the lending margin rather than giving rise to losses that need to be recognised as soon as they are foreseen, with subsequent changes in credit expectations giving rise to impairment losses. The eventual IFRS 9 approach involving recognition of 12-month losses where credit risk has not increased significantly since initial recognition is a pragmatic development of the idea in IASB (2009).

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[67]   FASB (2012), paragraph 825-15-25-1.

It could result in loss allowances being greater than under the more conceptually pure method proposed in IASB (2009), but has the advantages that it avoids implementation problems arising from the need to calculate a credit-adjusted effective interest rate and links to some extent (although not precisely) with regulatory requirements that many banks are subject to. As noted in subsection 3.3.2, the IASB itself recognises that the requirement to recognise 12-month expected credit losses is an operational simplification that proxies for its original proposal, and that cost-benefit is the only conceptual justification for it.

One could characterise the source of this difference between the FASB and the IASB with regard to the partial or full recognition of expected credit losses as relating to whether one views the initial expectation of loan losses as being compensated for in the lending margin, and therefore to be recognised over time, or as losses to be recognised immediately in loss allowances.

4.2.2.   One or two sets of expected losses/One or two 'measurement objectives'

An issue that has arisen prominently in debate about the respective merits of the IFRS 9 and FASB approaches is the relative desirability of

    (i) recognising different sets of expected losses (12-month or lifetime) depending on whether or not credit risk on a financial instrument has increased significantly since initial recognition, as required by IFRS 9, and

    (ii) recognising the same set of expected losses (all contractual cash flows not expected to be collected) regardless of whether or not credit risk on a financial instrument has increased significantly, as proposed by FASB.

The FASB sees its recognition of one set of losses as constituting the consistent application of 'one measurement objective' to all assets regardless of the degree of credit risk. Having two classifications (full recognition and partial recognition) is seen as introducing undesirable subjectivity, and therefore earnings-management opportunities, into the process of measuring impairment because of the choices that may exist with regard to classification. Transfers from the 12-month category to the lifetime category could introduce a 'cliff' effect. Also, the FASB reported that some stakeholders saw the criteria for transfer from the 12-month-expected-loss category to the lifetime expected-loss category as reintroducing an incurred loss recognition trigger, which was one of the main problems that the standard setters' work on impairment was aimed to eliminate[68].

A counter-argument to the perceived problems described above, arising from having two sets of expected losses (full or partial) depending on the circumstances, is that this provides opportunities for the communication of information that a uniform approach would not give. This argument was mentioned by the EFRAG paper on Adoption of IFRS 9 Financial Instruments[69]. It could further be argued that, because of the time horizon involved and the nature of the information and estimates that would have to be used, considerable subjectivity would be involved in measuring all lifetime expected credit losses on all financial instruments at initial recognition.

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[68] FASB (2012), page 5.
[69] EFRAG (2015).

4.2.3. Reserve adequacy

As referred to above, it is perceived by some users of financial statements that, because the FASB proposes a fuller recognition of expected losses than IFRS 9, it is more likely than IFRS 9 to provide 'reserve adequacy', i.e., full coverage within the loss allowance of all expected credit losses. However, one has to be careful here not to be swayed by arguments that owe more to prudential-regulatory concerns, which might give rise to bias in loss allowances, than to financial-reporting concerns. It is relevant here to note that the concept of 'prudence', which no longer figures in IASB and FASB conceptual framework documents although there has been some IASB consideration of its re-introduction, denoted the exercise of caution under conditions of uncertainty and not the creation of deliberate bias. The potential adverse consequences of upward bias in loss allowances are referred to at the beginning of subsection 4.2.

4.2.4.   Day-1 losses

Both the FASB proposal and the IFRS 9 requirement can give rise to 'day-1 losses', which appear counter-intuitive. If one accepts that, at initial recognition of an asset, its carrying amount is equal to its fair value (i.e., that it is equal to the expected future net-of-credit-loss cash flows discounted at an appropriate credit-adjusted effective interest rate), immediate reduction of the carrying amount through a loss allowance implies that the net carrying value is immediately set below fair value (i.e., reduced to an amount that is based on cash flows that are lower than expected and/or a discount rate that is too high). As the set of losses to be recognised is larger under the FASB proposal than under the IFRS 9 requirement, it is likely that this problem will be more pronounced under the former than under the latter. One might also argue that day-1 recognition of 12-month expected losses at initial recognition is an operationally simple approach to recognising losses that accrue continuously over an interval (e.g. a year) in a setting in which those continuously accruing losses are reported at the ends of the intervals (e.g. year ends).

4.3.   Issues to be considered in evaluating the contributions of the approaches to promoting financial stability

The question arises as to whether there is any difference between the FASB and IFRS 9 approaches with regard to their possible effects in promoting financial stability by helping to avoid future banking crises. This subsection discusses issues to be considered in this regard.

In considering this matter, it is helpful to make the following two points:

- First, banking regulators, in specifying how banks' regulatory capital is calculated, may require adjustments to be made in respect of loss allowances[70]. The effect on book equity capital of applying the impairment requirements of standard setters can therefore be modified in arriving at regulatory capital. For example, in adjusting its 2014 balance-sheet Shareholders Equity of USD 190,447 millions in order to arrive at its Tier 1 Capital of USD 152,739 millions, HSBC Holdings plc deducted USD 5,813 million in respect of '*negative amounts resulting from the calculation of expected loss amounts*'[71].

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[70]   See, for example, Basel Committee on Banking Supervision.

[71]   See Annual Report and Accounts 2014 of HSBC Holdings plc, page 246 (HSBC Holdings plc, 2014). For details of the calculation of regulatory capital calculations for U.S. Bank Holding Companies, see schedule HC-R of the FR Y-9C form published by the Board of Governors of the Federal Reserve System; http://www.federalreserve.gov/reportforms/forms/FR_Y-9C20150630_f.pdf.

- Second, accounting standard setters do not typically see it as part of their role to require that financial reporting should focus on the needs of regulators with responsibility for maintaining financial stability. The IASB (2010) and FASB (2010b) Conceptual Framework documents describe the objective of financial reporting as 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.*'[72].

The standard setters also refer as follows to the issue of 'bias' in the context of describing the requirement for the 'neutrality' element of the Conceptual Framework's fundamental qualitative characteristic of 'faithful representation': '*A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users*'[73].

In considering the issue of **whether financial reporting should focus on the needs of regulators with responsibility for maintaining financial stability**, the Conceptual Framework documents say the following: '*Some constituents said that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting. They stated that financial reporting should focus on the needs of regulators and fiscal policy decision makers who are responsible for maintaining financial stability.*'[74]. Consistent with the intention that the Conceptual Framework should '*facilitate the provision of unbiased financial and related information*'[75], the standard setters did not accept this argument[76].

Nevertheless, in its consideration of the argument that the Conceptual Framework should take account of the needs of regulators responsible for financial stability, they made the point that '*providing relevant and faithfully represented financial information can improve users' confidence in the information and, thus, contribute to promoting financial stability*'[77]. Consistent with this view, a recent U.S. study[78] reports evidence that **lack of timeliness in loan-loss recognition by banks reduces transparency in an important respect and contributes to problems during recessions**. One of the effects that they refer to is '*delayed expected loss recognition (DELR) creating a common source of risk vulnerability across high DELR banks simultaneously, which leads to risk co-dependence among banks and systemic effects from banks acting as part of a herd*' (p. 512).

Based on the above, our view is that the way to **judge the relative quality of different impairment approaches** should *not* be with regard to whether they directly address concerns with regard to loss-allowance adequacy on the part of bank regulators, who can require loan-loss allowances as reported in financial statements to be adjusted for regulatory-capital purposes, but **with regard to the quality of information they provide to markets and other stakeholders to promote transparency and market stability**. As referred to above, although insufficiency of loss allowances can be costly, erring on the upside with regard to loss allowances can also be costly in giving rise to double counting of initial loss expectations, disincentives to lending to high-credit-risk

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[72] See paragraph OB.2. The IASB (2010) and FASB (2010b) Conceptual Frameworks are the same, although the documents differ in some respects in their overall content.
[73] IASB (2010) and FASB (2010b), paragraph QC.14.
[74] FASB (2010b), paragraph BC1.20.
[75] FASB (2010b), introductory section.
[76] See Barth and Landsman (2010) for discussion relevant to this issue.
[77] FASB (2010b), paragraph BC1.23.
[78] Bushman and Williams (2015)

borrowers, apparent subsequent gains as excessive loss allowances are subsequently reversed, and incentives for lenders to run down loan books in order to realise accounting gains on 'under-valued' assets.

Both the FASB and the IASB have a shared objective to improve substantially the accounting for credit losses, in particular by requiring recognition of expected losses. The approaches adopted by the two standard setters differ from each other to some extent. The FASB, with an apparent focus on sufficiency of loss allowances, requires recognition of all expected future credit losses at each reporting date. The IASB's IFRS 9, with a focus on what the IASB sees as the economic substance of lending and loan losses and the dangers of unduly high loss allowances, requires more limited recognition of expected future credit losses. Both standard setters can be expected to succeed in addressing their shared objective to improve accounting for impairment arising from credit losses, in particular with regard to the recognition of expected losses, albeit in different ways reflecting their partially different focuses.

5. PROSPECTS FOR CONVERGENCE BETWEEN IASB AND FASB IN THE FUTURE

KEY FINDINGS

- The standard setters have deliberated extensively in reaching their current positions. There is no reason to expect the standard setters to move from their extensively considered current positions towards convergence with each other unless significant new information or new pressures emerge.

- In light of the possibility of material differences between the allowances given by the two approaches and the potentially significant costs that this might create for preparers and users of financial statements, pressures for change, including for convergence, could re-emerge once the FASB and IFRS 9 impairments standards are both implemented.

In this section, we reflect on the possibility of future convergence of the FASB and IASB with regard to impairment. Here, it is instructive to consider the history of the standard setters' work since 2009 on expected-loss approaches to accounting for impairment as outlined in Section 2.

The FASB started from a relatively straightforward and apparently generally intuitively appealing position that required immediate recognition of all expected credit losses. The IASB aimed to recognise the economic substance of lending and loan losses, as reflected in the relationship between expected credit losses and the pricing of financial assets. This gave rise to a proposal that involved recognising interest on a credit-adjusted yield basis with changes to initial expectations of credit losses subsequently being recognised as gains and losses.

After an extensive attempt to achieve convergence through the development of the Supplementary Document[79] and related deliberations, the two standard setters proceeded towards final proposals that differed from each other. The FASB proceeded to something close to its initial straightforward and generally intuitive approach of requiring immediate recognition of all expected credit losses. The IASB developed an approach, which addresses pragmatically but partially the objective referred to above to reflect the economic substance of lending and loan losses. Under the IASB approach, for assets for which credit risk has increased significantly since initial recognition, the loss allowance is an amount equal to lifetime expected credit losses; for assets for which credit risk has not increased significantly since initial recognition, the loss allowance is an amount equal to 12-month expected credit losses.

In considering whether convergence is likely to occur in the future, one might consider the issue both from the side of the standard setters and from the side of preparers and users of financial statements. The **standard setters** have made an extensive attempt to achieve convergence but have failed to do so. The standard setters have then gone their own ways on accounting for impairment, in part because timely implementation of high-quality expected-loss accounting for impairment, to replace the current incurred-loss model, was seen as important and preferable to further time-consuming and potentially fruitless efforts to achieve convergence. The FASB has reverted to something close to its initial approach; the IASB has moved some way from its initial approach to a pragmatic and partial approach

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[79] FASB (2011); IASB (2011).

to addressing its initial primary objective. Both standard setters appear confident that they have achieved their objectives, albeit in the case of the IASB through a significant degree of pragmatically-motivated modification. In our view, there is no reason to expect the standard setters to move from their extensively considered current positions towards convergence with each other unless significant new information or new pressures emerge.

It appears to us probable that implementation of the two different impairment standards side-by-side will bring forth from **preparers and users** new information and new pressures for convergence. Our reading of selected comment letters on the various proposals suggests that the **move towards non-converged standards is largely viewed as a necessary expedient in light of the pressing need to make accounting for credit-loss-related impairment more timely** rather than as something that is desirable in itself. For an illustration of views of users on the desirability of converged standards generally, see the paper by Lee (2011). Lee, a senior equity-research practitioner who was invited to write a discussion of an academic paper by Sunder (2011) that put arguments for the desirability of different sets of standards as opposed to an 'IFRS monopoly'[80], referred to the 'massive cost' to investors in dealing with significant differences across different GAAP regimes[81]. Although our reading of comment letters reveals **acceptance** on the part of some that different IASB and FASB standards on impairment might be desirable because of jurisdictional differences, we feel that there is a **predominant preference among commentators for a converged solution**[82].

Some commentators feel that material differences between the IASB and the FASB in accounting for credit losses could be **costly** in a number of ways. A flavour of the concerns is given in the FASB summary of commentators' feedback on FASB (2012). Here, it is reported that some commentators argued that: '*(a) certain financial institutions (specifically those that prepare financial statements under U.S. GAAP) will be at a regulatory capital disadvantage compared to those institutions preparing financial statements under IFRS, (b) investors would be affected when analyzing and comparing financial statements of financial institutions prepared under U.S. GAAP against those prepared under IFRS, and (c) financial statement preparers would face significant operational challenges when preparing financial statements under both U.S. GAAP and IFRS*'[83]. It was also reported that some commentators '*believe that international convergence is fundamental to global capital markets and anything less than full convergence on the recognition of credit losses on financial instruments would be detrimental to the competitiveness of global capital markets*' (see paragraph B2 of the summary of commentators' feedback). Recall also the reference in subsection 2.2.6 of this paper to the comment by a major U.K. bank to the effect that a material difference between the IASB and the FASB in accounting for credit losses would be costly in that it would confuse investors, give rise to the need for financial statement preparers to provide additional non-GAAP measures, and could affect the relative competitiveness of entities reporting under the two regimes.

Although it is difficult to establish on the basis of currently available information the likely magnitude of the differences in loan-loss allowance under the FASB proposals and the

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[80] Sunder (2011), p. 291.

[81] Lee (2011), p. 308.

[82] The IASB reported that many of their respondents who expressed a preference for convergence did so subject to convergence being to the IFRS 9 approach (IASB, 2014a, BC5.114).

[83] FASB (2012). The summary can be accessed at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162917634; the comment letters can be accessed at http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2012-260.

IFRS 9 requirements, examination of the magnitude of performing loans relative to Gross Loans and Equity gives some feel for the potential materiality of the differences. **There is reason to believe that the resultant differences in loan-loss allowances and equity could be proportionately material.** Therefore the pressures for change, including for convergence, could re-emerge once the FASB and IFRS 9 impairments standards are both implemented. In our view, it is quite possible that the issue of impairment might be revisited in the foreseeable future. However, none of this implies that we disagree with the EFRAG recommendation in EFRAG (2015) that IFRS 9 Financial Instruments should be endorsed.

6. CONCLUSION

> **KEY FINDINGS**
>
> - Standard setters have undertaken a lengthy journey to reach their current approaches to impairment, including an unsuccessful attempt at convergence.
>
> - The approaches of each of the two standard setters have a reasonable and intuitive basis, with the FASB wishing to ensure loss-allowance adequacy by requiring immediate recognition of all expected credit losses and the IASB wishing to reflect the economic substance of lending and loan losses by recognising that economic losses arise when credit loss expectations change from initial expectations
>
> - However, concerns have been raised about the standard setters' lack of convergence in this important area, including with regard to the costs that the existence of materially different impairment approaches might impose on the preparers and users of financial statements.
>
> - Although statements on this have to be qualified, it appears possible that the magnitude of the proportionate differences between loan-loss allowances and between equity under the two approaches could be material.
>
> - Renewed pressure for convergence could emerge once the two standards are operating side-by-side.
>
> - The authors' view is that, in view of the need for a timely implementation of a high-quality expected-loss impairment standard despite lack of convergence between the FASB and the IASB, the impairment requirements of IFRS 9 Financial Instruments should not prevent endorsement of the standard by the European Parliament.

This paper outlines the work of the FASB and the IASB since 2009 on the development of expected-loss methods for measuring the impairment of financial instruments arising from credit losses, and describes and compares key features of the different credit-loss impairment approaches developed by the two standard setters. It also provides information indicative of the possible effect of differences between the two approaches, summarises arguments for and against the main elements of the approaches proposed by the two standard setters, and comments on the prospects for potential convergence between the two standard setters with regard to the impairment of financial instruments arising from credit losses.

The history of the work of the standard setters in developing the current proposals, as contained in the IASB's IFRS 9 Financial Instruments (IASB (2014a)) and the FASB's latest exposure draft (FASB (2012)) as amended by subsequent deliberations, includes five principal proposal documents (Exposure Drafts and a Supplementary Document) interspersed with other proposals going back to 2009. The history includes an extensive and ultimately unsuccessful attempt by the two standard setters to produce a converged approach. In light of the perceived importance of timely implementation of high-quality expected-loss accounting for impairment, the two standard setters proceeded to their own separate expected-loss impairment approaches that differ from each other primarily in a respect that reflects different objectives evident in the initial proposals articulated by the two standard setters early in the process.

The FASB wishes to require that the current estimate of all contractual cash flows not expected to be collected by an entity in respect of its existing financial instruments should be recognised immediately, such that the allowance balance is sufficient to cover all

estimated credit losses. The IASB wishes to reflect the economics of lending and loan losses by reflecting that economic losses arise when credit loss expectations change from initial expectations, and to strike a balance between the dangers of unduly low loss allowances and the dangers of unduly high loss allowances: for assets for which credit risk has increased significantly since initial recognition, the loss allowance is an amount equal to lifetime expected credit losses but, for assets for which credit risk has not increased significantly since initial recognition, the loss allowance is an amount equal to 12-month expected credit losses. Setting the allowance equal to 12-month expected losses in the latter case is an operationally simplified approach to addressing an IASB (2009) objective to recognise initial expected credit losses over time as part of a credit-loss-adjusted effective interest rate. Both the FASB and IFRS 9 approaches have a reasonable and intuitive basis. However, concerns have been raised about the standard setters' lack of convergence in this important area, including with regard to the costs that the existence of materially different impairment approaches might impose on the preparers and users of financial statements.

Evidence on which to base assessment of the likely impact on loss allowances of the two standard setters' approaches relative to existing approaches or to each other's approaches is limited. However, it appears likely that loss allowances will rise under both approaches relative to current approaches because a broader set of losses will be recognisable than under current approaches and that they will rise more under the FASB approach than under the IFRS 9 approach, again because a broader set of losses will be recognisable under the FASB approach than under the IFRS 9 approach.

Some appreciation of the potential order of magnitude of the difference between allowances under the FASB and IFRS 9 approaches is given by considering that, as noted by the Financial Stability Board, the primary difference between the approaches of the FASB and the IASB could be said to relate to performing loans. Although it must be recognised that the performing loans category does not correspond precisely to the IFRS 9 12-month-expected-loss categorisation of loans giving rise to the difference between the FASB and IASB approaches, the fact that the performing loans of a sample of 84 European banks are typically about 90 % of Gross Loans and about seven times larger than Equity suggests that the proportionate effect on loss allowances of the FASB/IFRS 9 difference could be material.

In our view it is possible that pressures for a converged approach could re-emerge once the FASB and IFRS 9 standards become operational side-by-side as a consequence of costs imposed on preparers and users of financial statements by materially different outcomes of applying the two non-converged approaches. Meanwhile, we believe that the standard setters are right, in the absence of immediate prospects of convergence, to proceed now to higher-quality expected-loss-based standards even if they are not converged standards and even if the issue could be re-opened in the foreseeable future.

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