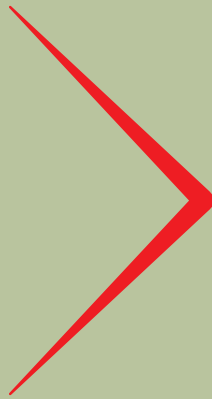




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Credit losses

*Accounting for credit losses:
the development of IFRS 9 and CECL*

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Executive summary

The financial and banking crisis of the late 2000s prompted criticism of delayed loss recognition under incurred-loss methods of accounting for credit losses. Both the FASB and the IASB aimed to make the accounting for credit losses more forward-looking and timely. Initially, they each proposed different approaches in a 2009 IASB exposure draft (ED) and a 2010 FASB ED. They then issued a joint FASB/IASB 2011 Supplementary Document and follow-on proposals aimed at achieving a converged expected-loss solution. However, they could not agree on a converged solution.

Consequently, each board issued an ED and then a final standard that included its own expected-loss method, with effective dates of 2018 for the IASB and 2020/21 for the FASB. The two boards did achieve convergence on the expansion of the information set to be used as a basis for recognising credit losses. However, they diverged on whether the method of accounting for credit losses should distinguish between assets that have not deteriorated in credit quality since initial recognition and those that have, with initially-expected losses for the former being recognised over time along with associated interest revenue.

The final FASB standard requires recognition in loss allowances of the full amount of losses expected to occur during the contractual life of all in-scope financial assets held at the reporting date, including the immediate establishment of allowances at the first reporting date after origination or purchase (often termed 'day 1'). The final IASB standard, on the other hand, requires what is seen as a practicable approach to the IASB's initial 2009 objective to link recognition of initially-expected credit losses to the accrual of interest over time. In-scope financial assets are initially placed in a category (good book) for which allowances recognise 12-month expected losses, including at day 1. If significant deterioration occurs, the assets are then moved to a category (bad book) for which allowances recognise lifetime expected losses.

This briefing reports results from analysis of comment letters in response to the FASB and IASB EDs and the joint FASB/IASB Supplementary Document that were issued between 2009 and 2013. Results reported in this briefing include the following:

- There was a clear preference among non-US respondents to the initial 2009 IASB ED for initially-expected losses to be recognised over time, and for this to be done in an operationally practicable manner.
- Responses to the 2011 Supplementary Document reveal a significant contrast between non-US respondents' preference for an approach involving the spreading over time of the recognition of initially-expected losses and US respondents' preference for an alternative allowance-adequacy-focused approach.
- Responses to the final FASB ED suggest substantial concern regarding the practicability of the FASB requirement for recognising allowances for all expected credit losses for the full contractual life of assets, although this may have been addressed by subsequent FASB clarification of the requirement.
- Responses to the final FASB and IASB EDs suggest substantial concern about the day-1 losses required by both standard setters, which are likely to be substantially different from each other for a given set of circumstances.

It remains to be seen what difficulties some of these issues might cause when the standards become effective.

1. Introduction

The financial and banking crisis of the late 2000s prompted criticism that the incurred-loss (IL) methods of accounting for credit losses were unduly restrictive and may have impeded timely recognition of predictable credit losses before the crisis.¹

Recommendations made by the Financial Crisis Advisory Group (2009), the Basel Committee on Banking Supervision (2009) and in a report to the G20 by the Financial Stability Board (2009) encouraged an exploration of less restrictive and more forward-looking methods of accounting for credit losses. These included methods based on expected loss (EL) – a well-established term within bank regulation relating to the determination of banks' capital requirements (Basel Committee on Banking Supervision, 2006).

The FASB and the IASB each aimed for more timely recognition of predictable credit losses, initially issuing exposure drafts (EDs) with different approaches (IASB, 2009; FASB, 2010). The IASB aimed to reflect within effective interest rates any initially-expected shortfalls relative to contractual cash flows that are reflected in initial carrying values of assets.² Initially-expected shortfalls would therefore be recognised over time across the expected life of assets. The FASB aimed to ensure that allowance balances were sufficient to cover all expected credit losses for the remaining life of assets. Allowances would therefore recognise immediately all expected shortfalls relative to contractual amounts receivable.

The FASB and IASB then sought to reconcile, within a common EL solution, the IASB's income-statement-focused objective and the FASB's balance-sheet-focused allowance-adequacy objective. This was attempted through a joint Supplementary Document (FASB/IASB, 2011a) and subsequent joint deliberations. In August 2012, the FASB indicated that it would cease consideration of the then-proposed partial recognition approach and would instead explore an approach that would reflect all credit risk. Each standard setter then issued its own ED (FASB, 2012; IASB, 2013a) with an expected-loss-based method that reflected aims of its initial ED. The IASB's method was included in IFRS 9 (IASB, 2014) with an effective date of 2018. The FASB's method, termed the Current Expected Credit Loss (CECL) model, was included in Accounting Standards Update No. 2016-13 (FASB, 2016), with effective dates of 2020 or 2021.

For proposal documents issued by the FASB and/or the IASB between 2009 and 2013, this briefing reports results from analysis of comment-letter responses from US respondents and non-US respondents, assumed to be representative of the views of FASB and IASB constituents respectively. In particular, it focuses on issues relevant to the standard setters' difficulties in achieving convergence and issues that may cause difficulties when the standards become effective. Section 2 provides an overview of the development of the standard setters' proposals. Section 3 reports results from analysis of comment letters. Section 4 concludes.

2. The development of the FASB and IASB expected-loss methods

This section provides an overview of the development by the FASB and the IASB of EL methods of accounting for credit-loss impairment to replace pre-existing IL methods.³ It is based on the authors' examination of FASB and IASB publications and meeting records, and on the authors' confidential conversations with observers of the process.

An indication of assets within the scope of the FASB and IASB proposals is given by the stated scope in the final standards. For the FASB, the scope is financial assets measured at amortised cost and some other items, and does not include available-for-sale debt securities (FASB, 2016, paragraphs 326-20-15-2 and -3). For the IASB, it is financial assets measured at amortised cost and those measured at fair value through other comprehensive income (IASB, 2014, paragraph 5.2.2).

2.1 IASB EXPOSURE DRAFT (ED) - NOVEMBER 2009

The credit-loss impairment method in IASB (2009) treated initially-expected credit losses on financial assets as being implicitly reflected in the initial carrying amounts of the assets. The effective interest rate would be calculated from initially-expected future cash flows net of any initially-expected shortfalls relative to contractual cash flows. This integrated effective interest rate (IEIR) would be used for accrual of interest revenue over time. Initially-expected credit losses would therefore be allocated over the expected life of assets, thereby avoiding both the overstatement of interest revenue in periods before loss events occur (IASB, 2009, paragraph BC11) and the unduly early recognition in income of these initially-expected losses. Subsequent revisions to expected cash flows, discounted at the initially-estimated IEIR, would then be recognised in full as they occurred. Figure 1 represents this diagrammatically. Subsequent feedback to the IASB suggested that the IEIR approach posed substantial challenges with regard to implementation and interpretation.

2.2 FASB EXPOSURE DRAFT (ED) - MAY 2010

Credit-loss impairment was one of various financial-instrument issues addressed in FASB (2010). FASB (2010) proposed that an entity should recognise impairment in net income 'when it does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected upon acquisition for purchased financial asset(s)' (FASB, 2010, paragraph 38).

Whereas the IASB proposals gave relatively high importance to income-recognition considerations, the FASB proposals gave relatively high importance to balance-sheet-focused allowance-adequacy considerations. Significant features of the FASB (2010) proposals were

that losses would no longer need to be 'probable' in order to be recognised and that it should be assumed that economic conditions at the impairment-measurement date would remain unchanged for the remaining life of the assets. Feedback to the FASB was largely supportive of the first of these but not the second.

Impairment proposals in FASB (2010) required recognition of the full amount of losses expected to occur during the contractual life of assets held at each reporting date, including the immediate establishment of allowances at the first reporting date after origination or purchase (often termed 'day 1').⁴ Day-1 loss became a controversial issue later in the process. See Figure 2 for a discounted-cash-flow (DCF)-based illustration of the general conceptual problem with the recognition of day-1 loss.

2.3 FASB/IASB SUPPLEMENTARY DOCUMENT - JANUARY 2011

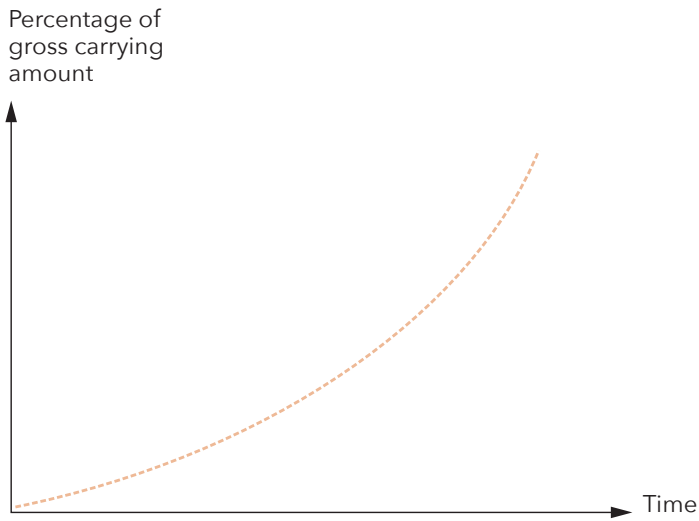
The Supplementary Document proposed a good-book/bad-book approach aimed at a compromise that would partially achieve important objectives of each standard setter: the primary objective of the IASB 'to reflect initial expected credit losses as part of determining the effective interest rate' and the objective of the FASB 'to ensure that the allowance balance was sufficient to cover all estimated credit losses for the remaining life of an instrument' (FASB/IASB 2011a, paragraphs IN5-7). At each reporting date, the impairment allowance would comprise:

- in the case of assets for which expected credit losses are to be recognised over time (good book), the higher of: (i) time-proportional expected losses, addressing the IASB's aim to reflect the relationship between pricing and expected losses;⁵ and (ii) losses expected to occur within the foreseeable future period (at least twelve months), addressing the FASB's loss-allowance-adequacy aim;
- in the case of all other assets (bad book), the entire amount of expected losses.

Classification and transfer of assets between books would follow entities' risk-management practices.

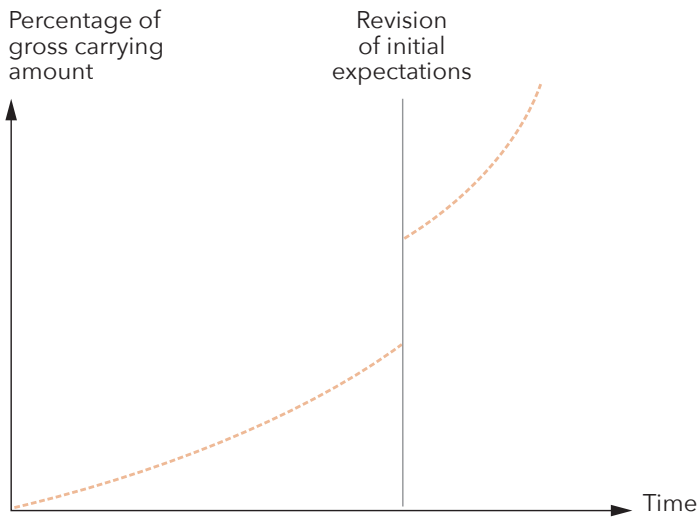
Unlike IASB (2009), FASB/IASB (2011a) proposed that initially-expected credit losses should be decoupled from the effective interest rate. Unlike IASB (2009) and FASB (2010), it also stated clearly that the information set used in estimating expected credit losses should include 'historical data, current economic conditions, and supportable forecasts of future events and economic conditions' (FASB/IASB, 2011a, paragraph B5). Similar wording proposing an information set that was broader than permitted by pre-existing IL methods was included in all subsequent FASB and IASB EDs and standards on credit losses.

Figure 1: Recognition over time of expected credit losses under IASB (2009)



PANEL A

Recognition of credit losses if initial loss expectations are realised



PANEL B

Recognition of credit losses if initial loss expectations are subsequently revised upwards

Figure 2: Numerical illustration of the conceptual problem with the recognition of day-1 loss

A bank originates at year 0 a portfolio of two-year loans (Currency Units (CU) 1,000.00). Contractual cash flows due from the borrowers and cash flows (net of expected credit losses) that, as at year 0, the bank expects to collect are given below. All cash flows are assumed to occur at yearly intervals. The effective interest rates based on contractual and expected cash flows are 10% and 8%, respectively.

	Contractual cash flows	Expected cash flows as at year 0
Year 1	100.00	100.00
Year 2	1,100.00	1,058.40
Effective interest rate	10%	8%

It is believed that the fair value of the portfolio at origination is CU 1,000.00. This can be written as the present value of the contractual cash flows discounted at the effective interest rate based on contractual cash flows or, as follows, as the expected cash flows discounted at the effective interest rate based on expected cash flows:

$$100.00/1.08 + 1,058.40/1.08^2 = \text{CU } 1000.00.$$

A day-1 loss would be recognised if a loss allowance were immediately established to write down the carrying value of the portfolio to the amount given by discounting the expected cash flows (net of expected credit losses) at the contractual effective interest rate:

$$100.00/1.10 + 1,058.40/1.10^2 = \text{CU } 965.62.$$

The day-1 loss to be recognised would be $1,000.00 - 965.62 = \text{CU } 34.38$.

It could be argued that CU 965.62 reflects initially-expected credit losses twice: within the cash flows and within the discount rate.

Notes to Figure 2

- Here, 'loss' is estimated using discounted-cash-flow (DCF). IASB (2014) requires that impairment of financial assets should be measured using DCF. FASB (2016) permits that impairment of financial assets may be measured using DCF but also permits other methods.
- The situation depicted above differs from one in which the transaction price exceeds fair value at initial recognition, where an initial write down would be uncontroversial.

2.4 THE THREE-BUCKET PROPOSALS - MID-2011 TO MID-2012

Following feedback on the Supplementary Document, the FASB and the IASB continued to work together towards a common solution by deliberating the three-bucket proposals (FASB/IASB, 2011b). The initial June 2011 three-bucket proposals classified assets into one of three categories (buckets):

- Bucket 1: assets not affected by observable events indicating a direct relationship to possible future default. Allowances would recognise a subset of expected losses, where options that were considered included time-proportional expected losses and 12-month expected losses.
- Buckets 2 and 3: assets affected by events indicating a direct relationship to future default, with bucket 2 comprising groups of assets for which specific assets in danger of default had not been identified and bucket 3 comprising specific assets for which credit losses are expected or have occurred. Allowances would recognise lifetime expected losses.

During their three-bucket deliberations, the FASB and the IASB agreed to develop a relative approach. All in-scope financial assets would initially be placed in bucket 1, for which the allowance at each date including day 1 would reflect 12-month expected losses. Assets would then be moved to lifetime loss if significant deterioration in credit quality occurred subsequently. Recognition of 12-month expected losses including at day 1 seemed closer to the FASB's preferred recognition of foreseeable-future-period expected losses than to the IASB's preferred recognition of time-proportional expected losses. However, the IASB accepted this - despite conceptual concerns regarding day-1 losses in particular - on the basis that it offered a practicable proxy for the IASB (2009) IEIR method and might facilitate FASB/IASB convergence.⁶

In early August 2012, the FASB indicated that it would not continue to pursue a 'dual-measurement approach' to accounting for credit losses that involved the three-bucket categorisation of financial assets into those that have not deteriorated in credit quality since initial recognition and those that have, with only partial recognition of expected losses for the first category. FASB staff were directed to explore an alternative approach that 'reflects all credit risk in the portfolio'.⁷ After this decision, the FASB and the IASB proceeded to develop their own separate standards while continuing to consult with each other.

FASB (2012) included an explanation of the August 2012 decision. It argued that application of two different measurement objectives would confuse users, involve a 'cliff effect' as assets were reclassified, create earnings-management opportunities, and could be seen as involving an undesirable IL-type recognition trigger (FASB, 2012, paragraph BC11).

Discussions at FASB/IASB and IASB meetings before and after the decision indicated that pre-existing differences in practice in the determination of loss allowances in the US and elsewhere had presented a serious challenge for convergence.⁸ Specifically, a method that

might increase loss allowances outside the US might decrease them in the US. Related to this, the American Banking Association noted evidence that, in determining loss allowances, US banks make substantially greater use than European banks of the assumption that losses are 'incurred but not reported'.⁹

2.5 IASB EXPOSURE DRAFT (ED) - MARCH 2013 AND IFRS 9 - JULY 2014

Key elements of the three-bucket approach were included in IASB (2013a) and IASB (2014). Assets were in one of three stages, similar to the three buckets:

- For assets that have not deteriorated significantly in credit quality since initial recognition (Stage 1), 12-month expected losses are recognised at each date, including day 1.
- For assets that have deteriorated significantly in credit quality since initial recognition (Stages 2 and 3), lifetime expected losses are recognised at each date.

The IASB's decision to proceed with a three-bucket approach in a new ED was taken at a December 2012 meeting.¹⁰ The board's initial acceptance of the 12-month allowance had been partly motivated by hope of convergence with the FASB, and this was now unlikely. However, they were reluctant to risk further delay by reconsidering other methods for the Stage-1 allowance.

Discussion at the meeting indicated that a major cause of the IASB's objection to the FASB's preferred method was the likely magnitude of the FASB's lifetime day-1 losses. These were expected to be substantially larger than the IASB's 12-month day-1 losses.

IASB members acknowledged the conceptual flaw in the 12-month allowance with its day-1-loss. However, partly in light of the difficulty of making estimates of the precision implied by our Figures 1 and 2, the IASB issued IASB (2013a) and IASB (2014) on the basis that the 12-month allowance was an acceptable practicable approach to recognition of initially-expected credit losses over time. One board member's concern about the day-1 loss requirement was reported in an alternative view in IASB (2013a):

'the loss allowance at an amount equal to 12-month expected credit losses would result in a credit loss at initial recognition even when a financial asset is priced on market terms and where, consequently, no economic credit loss exists [...] In no other area of financial reporting is an allowance immediately established to reduce the value of an asset that is purchased or originated on market terms' (IASB, 2013a, paragraph AV2).

No dissenting opinion on this matter was included in IASB (2014).

2.6 FASB EXPOSURE DRAFT (ED) - DECEMBER 2012 AND FASB ACCOUNTING STANDARDS UPDATE - JUNE 2016

The FASB (2012) ED issued in December 2012 proposed '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' (FASB, 2012, p. 5). FASB (2012) was developed into FASB (2016), which includes the CECL model. This requires the allowance for expected credit losses to be the amount necessary to reduce the carrying value of the assets to the net amount expected to be collected (FASB, 2016, paragraph 326-20-30-1).

There were substantial practicability concerns over the requirement to recognise at each reporting date (including day 1) all credit losses expected to occur during the contractual life of assets. The FASB acknowledged that it may not have explained its forecasting requirements very well in FASB (2012)¹¹ and it took steps to address this. In FASB (2016), for example, it explained that loss allowances could be based on historical loss information for the part of assets' contractual lives beyond which reasonable and supportable forecasts of expected credit losses could be made (FASB, 2016, paragraph 326-20-30-9).¹²

The day-1-loss feature prompted substantial concern on conceptual grounds and was highlighted by two dissenting FASB members (FASB, 2016, pp. 235-240). They argued that 'the bad-debt expense that is recorded on Day 1 is inconsistent with the definition of an expense' and referred to the belief of some commentators that 'the incremental loss that would be recognized [...] is not based on the economics of the transaction but rather on a prudential desire to have a higher level of loan loss reserves reflected in financial reports to investors'. In questioning the conceptual soundness of day-1 loss, they used language similar to that of the IASB (2013a) alternative view: 'They are unaware of any other area of financial reporting for which a loss and a related valuation allowance are immediately established to reduce the value of a recognized asset that is purchased or originated on market terms.'

2.7 CONCLUDING COMMENTS: OVERVIEW OF PROPOSALS

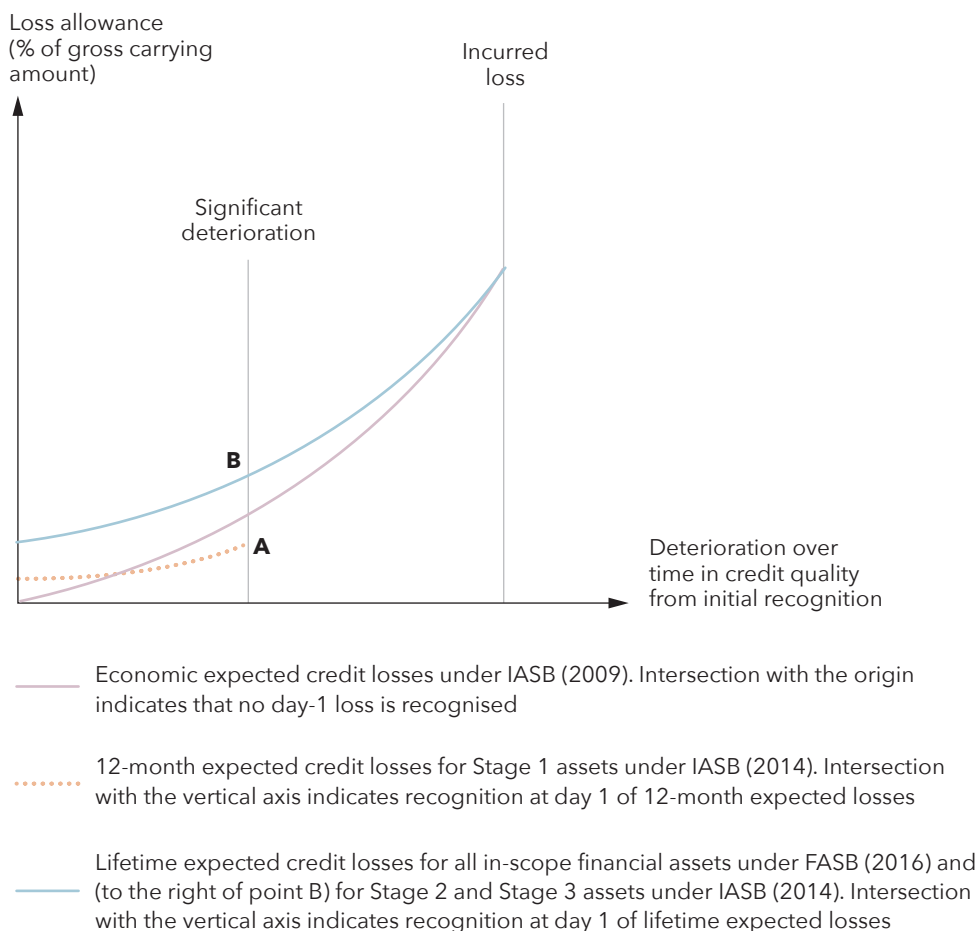
The process of replacing IL methods with EL methods has included consideration of two major issues. One is the information set permitted to be used in estimating credit losses to be recognised in loss allowances. Here, the FASB and the IASB moved relatively straightforwardly from the restricted IL information set to a broader information set, which is described in converged terms by both standard setters.

The other is whether there should be a distinction between financial assets that have not deteriorated in credit quality since initial recognition and those that have, with initially-expected losses for the former being recognised over time. Here the path has not been straightforward. The IASB favoured such an approach and pursued it. Due in part to concern that such an approach might result in US loss allowances of similar or smaller size than under the IL method as applied in the US, the FASB did not accept this approach. Instead, it pursued an allowance-adequacy-focused approach requiring recognition, including at day-1, of all

credit losses expected to occur during the life of assets held. See Figure 3 for a graphical representation of the contrast between IASB (2014) and FASB (2016) with regard to the recognition over time of expected credit losses.

In Section 3, we examine responses to standard setters’ proposals. In light of matters referred to in this section, we focus on issues likely to be relevant to the difficulties experienced in achieving convergence and to difficulties that may arise when the standards are implemented.

Figure 3: Recognition of expected credit losses under IASB (2009), IASB (2014) and FASB (2016)



Notes to Figure 3

- Figure 3 is based on a diagram from IASB (2013b, page 9) as adapted by O’Hanlon, Hashim and Li (2015, page 10).
- The jump from point A to point B occurs when assets are reclassified from Stage 1 (12-month losses) to Stage 2 (lifetime losses) under IASB (2014).

3. Analysis of comment letters

3.1 COMMENT LETTERS EXAMINED

We analysed responses to the following proposal documents: IASB (2009); FASB (2010); FASB/IASB (2011a); FASB (2012); IASB (2013a). Comment letters were obtained from standard setters' websites. Our analysis is based on our coding of letter writers' responses in relation to a number of issues. Some are issues on which the standard setters requested comment and some are significant issues on which the standard setters did not explicitly request comment, but on which respondents expressed views. For issues relating to proposed or possible accounting treatments, we recorded grounds, within ten broad categories, on which treatments were viewed positively or negatively. These were: practicability; usefulness; objectivity (including limitation on earnings management and reliance on judgement); day-1 loss (including where respondents use related terminology); conceptual soundness/economic substance other than day-1 loss (hereinafter 'other conceptual'); economic consequences; effect on regulatory capital; loss-allowance adequacy; loss allowance overstatement; 'cliff-effect'.

Table 1 summarises the letters examined within the project. All respondents are classified as non-US or US except for international accounting firms, international associations, international bank-regulatory organisations and other international regulatory organisations, which are classified as international. We exclude letters from individuals without stated affiliations. We assume that non-US respondents and US respondents are representative of the views of IASB and FASB constituents respectively. For non-US and US respondents, table 1 reports the numbers of respondents classified as preparers of financial statements and as non-preparers.¹³ Because many US community banks responded to FASB (2010) and many US credit unions responded to FASB (2012), this group of respondents is separately identified. In this briefing report, we report results only for those respondents classified as non-US or US. We do so for a subset of issues that are of particular relevance to difficulties that standard setters faced in attempts to develop a common FASB/IASB solution and/or may cause difficulties when the EL standards become effective.

Table 1: Summary of numbers of comment letters examined within the project

Proposal document	Non-US respondents			US respondents			International	Total
	Preparers	Non-preparers	Total	Preparers	Non-preparers	Total		
IASB (2009)	82	66	148	13	5	18	22	188
FASB (2010) (Note 1)	25	22	47	582	42	624	16	687
(excluding CB&CU)				(94)	(42)	(136)		
(CB&CU) (Note 2)				(488)	(0)	(488)		
FASB/IASB (2011a)	66	45	111	55	17	72	20	203
FASB (2012)	11	3	14	263	42	305	16	335
(excluding CB&CU)				(98)	(42)	(140)		
(CB&CU)				(165)	(0)	(165)		
IASB (2013a)	73	57	130	20	3	23	22	175

3.2 IASB 2009 ED: SPREADING OF INITIALLY-EXPECTED CREDIT LOSSES

The spreading over time of recognition of initially-expected losses was central to the IASB's approach throughout the process of developing an improved method of accounting for credit losses. Table 2 reports the responses by non-US respondents to IASB (2009) in relation to this issue. Panel A reports responses regarding the general principle of spreading, and panel B reports responses regarding the IEIR approach to spreading proposed in IASB (2009). In each panel, responses expressed as percentages of the total number of non-US respondents are categorised as positive, partial (partially positive), negative and neutral or missing. In each case for which the percentage is 20% or higher, we report the percentage of respondents referring positively or negatively to a ground for a response.

Panel A reports strong support for the spreading of initially-expected losses over time (positive + partial 66%). 24% of respondents expressed support for this on what we have termed the 'other conceptual' ground. However, panel B reports that the IEIR method for achieving spreading was not well supported (negative 62%). An untabulated test indicates that the proportion of negative responses from preparers (77%) was significantly higher than that from non-preparers (44%). Panel B also reports that the treatment attracted both substantial positive

Notes to Table 1

- (Note1) For FASB (2010), our initial data set included 2,971 letters. Most of these expressed objections to fair valuation (marking to market) but did not comment on credit-loss impairment. We analysed only those letters that commented on impairment proposals. (Although space limitations prevent us from tabulating results for FASB (2010), our analysis of responses to that ED has informed parts of the discussion in this report.)
- (Note 2) CB&CU denotes US community banks and credit unions.

comment and substantial negative comment on the other conceptual ground. Negative comment on this ground often reflected doubt about whether loans are priced by reference to expected losses in the way implied by IASB (2009) or about the justification for combining interest and credit losses. The treatment was also viewed negatively on the grounds of practicability, usefulness and objectivity. Practicability objections tended to relate to the linking of yield-calculation and credit-risk-management systems. Usefulness objections tended to relate to the potential for users to be confused by combination of interest and credit losses.

Table 2: Responses with regard to the spreading of recognition of initially-expected credit losses over the life of financial assets

Non-US respondents (148)	
Panel A: IASB (2009) - Spreading recognition of initially-expected credit losses over the life of financial assets in some way	
Positive	61%
Partial	<u>5%</u>
Positive + partial	66%
Negative	14%
Neutral or missing	<u>20%</u>
Total	<u>100%</u>
Principal stated grounds for responses (20% or more)	
Positives:	
Other conceptual	24%
Negatives:	
None	-
Panel B: IASB (2009) - Integrated effective interest rate (IEIR), including initially-expected credit losses, as in IASB (2009)	
Positive	15%
Partial	<u>19%</u>
Positive + partial	34%
Negative	62%
Neutral or missing	<u>4%</u>
Total	<u>100%</u>
Principal stated grounds for responses (20% or more)	
Positives:	
Other conceptual	20%
Negatives:	
Practicability	80%
Usefulness	41%
Objectivity	34%
Other conceptual	31%

3.3 FASB/IASB 2011 SUPPLEMENTARY DOCUMENT: GOOD-BOOK/ BAD-BOOK PARTITIONING, TIME-PROPORTIONAL EXPECTED LOSSES AND FORESEEABLE-FUTURE-PERIOD EXPECTED LOSSES

Secondly, we examined responses regarding key proposals made in FASB/IASB (2011a) as part of an attempted compromise route to a common FASB/IASB solution. Alongside the issue of good-book/bad-book partitioning, we also examined responses regarding the two good-book allowance measures of which FASB/IASB (2011a) proposed that the higher should be used: time-proportional expected losses (reflecting IASB preference) and foreseeable-future-period expected losses (reflecting FASB preference). Of the five proposal documents examined, FASB/IASB (2011a) is the only one that was jointly issued by the FASB and the IASB, and it attracted comparable numbers of responses from US and non-US respondents.

THE GOOD-BOOK/BAD-BOOK DISTINCTION

Table 3 panel A reports that the good-book/bad-book distinction was viewed more favourably by non-US respondents (positive + partial 86%) than by US respondents (positive + partial 49%). The difference between the proportion of non-US respondents and the proportion of US respondents giving a positive + partial response is statistically significant. The good-book/bad-book distinction was viewed positively on the other conceptual ground by 30% of non-US respondents but by only 1% of US respondents.¹⁴ The distinction was viewed more negatively on the practicability and usefulness grounds by US respondents than by non-US respondents. Similar percentages of non-US respondents and US respondents viewed this treatment negatively on the objectivity ground.

THE TIME-PROPORTIONAL APPROACH

Table 3 panel B reports that the time-proportional approach was viewed more favourably by non-US respondents (positive + partial 76%) than by US respondents (positive + partial 26%). For the positive + partial response, the non-US/US difference is significant. On the other conceptual ground, the time-proportional approach was viewed positively by 24% of non-US respondents and by 4% of US respondents and was viewed negatively by 8% of non-US respondents and 24% of US respondents. Substantial percentages of non-US respondents (23%) and US respondents (47%) viewed this approach negatively on the practicability ground. A higher percentage of US respondents (22%) than non-US respondents (6%) viewed it negatively on the grounds of usefulness.

THE FORESEEABLE-FUTURE-PERIOD APPROACH

For the foreseeable-future-period approach, table 3 panel C reports a difference between non-US respondents and US respondents in the opposite direction to that observed for the time-proportional approach. The foreseeable-future-period approach was viewed less favourably by non-US respondents (positive + partial 44%) than by US respondents (positive + partial 56%), but this difference is not statistically significant. This approach was viewed negatively on the ground of usefulness by similar percentages of US respondents (22%) and non-US respondents (21%). It was viewed negatively on the ground of day-1 loss by a substantially larger percentage of non-US respondents (36%) than US respondents (10%). Many respondents saw the compromise combination of time-proportional expected losses and foreseeable-future-period expected losses as conceptually unsound. Many said that, although FASB/IASB convergence on credit losses is important, it should not outweigh the need for high-quality accounting standards.

In interpreting results for issues referred to in table 3, we must note that patterns of response may, to some extent, have been driven by the different starting preferences expressed by the standard setters themselves in IASB (2009) and FASB (2010). However, the results taken together indicate the magnitude of the gap that the standard setters were seeking to bridge with their compromise proposals. Non-US respondents tended to favour good book/bad book partitioning in accounting for credit losses, whereas US respondents tended to oppose it. For any partial provisioning for good-book losses, non-US respondents tended to favour a time-proportional approach, whereas US respondents tended to favour a foreseeable-future-period allowance-adequacy-motivated approach.

Table 3: Responses with regard to FASB/IASB (2011a) proposed good-book/bad-book distinction and methods of determining good-book allowance

	Non-US respondents (111)	US respondents (72) (Note 1)	Significant difference (5% level) between US and non-US percentages?
Panel A: FASB/IASB (2011a) - Good-book/bad-book distinction			
Positive	82%	34%	Yes
Partial	<u>4%</u>	<u>15%</u>	Yes
Positive + partial	86%	49%	Yes
Negative	10%	43%	Yes
Neutral or missing	<u>4%</u>	<u>8%</u>	No
Total	<u>100%</u>	<u>100%</u>	
Principal stated grounds for responses: 20% or more (Note 2)			
Positives:			
Other conceptual	30%	(1%)	
Negatives:			
Practicability	(9%)	25%	
Usefulness	(10%)	29%	
Objectivity	20%	(19%)	

	Non-US respondents (111)	US respondents (72) (Note 1)	Significant difference (5% level) between US and non-US percentages?
Panel B: FASB/IASB (2011a) - For financial assets in the 'good book', it is appropriate to recognise an impairment allowance based on time-proportional expected losses (IASB preferred approach)			
Positive	70%	18%	Yes
Partial	<u>6%</u>	<u>8%</u>	No
Positive + partial	76%	26%	Yes
Negative	19%	64%	Yes
Neutral or missing	<u>5%</u>	<u>10%</u>	No
Total	<u>100%</u>	<u>100%</u>	
Principal stated grounds for responses: 20% or more (Note 2)			
Positives:			
Other conceptual	24%	(4%)	
Negatives:			
Practicability	23%	47%	
Usefulness	(6%)	22%	
Other conceptual	(8%)	24%	
Panel C: FASB/IASB (2011a) - For financial assets in the 'good book', it is appropriate to recognise an impairment allowance based on expected losses for the foreseeable future period (FASB preferred approach)			
Positive	32%	49%	Yes
Partial	<u>12%</u>	<u>7%</u>	No
Positive + partial	44%	56%	No
Negative	52%	35%	Yes
Neutral or missing	<u>4%</u>	<u>9%</u>	No
Total	<u>100%</u>	<u>100%</u>	
Principal stated grounds for responses: 20% or more (Note 2)			
Positives:			
None	-	-	
Negatives:			
Usefulness	22%	21%	
Day-1 loss	36%	(10%)	

Notes to Table 3

- (Note 1) As few US community banks and credit unions wrote comment letters in response to FASB/IASB (2011a), we do not report separate results for this group in this case.
- (Note 2) Relevant comparative statistics below 20% are provided in parentheses.

3.4 THE FINAL EDS - IASB 2013 ED AND FASB 2012 ED: ALLOWANCES FOR 12-MONTH EXPECTED LOSSES AND ALLOWANCES FOR ALL EXPECTED LOSSES

Thirdly, tables 4 and 5 report responses on a key element of each of the final EDs. In the case of IASB (2013a), this is the recognition of an allowance for 12-month expected losses for the good book with a significant-deterioration criterion for transfer from 12-month loss to lifetime loss, seen as a practicable way of addressing an important objective of IASB (2009). In the case of FASB (2012), it is the recognition of an allowance for all losses expected to occur during the contractual life of assets.

Table 4 indicates that, although the 12-month allowance proposed in IASB (2013a) is closer to the FASB-favoured foreseeable-future-period allowance than to the IASB-favoured time-proportional allowance, it was strongly supported by non-US respondents: positive + partial 72%. 47% of non-US respondents commented positively on the 12-month good-book allowance on the ground of practicability. 51% of them commented on it negatively on the ground of day-1 loss. However, of this 51%, only a minority (29% of the 51%) viewed the 12-month-allowance proposal negatively as a whole: in the absence of other major negatives, concerns about day-1 loss were not associated with substantial objection to the IASB (2013a) 12-month allowance. As stated in the note to table 4, the proportion of positive + partial responses on the significant-deterioration criterion is the same as that for the 12-month allowance (72%), although there is evidence of concern about this criterion on the practicability ground. Table 4 indicates that, despite concerns about a limited amount of day-1 loss, a substantial majority of non-US respondents see the good-book 12-month allowance with transfer to lifetime loss after significant-deterioration as acceptable.

Table 5 indicates that a high proportion of US respondents negatively viewed the requirement to recognise allowances for all expected credit losses for the full contractual life of assets. The proportion of negative responses for all US respondents was 85%. An untabulated test indicates that the proportion of negative responses from preparers (90%) was significantly higher than that from non-preparers (57%). For US respondents excluding community banks and credit unions, the proportion of negative response was 69% and for community banks and credit unions it was 99%. The proposal attracted substantial negative comment from both subsets of US respondents on the grounds of practicability, usefulness, objectivity and day-1 loss. Among community banks and credit unions, it also attracted substantial negative comment on the grounds of economic consequences, including with respect to possible disincentives to lend, and the effect on regulatory capital. Negative comment on the grounds of practicability, usefulness and objectivity largely reflected concern about perceived difficulties with the reliable estimation and interpretation of allowances covering losses for the full contractual life of assets (sometimes termed 'life of loan').¹⁵

Table 4: Responses with regard to IASB (2013a) 12-month expected losses for the good book

IASB (2013a) - Recognition of 12-month expected credit losses for good book (approximating outcomes from IASB (2009))		Non-US respondents (130)
Positive		59%
Partial		<u>13%</u>
Positive + partial		72%
Negative		23%
Neutral or missing		<u>5%</u>
Total		<u>100%</u>
Principal stated grounds for responses: 20% or more		
Positives:		
Practicability		47%
Negatives:		
Day-1 loss		51%

Note to Table 4

For the significant-deterioration criterion for moving out of the 12-month-loss category, the statistics for positive + partial (72%) and negative (22%) are almost identical to those reported above. However, whereas the 12-month allowance itself attracts positive (negative) comment from 47% (8%) of respondents on the practicability ground, the significant-deterioration criterion attracts positive (negative) comment from 8% (18%). (For the significant-deterioration criterion, none of our aggregate grounds are mentioned by 20% or more of respondents.)

Table 5: Responses with regard to FASB (2012) allowance for all expected losses

FASB (2012) – Recognition at each reporting date of an allowance for all expected credit losses for the full contractual life

	US respondents (305)	US respondents excluding CB&CU (140) (Note 1)	US CB&CU (165)
Positive	5%	10%	0%
Partial	7%	16%	0%
Positive + partial	12%	26%	0%
Negative	85%	69%	99%
Neutral or missing	3%	5%	1%
Total	100%	100%	100%

Principal stated grounds for responses: 20% or more (Note 2)

Positives:

None	-	-	-
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Negatives:

Practicability	84%	81%	86%
Usefulness	43%	41%	45%
Objectivity	53%	41%	64%
Day-1 loss	47%	38%	55%
Economic consequences	(16%)	(11%)	21%
Effect on regulatory capital	33%	(7%)	55%

Notes to Table 5

- (Note 1) CB&CU denotes community banks and credit unions.
- (Note 2) Relevant comparative statistics below 20% are provided in parentheses.

3.5 CONCLUDING COMMENTS: ANALYSIS OF COMMENT LETTERS

Non-US respondents (assumed to be representative of views of IASB constituents) appeared to be happier with the IASB (2013a) EL proposals than US commentators (assumed to be representative of views of FASB constituents) appeared to be with the FASB (2012) EL proposals. Responses summarised in tables 4 and 5 highlighted two significant and related potential problems that might be faced when the IASB and FASB standards become effective. One is the practicability of implementing the FASB (2012) requirement to recognise at each reporting date allowances to cover all losses expected to occur during the life of assets. Another is day-1 loss, which attracted substantial negative comment in response to both IASB (2013a) and FASB (2012).

The practicability concerns about FASB (2012) may have been addressed to a substantial degree in the years between the comment period for FASB (2012) and the issue of FASB (2016) through clarification that, beyond horizons for which reasonable and supportable forecasts of expected credit losses can be made, estimates of expected losses can be based on historical loss information. It remains to be seen, after implementation of FASB (2016), what level of difficulty actually arises from the requirement that allowances should cover all credit losses expected to occur during the life of assets.

Day-1 loss could be a problem for both IASB and FASB constituents, although there is reason to believe that it could be more serious for FASB constituents than for IASB constituents. The FASB's day-1 loss relates to all losses expected to occur over the whole life of assets, whereas the IASB's relates only to 12-month good-book losses. In addition, although IASB (2013a) included a board member's alternative opinion that was critical of day-1 loss whereas FASB (2012) contained no such alternative opinion, the proportion of IASB (2013a) respondents commenting negatively on day-1 loss was about the same as for FASB (2012). Furthermore, the FASB (2016) day-1-loss requirement was a major focus of a dissenting opinion in that standard, whereas there was no corresponding dissenting opinion relating to day-1 loss in IASB (2014).

4. Conclusion

In setting accounting standards relating to credit-loss impairment, standard setters have to take account, among other things, of both the need to limit discretion and thereby limit opportunities for undesirable earnings management and the need to allow information relevant to the estimation of credit losses to be reflected in loss allowances in a timely manner. The financial and banking crisis of the late 2000s helped prompt an increase in the relative weight attached to the second of these needs, and both the FASB and the IASB aimed to develop methods of accounting for credit-loss impairment that were more forward looking than the pre-existing IL methods. In doing so, the FASB and the IASB faced significant challenges, including that of achieving convergence against a background of pre-existing differences in the practice of accounting for credit losses.

In IASB (2014) and FASB (2016), the two standard setters achieved a converged broadening of the information set permitted to be used for the purpose of recognising credit-loss impairment. The information set will now include reasonable and supportable forecasts of future events (IASB, 2014, paragraph 5.5.17; FASB, 2016, paragraph 326-20-30-7), which should have a significant beneficial effect in addressing the lack of timeliness in credit-loss recognition that was highlighted in the aftermath of the crisis.

However, other problems have arisen. These may be attributable in part to the choice to improve credit-loss accounting by a route based on EL which is a concept that, in relation to credit losses, originated in bank-regulatory-capital requirements. The EL route appears to have contributed to the FASB's requirement that loss allowances at each date should recognise all credit losses expected to occur during the full contractual life of assets, which has created substantial practicability concerns. It also appears to have contributed to conceptually questionable requirements from the FASB and the IASB to recognise initially-expected losses within loss allowances at day 1. Although reflecting initially-expected losses at day 1 can be easily justified for the purpose of determining banks' capital requirements, it is seen by many as involving conceptually questionable double counting in the context of accounting for credit losses.

Related to these two issues, loss allowances under FASB (2016) and IASB (2014) for a given set of circumstances - including those established at day 1 - may be substantially different from each other. Furthermore, and again related to the issues referred to above, untabulated results from our examination of comment letters show that a substantial number of US respondents to FASB (2012) and some non-US respondents to IASB (2013) expressed preference for a modified and less restrictive IL-based approach over an EL-based approach. These observations prompt us to raise the question of whether beneficial changes in accounting for credit losses might have been achieved in a more straightforward and converged manner by following a less radical broader-information-set-based modified-IL-type route rather than by following an EL route.

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Endnotes

- 1 IFRS required that 'A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event')'. (IASB, 2003, paragraph 59). US GAAP had a similar requirement. For loans that are individually deemed to be impaired: 'impairment of receivables shall be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements [...] Losses shall not be recognized before it is probable that they have been incurred' (FASB Codification 310-10-35-4). For receivables in general, similar wording is used (FASB Codification 450-20-25-2).
- 2 The effective interest rate is the rate that discounts estimated future cash flows for the expected life of a financial asset to the asset's gross carrying amount. These cash flows should include contractual cash flows and transaction costs but not expected credit losses. See IASB (2014, p. 55) and FASB (2016, p.8) for current definitions of the term. The major innovation proposed by IASB (2009) was that expected credit losses would be included in the cash flows used to calculate the effective interest rate.
- 3 Although EL tends to denote more forward-looking methods of accounting for credit losses, the process of developing EL methods may not have been underpinned by a clear shared understanding of the distinguishing features of EL relative to IL in relation to credit losses. A FASB feedback summary reported comment that 'the term expected loss can mean different things to different people' (paragraph A.6 in <http://archive.ifs.org/Meetings/MeetingDocs/IASB/2013/July/5D-Impairment.pdf> [accessed 19 December 2017]). Hashim, Li and O'Hanlon (2017) have also observed that there are different understandings of the distinguishing features of EL, including: that impairment is based on expected losses; that impairment is based on expected losses where loss expectations are derived from an information set that includes forecasts of future events; that recognition of initially-expected losses is spread over the life of assets.
- 4 'Day-1' is a shorthand term that has been used, including by FASB and IASB board members, to denote what might more formally be termed the entity's first reporting date after the time of origination or purchase of an asset. In the remainder of this report, we use the term 'day 1' in this way.
- 5 The time-proportional allowance would be equal to all credit losses expected for the remaining portfolio life multiplied by the portfolio's age as a proportion of its expected life.
- 6 Discussion at a recorded IASB board meeting of 14 December 2012 is relevant to the latter point. Recording available at <http://media.ifs.org/2012/IASBMeetings/December/ImpairmentAR5141212.mp3> [accessed 19 December 2017].
- 7 See http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176160222921 [accessed 19 December 2017].
- 8 Recordings of relevant meetings are available at:
http://media.ifs.org/2011/IASB/July/Impairment_session2.mp3 [accessed 19 December 2017]
http://media.ifs.org/2012/IASBMeetings/October/Impairment_AP4_AM.mp3 [accessed 19 December 2017]
http://media.ifs.org/2013/IASB/July/Impairment_AR5_PM.mp3 [accessed 19 December 2017].
- 9 See <https://www.aba.com/Advocacy/Issues/Documents/CECL-backgrounder.pdf> [accessed 19 December 2017].
- 10 A recording of this meeting is available at <http://media.ifs.org/2012/IASBMeetings/December/ImpairmentAR5141212.mp3> [accessed 19 December 2017].
- 11 See, for example, paragraph 6 in <http://archive.ifs.org/Meetings/MeetingDocs/IASB/2013/July/5D-Impairment.pdf> [accessed 19 December 2017].
- 12 This point was stressed in communications with stakeholders, including at a meeting of the FASB of 4 February 2016 attended by representatives of US community banks.
- 13 In reporting our results, we sometimes refer to differences between responses of preparers and non-preparers. The latter group includes users of financial statements. Due to the small numbers of responses from users (typically about 5% of the total), we do not analyse these separately in this report. We note that the standard setters' principal route for feedback from users was through outreach and fieldwork. We also note that much of what preparers say relates to perceived user needs.
- 14 In table 3 and in a subsequent table, we report some comparative statistics that are below 20%.
- 15 The FASB's own summary of comment-letters for FASB (2012) noted that the majority of respondents objected to the proposed update, in part due to likely understatement of net asset values at day 1 (paragraph B20). See summary at http://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176162917634&d=&pagename=FASB%2FDocument_C%2FDocumentPage [accessed 19 December 2017].

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