Accounting for Financial Instruments

Summary of Decisions Reached to Date During Redeliberations

As of October 31, 2012

11. Sitzung IFRS-FA vom 04.12.2012
11_03e_IFRS-FA_FI_IMP_FASB_DecSum

The Summary of Decisions Reached to Date is provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Accounting Standards Update.

The Accounting for Financial Instruments Project is comprised of the following three topics:

1. Classification and Measurement
2. Credit Impairment
3. Hedge Accounting.

This document summarizes the decisions to date for each topic.

Classification and Measurement

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Credit Impairment

Current Expected Credit Loss Model (Based on FASB-Only Redeliberations)

In August and September 2012, the Financial Accounting Standards Board (FASB) made a number of key decisions on an alternative expected credit loss impairment model to address U.S. stakeholder's significant concerns about the understandability, operability and auditability of the three-bucket credit impairment model under joint development with the IASB and whether it would reflect an appropriate measure of risk. This alternative model is referred to as the Current Expected Credit Loss (CECL) model. The CECL model retains several key concepts that have been jointly deliberated and agreed upon with the IASB, including the main concept of expected credit loss and the current recognition of the effects of credit deterioration on collectability expectations. Unlike the three-bucket model, however, the CECL model utilizes a single-measurement objective (i.e., current estimate of expected credit losses) as opposed to the three-bucket model's dual-measurement approach, which requires a "transfer notion" to distinguish between financial assets that are required to use a credit impairment measurement objective of "12-months of expected credit losses" from those that use a credit impairment measurement objective of "lifetime expected credit losses." Following is a summary of the CECL model resulting from the FASB's discussion.

<u>Summary of the CECL Model</u>

At each reporting date, an entity recognizes a credit impairment allowance for its current estimate of the expected credit losses on financial assets held at the reporting date. The estimate of expected credit losses is neither a "worst case" nor a "best case" scenario, but rather reflects management's current estimate of the contractual cash flows that the entity does not expect to collect. Certain approaches based on probability of default expectations, loss rates, and discounted expected cash flows would be consistent with this principle. Under the CECL model, the credit deterioration (or improvement) reflected in the income statement will include changes in the estimate of expected credit losses resulting from, but not limited to, changes in the credit risk of assets held by the entity, changes in historical loss experience for assets like those held at the reporting date, changes in conditions since the previous reporting date, and changes in reasonable and supportable forecasts about the future. As a result, the balance sheet reflects the current estimate of expected credit losses at the reporting date and the income statement reflects the effects of credit deterioration (or improvement) that has taken place during the period.

Operationally, the FASB expects that expected credit loss estimates will often be measured for pools of similar asset types using the credit risk ratings determined by the entity as of the balance sheet date. As a result, entities could leverage their existing internal credit risk management systems to implement the CECL model. For example, if a pool of commercial mortgages held at the end of a reporting period is evaluated by the entity as a “Pass Category 2” loan, the entity might *begin* its estimate with its historical loss experience appropriate for that category, which would typically be quite low, and then adjust the historical loss experience for current conditions, and reasonable and supportable forecasts about the future. If credit conditions change during the next period such that a portion of the commercial mortgages are now categorized as “Pass Category 4,” the entity would begin to develop its current expected credit loss estimate for those loans based on historical loss experience appropriate for that category, thereby increasing its current estimate of expected credit loss. If credit conditions continue to deteriorate and at the third reporting period some of the commercial mortgages are rated “Special Mention,” the entity would likely begin its current expected credit loss estimate for the loans rated “Special Mention” with historical loss experience appropriate for that category and then adjust that historical loss experience as described above.

As risk increases in the various rating categories, the current estimate of expected credit loss would increase. Illustrated through use of a numerical example, for a pool of “Pass Category 2” commercial mortgages (which may include newly originated mortgages), 40 basis points[*] may represent the current expected loss, whereas a 7 percent loss might be expected for commercial mortgage loans that have deteriorated to a “Special Mention” risk rating. Any changes in the allowance—both increases and decreases -- would be recognized immediately in net income.

The key difference between the CECL model and the previous three-bucket model is that under the CECL model, the basic estimation *objective* is consistent from period to period, so there is no need to describe a “transfer notion” that determines the measurement objective in each period. As the example above illustrates, every period the estimates are updated for current information about the financial assets for which credit impairment is being measured using all supportable internally and externally available information considered relevant in making the forward-looking estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The estimates are never *limited* to losses expected over a specific period of time (whereas the “bucket one” estimate in the three-bucket model is limited to 12 months). As previously noted, after origination, expected credit losses for the loans in the earlier, higher-quality credit grades would typically be much less than expected credit losses for more severely rated loans that have significantly deteriorated in credit quality.

Consistent with current accounting requirements, interest income would generally be recognized on the basis of contractual cash flows.[†] However, for purchased financial assets that have experienced significant deterioration in credit quality since origination, the discount embedded in the purchase price that is attributable to expected credit losses (i.e., non-accretable yield[‡]) would never be included in interest income. In all other regards, these assets would follow the same approach described above

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[*] In this example, 40 basis points represents losses expected on a pool of newly originated commercial mortgage loans expressed as a percentage of the pool’s recorded investment. It does not imply that each loan will experience a 40 basis point loss. Rather, the entire contractual cash flows will be collected for a majority of the loans in the pool. A small percentage of loans will experience significant credit losses (well in excess of 40 basis points), but these loans are not yet individually identifiable.

[†] However, an entity should cease the accrual of interest income when it is not probable that the entity will receive full payment of principal or interest (that is, when the entity can no longer assert that the likelihood of collection is probable).

[‡] The non-accretable yield represents the discount inherent in the purchase price that is attributable to expected credit losses that exist at the date of purchase. Consistent with current U.S. GAAP and the approach under the three-bucket impairment model, the CECL model would never recognize that credit-related discount as “interest income.” Rather, if (subsequent to the date of purchase) there were a decrease in the expected credit losses below that expected at the date of purchase, such a change would be recognized as a reduction in “impairment expense” in that period.

(i.e., upon acquisition and at each reporting date an entity would recognize a credit impairment allowance for its current estimate of the contractual cash flows that the entity does not expect to collect). As a result, under this approach the allowance for originated financial assets[§] and purchased credit impaired financial assets would be measured consistently. However, balance sheet and income statement amounts for originated and purchased credit impaired financial assets would be presented separately.

Furthermore, users will continue to be provided transparency into current credit risk assessments and the effects of credit deterioration (or improvement) on collectability expectations through the credit quality and risk disclosures that already require that an entity provide quantitative and qualitative information (by class of financial receivable) about credit quality, including the amount of recorded investment by credit quality indicator.

It should be noted that the CECL model has been developed in the context of all financial assets (i.e., financial assets classified at amortized cost and financial assets measured at FVOCI). However, as a practical expedient, an entity need not recognize expected credit losses for financial assets classified as FVOCI when both (1) the fair value of the financial asset is greater than the amortized cost basis and (2) expected credit losses on the financial asset are insignificant.

In summary, the CECL model retains several key expected loss concepts that have been jointly deliberated and agreed upon with the IASB. The FASB believes that the CECL model will improve the understandability and simplify the implementation of the expected credit loss principle.

Technical Decisions Reached in Developing the CECL Model

This section provides details of the technical decisions reached in developing the CECL model summarized above.

Information Set to Consider

Consistent with the Board's previous decision on the three-bucket impairment model, an estimate of expected credit losses should be based on all supportable internally and externally available information considered relevant in making the forward-looking estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The information used should include qualitative and quantitative factors specific to the creditor, general economic conditions, and an evaluation of both the current point in the credit cycle and the forecasted direction of the credit cycle (for example, as evidenced by changes in issuer or industry-wide underwriting standards). An entity need only consider information that is reasonably available without undue cost and effort. The Board acknowledged that measuring expected credit losses requires judgment and estimates, and the eventual outcomes may differ from those estimates.

[§] Originated financial assets include purchased financial assets that have not experienced significant deterioration in credit quality since origination.

Decoupled Interest Approach

Consistent with current accounting requirements, and consistent with the Board's previous decision on the three-bucket impairment model, interest income would generally be recognized on the basis of contractual cash flows for financial assets that do not qualify as purchased credit-impaired (PCI).

Nonaccrual Principle

For purposes of interest income recognition, an entity should cease the accrual of interest income when it is not probable that the entity will receive full payment of principal or interest (that is, when the entity can no longer assert that the likelihood of collection is probable). If it is not probable that the entity will receive full payment of principal, the entity should apply the cost recovery method to account for payments received when a loan is placed on nonaccrual status. If it is probable that the entity will receive full payment of principal but it is not probable that the entity will receive full payment of interest, the entity should apply the cash basis method to account for payments received when a loan is placed on nonaccrual status.

Measurement Objective and Recognition Threshold

The model would utilize a measurement objective of "expected credit losses" and there would not be an initial recognition threshold that must be met before an entity recognizes a credit impairment. Expected credit losses are defined as the estimate of contractual cash flows not expected to be collected.

Measurement of Expected Credit Losses

Consistent with the Board's previous decision on the three-bucket impairment model, an entity's estimate of expected credit losses should reflect the time value of money. To the extent that an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized should be the financial asset's effective interest rate.

In applying this principle, because the amortized cost basis of a financial asset represents the principal and interest cash flows discounted at the original effective interest rate, measurement approaches that estimate expected credit losses based on historical charge-off rates are acceptable methods of estimating expected credit losses in a manner that reflects the time value of money. Similarly, as a practical expedient, measurement approaches for collateral-dependent financial assets that estimate expected credit losses by comparing the cost basis with the fair value of collateral are acceptable methods of estimating expected credit losses in a manner that reflects the time value of money.

Consistent with the Board's previous decision on the three-bucket impairment model, an entity's estimate of expected credit losses should, at a minimum, reflect at least two possible outcomes, including (1) an outcome in which a credit loss results and (2) an outcome in which no credit loss results. As a result, an entity would be prohibited from estimating expected credit losses on the basis of the most likely outcome for an individual financial asset.

In applying this principle, some measurement methods (such as a loss-rate method, a probability of default method, and a provision matrix method using loss factors) rely on an extensive population of actual loss data as an input when estimating credit losses and, therefore, inherently satisfy this requirement because the population of actual loss data reflects items within that population that ultimately resulted in a loss and those that resulted in no loss. Similarly, the use of the fair value of collateral in estimating credit losses for collateral dependent loans inherently satisfies this requirement because the fair value of collateral reflects several potential outcomes on a market-weighted basis.

Purchased Credit-Impaired Assets

PCI assets are defined as acquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the buyer.

These assets should follow the same approach as originated assets for purposes of credit impairment (that is, upon acquisition and at each reporting date an entity would recognize a credit impairment allowance for its current estimate of future contractual cash flows that the entity does not expect to collect). Changes in the credit impairment allowance (favorable or unfavorable) would be recognized immediately.

When recognizing interest income on PCI assets, the discount embedded in the purchase price that is attributable to expected credit losses (that is, nonaccretable yield) would not be recognized in interest income. One way an entity might practically follow this approach and integrate it into existing systems would be to deem the amortized cost of the PCI asset, at acquisition, to equal the sum of (1) the purchase price and (2) the associated impairment allowance at the date of acquisition. By doing so, the asset could then be accreted from the PCI amortized cost to the contractual cash flows (that is, par) without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.

Recognition of Credit Impairment as an Allowance

For debt instruments classified at either amortized cost or FVOCI (including debt securities), the estimate of expected credit losses should be recognized as an allowance (that is, a contra-asset) rather than as a cost-basis adjustment to the asset.

Presentation for Financial Assets Measured at FV-OCI

At a minimum, an entity should present on the balance sheet both the fair value and the amortized cost (net of allowance for credit losses) for financial assets classified and measured at FVOCI. If they are not presented on the balance sheet, the notes to the financial statements should include a full reconciliation of the difference between the fair value and amortized cost for such assets, including (1) amortized cost, (2) the allowance for credit losses, (3) the accumulated amount needed to reconcile amortized cost less allowance to fair value, and (4) fair value.

Application of the CECL Model to Debt Securities and Debt Instruments Measured at FVOCI

The CECL model would apply to financial assets classified at amortized cost and financial assets measured at FVOCI. However, as a practical expedient, an entity need not recognize expected credit losses for financial assets classified as FVOCI when both of the following conditions are met:

1. The fair value of the financial asset is greater than the amortized cost basis.
2. Expected credit losses on the financial asset are insignificant.

Application of the CECL Model to Trade Receivables, Lease Receivables, Loan Commitments, and Financial Guarantees

The CECL model would apply to receivables that result from revenue transactions within the scope of Topic 605 (and revenue transactions within the scope of the ongoing Revenue Recognition project), lease receivables recognized by a lessor in accordance with Topic 840 (and lease receivables recognized as a result of the ongoing Leases project), and loan commitments that are not measured at FVNI.

Subject to future discussions in the Insurance project on whether certain guarantees should follow an insurance accounting model, the CECL model also would apply to financial guarantees that are not remeasured at FV-NI and are not accounted for as insurance.

Application of the CECL Model to Modifications

The CECL model would apply to all modified instruments in which expected credit losses are (1) based on the expected shortfall in contractual cash flows (that is, the contractual cash flows to which the entity is legally entitled post-modification) and (2) discounted using the effective interest rate post-modification. To accomplish this, the guidance in Subtopic 310-40 would be amended to require that when an entity executes a troubled debt restructuring, the cost basis of the asset should be adjusted so that the effective interest rate post-modification is the same as the original effective interest rate, given the new series of contractual cash flows. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted at the original effective interest rate).

Disclosures

Disclosures that would be provided under the CECL model are as follows:

1. Expected credit loss calculations (disaggregated at the portfolio segment level):
   a. A discussion of the inputs and specific assumptions an entity factors into its estimate of expected credit loss, including a description of the reasonable and supportable forecasts about the future that affected their estimate.
   b. How the information above is developed and utilized in measuring expected credit losses.
2. Allowance narrative disclosures (disaggregated at the portfolio segment level):
   a. A discussion of the changes in credit loss expectations and the reasons for those changes.
   b. A discussion of the changes in estimation techniques used and the reasons for the change.
   c. Reasons for a significant amount of writeoffs.
3. Financial asset roll forward (disaggregated at the portfolio segment level):

a. A roll forward of the amortized cost balances of financial assets within the scope of the impairment model that are classified at amortized cost, from the beginning of the period to the end of the period.

b. A roll forward of the amortized cost balances of financial assets within the scope of the impairment model that are classified at FVOCI, from the beginning of the period to the end of the period.

4. Use of the practical expedient for financial assets measured at FVOCI (disaggregated at the portfolio segment level):

   a. The amortized cost balance of assets measured at FVOCI that apply the practical expedient to not measure expected credit losses.

5. Nonaccrual assets:

   a. The average recorded investment in nonaccrual debt instruments.

   b. The amount of interest income recognized during the period on nonaccrual debt instruments.

   c. The amortized cost of debt instruments on nonaccrual status as of the reporting date.

   d. The amortized cost of debt instruments on nonaccrual status for which there are no related expected credit losses as of the reporting date because the debt instrument is fully collateralized.

6. Purchased credit-impaired assets:

   a. A reconciliation of PCI assets purchased in the current period, including the purchase price of those assets, the discount attributable to expected credit losses, the discount attributable to non-credit factors, and the par value of the assets.

7. Collateral disclosures (disaggregated at the class level):

   a. A discussion of the quality of collateral securing an entity's financial assets.

   b. An explanation of any changes in the quality of collateral, whether because of a general deterioration or some other reason.

Transition Guidance for the CECL Model

The transition method for the CECL model would be a cumulative-effect approach. Under this approach, an entity would record a cumulative-effect adjustment to its statement of financial position as of the beginning of the first reporting period in which the guidance is effective.

Upon transition an entity would disclose the following:

1. The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.

2. The method of applying the adoption.

3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the reporting period that immediately precedes the effective date.

Comment Period

The comment letter period for the proposed Update would be the later of (1) 120 days from the exposure date of the proposed Update or (2) April 30, 2013.

Hedge Accounting

The Board has not begun redeliberations on hedge accounting. See Proposed *Accounting Standards Update* for a summary of the Board's decisions to date.

In December 2010, the IASB published the Exposure Draft, *Hedge Accounting*. The comment period for the Exposure Draft ended on March 9, 2011. The FASB participated in the IASB's discussion of the feedback that the IASB received on its Exposure Draft and will consider the feedback during its redeliberations.

On February 9, 2011, the FASB issued an Invitation to Comment, *Selected Issues about Hedge Accounting*, to solicit input on the IASB Exposure Draft, in order to improve, simplify, and bring about convergence of the financial reporting requirements for hedging activities. The comment period on the Invitation to Comment ended on April 25, 2011. The FASB has discussed the feedback received on the Invitation to Comment, which it will consider during its redeliberations.