

# FSR Insights

*Financial Instruments, Structured Products & Real Estate Insights*  
December 20, 2012

## *Proposed Changes to Accounting for Credit Losses in Financial Assets*

### *What's new?*

The Financial Accounting Standards Board (FASB) is proposing significant changes to current US GAAP for the accounting for impairment of receivables, loans, loan commitments, and debt securities (collectively, “in-scope financial assets”) not measured at fair value with changes in fair value reported in net income (FV-NI).

The “current expected credit loss” (CECL) impairment model, as proposed by the FASB, represents a **major shift from the “incurred loss model” under current US GAAP**. The proposed impairment model would require the recognition of a loss reserve upon initial recognition of in-scope financial assets. Under this model, the loss reserve amounts for in-scope financial assets would be estimated by taking into consideration past events, current conditions, and reasonable and supportable forecasts about the future. The proposed model would replace the five existing impairment models for debt instruments in current US GAAP.<sup>1</sup>

Under the CECL Model, a reporting entity would establish an allowance upon acquisition or origination of a debt instrument, which would reflect its current estimate of the expected credit losses. This would be adjusted on each subsequent reporting date.

<sup>1</sup> ASC 450-20 (formerly, FAS 5), ASC 310-10-35 (formerly, FAS 114), ASC 310-30 (formerly, SOP 03-3), ASC 320-10-35 (formerly, FAS 115), ASC 325-40 (formerly, EITF 99-20)

An entity would reflect a credit impairment allowance for its current estimate of the expected credit losses on in-scope financial assets. The loss reserve amount should reflect management’s current estimate of the contractual cash flows that the entity does not expect to collect, considering at least two alternatives: the possibility of a credit loss and the possibility of no credit loss. Certain approaches based on probability of default expectations, loss rates, and discounted expected cash flows are expected to be consistent with this principle.

The interest income recognition model set forth in ASC 310-20 (FAS 91) would be retained, while the interest income recognition model set forth in ASC 310-30 (SOP 03-3) and ASC 325-40 (EITF 99-20) would be superseded by the new model. This would eliminate the different accounting used for impairment and interest income recognition for purchase credit impaired assets.

### *Why now?*

Under current US GAAP, there are several different impairment and interest income recognition models applicable to receivables, loans and debt securities. These models are largely based on an “incurred loss” concept, whereby credit loss reserves are not recorded until losses are “probable.”

In recent years, many stakeholders have commented that the “probable” recognition threshold provides for losses that are “too little, too late.” In addition, current US GAAP tends to create a pro-cyclical loan loss reserve that results in entities having to build reserves in deteriorating conditions when they are least prepared to do so because of stress on earnings and capital. Finally, others cite the complexity in applying current impairment guidance. This is largely driven by the different impairment and interest income recognition models that apply to different asset classes of differing credit qualities.

The FASB believes that the CECL model serves to address constituent concerns with current US GAAP for the following reasons:

- It is forward looking in nature and based upon expected credit losses
- There is no recognition trigger, such as the “probable” trigger that exists today to assess loan losses
- The proposed model generally requires that an entity reserve for credit losses earlier in the asset’s life than permitted under current US GAAP
- The model applies to all financial assets that are debt instruments, thereby simplifying the multiple models and scope complexities in current US GAAP

### ***How does this impact me?***

The proposal would affect **all reporting entities**, including private and non-profit entities, regardless of size.

The model applies to the following financial assets subject to credit risk and are not measured at fair value with changes in fair value measured through net income (FV-NI), including:

- Financial assets that are debt instruments classified at amortized cost and FV-OCI
- Receivables that result from revenue transactions within the scope of Topic 605

- Reinsurance receivables within the scope of Topic 944
- Lease receivables recognized by a lessor in accordance with Topic 840 (and lease receivables recognized as a result of the ongoing Leases project)
- Loan commitments that are not measured at FV-NI

This proposal would provide consistent accounting treating for receivables, loans and securities not classified as FV-NI.

From an **operational perspective**, the proposal will affect different entities in different ways depending upon their current risk management practices and portfolio characteristics. Some potential operational considerations include:

- Expected loss modeling methodologies, associated internal control and disclosure implications, and ability to leverage existing operational systems and practices (such as, regulatory capital stress testing methodologies)
- Integration of risk and finance functions to effectuate an efficient financial statement closing process around the expected loss measurements
- Changes to existing reporting processes around purchased credit impaired assets, and troubled debt restructurings
- Data capture for quantifying transition impact on earnings and capital
- Reporting and disclosure implications of potential differences between US GAAP and IFRS

From a **capital perspective**, the proposal may lead to increased reserves for certain assets classes and increase the regulatory requirements for certain entities. There is uncertainty as to the regulatory agencies view on how the proposed changes may influence bank supervision or future changes to the regulatory capital regime.

## ***How does this proposal compare with IFRS?***

The FASB and the IASB have undertaken an effort to converge the accounting model for financial instruments over the last several years. However, in addressing impairment of financial assets, the FASB and the IASB have not been able to settle on a consistent methodology; instead, the FASB and IASB have developed different approaches.

The IASB has focused on a “credit deterioration” approach, whereby an entity builds loss reserves for assets as credit quality deteriorates over the life of an asset. Under this approach, financial asset(s) migrate out of “bucket 1” upon deterioration in credit, which triggers a lifetime credit expected loss reserve on the asset(s). Until a credit deterioration threshold is met, assets remain in “bucket 1,” which requires recognition of lifetime expected losses for credit loss events expected to occur within **12 months** from the reporting date.

Similar to the FASB’s CECL model, the “credit deterioration” approach is based upon an expected loss concept. Nevertheless, there are several key differences between the approaches. Appendix A provides a comparison of the IASB’s and FASB’s proposed impairment models.

## ***What should I do now?***

Entities should take the time to understand the proposal and how it differs from current US GAAP.

Accounting policy, business units, credit risk management, and financial reporting should be engaged in a coordinated discussion to understand implications of the proposal. These discussions should center on the development

of an impact analysis of the proposal on key financial reporting and regulatory metrics. The results of such an analysis should be included in a comment letter to the standard setting bodies and reflect, among other things:

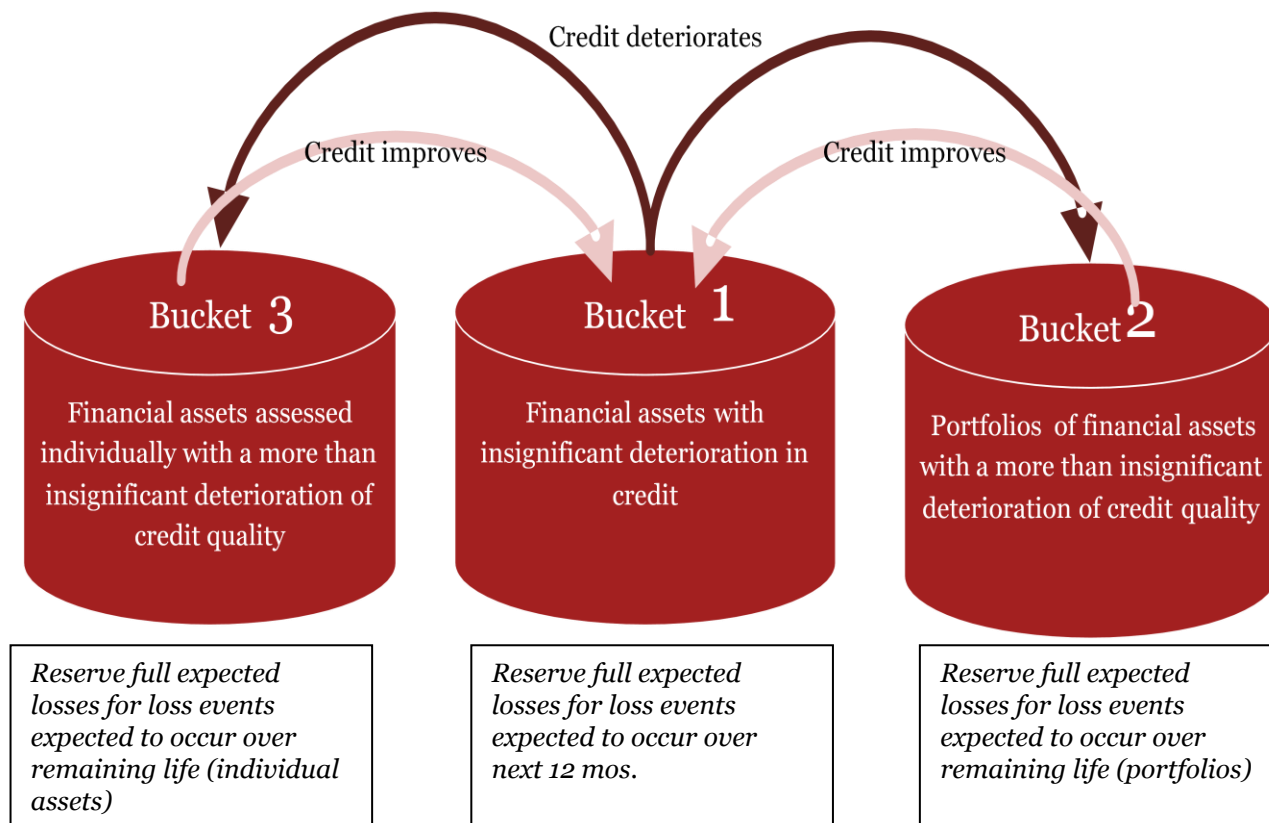
- Implications on operational efficiency and increasing transparency of risk measures in the financial statements
- Tangible observations on the level of reserves and capital impact
- Commentary on application of the model to specific asset classes
- Usefulness of reported information to financial statement users

## ***How can PwC help?***

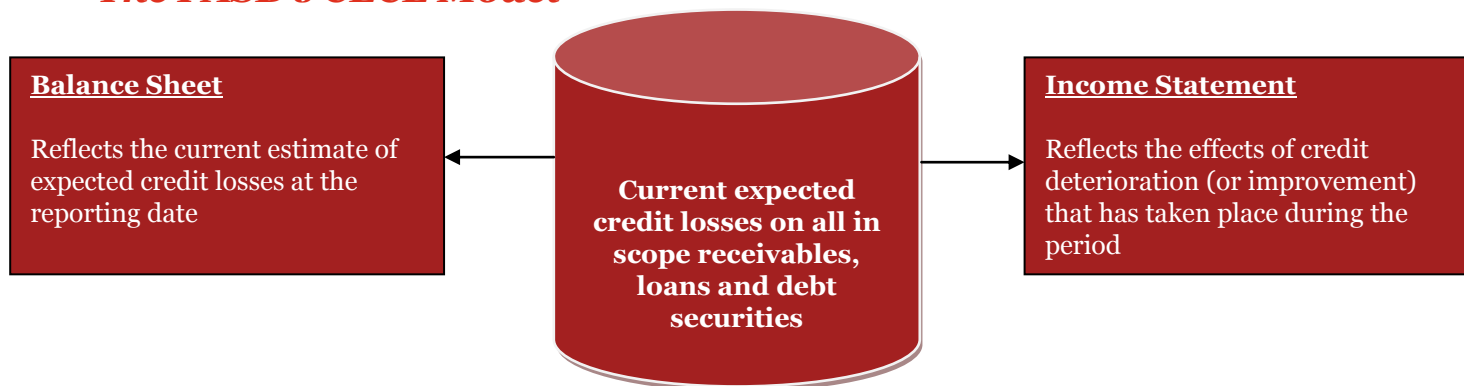
- Assist you in understanding how the proposal could impact your organization
- Assist you in thinking about the issues raised in the exposure drafts
- Identify ways to leverage existing operational practices, under current US GAAP, in an “expected loss” model
- Understand the differences from the IASB’s model and how multi-national organizations may develop compliant methodologies under US GAAP and IFRS
- Perform a control inventory and data requirements analysis for implementation of the new impairment model
- Review the risk in your various portfolios and cash flow estimation methodologies; identify specific concerns in application of the new impairment model to particular asset classes
- Coordinate a “test-run” of the impairment model on a sample of assets

## Appendix A

### The IASB's "Credit Deterioration Approach"



### The FASB's CECL Model



*The FASB's model maintains a single measurement objective of a current estimate of the expected credit losses on financial assets held at the reporting date. There is no "trigger" for loss recognition or "limit" on the loss estimation period.*

*Loss estimates are updated for current information about the debt instruments 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.*

## Additional information

*For a more robust conversation on the subject, you can contact:*

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