

Point (Counterpoint)

What Should Prevail: Regulatory Requirements or Accounting Principles?

In this blog post by Eliza Ong (with collaboration from Scott Ehrlich), Mind the GAAP examines whether the FASB's most recent proposals around impairments of financial assets are just what the markets ordered, or whether they potentially veer financial reporting in a dangerous direction.

On January 31, 2011, the FASB issued a [Supplementary Document](#) entitled "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Impairment".

In this document, the FASB outlines a brand new model for measuring impairment losses associated with open portfolios¹ of loans and debt instruments that are not measured at fair value with changes in value recognized through net income. The proposal would require an entity to segregate its portfolio into a "good book" and "bad book" based on its internal credit risk management.

- For the good book, an entity would record an impairment allowance based on the higher of time-proportional expected credit losses and the credit losses expected to occur within the foreseeable future (the "floor").
- For the bad book, an entity would record the entire amount of expected credit losses at each reporting date.

Most of the major accounting firms have published detailed analyses of the FASB proposal. For instance, a recent Deloitte [Heads Up](#) publication does a nice job of discussing the proposed model in plain English, and includes a worked example of how to calculate the impairment allowance for the "good book" in Appendix C.

Taking a step back, the proposal would result in a pretty dramatic change in how allowances for loan losses are established. Financial statement preparers would move from an "incurred loss" model to an "expected loss" approach, meaning far more reserves would be recorded upfront.

To demonstrate the difference between the two approaches, assume that an entity issues 1,000 loans on a given day.

- Under the incurred loss model, no allowance for losses would be recognized upon issuance of the loans. Simply, there is no way that there could have been a loss event occurring on the date of issuance – had there been, the entity would never have issued the loan in the first place.

¹ An open portfolio is a pool of financial assets which are grouped together based on certain common characteristics, (such as creditworthiness of the debtors, interest rate exposures, etc.) regardless of the time of origination.

- Under the expected loss approach proposed by the FASB, an allowance would in fact be established on the date of issuance. Although all 1,000 loans would probably be included in the “good book” on origination, the FASB proposal requires a minimum allowance be recognized equal to the credit losses expected to occur within the foreseeable future, which can be a period of no less than one year.

As a former banking analyst with a stint in a central bank, I can understand the rationale for the move from incurred loss to expected loss from a regulatory perspective. The recent financial crisis has revealed how quickly a financial institution’s capital can be eroded by deteriorating assets. This often results in a loss of confidence in that institution with potentially disastrous repercussions on funding. Other financial institutions stop lending in the money market, while depositors make a run on the bank. The ensuing panic could spread to other financial institutions, leading to systemic risk for the entire banking system. In some countries like Iceland and Ireland, the collapse of their banking systems had devastating consequences on their economies.

However, accounting practitioners like Scott Ehrlich believe that banking regulatory requirements should not drive accounting rules. In particular, Scott opposes the FASB proposal because it deviates from a fundamental principle of US GAAP – that entities should recognize expense when incurred and recognize liabilities when there is a present obligation. Scott’s main concern is that if entities were to accrue in advance for expected losses on financial assets, why shouldn’t they do the same thing for litigation, normal operating losses, etc.? In addition, Scott is also concerned that the expected loss model would result in “cookie jar” reserves because entities would be obliged to set up reserves in the good times, instead of waiting until when losses were actually incurred. Scott would instead prefer that entities provide additional disclosure on the portfolios of financial instruments and loss experience for different periods of time to satisfy regulatory concerns.

Unfortunately for Scott, I and many others feel that the FASB and IASB are on the train towards an expected loss model. While it doesn’t look like anything can be done to change that, users and preparers can and should provide comments to the FASB on how to simplify the proposed model from an operational perspective, especially with regards to the concept of the floor on the good book.

If you would like to discuss the proposal and its potential effects on your organization, don’t hesitate to contact us at info@mindthegaap.com.