Background information on the accounting for the initial estimate of expected credit losses and subsequent changes of estimates

Note: This document has been prepared by the staff of the International Accounting Standards Board (IASB) to help respondents understand the background accounting issues to the proposals in the Exposure Draft on amortised cost and impairment. This document does not represent the views of the IASB or represent any type of accounting or other guidance.

Background

The IASB’s exposure draft Financial Instruments: Amortised Cost and Impairment uses an approach for recognising impairment losses that is based on expected loss (EL). The exposure draft would result in a timing of loss recognition for EL as follows:

(a) The initial EL estimate is part of the cash flow estimate (a reduction of contractual amounts). The initial EL estimate is recognised over the life of the asset by adjusting the interest rate (the effective interest rate) used to calculate interest revenue in each period over the life of the asset.

(b) The present value of subsequent changes of the EL estimate is immediately recognised in profit or loss in the period in which it occurs. The revised cash flows are discounted at the (original) effective interest rate to determine this.

What is the rationale for this proposed treatment?

The rationale for this treatment is as follows:

(a) Initial EL estimate
   • The initial expectation of credit losses is reflected in the pricing of the financial asset on initial recognition. Hence that initial expectation should determine the interest revenue recognised over the life of the asset. Otherwise interest revenue is systematically overstated (or ‘front-loaded’) whenever credit losses are anticipated from inception on a financial asset or a portfolio of financial assets.
   • Conversely, immediately recognising initial EL would create a ‘day 1’ accounting loss even though the pricing of the loan asset is at a market rate. Doing so would result in overstating the profitability in subsequent periods (‘back-loading’ profitability).
   • The proposed treatment of initial EL reflects a credit-cost adjusted return that reflects the economic rationale behind originating or acquiring the asset.

(b) Subsequent changes in EL estimate
   • Changes in EL estimates reflect a change of the credit quality of the financial asset. That change reflects an economic gain or loss (the present value of the changes) because of changes that have happened in that period.
   • Immediate recognition of the effects of a change in EL means that the balance sheet amount is always the present value of the current expected cash flows discounted at the (original) effective interest rate. That provides a benchmark measurement to assess the original investment decision (including the original expected return).
   • Because the gain or loss is determined on the basis of a change in present value of all cash flows (principal and interest) the measurement of the gain or loss takes into account the interest on the financial asset in future periods.
- Resetting the discount rate could result in a rate below the risk free rate – including negative rates. Using a lower discount rate for a higher risk asset is counter-intuitive.
- Other IFRSs do not allow deferring the effect of changes in estimates that reflect gains or losses.
- For example, impairment tests for non-financial assets (IAS 36 *Impairment of Assets* and IAS 2 *Inventories*) such as property, plant and equipment, and inventory, and the re-measurement of pension liabilities (IAS 19 *Employee Benefits*) require the effect of changes in estimates to be immediately recognised in profit or loss in the period of change. The IASB has also recently decided to propose eliminating the ‘corridor approach’ for pension liabilities, which allowed allocation of the effect of some changes in estimates over future periods.
- Some have suggested the treatment of changes in accounting estimates under paragraph 36(b) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, whereby a change in accounting estimate is included in profit or loss in both the period of the change and future periods if the change affects both, might be applied. However, paragraph 37 of IAS 8 states that if a change in an accounting estimate gives rise to a change in an asset, then that effect shall be recognised by adjusting the carrying amount in the period of change. This requirement is illustrated in paragraph 38 by the requirement that a change in the estimate of bad debts affects only the current period’s profit or loss and shall be recognised in the current period.

*Note: A short audio recording of the IASB staff discussing the issues described in this document is also available on the IASB website.*