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A legal update from Dechert's Finance and Real Estate Group**Proposed FASB Rule Accelerating Recognition of Credit Loss**

The Financial Accounting Standards Board (FASB) recently released an exposure draft ("Exposure Draft")¹ that proposes a new approach to accelerate the recognition of credit losses ("Proposed Rule"). The FASB perceives delayed recognition of credit losses as a weakness in current US generally accepted accounting principles (GAAP). The Proposed Rule would affect entities holding loans, debt securities, lease receivables, loan commitments, and any other receivables that represent the contractual right to receive cash and is a break from a previous FASB Accounting Standards Update ("Update") and the International Financial Reporting Standards ("IFRS") approach.

The Proposed Rule removes the existing "probable" threshold in GAAP and replaces it with an allowance for expected credit losses. Current US GAAP includes five different incurred loss credit impairment models that generally delay recognition of credit loss until the loss is considered probable or has been incurred. Under the Proposed Rule, an entity would be required to impair its existing financial assets based on an allowance for expected credit losses. The FASB hopes that the Proposed Rule will better reflect the current estimate of cash flows expected to be collected at the reporting date by effectively amortizing the credit loss by the expected credit losses allowance.

The allowance for expected credit loss would be based on a broad range of information. Relevant information includes past events, historical loss experience with similar assets, borrower specific creditworthiness, current economic conditions and reasonable forecasts about the expected collectability of the assets' remaining cash flows. The allowance would more accurately describe the credit loss risk because, instead of estimating expected credit losses solely on the basis of the most likely outcome, the allowance would reflect both the possibility that a credit loss results and that a credit loss does not result.

The Proposed Rule differs in three ways from the FASB's May 2010 Update.² First, the Update would have required an entity to assume that the economic conditions existing at the reporting date would remain unchanged for the remaining life of the financial assets. Instead, the Proposed Rule broadens the range of information that an entity is required to consider. Furthermore, the Update proposed differing rules based on whether the asset was originated or purchased while the Proposed Rule makes no such distinction. Finally, while the Update would have dramatically changed the interest income recognition approach, the Proposed Rule maintains the current US GAAP approach that measures interest income and credit losses separately.

Despite initially coordinating with the IFRS, the FASB rejects the IFRS's three-bucket credit impairment model ("Three-Bucket Approach"). Current IFRS uses a delayed recognition approach similar to current US GAAP and generally only considers past events and current conditions in measuring incurred loss. The Three-Bucket Approach, like the Proposed Rule, would eliminate the probable threshold and broaden the range of information used to create the credit loss estimate. Unlike the Proposed Rule, the Three-Bucket Approach separates a portfolio into two classes based on certain criteria and applies different measurement objectives to each. For some assets, an entity would recognize lifetime expected losses for the financial assets where a loss event is expected in the next 12 months. For the other assets, the entity would

recognize all lifetime expected losses.

The FASB rejected the Three-Bucket Approach because the use of two different measurement objectives created ambiguity and is harder to implement. Also, stakeholders thought the criteria for determining which measurement objective would apply is essentially the same delayed recognition of credit loss that these new approaches are trying to solve. Finally, commentators were concerned that the Three-Bucket Approach would not result in a single recognized allowance for credit loss. Because of those issues, the FASB decided to break from the IFRS's Three-Bucket Approach.

The Proposed Rule is still in the comment period. The comment period ends on April 30, 2013 and comment letters to the over 20 questions presented in the Exposure Draft have already been posted. One of the comment letters ("Letter") is highly critical of the Proposed Rule because accountants or any other financial statement preparers may not be able to predict future economic events with a degree of precision that would be sufficiently reliable for use in financial statements.³ According to the Letter, the proper role for accountants and financial statements is to explain what "'has happened,' not what 'might happen.'" The Letter recommends that the FASB either withdraw or substantially modify the Proposed Rule. On the other hand, another comment letter supports the principle of accelerating the recognition of credit loss and offers alternative mechanisms to achieving that goal. Once the comment period ends, the FASB will issue final amendments and establish the effective date. Any affected entity would apply the Proposed Rule by a cumulative adjustment to financial statements as of the beginning of the first reporting period in which the Proposed Rule is effective.

Footnotes

1 *Proposed Accounting Standards Update: Financial Instruments - Credit Losses*, dated December 20, 2012.

3 Read the entire Letter [here](#).

2 *Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, dated May 26, 2010.

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