Credit Impairment:
New Fair Value Approach to Recognition of Estimated Losses Will Apply to Both Lenders and Other Financial Reporting Enterprises Holding Financial Assets

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Lenders have long been required to provide loan loss reserves, or Allowance for Loan and Lease Losses (ALLL), which are often mechanically dictated based on the extent of any arrearages on loans or leases – for example, by applying fixed percentages to loans 30 days in arrears. Entities other than financial institutions may hold traditional financial instruments as investments for otherwise idle cash, but most will have trade accounts receivable, which often constitute a substantial portion of the entity's current assets. These will commonly require that an allowance for uncollectible amounts be provided.

The use of fair value has greatly expanded over the past decade, and the proposal considered here shows that this trend will continue. Heretofore, different financial assets have been valued alternatively at lower of cost or market, at fair value, or at net realizable value, depending on the instrument and nature of the reporting entity. With the exception of financial assets carried at fair value, to the extent that *impairments* have needed to be recognized, the venerable "realized loss" model prescribed by FASB Statement No. 5 (dating from the mid-1970s) has been the prescribed approach. This is about to change in a very significant manner.

The realized loss model stipulated that impairment losses, including a range of so-called contingent losses, such as those arising from litigation, were to be recognized formally by charges made in the current period income statement only when it became *probable* that the loss had or would occur, and when the amount of the loss was *reasonably estimable*. This had the effect of delaying loss recognition until a high threshold of likelihood, generally in the range of 85% to 90% had been reached, and then, suddenly, recognizing the full amount of the potential loss. Although this system worked adequately for almost 35 years, the financial crisis that began in 2008 caused the realized loss model to be re-examined and severely criticized, primarily by Congress. Implications include that this peculiarity of GAAP may have exacerbated the crash by, first, under-recognition of deteriorating credit quality, and then by over-stating the impact of likely losses, creating or adding to the panic atmosphere.

Whether this perception was accurate or not, it did trigger a re-examination and then the creation of a new *expected loss* approach. Although this was jointly developed by FASB and the international standard-setter, IASB, these organizations ultimately agreed to disagree, and they will almost certainly promulgate divergent standards sometime in 2014.

In brief, whereas the *incurred loss* approach imposed a sharply demarcated threshold for loss recognition – at least, to the extent that the qualitative term "probable" could be uniformly applied – the soon-to-be-mandated *expected loss* model will require that financial asset valuation take into account the likelihood – no matter how small – of non-performance. Put another way, the anticipated standard removes loss accrual from being a *recognition* issue and makes it a *measurement* issue.

Conceptually, this will mean that a range of possible outcomes, from complete satisfaction of the obligation, as an upper limit, to zero recovery, as a lower limit, would have to be articulated. Probabilities for each of those would need to be subjectively assigned, in order to compute the *probability-weighted net*

recovery amount. This, obviously, cannot be done in practice, since it would be impossible, for example, to differentiate between the likelihood of a loss of 5% of the face value of a receivable and a 5.5% loss. The proposed standard will not dictate that a large number of discrete outcomes be quantified. It will require that at least two outcomes be so described, and furthermore that full recoverability and complete worthlessness always be assigned probabilities. Thus, if only two discrete outcomes are projected, those must be complete collectibility and zero recovery. If additional outcomes are projected, these will fall at interim points within the range.

It is anticipated that most financial statement preparers will opt for the two-end-points approach, which, although the simplest methodology, will still require that the probabilities be assessed with some care. The computational difficulties will scale up from that most basic permitted approach. For example, if odds of collecting 100%, 75%, 50%, 25% and 0% of face value are projected, this will require that five specific probabilities be assigned. In all cases, the probabilities of the various projected outcomes must add to 100%.

It is clear that the proposed *expected loss* approach is a more meaningful way to compute the necessary adjustment to reduce the net carrying value of receivables and other financial assets to fair value amounts. For financial assets carried at other than fair value, with changes in value reported immediately in current earnings, this methodology will represent a significant improvement in financial reporting, albeit limited by the preparers' ability to accurately assign likelihoods to various outcomes.

To assist users in weighing the accuracy of those assessments, the standard will require an expansion of informative disclosures, or footnotes, to detail the factors considered in setting the probabilities of the various outcomes. Outside auditors will have to concur with the reporting entities' techniques for accomplishing the newly-defined objectives. Aspects to be considered will include historical experience, exogenous matters such as the current and anticipated states of the economy, and debtor-specific concerns. Reasonably-based forecasts of changes in environmental factors will have to be part of this process.

This anticipated change in financial reporting standards is yet another step in the inexorable move toward fair value accounting. Whatever the limitations of fair value, it is evident that even necessarily imprecise estimates of fair value are more useful for making economic decisions that are mathematically exacting than measures based on historical costs. Look for this trend to continue.

About the Author: Barry Jay Epstein, Ph.D., CPA, CFF, a litigation consultant with Cendrowski Corporate Advisors, has more than 40 years experience as an accountant, auditor, lecturer, writer, and financial executive. Dr. Epstein specializes in the areas of white-collar defense, financial reporting fraud and securities litigation, accountants' liability and accountant malpractice, and advises preparers and auditors on technical GAAP, GAAS, and IFRS matters. He can be reached at **866-717-1607** or bje@cendsel.com.

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