AccountancyAge

IASB changes overshadowed by break-away from FASB

by Rachael Singh 08 Mar 2013

THE INTERNATIONAL accountancy standards setter has proposed changes to the way losses and loans are accounted, something that has been urgently called for by the G20. But, its introduction is shadowed by the earlier failed attempts to produce a unified proposal with the US accountancy standard setter.

The proposed changes are expected to enable organisations and banks, in particular, to better align the management of their credit risk with their financial statements. Corporates will also be impacted by the changes on short-term trade receivables, however this is expected to be a minor change that shouldn't affect its balances.

The proposal is designed to address concerns that financial institutions are provisioning loan losses too late. The current accounting method was criticised for delaying the recognition of loan losses and for failing to accurately reflect credit losses that were expected to occur.

Accounting for these financial instruments is now proposed to include more forward-looking information, meaning any losses would be accounted for earlier than what currently applies, explains Deloitte lead IFRS financial instruments partner Andrew Spooner.

These changes have been a contentious issue for some time. It has been argued that if changes to accounting for impairments on financial instruments had been around earlier, the financial crisis could have been averted because it would have allowed banks to account for loan defaults at an earlier stage and offer a clearer picture of losses on the balance sheet.

However, the ICAEW has argued that this is inaccurate. "There is little evidence to suggest that the incurred model had any significant role to play in the crisis nor that an expected loss model will prevent future crises," said ICAEW's head of Financial Reporting Faculty Dr Nigel Sleigh-Johnson.

"It is important to be realistic; this is not going to be the panacea. There are potential pitfalls linked to any model, including expected loss models; the proposals could, for example, increase the potential for profit smoothing."

Two tribes

Despite the arguments for and against changing accounting rules, both the IASB and US standard setter FASB (Financial Accounting Standards Board) have agreed change is necessary. However, after much negotiation the two bodies have failed to agree on how that change will occur.

The consultation of the IASB draft proposals, published this week; Financial Instruments: Expected Credit Losses, is due to end in July. However discussions between FASB and IASB broke down last year after months of negotiations.

Despite several consultations and deliberations creating one impairment standard that both the IASB and FASB agreed on has "proved impossible" said ICAEW's Dr Sleigh-Johnson.

A statement from the IASB in the proposal's highlights said: "The boards have found it difficult to achieve a converged solution because of jurisdictional differences in regulatory and systems environments."

Hans Hoogervorst, chairman of the IASB said: "Our proposals are a simplified version of the expected credit loss approach that we originally jointly developed with the FASB. We believe the model leads to a more timely recognition of credit losses. At the same time, it avoids excessive front-loading of losses, which we think would not properly reflect economic reality.

In December 2012 FASB issued its own draft proposal: I*mprovements to Accounting for Credit Losses on Financial Assets*, with the consultation closing on 30 April.

Regrettably, the initial commitment of the IASB and FASB to work together on joint proposals ended last year, explains Andrew Vials, KPMG's global IFRS financial instruments leader. He added that the latest IASB proposals are "quite different" to FASB.

"This is a big disappointment. [IASB & FASB] have indicated that they plan to discuss jointly the comments received on their respective proposals, and we encourage them to do so with the aim of arriving at a single solution. However, the deadlines for providing responses to the exposure drafts are different, making it difficult for constituents to give informed feedback based on full consideration of both models," added Vials.

There are also technical differences between the two, which could lead t material differences in the figures posted.

The institute's Sleigh-Johnson believes the IASB latest proposals appear to be more "operational in practice" which could give it an edge over FASB. "However, it will take time to fully assess the likely practical implications," he said.

The fine print

According to the highlights of IASB's proposal, it appears based on a credit loss model that was previously agreed between the IASB and the FASB, but it has been simplified to reflect feedback received from interested parties. It acknowledged that FASB had published an alternative expected credit loss model and the two sets of proposals have overlapping comment periods.

In the detail IASB outlines the difference between what happens now to what it hopes is accounted for in the future. It explains that the existing incurred loss model in results in credit losses being recognised only when a credit loss event occurs. Changes in the creditworthiness of borrowers are not recognised until such a credit loss event occurs (typically when a payment default actually occurs). However, the change in the creditworthiness of borrowers results in an economic loss.

Expected credit losses are always recognised at what the IASB describes in its proposals as "lifetime expected credit losses". This means that an entity would not measure the loss for any financial instruments using 12-month expected credit losses, but a longer period.

But users should be warned - judgements on this type of loan impairment is up to judgment, explains KPMG's International Standards Group partner Chris Spall.

"Estimating impairment is an art, rather than a science, involving difficult judgments about whether loans will be paid as due and, if not, how much will be recovered and when. The proposed model widens the scope of these judgments," he said.

"These new rules would give rise to challenges, as new judgments would have to be made by preparers, reviewed by auditors and understood by users of financial statements, including prudential and securities regulators."

The IASB consultation closes on 5 July 2013 and a project team will host an interactive webcast on the proposals on 13 March. To register, click **here.**