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Re: Proposed Accounting Standards Update: Financial Instruments—Credit Losses (Subtopic 825-15)

The Accounting Principles and Auditing Standards Committee ("Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the above referenced ASU. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 40,000 members. The Committee includes 49 members, of whom 53 percent are from local or regional firms, 27 percent are from large multi-office firms, 10 percent are sole practitioners in public practice, 8 percent are in academia and 2 percent are in international firms.

The Committee is disappointed that the FASB and the IASB have not achieved a greater level of convergence in this project, especially considering its importance and the publicity that accounting for credit losses has received. Both credit loss models are based on expected losses, albeit with relatively minor recognition and measurement differences. We believe either approach is acceptable, with neither being intellectually (or theoretically) superior to the other. We urge the Boards to decide on one model or the other after the exposure period is over.

A failure of the Boards to converge on this issue could create severe operational issues for multi-national entities subject to IFRS in some reporting jurisdictions and US GAAP in others. Two different structures to estimate losses, and potentially two different recognition and measurement requirements for the same local entity, could be unduly expensive. While adoption of IFRS requirements into US GAAP might be a solution, achievement of that is uncertain

The following represent the Committee's responses to the Questions for Respondents in the Proposed Update.

Question for All Respondents

Question 1: Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

The Committee agrees with the scope of financial assets included in the proposed update except for the inclusion of reinsurance receivables. We believe that reinsurance receivables should be subject to insurance accounting, consistent with how the IASB has decided to handle them. Since the expected value measurement would be the same either way, we see no point in the FASB and the IASB handling them in a different manner, and suggest that since the IASB already has made their decision to subject them to insurance accounting, and because they result

from an insurance transaction, they would be better dealt with by the FASB as part of insurance accounting.

Questions for Users

Question 2: The proposed amendments would remove the initial recognition threshold that currently exists in U.S. GAAP and, instead, view credit losses as an issue of —measurement□ as opposed to an issue of —recognition□ because the credit losses relate to cash flows that are already recognized on the balance sheet. Do you believe that removing the initial recognition threshold that currently exists in U.S. GAAP so that credit losses are recognized earlier provides more decision-useful information?

The Committee agrees that expected credit losses relating to financial assets should be recorded irrespective of whether such losses can be viewed as probable. The Committee agrees that the issue of credit losses is primarily an issue of measurement rather than existence, especially for portfolios of loans.

Question 3: As a result of the proposed amendments, the net amortized cost on the balance sheet (that is, net of the allowance for expected credit losses) would reflect the present value of future cash flows expected to be collected, discounted at the effective interest rate. Do you agree that the net amortized cost (which reflects the present value of cash flows expected to be collected) results in more decision-useful information than currently exists under U.S. GAAP?

Yes, the Committee agrees that this information is more useful.

Question 4: The Board has twice considered credit loss models that would permit an entity not to recognize certain expected credit losses. In the January 2011 Supplementary Document, the Board considered a model that would permit an entity not to recognize some credit losses expected to occur beyond the foreseeable future. In the recent discussions on the three-bucket impairment model, the Board considered a model that would permit an entity only to recognize lifetime credit losses for loss events expected to occur within a 12-month horizon. Instead, the proposed amendments would require that at each reporting date an entity recognize an allowance for *all* expected credit losses. Do you believe that recognizing *all* expected credit losses provides more decision-useful information than recognizing only *some* of the expected credit losses? If not, how would you determine which expected credit losses should not be recognized (for example, 12 months or similar foreseeable future horizon, initial recognition threshold, and so forth)?

The Committee believes that the recordation of expected losses as of each balance sheet date more closely represents the expectations of users since users most likely do not make a distinction between losses expected to be incurred in the short term from losses expected throughout the term of the asset. The Committee recognizes that this will add uncertainty to the estimation process but that such uncertainty is inherent in impairment measurement for any asset including financial assets. We do believe that it should be clear that if the possibility of a loss is remote, the appropriate estimate of expected loss may be zero.

Question 5: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provide decision-useful information?

The Committee recognizes that forecasts may be inherently unreliable, but believe that such information may be useful in estimating expected losses.

A minority of the Committee disagrees that information based upon forecasts provides decision-useful information. The minority notes that forecasts, even if reasonable and supportable, frequently differ based upon the forecasters' perceptions of the economic cycle and other considerations. Accordingly, the minority believes that the consideration of forecasts will likely result in inconsistent and unreliable estimates of credit losses.

Question 6: For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be amortized into and recognized as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognized as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you believe that using the same approach to recognize changes in the credit impairment allowance for purchased credit-impaired assets and non-purchased-credit-impaired assets provides decision-useful information? Do you believe that this is an improvement from the current model used for purchased credit-impaired assets?

Yes, the Committee believes this is an improvement. It will assist users assessment of interest return and credit risk for financial assets of an entity.

Question 7: As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost amount of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. The proposed amendments would require an entity to disclose the amortized cost basis of assets that apply this practical expedient each period. Do you believe that the practical expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable? Why or why not?

The Committee supports this practical expedient since assets meeting these criteria are unlikely to have material change in market value resulting from credit risk.

Question 8: The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this approach provides decision-useful information?

The Committee agrees that placing assets with substantial risk of credit loss on non-accrual status will avoid overstatements of both interest income and credit loss provisions; however, the Committee believes that interpretation of the term "substantially all" may be difficult to apply in practice. For example, if it is estimated that only 95% of principal will be collected but all of the interest does this result in non-accrual because substantially all of principal is not probable of collection?

Questions for Preparers and Auditors

Question 9: The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?

Yes. For the reasons stated in answer to Question 5 the Committee believes that the assessment of whether management has appropriately considered reasonable and supportable forecasts will be difficult due to the proliferation of financial and economic forecasts in the public market and the frequent disagreement among forecasters. The Committee sees less of an issue with current conditions, especially those monitored by the entity and considered in their loan approval or underwriting practices.

Question 10: The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?

The Committee believes that entities have sufficient historical loss data and assessments of current conditions, but as noted in answers to Questions 5 and 9, the Committee believes that forecasts of economic conditions may not be viewed as reliable if they differ significantly,

which they frequently do. Accordingly, entities will need to take great care in how they use forecasts to estimate expected losses.

Question 11: The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?

No. The Committee agrees that the commonly used methods described in the proposed Update implicitly satisfy this requirement.

Question 12: The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?

No. The Committee agrees that the commonly used methods implicitly reflect the time value of money.

Question 13: For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for expected credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?

No. The Committee supports this approach as noted in the answer to Question 6 and does not believe it raises any significant operability or auditing concerns.

Question 14: As a practical expedient, the proposed amendments would allow an entity to not recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?

No. The Committee does not foresee any significant operability or auditing concerns.

Question 15: The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?

To the extent that conditions for non-accrual are specified for regulated entities, this provision may not change current practice. For other entities, this provision may be difficult to apply because of the use of the term "substantially all" and the interplay between (a) estimates of credit losses determined without reference to "probable" and determination of the probability of receiving substantially all principal or interest and (b) this separate non-accrual determination.

Questions for All Respondents

Question 16: Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?

Yes, the Committee believes the distinction is relevant.

Questions for Users

Question 17: Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?

Yes, the Committee believes they are useful.

Questions for Preparers and Auditors

Question 18: Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?

No, the Committee does not foresee significant operability or auditing concerns.

Questions for All Respondents

Question 19: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

No. If the Update were issued as written, additional guidance would be necessary to describe appropriate accounting when management is faced with multiple economic forecasts from reasonable and supportable sources.

Questions for All Respondents

Question 20: Do you agree with the transition provision in this proposed Update? If not, why?

Yes.

Question 21: Do you agree that early adoption should not be permitted? If not, why?

Yes.

Question 22: Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?

Depending on the timing of the issuance of the Update, consideration should be given to the educational cycle for nonpublic entities.

Questions for Preparers and Auditors

Question 23: Do you believe that the transition provision in this proposed Update is operable? If not, why?

Yes.

Question 24: How much time would be needed to implement the proposed guidance? What type of system and process changes would be necessary to implement the proposed guidance?

There should be at least six months between issuance of the Update and the date is it first required to be applied. To the extent that entities do not have systems to track historical loss data or monitor current conditions, such systems will need to be developed. The Committee believes that, for the most part, such systems already exist. If the Update were issued as written, the Committee believes that substantial work would be needed to identify appropriate forecasting sources and processes to deal with conflicting forecasts.

The Committee would be glad to discuss its comments further should you have any questions or require additional information.

Very truly yours,

Howard Sibelman, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants