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2012-260 Comment Letter No. 181 330 North Wabash, Suite 3200 Chicago, IL 60611



May 30, 2013

Via email to director@fasb.org

Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, Credit Losses (File Reference No. 2012-260)

Dear Ms. Cosper:

We are pleased to provide comments on the credit loss exposure draft (the ED), and commend the Board for its continued effort to develop a high-quality impairment model.

The ED simplifies earlier proposed approaches by requiring a single estimate of the current amount of expected credit losses to reflect management's estimate of *all* cash flows not expected to be collected from a recognized financial asset. We understand the expected loss model responds to criticism of the incurred loss approach in current U.S. GAAP. That is, the Board has concluded that concerns about the reliability of an estimate due to the uncertain timing of a loss should not be the primary driver of whether the credit loss should be recognized. However, we believe there are both conceptual and practical weaknesses with this perspective.

Conceptually, the fact that a pool of financial assets has historically generated a certain level of credit losses over time does not mean an equal amount of losses exist at inception for a new loan that shares the same risk characteristics. Credit losses occur over time, just as companies accrue payroll periodically rather than recording all future compensation for the expected employment term at the date of hire. While compensation is beyond the scope of the ED, its application to high quality financial assets highlight flaws in the Board's model. For example, we note non-financial companies may place excess cash in US Treasuries and it is not clear how the Board intends companies to quantify expected losses for them, a scenario the ED indicates must be assumed.

More generally, we are not certain the ED will fix the perceived "too little, too late" loss recognition pattern that some stakeholders assert is a flaw in the incurred loss model. Even under an expected loss model, no one could have fully anticipated the 2008 credit crisis. This implies it is unlikely that allowances would have been sufficient to absorb the losses that actually occurred. An expected loss model might also have unintended consequences. Specifically, it may act as a disincentive for longer term lending transactions in an economic downturn, or a time of general economic uncertainty due to the negative impact it will have on financial results and regulatory capital. It may also increase the likelihood of opportunistic reductions in the current period provision and allowance.

As indicated in our letter to you on the May 2010 financial instruments proposal, we continue to believe recognizing losses should coincide with when they are incurred. The application of that

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principle could still be improved by reducing the recognition threshold, rather than eliminating it. For instance, a loss could be recognized when it is "more likely than not" incurred instead of waiting until it is "probable." We acknowledge that even a lower loss recognition threshold may be insufficient by itself. Therefore, we would welcome new implementation guidance for identifying triggering events in a portfolio context. For instance, in a pool of similar financial assets, historical loss statistics might serve as a practical expedient for determining when to record losses at different points over time under an incurred loss model, rather than at Day 1.

Indeed, we have observed many financial institutions have modified their approaches to estimating credit losses under current U.S. GAAP in consultation with their auditors and regulators. This is reflected in "environmental" adjustments applied to historical loss data, as well as analyzing loans on a more disaggregated basis, such as by loan type. We believe these recent developments in current practice—combined with the latitude the Board intends to provide for measuring credit losses (as reflected in the proposed implementation guidance)—represent an opportunity for the Board to refine today's incurred-loss accounting model in a manner that would better portray credit risk for users. Retaining an incurred-loss model would also mitigate concerns that we express in the attached appendix about developing "reasonable and supportable forecasts" of future cash flows that are likely to present implementation challenges.

Lastly, the appendix includes our recommendations for improving the proposal if the Board moves forward with an expected loss model.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting at (312) 616-4667 or Adam Brown, Partner in the National Accounting Department at (214) 665-0673.

Very truly yours,

BDO USA, LLP

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Appendix

Note: We have responded to all questions other than those posed specifically to users.

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?

We recommend excluding defined contribution pension plan loans. A loan to a plan participant secured by the participant's own vested balance does not represent credit risk as described in the ED, which contemplates whether cash flows will be collected from third parties.

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 collectibility 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?

We do not anticipate significant difficulties related to evaluating past events, historical loss experience and current conditions. However, we are concerned about challenges in practice that are likely to arise in connection with "reasonable and supportable forecasts" of future cash flows.

For regulated financial institutions, there are differences of opinion in current practice between practitioners (preparers and auditors) and regulators in the application of the incurred loss model. In our experience, regulators charged with a "safety and soundness" mandate exert significant influence in practice, in some cases concluding a larger reserve may be appropriate compared to estimates that practitioners develop. For example, we are aware of FDIC consent orders prohibiting reductions of an allowance account, regardless of credible analyses that suggest a reduction is appropriate. These situations suggest the involvement of regulators may challenge practitioners' attempts to reach consensus on what constitutes reasonable and supportable forecasts.

While regulators may be concerned with *unexpected* credit losses, we believe they are also focused on *expected* credit losses—a distinction that will be difficult to parse under the ED. Therefore, it will be important to understand how regulators interpret what constitutes "reasonable and supportable forecasts" of future cash flows under an expected loss model. We support the Board's discussion with members of the regulatory community on this point and believe some form of ongoing dialogue will be necessary to promote consistent application. This may be accomplished through implementation efforts similar to the 123R Resource Group and the Derivatives Implementation Group (DIG).

Beyond financial institutions, auditors and, indirectly, issuers in other industries are subject to oversight by the PCAOB. Similar to Level 2 and 3 fair value estimates, such as certain illiquid securities and goodwill, we would expect the PCAOB staff to focus on the inputs used to develop expected loss measurements. Many commercial and retail companies do not presently maintain loss migration statistics or other measures related to credit deterioration with the same level of sophistication that banks employ. Given the broad scope of the proposed impairment model, it would be helpful to solicit the PCAOB staff's perspective on initial implementation of the

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¹ As discussed in the March 25, 2013 FASB Frequently Asked Questions publication (Question 4).

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standard, rather than waiting to learn they may hold a different view that only becomes evident in individual inspections a year or more after initial adoption.

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?

We expect most entities will have historical data associated with the credit they extend to counterparties, or be able to make reasonable estimates about historical information using external data such as ratings information and FICO scores. At initial adoption, banks and other creditors with long-term financial assets will need to determine whether to discount historical loss data that reflects the recent credit crisis, and if so, to what extent. In other words, it would not be reasonable to assume loss levels from the 2008-2010 timeframe will continue indefinitely. Therefore, it is not yet apparent how this data will be used in practice to develop supportable forecasts under the proposed amendments. In this context, we recommend incorporating guidance within 825-15-25-3 from that provided in the March 2013 FAQ document, which states: "...when the current and expected economic conditions facing the entity are more favorable than the economic conditions that existed for the period over which historical statistics were developed, the Board expects that the current expected credit loss estimate would be lower than the historical average."

For shorter term instruments, such as trade accounts receivable that typically settle within 90 days, we would expect many companies to assume future credit losses will be consistent with relevant historical data, unless there are observable indications to the contrary.

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?

BC30 states "[t]he Board understands that many entities evaluate financial assets for impairment by aggregating assets with similar risk characteristics....Therefore, the Board anchored its analysis on the expected losses for groups of similar financial assets rather than a particular financial asset held by the entity." We believe there are both conceptual and practical weaknesses with this perspective.

Conceptually, the fact that a pool of financial assets has historically generated a certain level of credit losses, does not mean an equal amount of losses exist at inception for a new loan that shares the same risk characteristics. Credit losses occur over time, just as companies accrue

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payroll periodically rather than recording all future compensation for the expected employment term at the date of hire. While compensation is beyond the scope of the ED, its application to high quality financial assets highlight flaws in the Board's model. For example, we note non-financial companies may place excess cash in US Treasuries and it is not clear how the Board intends companies to quantify expected losses for them, a scenario the ED indicates must be assumed.

The ED also appears inconsistent with a decision reached in the revenue recognition project. The Board has decided that estimates of variable consideration can be developed using a probability-weighted approach or a most likely approach to determine the transaction price. The second approach may be useful when there are only two possible outcomes in a contract, such as whether the entity will be entitled to a performance bonus. While the estimate of transaction price is not intended to capture credit risk, we expect practitioners will find it counterintuitive to record a receivable related to variable consideration for an individual contract, but nonetheless record a Day 1 credit loss for a portion of that contract based on a portfolio concept. The confluence of these two decisions guarantees that Day 1 losses which never materialize will be reversed at a future date. We question the decision-usefulness of that outcome, particularly for reporting entities that do not engage in a large volume of homogenous transactions.

More generally, we are not certain the ED will fix the perceived "too little, too late" loss recognition pattern that some stakeholders assert is a flaw in the incurred loss model. Even under an expected loss model, no one could have fully anticipated the 2008 credit crisis. This implies it is unlikely that allowances would have been sufficient to absorb the losses that actually occurred. An expected loss model might also have unintended consequences. Specifically, it may act as a disincentive for longer term lending transactions in an economic downturn, or a time of general economic uncertainty, due to the negative impact it will have on financial results and regulatory capital. It may also increase the likelihood of opportunistic reductions in the current period provision.

As indicated in our letter to you on the May 2010 financial instruments proposal, we continue to believe recognizing losses should coincide with when they are incurred. The application of that principle could still be improved by reducing the recognition threshold, rather than eliminating it. For instance, a loss could be recognized when it is "more likely than not" incurred instead of waiting until it is "probable." Such an approach would still accelerate the timing of loss recognition, but mitigate the concerns outlined above about "reasonable and supportable forecasts" of future cash flows in the absence of a recognition threshold.

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?

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Since the Board has concluded that estimation techniques based on historical write-off experience implicitly reflect the time value of money, we do not envision operational difficulties. In other words, we are not aware of methods used to estimate losses that ignore historical write-off experience. In the final amendments, we recommend codifying the Board's decision that "an entity may use any method that reflects the time value of money explicitly...or implicitly..., with no need to reconcile those approaches" to clearly establish the Board's intent to provide practitioners ample flexibility for methods used to estimate credit losses.

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, we do not foresee significant operational 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?

We recommend broadening the practical expedient to include any instrument not carried at fair value through earnings for which the expected credit losses on the individual financial asset are insignificant. We don't see a basis for limiting the exception to instruments carried at fair value with qualifying changes in fair value recognized in other comprehensive income (FV-OCI), while excluding those carried at amortized cost. In other words, why would a financial asset's fair value be relevant to booking credit losses when its losses are insignificant?

As drafted, we note slight increases in interest rates could result in many instruments not qualifying for the exception since an asset's fair value would fall below its amortized cost. Indeed, in a rising interest rate environment, virtually no fixed-rate instrument originated prior to the interest rate rebound would be eligible for relief. A broader exception would also mitigate concerns related to Day 1 losses discussed above (US Treasury securities and trade receivables that reflect variable consideration).

Alternatively, if the Board maintains a requirement related to fair value in order to qualify for the practical expedient, we recommend allowing entities to estimate expected losses using a single best estimate, at least for high quality debt instruments. This would accommodate situations in

² Ibid (Question 16).

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which it is not meaningful to report Day 1 credit losses, such an investment in US Treasuries or a loan equal to 80% or less of the related collateral value. Additionally, guidance may be needed regarding whether an investor should consider or ignore the effect of hedges related to the debt instrument's fair value for purposes of whether the debt instrument itself meets the proposed exception.

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?

No, we do not foresee significant changes to current practice or operational concerns.

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?

The distinction will be relevant for purposes of recording write-offs, i.e., charging amounts against the allowance account. The language proposed in 825-15-35-1 states a write-off should be recorded "in the period in which an entity determines that it has no reasonable expectation of future recovery." However, with respect to troubled debt restructurings (TDR), the proposed amendments to 310-40-35-10 indicate "the cost basis of the modified asset shall be adjusted (with a corresponding adjustment to the allowance for expected credit losses) so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of cash flows." In effect, modifications that qualify as TDRs will give rise to partial write-offs prior to the point an entity determines it has no reasonable expectation of a future recovery for the rest of the loan.

We find it inconsistent to record a write-off—which should signal there is no reasonable expectation of recovery—in order to preserve an effective interest rate on a troubled loan in future periods. This is particularly true when that effective interest rate may no longer be representative of the loan's current condition. As such, we do not find the Board's conclusions persuasive in BC47, and would support a broader reconsideration of TDR accounting.

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

We believe several elements of the proposed disclosures go beyond those appropriate for audited footnotes, veering into information better suited to MD&A for SEC registrants.

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While users may have a legitimate interest in understanding how management monitors the credit quality of its debt instruments, ³ that objective is quite broad and it is not apparent what level of added assurance an auditor will provide on that point beyond reviewing a public company's SEC filing for consistency with the auditor's general understanding of the company. The same is true of disclosures more closely related to the allowance: ⁴ narrative discussions encompassing the information management considered while estimating the allowance, the economic circumstances that caused changes to the allowance, as well as discussions of portfolio risk characteristics and changes in factors that influenced management's thinking during the current period.

Based on recent stakeholder feedback related to the Board's project on liquidity and interest rate risk, as well as the disclosure framework, we suggest reconsidering the more subjective components of the disclosure package proposed in the ED. We note similar information will be provided under existing MD&A and Guide III disclosures for public companies. We also suggest liaising with the Private Company Council before moving forward.

Apart from these comments, if the disclosure provisions are adopted as proposed, we recommend reducing the requirements applicable to interim periods (825-15-50-4 through 50-10, and 50-16 through 50-17). We would not expect most of the narrative discussion as to how management evaluates risk and the type of information considered during an interim period to change significantly compared to the last annual period. However, to the extent significant changes arise during an interim period, we agree disclosure should be provided.

We note an exemption for certain disclosures related to short-term trade receivables under Topic 605 would be provided in paragraph 825-15-50-7. The Board may wish to consider providing similar relief for the requirements proposed in 825-15-50-16 through 17. We are not certain an "aging analysis" or detailed information related to trade receivables that are on "nonaccrual status" is relevant. Perhaps disclosing the total amount past due over a specified age (e.g., 120 days) would suffice.

Lastly, the interaction between the reconciliation disclosure proposed in 825-15-50-15 and the presentation guidance in 825-15-45-2 is not clear. Paragraph 45-2 states:

For recognized financial assets within the scope of this Subtopic that are measured at fair value with qualifying changes in fair value recognized in other comprehensive income (other than purchased credit-impaired assets and loan commitments), the estimate of expected credit losses is a contra-asset that reduces the amortized cost of the asset. *The net amortized cost* amount for such assets (that is, net of the allowance for expected credit losses) *shall be included on the statement of financial position*. (emphasis added)

If an asset is reported on the balance sheet at FV-OCI, does the requirement that its net amortized cost "be included" on the balance sheet necessitate a separate line item? If those two components are presented separately, a third item is also required for the difference between fair value and amortized cost. This would effectively elevate the footnote disclosure in paragraph 50-2 to the primary financial statements. Alternatively, if the Board simply intends for items reported at FV-OCI to also include a parenthetical disclosure of the related amortized cost, we recommend rephrasing 825-15-45-2 to state this more clearly. Otherwise, the requirement to "include" amortized cost on the balance sheet could be misunderstood.

⁴ See 825-15-50-8 and 50-9 of the ED.

³ See 825-15-50-4 of the ED.

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In addition, we note the following two statements in the companion exposure draft on recognition and measurements appear inconsistent with the credit loss ED:

- ...the guidance in the [recognition and measurement ED] would not require presentation of the amortized cost of financial assets in the fair value through other comprehensive income category (BC276).
- The guidance in the proposed Update on credit losses would require the allowance for credit losses to be presented on the face of the statement of financial position, with a reconciliation from amortized cost to fair value presented in the notes (BC279).

The first bulleted statement indicates amortized cost would not be presented, which conflicts with the last sentence in 825-15-45-2 above that states the net amortized cost shall be included on the balance sheet. The second bulleted statement refers to a presentation of the allowance for credit losses; however, paragraph 45-2 says the "net" amortized cost is to be presented (that is, net of the allowance for credit losses). In short, the final amendments related to FV-OCI instruments should ensure the related presentation and disclosure guidance is clear and internally consistent.

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?

We recommend adding implementation guidance related to debt securities to promote consistent application of a final standard. While credit risk is conceptually similar between loans and securities, there are practical differences. These include the ability to negotiate with a borrower, estimating the effect of prepayment speeds, the impact of different vintages, and the interaction of securities issued by the same vehicle but in different tranches.

Separately, we recommend providing examples of when a loan is considered collateral dependent, highlighting the relevance of the asset's operation "by the lender" since that phrase does not exist in the current definition. While the ED would remove the requirement to use a collateral-dependent approach to measuring impairment when foreclosure is probable, we suspect regulators may continue to believe that method is preferable as a loan approaches foreclosure. As such, examples would foster comparability.

Paragraph 825-15-25-10 indicates it is inappropriate to recognize interest income when it is not probable that the entity will receive substantially all of an asset's principal and interest. Paragraph 25-11 states interest income should be recognized when that condition is no longer met. We suggest providing implementation guidance addressing when an entity transitions an asset out of non-accrual status. Specifically, is there a cumulative adjustment of prior unrecognized income, or would income only be recognized on a purely prospective basis? Or is a yield adjustment during future periods appropriate over which to recognize previously unrecognized interest?

Lastly, it would be helpful to provide an illustration that more clearly demonstrates the guidance proposed in paragraph 825-15-55-24. For instance, in Example 1 (825-15-55-17 through 55-24), if credit deterioration during the first quarter was worse than original expectations, how would the loss rate be updated in a non-linear fashion for the amortizing loans that are still outstanding at the end of the interim period?

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

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We agree.

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

We agree.

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?

Similar to most recent transition decisions the Board has made, we recommend providing private entities with an additional year to benefit from the experience of public companies.

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

We have not identified any operational constraints related to initial transition.

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?

We recommend deferring the effective date for the financial instruments project (i.e., recognition and measurement, and impairment) for at least one year beyond the initial adoption of the pending revenue recognition project. As the Board moves closer to completing its efforts in this area and continues to make progress on the lease project, it may wish to revisit earlier discussions regarding a "big bang" approach vs. a "staggered" implementation of the major convergence projects.