

**Financial Accounting and Reporting Section
of the American Accounting Association**

Financial Reporting Policy Committee

**Response to the FASB Invitation to Comment:
Financial Instruments—Credit Losses
(Subtopic 825-15)**

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The Financial Reporting Policy Committee (the Committee) is charged by the Financial Accounting and Reporting Section of the American Accounting Association to provide comments based on academic analyses and research findings on discussion papers, exposure drafts, and accounting standard updates related to financial accounting and reporting issues. The Committee is pleased to provide the Financial Accounting Standards Board (the Board) comments on the Proposed Accounting Standards Update, “*Financial Instruments—Credit Losses*.” The comments in this letter reflect the views of the Committee’s members and are not an official position of the American Accounting Association or the Financial Accounting and Reporting Section.

General Comments

We believe that the use of an expected loss model to measure and recognize credit losses is better than the currently-used incurred loss model as the expected loss model better matches the underlying economic reality. Specifically, interest rates charged on loans should incorporate a component for expected credit losses, thus providing for a measurable expected credit loss when a loan is made and at every future date until it is repaid.

Although there are practical difficulties in isolating and measuring this component, we contend that these measurement difficulties are not that different from those in the incurred loss model. The primary differences seem to be of timing, and potentially, a reduction in the verifiability of the measurement. We believe that benefits of providing users with more timely recognition of credit losses outweigh any potential reduction in measurement verifiability.

Scope

Question 1: Scope of financial assets included

The current scope of financial assets included encompasses the vast majority of—if not all—financial assets. Therefore, we believe the scope of the proposed accounting standard update is appropriate.

Recognition and Measurement

Question 2: Removal of initial recognition threshold

Conceptually and empirically the incurred loss model results in less timely information for users of financial statements, so we agree with the removal of any threshold that delays timely measurement and recognition of expected credit losses. Academic research suggests that firms can use subjective thresholds to delay timely loss recognition. Vyas (2011) examines the timeliness of accounting write-downs during the recent credit crisis, using credit indices as a benchmark. He finds that accounting write-downs were not as timely as the write-downs implied by the credit indices. Furthermore, in additional cross-sectional tests, he finds that the timeliness of write-downs is associated with firm characteristics such as the quality of corporate governance, whether the firm is subject to litigation pressures or prior regulatory investigations,

the complexity of the firm's exposures, and leverage. These results suggest that the current approach results in loss recognition that is subject to manipulation. Therefore, we conclude that keeping the current initial recognition threshold has no merit.

Questions 3–5

Question 3: Is the present value of the cash flows expected to be collected more decision useful than current GAAP requirements?

Question 4: Does recognizing all expected credit losses result in more decision useful information than some expected losses?

Question 5: Do you believe that expected credit losses based on past events, current conditions and reasonable and supportable forecasts provide decision useful information?

We believe the answer to the above three questions is “yes.” Academic research generally supports this conclusion; we discuss this research below. All business decisions require managers to use forecasts of uncertain outcomes. Therefore, we start from the premise that any reasonable provision or allowance for credit losses is likely to be decision useful. We also believe that more timely measurement and recognition will be more decision useful. As with all measurements that require judgment and look to forecasts, however, there is the potential for mis-measurement and misuse if managers and users of financial statements rely on them too heavily.

The various measurements of, and disclosures about, credit losses currently provided in financial statements, particularly regarding the loan portfolios of banks, have been shown to provide a useful measure of expected credit losses. Harris, Khan and Nissim (2011) construct an expected credit loss measure from the current disclosures and find that this measure performs better than charge-offs, realized credit losses and fair value of loans in predicting credit losses. We expect that the forward looking measures proposed by this update will perform better than the

researcher-generated measure as they will be based on management's estimates, thus supporting the concept of measuring credit losses on an expected basis.

Archival research to date can only examine the currently-used incurred loss model. However, even the incurred loss model uses forward looking information. Examining differences in how firms implement the model may improve insight into the possible impact of a credit loss model that explicitly considers future events.

Delaying recognition of credit losses has significant real impacts on banks and the economy as a whole. Beatty and Liao (2011) examine the relation between delays in expected loss recognition and a bank's willingness to lend. Exploiting differences in how US banks apply the incurred loss model and using the capital crunch theory of lending, they find lower reductions in lending in recessionary periods, compared with expansionary periods, among banks with timelier loss recognition. These results support the claim in 2009 of the Comptroller of the Currency, John C. Dungan, that the incurred loss model magnified the impact of the economic downturn. Presumably, an expected loss measurement model would reduce the ability to delay loss recognition.

Bushman and Williams (2012) exploit the differences in loan loss provisioning across 27 countries, examining two dimensions of forward-looking provisioning: income smoothing and timely loss recognition. When the forward-looking provisioning is designed to smooth earnings, discipline over the bank's risk-taking by is reduced, consistent with reduced transparency inhibiting the influence of outside monitors. However, when the forward-looking provisioning reflects more timely recognition of expected future loan losses, there is enhanced risk taking discipline on the part of the bank.

Although academic studies generally conclude that the incorporation of forward-looking information in the financial statements has a positive impact on banks and the economy as a whole, there may be unintended consequences. To reduce this possibility, we urge the Board to require the disclosures to be sufficiently detailed to ensure investors can identify any biases in the lender's use of forward looking information.

Forward looking information about credit losses and other risks (particularly interest rate risk) is already available in the financial statements when fair values of financial assets are either disclosed or recognized. Several recent papers examine the relation between these disclosed fair value numbers and credit risk, both at the account level and at the firm level. At the account level, Cantrell, McInnis, and Yust (2013) compare the ability of the incurred loss model and the fair value of the loans to explain future credit losses, as measured by future charge-offs or future non-performing loans. They find that the incurred loss model better predicts future credit losses better than the fair value of the loans. This result is consistent with the findings of Harris, Khan and Nissim (2011), that the combined measure of the current disclosures about credit risk outperforms fair value measures. At the firm level, Blankespoor, Linsmeier, Petroni and Shakespeare (2013) compare the association between a bank's credit risk, measured as bond yields and bank failure, and leverage measured using three different systems: current GAAP, all financial instruments measured at fair value, and regulatory capital rules. Contrary to the account level analysis, they find that fair value leverage is more closely associated with measures of credit risk than current GAAP leverage or tier 1 leverage. Furthermore, they find that the biggest increase in the association between credit risk and leverage occurs when loans are measured at fair value. The two seemingly contradictory results have not been reconciled in the literature.

However, the Blankespoor et al. result suggests that forward looking information is associated with the firm's credit risk, but fair values include a wider range of risks including interest rate risks.

In sum, the academic evidence points to the decision usefulness of forward-looking information.

Question 6: Do you believe that using the same approach to recognizing changes in the credit impairment allowance for purchased credit impaired assets and non-purchased credit impaired assets provides decision useful information?

We believe the same approach should be used for purchased and non-purchased credit impaired assets.

Question 7: Do you believe the practical expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable?

We have no firm view here other than to point out that we believe in the accounting principle of economic substance over form. Therefore, we think it is reasonable to exclude from a measurement requirement any measurement that has little impact on economic substance.

Disclosure

Question 17: Do you believe the disclosure proposals would provide decision useful information?

Given the potential biases in measuring expected losses, it is important that the disclosures provide sufficient information to allow users to assess the bias. We believe that quantitative disclosures are insufficient, and that there should be some discussion about the credit risk component of interest. In a different setting, Hutton, Miller and Skinner (2003) provide evidence on the role of quantitative disclosures, finding that manager-provided good news forecasts are

provide information to the market only when supplemented by verifiable forward-looking statements. This result highlights the importance to the market of credible qualitative information.

Implementation Guidance and Illustrations

Question 19: Do you believe that the implementation guidance and illustrative examples included in the proposal are sufficient?

Interest rates are influenced by the time value of money, credit risk and other risks. In the implementation guidance and illustrations, it is important to show how the credit risk component is isolated and incorporated into the measurement. We believe the current guidance does not provide enough information in this regard.

Transition and Effective Date

Question 20: Do you agree with the transition provision in this proposed Update?

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

Question 22: Do you believe the effective date should be the same for a public entity as for a nonpublic entity? If early application is not permitted, then will public and private banks be recording credit losses under different accounting models?

We believe that all companies should measure credit losses similarly, and see no reason why public and private banks should be treated differently.

References

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