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Re: File Reference No. 2012-260

Dear Ms. Cosper:

Grant Thornton LLP appreciates the opportunity to comment on proposed Accounting Standards Update (ASU), *Financial Instruments—Credit Losses*. We support the efforts of the Financial Accounting Standards Board and the International Accounting Standards Board to reach a converged solution on credit losses and we believe that the Boards should utilize the feedback received on both proposals to come to a converged solution that eliminates or minimizes the current differences in the two boards' proposed approaches.

We note that the proposed Current Expected Credit Loss (CECL) model is a significant departure from the existing incurred loss model. We believe that in order for the proposed model to be an improvement in financial reporting for financial statement users and be operational for prepares to apply, significant additional work is required. We believe that the operational issues go beyond implementation guidance that could be provided by the FASB and warrant a joint effort with other regulatory bodies to outline expectations on how preparers should support their allowance for credit loss estimates under the proposed model. For example, we note that the SEC and bank regulators have provided significant implementation guidance and expectations related to the existing loan loss model. We believe such guidance must be updated and evaluated to determine whether the proposed model could be made operational for preparers.

We believe that while the proposed model could potentially mitigate some of the concerns raised during the financial crisis about "too little, too late," it will still not cure all major concerns raised during the financial crisis. For example, it likely would not address the inherent time lag between occurrence of the loss causing event and the loss becoming evident to the lender. Additionally, we believe the proposed model may not address other events leading up to the financial crisis. For example, leading up to the financial crisis certain entities reduced underwriting standards as noted by an increase in "low documentation" loans, "no documentation" loans, "subprime" loans, and loans being underwritten with higher than "traditional" loan to value ratios that were based, in part, on expectations that real estate prices



would keep increasing. These new products resulted in increased risk for the financial institutions that underwrote these loans. We note that these changes in underwriting are currently (in an incurred loss model) required to be considered by financial institutions in adjusting historical loss experience when estimating the allowance for loan losses. Under the proposed model, it is not clear how simply moving to an expected loss model would result in the ability of an entity to better estimate how such changes in underwriting would impact the allowance for credit losses. As such, we believe that efforts to improve the estimation of the allowance for credit losses must go beyond the accounting framework and consider things such as improvements in credit administration, underwriting criteria, and how entities can better correlate trends in the portfolio to the need to adjust the allowance for credit losses.

Below we have raised issues that we believe are either fatal flaws in the proposed model, significant items that may not have been considered by the Board, or flaws in the application of the proposed model. In addition, we have suggested certain improvements to the existing incurred loss model should the Board ultimately conclude the CECL model is not a feasible solution that both improves financial reporting and is operational for prepares to apply.

Our responses to the questions for respondents have been included in Appendix A to this letter.

Day one allowance

The proposed model would result in an entity recognizing a loss on initial recognition of a debt instrument. We believe that recognizing a credit loss on day one is not an economically faithful representation of the origination or acquisition of a debt instrument. While we agree that making a loan or purchasing a debt security results in an entity taking on risk, an entity generally prices that credit risk into the contractual yield or acquisition price to compensate for the risk.

According to the Board's March 25 *Frequently Asked Questions* (FAQ) document, "the Board believes that the measurement objective of interest income is to reflect the rate of return implicit in a debt instrument (that is, the contractual interest rate adjusted for any net deferred loan fees, premiums, or discounts existing upon initial recognition, which is referred to as the effective interest rate)." It is not clear why the Board believes the rate of return implicit in a debt instrument should not factor in credit risk. In other words, why would an entity recognize interest income based a rate of return it does not expect to collect?

Proposed solution to the day one phenomenon

We believe that if the application of the CECL model results in a day one allowance, such determination really means that the contractual return on the investment is not consistent with management's estimated return at acquisition. We believe that rather than recognize a day one provision for credit losses, the entity should instead reduce its effective yield such that the discounted cash flows expected at acquisition are equal to the amount of the day one carrying amount of the loan. As a result, we believe that the measurement objective of interest income

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¹ Refer to SEC Staff Accounting Bulletin: No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues and the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses



at initial recognition should be to reflect the <u>initial expected</u> rate of return implicit in a debt instrument (which will often differ from the contractual terms). To satisfy stakeholder needs to see interest income based on the contractual rate, separate presentation within the statement of income of the amortization of this credit premium could be provided. We believe current methods of amortizing loan origination costs could be utilized for these premiums without introducing significant operational challenges. If left as is, an entity would recognize a day one allowance and subsequently recognize interest income that is overstated (as it would likely be shown as the rate of return on the outstanding principal balance and not the return on the outstanding principal balance less the allowance for credit losses). We believe our proposed approach would be more representationally faithful to investors and consistent with the conclusions reached by the Board in BC40 of the proposed ASU's basis for conclusions, in which the Board states that for certain assets it is not representationally faithful to recognize interest income based on contractual cash flows.

Less meaningful income statement

Today's incurred loss model is an income statement—driven approach that seeks to reflect in each statement of financial performance losses that occurred during that period. The allowance balance, therefore, simply reflects an estimate of past losses that have not yet been confirmed (and charged-off). In contrast, the proposed CECL model is focused on the balance sheet, as the allowance for credit losses would reflect the present value of future cash flows not expected to be collected over the life of the assets. As such, under the CECL model, actual credit deterioration would not be reflected in the income statement in the period of such deterioration unless it is unexpected. Instead, the income statement loss provisions would reflect expected credit losses in the period of origination or acquisition of the financial asset, with changes in expectations reflected in later periods.

We believe a change from the current income statement driven approach to a balance sheet approach would result in a potentially less meaningful income statement for financial statement users. Please refer to paragraph 64 and 65 in the Basis for Conclusions of FASB Statement 5, Accounting for Contingencies, for investor considerations raised in deliberations on FASB Statement 5. We would be interested to understand why the financial statement user community's views have apparently changed and/or whether financial statement users are aware of and supportive of the income statement ramifications of the CECL model.

Significant departure from the conceptual underpinnings of ASC 450 without clear explanation of why the Board now believes certain credit loss contingencies warrant a separate contingency model. We understand why the Board has decided an expected loss model is needed to address the perception that the current accounting model resulted in banks recognizing allowance for loan losses that were deemed to be "too little, too late." However, we believe that it is imperative that the Board carefully consider whether the allowance for credit losses should be based on an expected loss model and should be recognized and measured differently from other contingencies. More specifically, it is not clear to us how the Board considered the following three important conclusions reached in FASB Statement 5 that appear to contradict conclusions reached in this proposed ASU:



- All loss contingencies have common characteristics and should be subject to the same
 model (refer to paragraphs 56-58 of the Basis for Conclusions in FASB Statement 5). It is
 unclear why the Board believes that the uncollectibility of a receivable, loan, debt security
 and other items within the scope of the proposed ASU have unique characteristics that
 warrant a separate model from other loss contingencies.
- 2. Accounting accruals do not provide protection against losses (refer to paragraphs 61-66 of the FASB Statement 5 Basis for Conclusions). It is unclear whether the Board considered the potential perception that the CECL model would provide "protection" against losses and capital.
- 3. The concept of a liability (refer to paragraphs 69-73 of the FASB Statement 5 Basis for Conclusions). It is unclear how an expected loss approach to measuring a contingency is consistent with the concept of a liability.

It is important to emphasize that we are not suggesting that the Board consider an expected loss approach for all loss contingencies. Rather, if the Board ultimately concludes that credit losses on financial assets should be subject to an expected loss model, we believe that the Board should fully consider the decision process in FASB Statement 5 and explain the basis for a conceptual change in accounting for certain loss contingencies.

We believe an allowance based on expected losses creates a perception that the allowance for credit losses provides protection against losses (and capital) as noted by the regulators who have stated that regulatory capital should only be for unexpected losses. While we understand the regulators' view point and rationale, we continue to question why regulatory capital cannot be made dynamic or why regulators could not require banks to increase their capital in order to account for expected losses and/or increased credit risk.

Measurement uncertainty

The measurement uncertainty in the allowance and provision for credit losses will be substantially greater than currently exists. Provisions and allowances for credit losses under current GAAP are typically highly uncertain but they relate only to actual losses incurred during the historical periods reported. That uncertainty will be amplified when estimates of future losses must be included in the allowance and provision for credit losses. As a result, financial statements will be subject to greater measurement uncertainty.

Susceptible to earnings management

The concerns noted above about measurement uncertainty also point to the CECL model potentially resulting in financial reporting that is susceptible to earnings management. Further, the ability of an entity to establish a day one allowance for purchased credit impaired assets raises the concern that entities needing an increase in their allowance may be able to purchase very low quality loans so that very large imputed allowance balances can be added to their existing allowance balance. In other words, when an entity purchases a portfolio of loans, there likely would be an inherent bias to establish the allowance on those acquired loans based on the upper range of the CECL estimate and as a result entities may be able to purchase allowances for credit losses.



Conflict with Concepts Statements 7
Paragraph 41(b) of Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* states that

Interest rates used to discount cash flows should reflect assumptions that are consistent with those inherent in the estimated cash flows. Otherwise, the effect of some assumptions will be double counted or ignored. For example, an interest rate of 12 percent might be applied to contractual cash flows of a loan. That rate reflects expectations about future defaults from loans with particular characteristics. That same 12 percent rate should not be used to discount expected cash flows because those cash flows already reflect assumptions about future defaults.

The proposal would require that present value of expected cash flows be computed using each loan's effective interest rate. The effective rate incorporates original expected losses and after subtracting expected losses from contractual cash flows, use of the effective interest rate to compute present value double counts the expected credit losses.

Proposed single model does not work for all potential scenarios/debt instruments

We applaud the Boards efforts to replace the multiple impairment models in GAAP with a single impairment model. We believe this will reduce complexity. However, we believe that further work is needed in order to address the following potential anomalies in the proposal:

- The proposed model would require an entity to "gross-up" the balance sheet when initially recognizing purchased credit impaired loans in order to recognize the day one allowance. While this may work well for many loan types, the proposal is silent as to whether there would be situations in which the amortized cost amount would not be equal to the unpaid principal. For example, assume an entity acquires a deeply discounted loan in which the carrying amount is \$100 and the day one allowance would be \$95. Does it make sense to gross up the loan? Or should a portion of the loan be "charged-off" prior to recognition?
- If an entity concludes that an acquired asset is not a purchased credit impaired financial
 asset, why is the entity "penalized" by being required to recognize the day one allowance for
 credit losses in earnings rather than directly to the allowance as would be required for a
 purchased credit impaired asset?
- The CECL model would require that the estimate of expected credit losses always reflect the
 possibility that a credit loss results and the possibility that no credit loss results. It is unclear
 how this principle would be applied in all scenarios, but the model seems to require that an
 entity always recognize an allowance for credit losses, even if there is strong evidence that
 impairment is not expected. Consider the following scenarios in light of the proposed
 guidance:
 - A bank has made a loan that is fully secured by a certificate of deposit held by the bank in safekeeping. One could argue that impairment is unlikely. Would such conclusion change if the collateral is instead real estate that more than adequately covers the contractual cash flows?
 - Consider a manufacturer that has a large receivable outstanding at year-end with a highly rated counterparty for which it has done a full credit review.



Further presume that the manufacturer has information available shortly after the balance sheet date and before report issuance that further shows the receivable has been collected in full. Would the entity still need to recognize an allowance for credit losses at year-end?

- Consider an investor in U.S. Treasury securities. How does the investor reflect the possibility that a credit loss results with respect to any such security when there is no historical record of any such losses to consider?
- Defined contribution pension plans commonly allow participants to borrow against their vested account balance. These loans cannot be sold, and the loan is secured by the participant's vested account balance thereby mitigating the credit risk to the plan. As was noted in ASU 2010-25, *Reporting Loans to Participants by Defined Contribution Pension Plans* (a consensus of the FASB Emerging Issues Task Force), if the participant were to default, the participant's account balance would be reduced by the unpaid balance of the loan with no effect on the other participants' investment balances.

Reasonable and supportable forecasts / reliance on historical data
The proposed model would require an entity to consider reasonable and supportable forecasts.
We believe the Board should provide examples of what they believe are "reasonable and supportable forecasts." We note that we have been often asked by various interested parties what a "reasonable and supportable forecast" would be. Further, we have been asked how far one would need to look out into the future in applying the CECL model.

In addition we note that the Board has indicated in the March 25 FAQ document that one way an entity could comply with the requirement to consider reasonable and supportable forecasts is to utilize historical data. We are concerned with the potential end result of entities over relying on historical data because in the periods leading up to the financial crisis many entities had low historical loss experience. On the other hand we are also concerned by the counter-suggestion made by some to limit the forecast period to some undefined "foreseeable" period less than the contractual life of the loans. We are unclear as to the basis for determining that undefined "foreseeable" period.

Our concerns on reasonable and supportable forecasts and the reliance on historical data is discussed further in our response to Question 9 for respondents in Appendix A.

Amplified pro-cyclicality

The proposal requires that a loss provision related to changes in expectations about losses includes amounts for all future years of the loan portfolio. This loss provisions is likely much greater than the loss provision that would be made under the incurred loss model, which has been criticized for pro-cyclicality.

Further work is needed on how an expected loss model would be understood depending on current position in the economic cycle

The model was effectively built to address the perceived problem of allowances that were deemed to be "too little, too late." In other words, the model attempts to have a desired outcome that would result in an entity not delaying recognition of its allowance for credit



losses. However, it is not clear as to whether the proposed model has been fully considered in various stages of the economic cycle. For example,

- Assume a bank has perfectly estimated the contractual cash flows it does not expect to
 collect under the CECL model. Further, assume we are in the midst of a financial crisis, and
 the bank begins confirming those expected losses through charge-offs, thus reducing its
 allowance for credit losses. How would regulators and financial statement users react to
 banks reducing their allowance for credit losses in the midst of a financial crisis?
- Assume we are at the same spot we are today. Many banks have experienced improvement in
 their credit portfolio such that they are releasing reserves. As banks began to release reserves,
 the regulators became concerned that the reduction in the reserves were outpacing the
 improvements in the economy. Under the revised model such releases may potentially be
 greater and faster than under today's incurred loss model.

Nonaccrual concept appears incompatible with the requirement that the allowance for credit losses represent the current estimate of contractual cash flows not expected to be collected

The proposal would formally introduce into GAAP a nonaccrual principle. Introduction of a nonaccrual concept would potentially create conceptual and calculation inconsistencies. We believe that the introduction of a nonaccrual concept conflicts with the requirement that the allowance for credit losses represent the contractual cash flows not expected to be collected, as placing a loan on nonaccrual would appear to double count expected lost interest income (as it would be considered in nonaccrual and in the estimate of the allowance for credit losses).

The proposal states as a fundamental principle that the interest income line of the income statement should report contractually required interest income with losses reflected separately in the bad debt provision. Placing a debt instrument on nonaccrual, as directed by the proposal, causes the recognition of the expected loss of some contractual cash flows to be shown in the interest income line of the income statement (by non-recognition of interest income) rather that the provision for credit losses. As such, by placing a debt instrument on nonaccrual, it is unclear how an entity would comply with the requirement that the allowance for credit losses reflects the current estimate of contractual cash flows not expected to be collected. In other words, if a loan is placed on nonaccrual, how would the entity increase its allowance amount such that it reflects the current estimate of contractual cash flows not expected to be collected?

We did consider one potential solution, which is that the fundamental principle in the proposed standard be changed from (a) the allowance for credit losses represents the current estimate of contractual cash flows <u>not expected</u> to be collected to (b) the amortized cost less the allowance for credit losses represents the contractual cash flows <u>expected</u> to be collected. However, we note that the credit loss model would also apply to items in FVOCI and this suggested approach would not appear to work for such items.

Burden for small to medium size financial institutions and non-financial service entities

We note that small to medium size financial institutions and non-financial service entities will likely face significant challenges in applying this proposal especially when it comes to



considering forward looking information and access to sufficient historical data to apply the model. We generally understand that such data is less available for small to medium size financial institutions and non-financial service entities.

Write-off timing

We believe that a critical component of this proposed ASU is clear guidance about when a financial asset should be written-off, given the importance of historical charge-off experience to the overall model. Based on the proposed ASU, we expect that many entities would continue to use historical charge-offs as a starting point for the allowance for credit losses. As such, we believe the Board should provide clear guidance as to what is meant by "no reasonable expectation of recovery." Further, it is not clear if this definition is intended to result in an entity having minimal recoveries.

Collateral dependent definition

The proposed ASU will only allow an entity to measure impairment based on the fair value of the collateral when the repayment is expected to be provided primarily or substantially *through the operation (by the lender)* or sale of the collateral, based on an entity's assessment as of the reporting date. In practice, certain financial institutions measure impairment based on the fair value of the collateral if the repayment is expected to be provided solely by the operation by the lender *or the borrower*. For example, a financial institution may base impairment on the fair value of the collateral if the lender has made a loan on an apartment building and the sole source of repayment is rent received by the borrower on the apartment building. The Board should explain the rationale for this change in the basis for conclusions given its potential implications to financial institutions.

We also believe the Board should clarify whether the fair value of the collateral should be adjusted to consider the expected timing of its receipt. For example, assume an entity determines a loan qualifies for the collateral dependent practical expedient. Would impairment be measured (1) based on the fair value as of the balance sheet date or (2) if the bank expects foreclosure and sale would not be until two years after the balance sheet date, would the fair value need to be adjusted for this delay in timing given the "expected" loss model?

Alternative suggestion if the Board concludes that the CECL model is not feasible

If the Board ultimately concludes that the CECL approach would not improve financial reporting and be operational for prepares to apply (in other words the concerns with the proposed model outweigh the perceived benefits), we believe that the Board could consider a simplified, principles based approach to revising the accounting for credit losses on debt instruments. In modifying existing GAAP, we believe the following enhancements could be considered:

Specify that while the model continues to be an incurred loss model, an entity is not
precluded from considering all reasonable and supportable information available before the
financial statements are issued or are available to be issued about events or circumstances
existing as of the balance sheet date that indicate a loss has occurred provided that such loss



can be reasonably estimated. This may involve lowering the threshold from "probable" to "more likely than not."

- Provide clear guidance as to what an entity is measuring under an incurred loss model. In other words, what is the loss causing event or circumstances an entity is accruing for? For example, we have observed that in practice some believe that a loss should not be recognized until the loss becomes evident to the lender (for example, it shows up on the past due list) rather than the earlier loss causing events (for example the earlier loss causing event may be the fact that the borrower has lost his or her job, borrower has experienced a decline in revenue, or the borrower has lost a major customer or tenant). Accordingly, under our alternative we believe a loss discovery period should be considered and incorporated into the model. We note that a loss discovery period concept was previously considered in a proposed Statement of Position by the AICPA's Accounting Standards Executive Committee in 2003 as part of enhanced guidance on applying the incurred loss model but the SOP was not issued. However, we believe that the credit crisis has illustrated an increased time horizon between the loss event and the confirmation of the loss event or charge-off (for example, due to increased workout periods), and therefore this concept should be reconsidered. We observe that not all entities consider a loss discovery period today.
- Provide clear guidance as to when a debt instrument should be charged-off.
- Address preparer/user concerns about the differences in purchased credit impaired (PCI) assets and originated assets by requiring that such assets be separately reported on the balance sheet and ensuring that disclosures are appropriate to help a user understand the difference between PCI and non-PCI assets.
- Consider targeted changes to the current ASC 310-30 model to address concerns raised by preparers in the operationally of the existing model.
- Retain and apply the existing other-than-temporary impairment guidance for debt securities to financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income, but specify that changes in credit would be recognized as an allowance rather than a direct write-down to the debt security.
- The Board and regulatory constituents should provide additional implementation guidance to assist preparers in documenting and supporting their allowance methodology that also considers the differences in size and complexity of debt portfolios and between entities.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mark K. Scoles, Partner, Accounting Principles Consulting Group, at 312.602.8780 or Mark.Scoles@us.gt.com; or Jamie Mayer, Managing Director, Accounting Principles Consulting Group, at 312.602.8766 or <u>Jamie.Mayer@us.gt.com</u>.

Sincerely,

/s/ Grant Thornton LLP



Appendix A – Responses to questions for 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?

We generally agree with the scope of the proposed ASU. However, we believe that the final ASU should clarify:

- where in the statement of financial position the allowance for credit losses should be reported for loan commitments
- the applicability to financial guarantees
- the applicability to not-for-profit entities considering the Board has a separate project on its agenda
- the applicability to loans to participants in defined contribution plans. Refer to our above discussion in "proposed single model does not work for all potential scenarios/debt instruments." We generally believe participant loans should be scoped out of the proposal.
- the interaction of the proposed model for lease receivables with the proposed leasing standard
- the interaction of reinsurance receivables guidance with the insurance contracts project.

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?

We believe that the Board should clarify the view that the estimation of credit losses is only an issue of measurement. For example, we observe that the measurement of credit losses is likely impacted by events subsequent to origination or acquisition such as the performance of the debt instrument. An entity likely would expect that a receivable that goes into default would have a higher loss rate associated with it than a debt instrument that is high risk but not in default. Although the Board has specified that the estimation of credit losses is only an issue of measurement, we believe that recognition significantly impacts such measurement.

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 have concerns about the operability of basing the estimate of expected credit losses on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts.

Reasonable and supportable forecasts

We believe the Board should provide examples of what they believe are "reasonable and supportable forecasts." We note that we have been often asked by various interested parties what a "reasonable and supportable forecast" would be. Further, we have been asked how far would one need to look out into the future in applying the model.

Adjusted historical loss experience

We note that many entities' current starting point in determining their allowances for loan losses is historical charge-off experience, which is then adjusted for various factors (including current conditions) that cause estimated credit losses to differ from historical loss experience. We note that under the current model, entities often struggle with what the historical base period should be (for example one year, three years, five years or some other base period) and how to determine and support the adjustments needed to that historical loss base period in order to appropriately capture the losses that have been incurred in the portfolio.

We believe these struggles would be amplified under the proposal by requiring entities to also incorporate forward looking forecasts into adjusting historical loss experience. Further, guidance likely would be needed to assist an entity in evaluating whether such forecast is reasonable and supportable. Guidance would also likely be needed to determine whether such forecasts are already considered in the historical base period. In other words, before adjusting the historical loss experience an entity would need to understand what that historical loss experience does and does not capture.

In addition, we note that as discussed in the March 25 FAQ document, the Board has indicated that (in part):

(Question 13) The Board expects that this life-of-loan estimate will largely be informed by historical lifetime loss experience for similar assets...However, an entity's ability or inability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan would only affect the entity's analysis of whether (and how) the historical loss experience is adjusted for what is currently expected. Furthermore, an entity's ability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan does not override the need to consider historical loss experience for similar assets of similar credit risk as the foundation of the estimate of expected credit losses.

To that end, the Board did not intend to prescribe or prohibit specific approaches or assumptions in how management develops its expectation about the future. In outreach discussions performed to date, the staff has heard preparers describe several different approaches for adjusting historical loss experience for current conditions and reasonable and supportable forecasts about the future, including:



- a. Reverting to unadjusted historical averages for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts, or
- b. Assuming that economic conditions will remain stable for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts (that is, freezing the furthest reasonable and supportable forecast and utilizing that forecast for the remaining future periods).

This guidance provided in the FAQ appears to imply that an entity would potentially need to have historical loss information over a longer period of time than is generally utilized in current practice. We would expect that many entities would not have the historical loss experience over such longer time frames and information about factors that led up to the charge-offs in order to be able to properly adjust the allowance estimate. Further, if an entity has acquired debt instruments, the proposed approaches would likely not be operational as we would expect the entity would not have sufficient historical information.

We believe it is important to emphasize that a charge-off is merely the confirmation of a loss that likely occurred much earlier than the actual charge-off and therefore an entity must understand the environment and circumstances that caused the loss in order to properly adjust the loss experience and to determine if the historical loss experience is an appropriate measure of future expectations. Under current GAAP adjustments are needed to historical loss experience for the following three primary reasons:

- The historical charge-off rate reflects the period over which the charge-offs were confirmed and recognized, not the period over which the earlier losses occurred. That is, the charge-off rate measures the confirmation of losses over a period that occurs after the earlier actual losses. During the period between the loss-causing events and the eventual confirmations of losses, conditions may have changed.
- b There is always a time lag between the period over which average charge-off rates are calculated and the date of the financial statements. During that period, conditions may have changed.
- c The charge-off rates are just that: rates of charge-off over a period of time. Refinement of the methodology should be considered for the estimated loss discovery period, that is, the average period between when losses occur and when the loans are written down as a result.

We believe that under the proposed model, an entity would need to understand what the historical loss experience is and is not capturing in order to appropriately adjust the historical loss experience such that the allowance reflects the current estimate of contractual cash flows not expected to be collected.

Under approach A in response to question 13 of the FAQ document, while we observe that the staff appears to indicate that an entity would be able to revert to unadjusted



historical future periods or freeze expectations, we do not believe this is consistent with the principles in the proposed model. For example, if a bank has had minimal losses over a significant period of time that is used as that historical base period, we believe that any differences in the underwriting (as an example of one of many adjustment factors to consider) from that historical base period would need to be considered in estimating the expected credit losses. We believe that simply reverting to unadjusted historical loss experience would generally not appropriately reflect the current estimate of contractual cash flows not expected to be collected.

Special considerations for entities applying a loss rate methodology We note that a many banks currently apply a FAS 5 methodology for loans not specifically identified for impairment using a loss rate methodology similar to the below formula.



It should be noted that often the adjusted historical loss experience or loss rate is expressed as an annualized loss rate. We note that institutions may further adjust that annualized adjusted historical loss rate to consider the period it takes from a loss event through the confirmation of the loss (loss discovery period or loss emergence period) which may result in the loss rate being increased or decreased depending on the loss discovery period.

In order to apply the proposed model, we question whether a loss rate methodology could be adjusted such that the allowance would represent the current estimate of contractual cash flows not expected to be collected. An entity that currently applies a loss rate methodology would be challenged in determining how it could adjust the historical loss rate to comply with the CECL model. Issues include

- The historical charge off accumulation period is now typically one to three years, not an entire business cycle or even correlated to the typical life of the loans in the loan portfolio
- The historical charge offs are the result of even earlier loss events. Extrapolating from the conditions under which the losses occurred to the periods after the balance sheet date over which the loan portfolio will be collected will be difficult.
- Management may have difficulty in supporting the resulting measurement uncertainty in the allowance estimate.
- We are also concerned by the counter-suggestion made by some to limit the forecast period to some undefined "foreseeable" period less than the contractual life of the loans. At some point the estimate becomes purely a matter of management judgment.

Implications for debt securities

We note that the proposal would likely require preparers to obtain a potentially significant amount of new information from third parties on similar debt securities' historical loss



experience and other data points. We are concerned that much of the proposal and discussions have been around how the model would apply to loans and we believe specific guidance is needed as to how the model would be applied operationally to debt securities.

Alternatively, we suggest that the Board consider whether the current model for debt securities is "broken" such that it requires the changes suggested by this proposed model.

Contractual term

The Board has observed in BC 24

...that estimating expected credit losses over longer periods of time (such as the contractual term of financial assets) requires a significant amount of judgment, especially when discounted cash flow techniques are used. Although an entity is required to estimate credit losses over the entire contractual term of the financial assets, the Board recognizes that as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses increases because the availability of detailed estimates for periods far in the future decreases.

We believe that requiring an entity to estimate expected losses over the contractual term of a debt instrument will be extremely challenging, and given the significant management judgment and measurement uncertainty involved in estimated losses over the contractual term, we question whether this will be an improvement in the reporting of estimated credit losses. While the Board's FAQ document has suggested some approaches to doing so, as noted above we do not believe such approaches will be operational.

Historical loss data on purchased debt instruments

We believe that an entity that has purchased debt instruments will not likely have historical data on the amount and timing of historical losses and therefore may have difficulty in estimating expected losses.

Underwriting

The proposal indicates that the estimate of expected credit losses shall be based on internally and externally available information that is relevant in making the estimate. The proposal further indicates that such information should consider "current evaluation of borrowers' creditworthiness and an evaluation of both the current point in, and the forecasted direction of, the economic cycle (for example, as evidenced by changes in lender-specific or industry-wide underwriting standards)." While we agree that changes in underwriting may impact the allowance for credit losses, it may not impact the current portfolio. For example, assume a bank modifies its underwriting standards one month prior to year-end and makes no new loans under those revised standards. Under such scenario, we do not believe that such changes would impact the CECL estimate. As such, we believe that the Board should clearly explain how changes in underwriting should be considered.



Model validation

We believe that it would be more difficult for an entity to validate loss rates given that the model would now incorporate expectations that may never be confirmed. We believe further consideration is needed as to how one would validate loss rates, specifically the incorporation of forecasts and especially with ever changing pools of loans. Under current practice, an institution is expected to have procedures that adjust loan loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary. However, under the proposed approach actual charge-offs may never occur or may not be able to be correlated to the expected loss estimate, especially with non-static pools.

Auditability

We believe that the ability to audit the CECL allowance is significantly dependent on management's ability to support how it has come up with its allowance for credit losses, including having a sound process and internal controls related to its allowance for credit loss estimate. In other words the auditability is significantly dependent on the ability of the Board to make the proposal operational for preparers.

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?

Refer to our response to question 9.

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?

Refer above to our comments in the introduction on how this principle would apply to all scenarios under the section "Proposed single model does not work for all potential scenarios/debt instruments."



We agree with the basis for this principle. In particular we note that the allowance for credit losses requires significant management judgment and that the determination of the allowance for credit losses is not a precise estimate. As such, we believe that the result of management's allowance estimation process is an estimate that falls within a range of expected losses (i.e. range of uncertainty). We believe that the current language may be confusing to some. We note that in practice a similar concept is applied by many entities, but is articulated as considering a range of estimated losses (for example, a bank may consider a range of historical loss experience in its allowance for credit losses). As a result, we suggest that the Board consider replacing the language in the standard to state something along the lines of "the allowance for credit losses should consider a range of potential outcomes between scenarios in which a credit loss results and no credit loss results. Inherent in this principle is that an entity would consider a range of qualitative and quantifiable information that informs its judgment on the appropriate allowance for credit losses.

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?

We agree that the allowance for credit losses should reflect the time value of money. However, we are unclear how the Board has concluded that loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method implicitly reflect the time value of money. For example, we note that a loss rate method does not consider the timing of a charge-off, only the amount. Our modeling under both the implicit and explicit methods leads us to question how the Board concluded that the results are not materially different in all circumstances. It appears that these implicit approaches are viewed more as practical expedients. Further, it is possible that an entity may apply other methods beyond those cited by the Board as implicitly reflecting the time value of money. As such, we believe it is imperative for the Board to provide principles-based guidance that can be used by constituents in order to evaluate whether their methodology "implicitly" reflects the time value of money and is a permissible substitute for a discounted cash flow approach.

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?

Initial bifurcation of credit/non-credit discount

We do believe that depending on the facts and circumstances relating to a particular acquisition, entities may face constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition due to a lack of information to compute the day one allowance. We note that ASC 805, *Business Combinations*, allows entities up to one year to obtain information about facts and circumstances that existed as of the acquisition date that, if known would have affected the acquisition date fair value. We believe a similar accommodation should be provided to the acquisition of purchased credit impaired financial assets and the bifurcation of the credit and non-credit discount.

Definition of purchased credit impaired

An acquired financial asset (individually or on a pooled basis) would meet the definition of a PCI asset if it has experienced a *significant deterioration* in credit quality since origination, based on the assessment of the acquirer. It is not clear how one would determine *significant deterioration* other than very limited guidance in BC40 of the proposed ASU which states "such that there is a significant difference between the contractual cash flows and the expected cash flows."

We believe that the Board should seek to further reduce complexity by having all acquired financial assets accounted for in the same manner and not distinguish between those with significant deterioration and those without significant deterioration since origination. We believe this approach would also be consistent with the notion in the proposed ASU that the accounting for credit losses is solely an issue of measurement and therefore we believe having a recognition threshold is inconsistent with the rest of the proposed ASU. Refer to our comments in the introduction under the section "Day one allowance."

If the Board does not agree with our recommendation, we believe that additional application guidance is needed to determine whether there has been significant deterioration since origination. We believe that additional implementation guidance is imperative given the significant day one accounting differences between a PCI and non-PCI asset.

Initial applications to acquired groups

The proposed ASU would allow acquired groups of financial assets with shared risk characteristics to be evaluated on a pooled basis to determine if such pool meets the definition of a PCI asset. The term "shared risk characteristics" has been loosely defined under the proposed ASU. As a result, we are unclear as to how the Board's expects such pools to be determined. For example, would an entity that acquires 250 residential 1-4 family mortgages



with some good and some bad loans simply be permitted to group the loans together because all 250 loans are of the same asset type? We question this as it would be a significant loosening of the conditions in ASC 310-30 that allows an entity the option to pool acquired loans.

Subsequent applications to acquired groups

The proposal would allow an entity to determine whether purchased assets meet the definition of a purchased credit impaired asset on an individual or pool basis. If an entity determines that the acquired assets meet the definition of a PCI asset on a pooled basis, we would expect that the entity would likely determine its day one credit and non-credit discount on a pooled basis. Unlike the current guidance in ASC 310-30, the proposal would not require an entity to maintain the integrity of the pool and is silent on how one would subsequently account for the day one allowance and interest income, or how one would account for a loan in a pool that is derecognized. For example, the proposal lacks guidance on how one would allocate the day one allowance amongst assets if the entity subsequently determines that it is going to apply the CECL model on individual asset basis. Similarly, it lacks guidance as on how one would allocate the non-credit discount amongst individual assets. Additionally, would an entity be required to use a composite interest rate? If the troubled debt restructuring (TDR) concept is retained, would an entity need to apply the TDR concept to loans in the acquired group?

Interest income

We request that the Board provide clear guidance as to how interest income should be recognized on PCI assets. As more fully discussed below, we believe that the guidance in "standard" part of the proposal is inconsistent with the Basis for Conclusions.

The proposed ASU provides limited guidance on recognizing interest income for PCI assets. Proposed ASC 825-15-25-9 indicates that "when recognizing interest income on purchased credit-impaired financial assets, an entity shall not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition." It also indicates that the allowance for PCI assets "shall be an estimate of all contractual cash flows not expected to be collected." The Board intends for this to result in the impairment accounting model for originated, non-PCI, and PCI assets being the same after acquisition.

We believe the guidance in proposed ASC 825-15-25-9 is unclear about the meaning of "shall not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition." More specifically, it is unclear whether the interest income that should not be recognized relates only to the credit discount at acquisition (which would be a discounted amount to reflect the time value of money) or an undiscounted amount for the credit discount at acquisition.

Based on the perceived conflict between the "standard" part of the proposal and the Basis for Conclusions, we believe that there are two potential approaches to interest income as discussed below.



Approach #1

We believe one potential interpretation of recognizing interest income on PCI assets would have the income statement effect of grossing up interest income and recognizing a provision for credit losses in future periods (due to the time value of money). This would be because the FASB has indicated that the day one allowance would be recognized as an adjustment that increases the cost basis of the asset and that the allowance for credit losses would be an estimate of all contractual cash flows not expected to be collected. So, in other words, the effective yield would be multiplied by a cost basis that was "grossed up" by the day one allowance (not the cost basis in which the yield was determined). As a result, even if the entity's estimate of expected cash shortfalls was perfect at acquisition, a provision for credit losses would be required in each subsequent reporting period. This subsequent provision would offset the interest income recognized on the grossed-up asset.

Approach #2

However, the Basis for Conclusions (BC40) indicates that "recognizing interest revenue on the basis of contractual cash flows for all purchased assets could result in situations in which an entity accretes to an amount that it does not expect to collect, which would result in artificially inflated yields ... as such it is inappropriate to accrete from the purchase price to the contractual cash flows ... it is more representationally faithful to recognize yield by accreting from the purchase price to the cash flows expected to be collected at acquisition. As a result, the Board decided that the discount embedded in the purchase price that is attributable to credit losses at the date of acquisition of a purchased credit-impaired asset should never be recognized as interest income." This guidance included in the Basis for Conclusions appears to contradict the guidance included in proposed ASC 825-15-25-9.

Based on the guidance in the Basis for Conclusions, we believe that interest income would be recognized in a manner that is similar to ASC 310-30, such that no provision for loan losses is required in subsequent periods if there is no change in the acquirer's cash flow estimates. In other words, the acquirer would recognize a lower yield than would be the case under Approach #1 (as the yield determined in Approach #1 would be based on the cost basis of the asset without the credit loss adjustment gross-up).

Under the first approach, we believe an entity would (1) recognize interest income it does not expect to collect, which would need to be offset by a provision for credit losses in each future period, and (2) recognize a provision for credit losses in future periods, even if its estimate of cash flows at acquisition was perfect. In contrast, the second approach would appear to achieve the Board's objective in the Basis for Conclusions that "it is more representationally faithful to recognize yield by accreting from the purchase price to the cash flows expected to be collected at acquisition." However, Approach #2 would appear to be inconsistent with proposed ASC 825-15-25-1, which indicates that expected credit losses are a current estimate of all contractual cash flows not expected to be collected.

It should be noted that both approaches appear to result in the same net income recognized during a period; however, the amounts recognized as interest income and the provision for credit losses amounts would be different.



We would also be happy to share our models that illustrate the differences discussed above with the FASB staff.

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?

The proposed practical expedient would result in a different measurement of credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income as opposed to financial assets measured at amortized cost. It is not clear whether such measurement differences would or would not be significant to the statement of net income.

An entity would be prohibited from explicitly applying the practical expedient if the fair value of the financial asset is lower than its amortized cost due to factors other than credit risk, such as liquidity or changes in interest rates. As a result, the practical expedient may have limited applicability in certain stages of the economic cycle, such as during the recent credit crisis when many securities were underwater or in a rising interest-rate environment. Because fair value is impacted by things other than credit, we believe that the first criteria should be eliminated.

We also believe that additional guidance is needed as to how an entity may determine whether the expected credit losses are insignificant. Would one need to complete a quantitative analysis or could it purely be a qualitative analysis? If it is expected to be primarily a qualitative approach, we recommend that the guidance in ASC 320-10-35-33G and 35-33H be retained. We are unclear why the Board has chosen to supersede this guidance as we believe it provides helpful guidance in applying the proposed model to debt securities.

We also believe that the Board should articulate why an asset classified in FVOCI may potentially be scoped out of the impairment guidance under the practical expedient, but if the asset was recognized in amortized cost the entity would be required to recognize an allowance for credit losses.

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?



We do not believe that this would significantly change current practice for non PCI assets for financial institutions. The impact on non-financial institutions would be dependent on their interest income recognition policies.

As noted above we have significant concerns as to the interaction of the nonaccrual principle with the requirement that the allowance for credit losses represent the current estimate of contractual cash flows not expected to be collected. Refer to our response in the introductory section under "Nonaccrual concept appears incompatible with the requirement that the allowance for credit losses represent the current estimate of contractual cash flows not excepted to be collected."

In addition, we do not believe the proposal provides sufficient guidance to address other issues that are encountered in applying a nonaccrual principle. For example, when can an asset be removed from nonaccrual? How would the nonaccrual principle apply to specialized loan types such as reverse mortgages? If a loan is removed from nonaccrual and placed back on accrual status, would interest income be based on the original effective interest rate with a "pickup" at the end, or would the effective interest rate be adjusted upon removal from nonaccrual? Please refer to the definition of nonaccrual included the FDIC Call Report Glossary and other guidance included in the OCC Bank Accounting Advisory Series question and answer document, and consider this in providing additional implementation guidance or redrafting the nonaccrual principle.

Application of Nonaccrual to PCI assets

The proposal would require an entity to 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. It is not clear how this principle would be applied in the context of PCI assets and would appear to indicate that most PCI assets would be required to be placed on nonaccrual at acquisition and likely over the life of the loan. We believe the Board should clarify whether this was their intention.

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?

Continued relevancy of the TDR concept

We believe that the distinction between TDRs and nontroubled restructurings is less relevant under the proposed model in that it would no longer determine the impairment model to



consider (FASB Statement 5 versus FASB Statement 114) and "impaired loan" disclosures have been eliminated. The only relevancy of the TDR concept appears to be whether the effective interest rate on the modified asset should continue to be the original effective rate or the new effective interest rate. Further, we note that there is no TDR concept in IFRS.

Based on the decreased relevancy of the TDR concept under the proposal, the added disclosures about assets modified, and to achieve convergence with IFRS, we believe that the TDR concept should be eliminated from GAAP. We agree with the Board's view that an 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 and therefore the original effective interest rate should remain in effect. However, we believe that rather than retain the TDR concept, GAAP should presume that the original effective interest rate is maintained unless (1) the borrower is not experiencing financial difficulty, (2) the terms of the new loan resulting from a loan refinancing or restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, and (3) such modified terms are not more than minor.

We also note that under current GAAP, a loan restructured as a TDR must be reported as an impaired loan even though the loan is performing under the revised terms and an entity is only permitted in limited circumstances to discontinue reporting the loan as a TDR. This current GAAP requirement has led to various questions from investors as to why the number of impaired loans is so high even though the loans are performing. We believe that this should be considered by the Board in determining the continued relevancy of the TDR threshold.

Impact of a TDR

Under the proposed ASU (ASC 310-40-35-10) if an entity executes a troubled debt restructuring, the cost basis of the asset should be adjusted so that the effective interest rate (post-troubled debt restructuring) is the same as the original effective interest rate, given the new series of contractual cash flows. Under the proposed guidance, we believe that there are potential scenarios in which the cost basis of the asset would need to be adjusted upward in applying the guidance in ASC 310-40-35-10. We are unclear if the Board considered this in drafting the guidance or whether the Board truly meant that an entity should only charge-off the carrying amount of the asset that exceeds the discounted amount of the new series of cash flows.

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 that the disclosure package for financial instruments should be considered holistically once this project and the recognition and measurement project is completed, together with all existing disclosures and the disclosure framework project. We believe that complexity in the disclosures could be reduced by requiring a single disaggregation threshold, rather than requiring certain disclosures to be provided based on portfolio segment and certain disclosures based on class of financial asset.



We are unclear how the roll forward provides a financial statement user with information relevant to changes in the expected cash flows and believe that if such information may be more appropriately conveyed through a qualitative disclosure.

As a side note, the roll forward in proposed ASC 825-15-50-12 is missing the changes due to amortization and accretion.

The guidance in ASC 825-15-55-12 and examples provided in the illustration section of the implementation guidance (in other words the examples mentioned in ASC 825-15-55-16) should be expanded to include examples for debt securities and other financial instruments that would be subject to the proposed ASU besides just loans.

We are unclear about how the term "par" in ASC 825-15-50-18 would be applied to non-debt securities such as loans which do not have a "par" amount or are not described in terms of a "par" amount.

Proposed ASC 825-15-45-3 indicates that:

For recognized purchased credit-impaired assets within the scope of this Subtopic that are not measured at fair value with all changes in fair value recognized in current net income, an entity shall present the estimate of expected credit losses on the statement of financial position as an allowance that reduces the sum of the asset's purchase price and the expected credit losses on the asset at the time of acquisition.

We believe that the proposed language is confusing as it suggests that there are two separate allowances. Alternatively, we suggest that it should indicate that "an entity shall present the estimate of expected credit losses on the statement of financial position as an amount that reduces the carrying amount of the PCI asset." The carrying amount of a PCI asset should be separately defined and should consider subsequent changes that impact the carrying amount.

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 generally believe that the examples included in the proposed update are helpful; however, we do not believe they provide sufficient information to assist preparers in applying the model. For example, while example 1 beginning in proposed ASC 825-15-55-17 provides a good conceptual example, it does not address issues we have raised earlier in our comment letter. We believe additional implementation guidance is needed to make the proposal operational – for example, to explain how one would convert qualitative and/or quantitative factors and adjust historical loss data.

In addition, an example should discuss the day 2 accounting.



We also believe that implementation guidance is needed as to how one would apply the model for variable rate instruments. The Board should consider the existing guidance in ASC 310-30-35-28 which indicates:

If the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraphs 310-10-35-16 through 35-17. The creditor's choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

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

We agree that the transition should be a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. However as noted in our response to Question 23, it does not provide clear guidance for how certain changes between today's GAAP and the proposed ASU would be accounted for.

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

We agree that early adoption should not be permitted.

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?

We generally believe that nonpublic entities should be afforded a one year deferral. However, we encourage the Board to discuss this matter with the Private Company Council.

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

No. In particular, we believe that specific transition guidance is needed for financial assets currently accounted for under ASC 310-30, debt securities for which there has been an other than temporary impairment previously recognized, any indemnification assets related to items in this proposed ASU, and all purchased assets existing as of the transition date.

Transition considerations for loans currently accounted for under ASC 310-30 The following are implementation issues we believe need to be addressed at transition:



- A loan may be accounted for under ASC 310-30 today if it explicitly meets the scope of ASC 310-30 or if an entity has elected to apply the guidance in ASC 310-30 as an accounting policy election if certain criteria were met as discussed in the AICPA "Confirmation Letter."² It is not clear whether all loans currently considered "PCI" assets would meet the new definition or how an entity would go about determining whether a PCI asset would meet the new definition.
- If an entity's expected cash flows have increased since acquisition and therefore the entity
 has increased its yield under existing GAAP, would the entity need to adjust the effective
 interest rate upon transition to comply with the proposed model? How would it go about
 doing so?
- If an entity currently applies ASC 310-30 on a pooled basis, would it be permitted to apply the new model on an individual asset basis? If so, how would it go about determining the carrying amount and yield on specific loans?
- The new model would require an entity to bifurcate the credit and non-credit discount. For existing assets, when would an entity make the evaluation of the split between credit/non-credit (acquisition or transition date)? Or would the non-accretable yield (although not necessarily all credit related), be used as the credit discount with no non-credit discount?
- Would an entity that previously pooled loans for purposes of applying ASC 310-30 now be required to assess the individual loans for TDR classification given the removal of the scope exception provided by ASU 2010-18—Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force, provided the TDR concept is retained?

Other than temporary impairment

If an entity has previously recognized an other-than-temporary impairment in which it reduced the cost basis of the asset, it is not clear whether the entity would be able to "write the asset up" to comply with this proposed standard which does not require a write-down when there is credit impairment. We believe the transition guidance should specifically address this issue.

Loss Share Agreement

It is not clear whether any corresponding adjustment needed to a loss share asset would be subject to the transition guidance in this standard. We believe that any corresponding adjustments needed for the accounting for the loss share asset as a result of this proposed ASU should be given the same transition guidance.

Other purchased assets

We note that it may be possible that a purchased asset is not in the scope of ASC 310-30, but meets the criteria to be accounted for under the definition of a PCI asset. It is not clear whether an entity would need to determine if all purchased assets existing as of the transition date would be subject to the PCI guidance and if so, what date would the evaluation be made as of.

 $^{{}^2\ \}underline{http://www.aicpa.org/advocacy/financial reporting/download able documents/confirmation-letter-on-day-2.pdf}$



Further, how would an entity determine the original split between the credit and non-credit discount?

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 believe that the amount of time needed to implement the proposed guidance is significantly dependent on providing preparers with updated guidance on documenting the allowance for credit losses and practical means to adjust what they are doing today to encompass the proposed changes. We believe that based on the proposal, certain information required to be utilized in the proposal may be difficult for entities to obtain and evaluate. We believe that the proposed model would also have a significant impact on an entity's governance, models, internal controls, and processes. As such, we believe these changes will take three or more years to implement.