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Ms. Susan Cospers
Technical Director
Financial Accounting Standards Board
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File Reference No. 2012-260- *Proposed Accounting Standards Update, Financial Instruments – Credit Losses (Subtopic 825-15)*

Dear Ms. Cospers:

The Financial Reporting Executive Committee (FinREC) appreciates the opportunity to comment on the Proposed Accounting Standards Update (ASU), “Financial Instruments-Credit Losses.” FinREC continues to support the efforts of both the FASB and the IASB to develop a model that responds to the criticism received in the recent crisis regarding the current approaches in U.S. generally accepted accounting principles (U.S. GAAP) and the International Financial Reporting Standards (IFRS). While we strongly support convergence in this very important area, we agree that convergence should not be a goal more important than a high quality accounting standard.

Convergence provides substantial benefits for the financial markets. It would enable analysts to compare results of operations and financial positions for companies across the globe without needing to compensate for multiple accounting and reporting frameworks. Convergence would also be beneficial to preparers with operations in multiple jurisdictions, some of which report under both U.S. GAAP and IFRS. Having to maintain more than one financial reporting system has significant costs and adds much complexity to entities’ reporting process.

We believe the current expected credit loss model (or CECL) proposed by the FASB, as well as the current IASB proposal, still requires significant work in order for it to be operational and result in an improvement in financial reporting that is representationally faithful. Specifically, we observe that the FASB’s proposed model:

- Lacks a strong enough conceptual basis for sound financial reporting;
- Departs significantly from the incurred loss model;
- Creates two incompatible loss contingency models;
- Double counts expected losses; and
- Creates an increased but unjustifiable accounting and financial reporting burden for smaller financial institutions and nonfinancial services entities.

Therefore, we encourage the FASB to continue to work with the IASB with the joint objective of developing a high quality, and converged approach, to accounting for credit losses.

As it pertains to the FASB’s proposed ASU, we provide below and in the Appendix to this letter more discussion regarding our above observations.

FinREC Comment Letter Proposed ASU on Financial Instruments: Credit Losses***Lacks a strong enough conceptual basis for sound financial reporting***

As constructed, this model does not provide a strong enough conceptual basis for sound financial reporting. Thus, consistent with our March 30, 2011 and September 30, 2010 letters to the FASB, we are reaffirming our position that “the incurred loss model for recognition of credit impairment should be retained since we believe losses should not be recognized until there is a triggering event.” Moving toward an expected full lifetime credit loss impairment concept needs to be justified on a principle basis, since it may have an important impact on the concepts underlying the fundamental principles of accounting beyond financial instruments impairment. We do not believe that such a significant change in U.S. GAAP is appropriate without properly articulating a strong principle with a sound conceptual basis that could be used as a foundation in all impairment considerations.

It is unlikely that financial institutions’ expectations about the future would have predicted the extent of the losses that was realized in the recent financial crisis. Therefore, introducing guidance that would result in earlier and increased loss recognition as a means to provide a shield of protection against future losses does not provide a satisfactory resolution to the concern that the incurred loss model is inadequate. In fact, this action compromises the fundamental accounting principle that losses are recorded when incurred, rather than when there is a possibility that they may occur in the future. The proposed CECL model appears to contradict the Basis for Conclusions in FASB Statement No. 5, which concluded that “accounting accruals do not provide protection against losses.” Thus, it would be helpful if the FASB would explain how this proposed model reconciles with this fundamental principle.

Finally, we are concerned that the proposed CECL model is inconsistent with the economics; thus, it is not representationally faithful. That is, while credit losses on financial assets would be recognized on day one, the interest revenue to be generated by the asset is recognized only as time passes until the instrument matures. We do not believe potential future credit losses should be recognized on day one, since as a factual matter the entirety of a financial asset’s losses do not occur at inception.

Departs significantly from the incurred loss model

The proposed impairment model is a significant departure from the incurred loss model in ASC 450, *Contingencies* (f/k/a FASB Statement No. 5 or FAS 5), which is broadly applicable to loss (and gain) contingencies beyond the topic of credit loss reserves and the financial services industry (e.g., litigation loss contingencies and natural disasters). Moreover, beyond removing financial instruments from the scope of ASC 450, the ASU does not explain the distinctions between financial instrument losses and other loss contingencies that justify a separate accounting model for impairments of financial instruments that are not measured at fair value.

Creates two incompatible loss contingency models

We are concerned that, in FASB’s effort to create a single credit impairment model, the Board would be creating two incompatible loss contingency models – the proposed CECL model that would be required for financial instruments and the current incurred loss model that would continue to be used for all other loss contingencies. It is unclear why certain loss contingencies should now be accounted for differently from the current model in ASC 450, noting that paragraph 57 of the Basis for Conclusions in FAS 5 indicates, “The Board has concluded that loss contingencies such as those given as examples in paragraph 4 of this Statement have common characteristics and that questions about accounting for and reporting of those contingencies should be resolved comprehensively.” The

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examples in paragraph 4 include various loss contingencies (besides the collectability of receivables) that would not be in the scope of the proposed ASU. If the FASB decides to go forward with the CECL model, we believe that the FASB needs to consider whether the accounting model for all loss contingencies should be revised to achieve consistency. However, as we do not favor an expected loss model, we would not support changing the literature related to other contingencies to conform to this proposal.

Double counts expected losses

The CECL model would double count expected losses. According to Concepts Statement No. 7, paragraph 41(b), “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.” The same paragraph further provides an example illustrating that when determining present value, contractual cash flows should be discounted using the rate that reflects expectations about future defaults (i.e., the effective rate). However, that same “rate should not be used to discount expected cash flows because those cash flows already reflect future default assumptions.” The CECL model, by first reducing the contractual cash flows to expected cash flows and then discounting these reduced cash flows at the financial asset’s original effective rate, clearly violates that fundamental principle.

Creates an unjustifiable burden for smaller financial institutions and nonfinancial service entities

We believe that the proposed approach of measuring impairment places a greater burden on smaller financial institutions and entities outside of the financial services industry that provide financing to their customers over longer terms. This population generally lacks the operational capacity and sophistication to apply this complex model. As a result, these entities will now be forced to bear the crux of the crisis by incurring significant, and unwarranted, implementation costs. Such costs include staff retraining, system reconfigurations or, in many cases, full system procurements. We believe that, especially for those companies, the potential costs of compliance with this approach outweigh the likely benefits to financial statement users.

The proposed disclosure requirements that will be imposed on small and mid-sized financial institutions, and other nonfinancial industries, also seriously warrant reconsideration. These disclosures are a significant increase over what is currently required. Companies would be required to derive their impairment estimates using complex calculations in areas where they may not currently have the historical and forecast data to support the estimates. To require such extensive disclosures is a contradiction to FASB’s current disclosure framework project, which seeks to streamline the information currently being reported for all entities. FASB should consider the impact of requiring these disclosures in relation to the goal of its ongoing projects aimed at improving relevance and reducing the reporting burden for small and mid-sized entities, nonprofits and private companies.

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FinREC’s Proposed Solution

While we favor the incurred loss model over FASB’s proposed CECL model, we acknowledge that the current incurred loss model needs improvement. In order to achieve a more timely recognition of incurred losses, we suggest lowering the threshold of when credit losses should be recognized from “probable” to “more likely than not.” If this proposal were accepted, we recognize that more specific

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criteria may have to be developed for the “more likely than not” threshold for consistent application in this context. However, the term, “more likely than not,” is currently used for uncertain tax positions. Thus, we believe that this is a better defined term (greater than 50%) and easier to understand.

In the event our recommendation in the preceding paragraph is not accepted, we also could support an expected loss model that incorporates limited forecasts of the future as long as they are supportable and based on reasonable objectively determinable assumptions. We believe such a concept is a compromise between the current incurred loss model and the FASB’s proposed CECL model as it would reduce the expected loss forecast estimate from over the life of the asset to some shorter foreseeable timeframe and builds on the currently used concept of an emergent loss period. We recognize that the term foreseeable timeframe, or *foreseeable future* as currently defined in the accounting literature, covers differing time horizons, depending on the industry and specific accounting standard. However, the FASB could use examples or implementation guidance to articulate how the term would be applied to a credit loss assessment.

We have provided more specific comments on the proposed ASU in the Appendix following this letter.

Representatives of FinREC and the Financial Instruments Task Force would be pleased to discuss our comments with you at your convenience.

Sincerely,

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Chairman, FinREC

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FinREC Comment Letter Proposed ASU on Financial Instruments: Credit Losses**Appendix****Additional Observations**

We note and are also concerned that the effect of the current proposal will be to increase recognized losses significantly upon adoption of the final standard and at the inception of new financial assets, although over an asset's life the amount of these losses should ultimately be the same as under the incurred loss method. While we certainly understand the need for the FASB to reexamine its current guidance in lieu of the recent crisis, it is important to note that the current impairment guidance was not the root cause of it. While some contend that a contributing factor to the crisis was that the probable threshold for recognizing losses under the current incurred loss model is too high, given its severity, even if an expected credit loss model had been in effect in the years leading up to the crisis, it is unlikely that such a model could have anticipated losses of the magnitude experienced, since historical data would not have incorporated such large losses from prior periods.

Representational Faithfulness

We are concerned that the proposed CECL model is inconsistent with the economics; thus, it is not representationally faithful. We do not believe credit losses should be recognized on day one, since as a factual matter all of a financial asset's losses do not occur at inception. While credit losses on financial assets would be recognized on day one, the interest revenue to be generated by the asset is recognized only as time passes until the instrument matures. Thus, the proposed CECL model does not appropriately match the recognition of losses with the interest income that is inherent in the instrument to compensate the lender for these potential losses.

Further, consider the following example:

A technology company buys a AA-rated two-year bond in the market place and pays fair value of \$1,000. It classifies the bond as FV-OCI. Assume that industry-wide statistics show that historically AA-rated bonds can lose 1%. Also assume that the practical expedient is not elected.

Under the ASU, the technology company would recognize a day-one loss of \$10 in its income statement. In addition, because the bond has a fair value of \$1,000, it would write up the bond from \$990 to \$1,000 with a credit to other comprehensive income. (As a side note, had the bond been classified as FV-NI, the company would recognize no loss on day one.) We find these results problematic. They are not consistent with the economics and are not representationally faithful. The company did not lose \$10 on day one.

As another side note, assume that the technology company acquired bonds that had been downgraded over time to below investment grade at the time of purchase. Perhaps these bonds qualify as purchased credit-impaired financial assets under the ASU. If so, the technology company would establish the allowance for credit losses as part of purchase accounting, thus avoiding the day-one loss. Yet, had the technology company purchased a newly issued, below investment grade bond, it would record a day-one loss in earnings. Again, we find these varying results problematic.

FinREC Comment Letter Proposed ASU on Financial Instruments: Credit Losses**Time Horizon**

We could support a model that incorporates limited forecasts of the future as long as they are supportable and based on reasonable assumptions. We believe such a concept is a compromise between the current incurred loss model and the FASB's proposed CECL model as it would reduce the expected loss estimate from losses over the life of the loan (asset) to losses over some shorter foreseeable timeframe and builds on the currently used concept of a loss emergence period. We recognize that the term foreseeable timeframe, or *foreseeable future* as currently defined in the accounting literature, covers differing time horizons, depending on the industry and specific accounting standard. For example, ASC Topic 740-30-25-19 (formerly APB 23, paragraph 12) provides an exception to the requirement that a parent company accrue income taxes on undistributed earnings of a foreign subsidiary, and states: "If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the *foreseeable future* but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance; ..." In addition, ASC Topic 948-310-25-1 (f/k/a FASB Statement No. 65, paragraph 6) states: "A mortgage loan transferred to a long-term-investment classification shall be transferred on the transfer date. A mortgage loan shall not be classified as a long-term investment unless the mortgage banking entity has both the ability and the intent to hold the loan for the *foreseeable future* or until maturity." Thus, the term will need to be clearly defined and articulated. Should the FASB choose to leave it subject to interpretation, we suggest that illustrative examples be provided.

We also observe that, as FASB noted in BC 24 of the ASU, estimated losses during the "foreseeable future" may become increasingly subjective the further the forecast period is extended. While we recognize that under the CECL model future events need to be considered in determining the allowance, we believe the horizon should be limited to a period over which objectivity can be maximized, and potential manipulation can be minimized and that would encourage consistency across reporting entities. Because the entity will need to estimate future events (economic downturns in the market, people encountering hardships, etc.) and the periods in which those events will happen, it will be difficult for an auditor to obtain sufficient corroborative evidence to validate management's assumptions.

We also observe that the further management must forecast the timing of expected losses, the more difficult it will be to audit, particularly the further it extends beyond a 24-month horizon. Regulatory guidance indicates that generally institutions should use at least an annualized or 12-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses, but also indicates that this rate could vary. Thus, our recommendation also falls within regulatory parameters. Establishing a uniform look-forward period provides some consistency and offers the opportunity for comparability across companies within various industries.

Collateral Dependent Financial Asset

The proposed definition may create a substantial change in practice for certain financial institutions. The current definition in ASC 310 defines a collateral dependent loan *as a loan for which the repayment is expected to be provided solely by the underlying collateral*. It does not specify that repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral. The term "by the lender," as proposed, is not explicit currently and, as a result, practice varies. We support this change. However, while FASB's intention may have been to

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narrow its applicability, please expand the discussion so that constituents are aware of this change and explain the rationale for such change.

Fair Value

The definition of fair value in the Glossary in the ASU as “the amount at which an asset (or liability) could be bought (or incurred)” is not consistent with the definition found in ASC 820, which states that the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price).

Purchased Credit-Impaired (PCI) Financial Assets

The proposed definition in the ASU is slightly different from the current definition in ASC 310. ASC 310 defines purchased credit-impaired financial assets as loans with evidence of credit deterioration acquired by completion of a transfer for which it is probable at acquisition that the investor will be unable to collect contractually required payments receivable. The proposed definition requires that the financial assets have experienced *significant* deterioration in credit quality since origination. We are concerned that the proposed definition will make it more difficult for loans to qualify to apply the proposed model. Additionally, how would an entity define significant deterioration? We recommend that FASB retain the current definition in ASC 310.

Recognition

Regarding paragraph 825-15-25-9 of the ASU, when recording the allowance for expected credit losses for purchased credit-impaired assets at the acquisition date, shouldn't the charge-off principle also be considered if an entity knew at inception that there is an amount that will not be realized? In this case, why wouldn't the entity be allowed to write down the loan at inception rather than recognizing that amount as an allowance for expected credit losses?

For purchased credit-impaired loans that have been subsequently modified in a troubled debt restructuring (notwithstanding our request to remove the concept of TDR in the response to Question 16 below), clarification is needed as to whether those loans can remain in the pool or will have to be removed and independently evaluated individually for impairment.

In paragraph 825-15-25-10 of the ASU on interest recognition, the FASB applies the term “probable” to the entity receiving substantially all principal or interest. Please consider cross referencing this term to the current definition in ASC 450 (and ASC 310). In addition, please clarify how this guidance would apply to purchased credit-impaired assets.

Measurement

The proposed guidance presumes that every financial asset will have an associated allowance for expected credit losses. We do not believe it is prudent to make such a blanket inference, when evidence may exist on a granular level to disprove this presumption.

Write-Offs

Paragraph 825-15-35-1 of the ASU states, “an entity shall directly reduce the cost basis in a financial asset (or portion of a financial asset) within the scope of this Subtopic in the period in which the entity

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determines that it has no reasonable expectation of future recovery.” Please clarify how an entity should make this determination. How would an entity determine the triggering threshold that would meet these criteria? Would a recovery have to be all of the remaining balance or some portion? The FASB should consider providing examples adding more description in this section.

PCI Financial Assets Disclosure

Paragraph 825-15-50-18 of the ASU requires an entity to provide a reconciliation of the difference between the purchase price of the assets and the par value of the assets, including:

- a. The purchase price
- b. Based on the acquirer’s assessment, the discount attributable to expected credit losses
- c. The discount (or premium) attributable to other factors
- d. The par value

Financial assets such as loans are generally not described in terms of par value. Consider changing language to the principal amount.

Credit Impairment for Securities

We believe the ASU does not give sufficient guidance on how it should be applied to debt securities. As a result, significant implementation issues are certain to arise. For example, reporting systems may not collect all the information needed for the extensive disclosures which would be newly required for debt securities. With debt securities, the investor has no ability to negotiate with the issuer; thus, in the event of impairment, the investor may be very uncertain about how much it will likely receive. How would these circumstances be reflected in the requirement to calculate at least two scenarios under the discounted cash flow models?

In addition, determining the recovery on an impaired investment security under two scenarios may consist of discrete outcomes and distinct conclusions depending upon the outcome of a specific event, resulting in either zero loss or some undetermined amount that would be decided by the bankruptcy courts. It would be helpful if the FASB provided an example to demonstrate how this guidance would have been applied in 2008 when the government bailed out certain financial institutions. At that time, the loss scenarios were 1) zero, in the event the government went forward with the bail-out, or 2) some significant undetermined amount (a high likelihood of 100% loss) if the institution were to be declared insolvent. Would the FASB suggest weighting each possible outcome at a 50% probability to measure the expected loss and later reverse the expected loss when the government agreed to the bail-out?

Finally, how would you determine when a debt security reaches the significantly impaired threshold for the special treatment for purchased credit-impaired assets? Guidance is also needed on when it would be appropriate to evaluate credit impairment for a single security vs. a pool of securities.

Credit Impairment for Trade Receivables

More clarity is needed on how to apply the proposal to trade receivables. We believe the current model works for current short-term trade receivables and they should be outside the scope of the ASC, while long-term financing trade receivables are appropriately included.

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Issues Clarified in the Staff Q&A

The issuance of the FASB Staff Paper titled, Proposed ASU Financial Instruments Credit Losses, Frequently Asked Questions, dated March 25, 2013 was very helpful in clarifying many concepts ambiguous in the proposed ASU. However, we point out that the staff's Q&A technically cannot be considered authoritative guidance. We believe that many of the points made within this Q&A should be codified into GAAP. For example, Question 13 of the Q&A describes two alternative methods for adjusting historical loss experience for current conditions and reasonable and supportable forecasts about the future that was not found in the proposed ASU. Those two methods are:

- 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).

The staff indicated that the proposed guidance would not preclude using either of these approaches. We believe that this is useful implementation guidance for preparers once finalized. However as time passes, we are concerned that without codification this clarifying response, as with others found only in the Q&A, may be overlooked or not even considered because the Q&A is the opinion of the FASB staff and not the official position of the FASB. As such, we believe that such clarifying points should be included in the final ASU.

Other Presentation Matters

Paragraph 825-15-45-3 of the ASU indicates that "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." This proposed language is confusing and suggests that there are two different allowances. We recommend that this language be revised.

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FinREC Comment Letter Proposed ASU on Financial Instruments: Credit Losses**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?

Response

We have concerns with the scope of this proposal. Regarding the overall scope, the FASB should reconcile the conclusions reached in the CECL model regarding recognition of expected losses for financial assets with the guidance formerly in FASB Statement No. 5 and currently in ASU 450. Why would the proposed guidance only apply to credit losses on financial instruments and not to the other types of contingencies covered in ASC 450?

As it relates to Not for Profits (NFP), promises to give should be scoped out of this document as they do not represent extensions of credit. These are promises to make a future contribution that are not the same as exchange or similar transactions resulting in the extension of credit. Because promises to give are the result of nonreciprocal transactions, the NFP accepts but does not negotiate terms, obtain collateral, or require credit reports or financial information from donors. The decision is not whether to extend credit, rather to determine fair value upon receipt of a promise and then to wait patiently for the payment. In determining fair value, information about the donor's ability to pay is primarily based on demographics, the donor's reputation (including history of paying past promises) and public information. Most NFP entities do not obtain information on donors that would be tantamount to conducting a credit risk analysis. Thus, it is not practicable to apply all of the expected loss model and the related disclosures, not cost beneficial and not useful to users of the financial statements.

In addition, loans provided by NFP entities for program purposes should be scoped out of this pronouncement because they are also not an extension of credit in the typical sense. Such loans, as described in chapter 8, "Programmatic Investments," of the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, have as their primary purpose the achievement of the NFP's programmatic mission. They include microfinance, economic development, and even student financial aid that are provided to individuals who, generally, do not have creditworthiness. Stated interest rates on programmatic loans are normally below market compared to loans of similar credit risk, often at very low rates and sometimes without interest. Loan terms vary based on the needs of the borrower, the type of program or project, and the needs and expectations of the NFP. Sometimes, this includes loan forgiveness upon changes in conditions or achievement of certain programmatic goals. These transactions are structured as "loans," rather than "grants," because loans are believed to motivate the recipient more than a grant would and because any loan repayments will provide funding for future program purposes, reducing reliance on future contributions. Return on investment is not the primary objective. It is often the case that NFPs will not pursue collection of loans that become delinquent, because the loan program exists to further the NFP's mission rather than to make a profit.

Loans to participants in defined contribution pension plans should also be specifically excluded from the scope of this ASU. The objective of this proposed Standard is to provide guidance on how an entity should recognize and measure expected credit losses on financial assets on the basis of an entity's current expectations about the collectability of contractual cash flows. As the FASB acknowledged in ASU 2010-25, because of the unique nature of loans to participants in defined contribution pension plans, a plan would not incur credit losses on those loans. Participant loans are

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not an extension of credit to an employee, but rather a loan from the participant's vested account balance; a participant taking out such a loan essentially borrows against his own individual vested account balance. If a participant were to default, the participant's account balance would be reduced by the unpaid balance of the loan with no effect on the plan's investment returns or any other participant account balances. Furthermore, participant loans cannot be sold by the plan. As such, the evaluation of the collectability of participant loans would provide no benefit to the users of defined contribution pension plan financial statements.

The ASU needs to clarify whether financial guarantees are within the scope. The scope for financial guarantees is explicitly stated in the Exposure Draft, Financial Instruments – Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities (recognition and measurement ASU) and this ASU should also make it clear. Furthermore, The Board recently decided which guarantee contracts will be in the scope of the new insurance contracts standard, but it would be helpful to have this guidance clearly describe when a contract might be in scope for the impairment model. Moreover, if there is a timing difference in effective dates with the insurance contracts standard, guidance should be provided as how to proceed in the interim periods.

Finally, we believe that measurement of all insurance related balances (including insurance receivables, reinsurance receivables, and policy loans) should be addressed in the insurance contracts project, and excluded from the financial instruments project.

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

Response:

We have concerns about the operability and auditability of certain aspects of the proposal. Both the entities and their auditors will face challenges. Entities will be required to clearly document the support for assumptions used and develop controls to validate selected forecast assumptions internally. This will be a challenging exercise because the loss data most entities currently use typically represents one year of losses and not lifetime losses. Additionally, entities' ability to look forward into the future diminishes greatly the further an entity is required to do so.

Auditors will need to look at how the entity has developed its estimate and the controls around it. While auditors currently perform audit procedures on forecasts relating to recorded account balances, it may be more difficult to test the accuracy of whether an entity used reasonable and supportable forecasts that affect the expected collectability of the asset's remaining contractual cash flows over the life of the asset. Therefore, the FASB should consider shortening the timeframe to a foreseeable future concept as discussed in our cover letter. At a minimum, the ASU should specify that forecasted cash flows should be for the weighted average expected lives of the assets.

Auditors commonly develop their own estimate of an impairment reserve, may back-test the actual losses compared with the reserve and/or evaluate client internal control processes and whether appropriate data is being used. Auditors would have difficulty coming up with their own estimates for

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the future in developing an estimate of the impairment reserve that would be useful in evaluating the adequacy of the clients' credit loss reserves. With respect to back-testing, this is easy to do in an incurred loss model, but would be more complex with a forecast.

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 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 that reflects current conditions and reasonable and supportable forecasts until such time an entity can build up its own internal loss data?

Response

We do not foresee significant issues with financial institutions being able to acquire the historical data to support their forecast assumptions for loans, if limited to a 24-month period and it is not available internally, since there are certain rating agencies that publish data which could assist them in forecasting losses for public companies. However, a non-financial institution with a limited number of receivables from non-public or unrated entities could not utilize data from such agencies and would likely not have its own historical data upon which to base forecast assumptions. Additionally, to forecast credit losses for securities may be more difficult since the model is new and entities do not currently maintain a data base of expected losses for securities.

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?

Response

When using a discounted cash flow methodology, the ASU requires at least two separate calculations. What is not clear is how the ASU expects the two calculations to be weighted when determining the amount of impairment to be recorded, if a Concepts Statement No. 7 calculation of present value is not required. We believe that using the "best" (i.e., most likely) estimate is more appropriate and the FASB could preclude a zero estimate if that is its concern. An example illustrating how the Board expects this to be applied would be helpful in the implementation guidance, particularly when done for a single loan or long-term receivable and a debt security (where there is no ability to negotiate with the issuer). Additionally, consider providing an example of a case where an entity has to prepare two scenarios where one loss scenario has a very low probability of loss occurring, for example, less than 1% and out many years in the future.

Paragraph 825-15-25-5 indicates that, "...a probability-weighted calculation that considers the likelihood of more than two outcomes is not required." Please clarify the meaning of this concept. How would an entity estimate expected credit losses without doing some form of a probability

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weighted approach? We believe the FASB should continue to allow an entity to use its best estimate as an alternative measurement approach.

Additionally, the CECL model seems to be in conflict with the proposed revenue recognition model, which says that an entity can determine the transaction price of the receivable using its best estimate. However, the proposal would preclude the entity from applying a best estimate for reserving for the day-one credit loss.

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?

Response

Paragraph 825-15-55-3 of the ASU requires that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Time value is currently not taken into consideration when using loss-rate, roll-rate or probability-of-default methodologies (except to the extent those methodologies apply loss rates to an amortized cost book value). That is, these methods do not take the timing of losses into account in determining their loss rates. Thus, it is unclear how the FASB believes that these methods would implicitly include the time value of money. It is imperative that the FASB clearly articulate how these other approaches implicitly meet such requirement so that constituents can evaluate whether other approaches not contemplated by the FASB would or would not meet this requirement. We do not object to the ASU permitting these methods, however, as acceptable alternatives to a discounted cash flow methodology.

Additionally, the proposed guidance indicates that a discounted cash flow model is an example of a method that explicitly reflects the time value of money by forecasting future cash flows (or cash shortfalls) and discounting these amounts to a present value using the original effective interest rate. As pointed out in our cover letter, this approach includes a fundamental flaw because it double counts expected losses. When discounting cash flows expected to be collected, the FASB should provide for the use of a risk-adjusted rate.

While discounting seems conceptually appropriate under the “full life-of-asset” approach proposed when using a discounted cash flow methodology, we do not believe that the added complexity that discounting entails will yield meaningful financial reporting benefits to users when using the methods the ASU deems to implicitly incorporate the time value of money. For assets with shorter lives, discounting only adds complexity without a significant difference in results.

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-

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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?

Response

We do not foresee difficulty in identifying credit losses expected at the date of acquisition, since entities must currently identify the portion of the purchase discount not expected to be collected (the non-accretable difference). However, it is unclear how this requirement would be implemented upon adoption of the ASU for existing purchased credit-impaired loans. FASB should provide guidance in the final standard. Furthermore, see our response to Question 20.

Please explain why the proposed PCI guidance is acceptable for PCI assets but not for non-PCI assets. Please also explain why the FASB has concluded that they should be accounted for differently.

Additionally, please clarify the proposed treatment of purchased assets that are not credit impaired. Is this the same as for originated assets?

Question 14: As a practical expedient, the proposed amendment 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 assets 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?

Response

We are concerned that many high quality financial assets will not meet this practical expedient. In the case where a financial asset's fair value changes solely due to changes in interest rates, condition (a) would likely not be met in a rising interest rate environment. We believe the criteria for qualifying for this expedient need to be revised so only changes in fair value due to changes in credit would affect eligibility. Alternatively, eliminate the first criterion altogether. Fair value is not relevant in this context when dealing with credit losses.

Also, if the intention is that the practical expedient be used only for high quality financial assets, please define the term "high quality." Will an entity be allowed to define high quality as being AA or higher, as is currently interpreted in applying EITF 99-20? In evaluating whether the amount of credit loss is insignificant, will a qualitative, rather than quantitative, assessment be acceptable?

Furthermore, please explain why the practical expedient does not apply to financial assets recorded at amortized cost. It is unclear what the FASB is trying to achieve. The practical expedient should also apply to assets carried at amortized cost, such as trade receivable customers in good standing. Moreover, consider the case where the same financial instrument is held in both the Amortized Cost category and the FV-OCI category. A situation would then arise where the asset in the FV-OCI

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category qualifying for the practical expedient would have no allowance for credit losses, while the same asset in the Amortized Cost category would have an allowance. We believe this inconsistency is inappropriate.

Question 15: The proposed amendments would require that an entity place financial assets on nonaccrual status when it is not probable that the entity will receive substantially the entire 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 the proposed amendment?

Response

Further clarification is needed of whether the definition of “probable” in this paragraph is intended to be the same as in ASC 450. In applying paragraph 825-15-25-10 of the ASU to purchased credit-impaired assets, we believe the appropriate standard would be to determine the probability of recovering the “purchase price” rather than the “principal.” Under current financial industry practice, purchased credit-impaired loans are rarely considered non-accrual, since they continue to accrete purchase discount and this concept is generally not applied to debt securities. While we acknowledge that there are differences with current regulatory practices, they are for the most part consistent.

We are also uncertain how a non-accrual concept would be applied to debt securities and other financial assets carried at fair value through other comprehensive income. Currently, the change in fair value (mark-to-market) of an AFS debt security is allocated between contractual interest income and OCI. If interest income could not be accrued, the entire mark-to-market would be recorded in OCI.

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?

Response

We do not believe that the distinction between troubled debt restructurings (TDRs) and nontroubled debt restructurings will be relevant under the proposed model, since such a designation would not impact the determination of the impairment reserve under the CECL model. Discontinuing the current accounting for TDRs would bring U.S. GAAP closer to convergence with the IASB standards as the TDR concept is nonexistent in IFRS as an accounting concept. However, we believe that providing disclosure of the types and amounts of modifications provided would continue to be appropriate.

However, if a distinction is made to require preparers to categorize TDRs separately, we have concerns regarding the requirement to write off the difference between the asset’s purchase price and the expected credit losses on the date the loan is recognized as a TDR. We believe this is punitive and

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does not allow for management's changes in its estimates to be reflected in the allowance nor does it allow improvements in the credit expectation until the cash is recovered.

Likewise, it does not make sense to preserve the original interest rate, since the credit environment may have changed. A concession may lead to a write-off (since write-offs of other assets are judgmental), but it is mandatory in this proposal. The difference is not justified.

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

Response

FASB's intention to require that these disclosures be provided on an interim basis will add a significant burden to financial reporting. It may also overburden users of the financial statements and appears to be counter to the goal of the disclosure framework project currently under way that strives to reduce reporting complexity.

Paragraph 825-15-50-8(c) of the ASU requires an explanation of the economic circumstances that caused changes in the allowance for expected credit losses. We believe such a discussion could require disclosure of proprietary information about the company's forecast assumptions. Moreover, such a discussion of forward-looking items is not appropriate in the financial statements. Rather, it would be more appropriate in Management's Discussion and Analysis.¹

The disclosures proposed for a roll forward for certain debt instruments are currently not done. Much of this information is already in the cash flow statement, albeit not disaggregated. We question whether it is decision useful information to provide a roll forward of debt instruments. Also, if this required disclosure is kept in the ASU, the required components of the roll forward are missing amortization and accretion.

The ASU requires that all debt securities have an allowance for expected credit losses, so securities will become subject to the current extensive disclosures for financing receivables in ASC 310-10-50-11B and 11C (paragraphs 825-15-50-9 and 10 of the proposed ASU). We believe the disclosures are more applicable to loans than debt securities.

Paragraph 825-15-50-15 of the ASU indicates that an entity shall disclose a reconciliation of the difference between the fair value and amortized cost for assets measured at fair value with qualifying changes in fair value recognized in OCI (if all of the following items are not already presented on the balance sheet – amortized cost, allowance for expected credit losses, accumulated amount needed to reconcile amortized cost less the allowance for expected credit losses to fair value, and fair value). We do not believe the information is meaningful as it is easily calculated from information already disclosed.

In paragraphs 825-15-55-12 and 13 of the ASU, we note that many of these proposed disclosures have been previously exposed in earlier draft guidance (e.g., staff draft on financial statement presentation). The disclosures as proposed again by the FASB would significantly increase the existing disclosure

¹ Please refer to our separate comment letter on the FASB's Disclosure Framework (File Reference No. 2012-220) dated December 11, 2012.

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requirements, are extremely burdensome to comply with and may not provide decision useful information.

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?

Response

We believe that the implementation guidance and illustrative examples are not sufficiently clear and need to be more robust. For example, in the illustrative example in paragraph 825-15-55-41 of the ASU, it would be helpful to discuss the subsequent accounting for noncredit discount and the allowance. Perhaps a footnote could be added that articulates that the \$75,000 will be accreted into interest income over the life of the loan while the \$175,000 will grow (due to discounting), which will go through the provision. In addition, we believe it would be useful to include one of the examples in SOP 03-3, such as accounting for changes in cash flows, in addition to the zero coupon bond example provided below.

In addition, none of the implementation guidance addresses application of the ASU to debt securities (a single security and a portfolio of securities) and a revolving loan portfolio. This is an important omission which should be rectified. Furthermore, as indicated earlier, an example of a single (not portfolio) longer term receivable from an unrated company is needed. Please provide numeric examples.

Consider adding the following to better illustrate Example 6 in the ASU:

Assumptions

- Zero coupon bond par \$100 at maturity
- Matures in 5 years
- “Expected” collection at maturity of \$80
- Purchase price \$50 results in expected yield of 9.856%
- Over the remaining life of bond, initial estimate unchanged (assumes original estimates were perfect)
- The zero coupon bond qualifies for the amortized cost category under the proposed ASU Sub-Topic 825-10

Journal Entry on Date of Purchase

Bond—par amount	\$100.00	
Bond—noncredit discount		\$37.50 (1)
Allowance for credit losses		12.50 (2)
Cash		50.00

- (1) This is discount needed to yield 9.856% on a purchase price of \$62.50 to collect \$100 at maturity, i.e., isolating the credit loss in accordance with the definition of “Effective Interest Rate” in the Master Glossary, which states, in part: “For purchased credit-impaired financial assets, however,

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the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition.”

- (2) Present value at 9.856% of amounts not “expected” to be collected of \$20—see paragraph BC 16 of the ASU

Activity over Life of Bond and Journal Entries

	<u>Day 1</u>	<u>Over 5 Years</u>	<u>One Day Before Maturity</u>
Par	\$100.00	--	\$100.00
Noncredit discount	(37.50)	\$37.50	--
Allowance for credit losses	<u>(12.50)</u>	<u>(7.50)</u>	<u>(20.00)</u>
	<u>\$50.00</u>	<u>\$30.00</u>	<u>\$80.00</u>
Noncredit discount	\$37.50		
Provision for credit losses	7.50		
Interest income		\$37.50	
Allowance for credit losses		7.50	
Cash	\$80.00		
Allowance for credit losses	20.00		
Par		\$100.00	

Income Statement

Interest income	\$37.50
Provision for credit losses	<u>(7.50)</u>
Net interest income	<u>\$30.00</u>

Some believe that while consistent with the standard part of the proposed ASU, accruing \$37.50 of interest income and adding \$7.50 to the allowance through the provision for credit losses in the example above (rather than accruing \$30.00 of interest income) is inconsistent with paragraph BC40 in the Basis for Conclusions. They hold this view because it appears that the procedures called for by the proposed ASU result in the entity's accruing interest “to an amount that it does not expect to collect.” In BC40, the Board says 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.” In the example above, the investor paid \$50.00 and expects to collect \$80.00 resulting in a yield of \$30.00. While the example results in a net of \$30.00 to income, the display is different. The Board should explain and reconcile between the proposed standard and the Basis for Conclusions.

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

Response

We agree with the transition provision in the proposed ASU that would require a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance becomes effective. We believe that the effective date should be no sooner than three years after issuance of the final standard.

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Also, we ask the FASB to clarify how the transition provision would be applied to ASC 310-30 loans (formerly SOP 03-3 loans) and debt securities (also see response in Question 13). Should entities assume that the yield at acquisition has not changed? Should pools set up initially be retained or updated? Should an impairment allowance be established at the transition date for existing SOP 03-3 loans so they are presented at an amount gross of the impairment reserve?

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

Response

We would not object to an entity being able to choose early adoption, as long as they also elect to early adopt the proposed ASU Subtopic 825-10 on classification and measurement.

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?

Response

We believe that the FASB should provide additional time, at least one year, for nonpublic entities to adopt this ASU.

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

Response

We believe that the transition provision is operable with the clarifications discussed in our response to Question 20.

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?

Response

We think that three years would be sufficient for a large public entity to implement the proposed guidance. It would require some system modifications since, while some entities currently have the historical information available, it may not currently reside within the financial reporting system. Thus, many entities will have to build new systems, or revise existing ones, to comply with some aspects of this proposal. In addition, developing forecast assumptions and incorporating them into the existing loss-rate, roll-rate or probability-of-default models will take time.