

April 1, 2011

Mr. Russell G. Golden
FASB Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2011-150

Dear Mr. Golden:

We are pleased to comment on the supplementary document entitled “*Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, Impairment.*” While we support the Board’s efforts to reach common ground with the International Accounting Standards Board (IASB), we have some significant concerns with the proposed approach, primarily because we believe that it would introduce unnecessary complexity to the measurement process.

Under existing guidance, the impairment allowance for open portfolios of loans is generally determined under a “FAS 5” approach and entails applying estimated loss factors to the outstanding balance within each loan pool or segment. Under the common approach proposed in the supplementary document, not only would separate and distinct computations of impairment allowances be required for the ‘good book’ and the ‘bad book’ portions of open portfolios, but also the determination of the impairment allowance for the ‘good book’ portion itself appears to necessitate multiple computations of expected losses for various time frames. Minimally, reporting entities would need to separately compute time proportional expected credit losses and credit losses expected to occur within the foreseeable future for each segment within the ‘good book’ open portfolio. However, it appears that the Board expects more than just these two computations. Specifically, in paragraph B7 of the supplementary document, the Board states that “*As a practical matter, for pools of financial assets with longer expected lives, determining the time-proportional allowance amount would involve developing expected loss estimates for both shorter-term and medium-term time periods and for time periods that are farther into the future.*”

Coupled with this is the additional complexity and subjectivity of continuously establishing the weighted average expected life for each ‘good book’ segment of an open portfolio, with consideration given to defaults, extensions, prepayments, renewals and any other factors that cause the expected life to differ from the contractual life.

As noted in the introductory section of the supplementary document, the Financial Crisis Advisory Group identified the complexity of multiple impairment approaches as one of the two primary weaknesses in accounting standards and their application. We have identified several areas where the proposed common approach would increase, rather than decrease the level of complexity from the existing FASB model as well as the model proposed by FASB in the May 2010 exposure draft on financial instruments. For these reasons, we favor the FASB preferred approach to recognize expected credit losses for the foreseeable future over the proposed common approach or the preferred IASB approach. Our responses to specific questions raised in the exposure document follow.

Question 1: *Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?*

Regarding the requirement to recognize the higher of time proportional expected credit losses or credit losses expected to occur within the foreseeable future for the 'good book', we believe the requirement to estimate time proportional expected credit losses adds unnecessary complexity and does nothing to address the perceived issue of delayed recognition of credit losses.

With regards to the application of the proposed approach to 'good book' loans, we believe that whether it will address the issue of delayed recognition of credit losses will vary between reporting entities depending on how each reporting entity defines and interprets the term "foreseeable future". Without examples or guidelines as to how to define the foreseeable future, we suspect that many reporting entities may default to the use of the minimum twelve month period, which would likely result in an estimated allowance that approximates what is computed currently under existing guidance for homogeneous loan pools. This is consistent with the Board's observations from outreach activity as noted at paragraph BC82 in the supplementary document. ("*The FASB learned from many constituents . . . that forecasting and recognizing impairment losses for the twelve months after their reporting date may not significantly change current allowance balances.*") Others may interpret the term foreseeable future in such a manner that loss recognition would extend well beyond those losses that have been incurred at the balance sheet date. Thus, if this model is ultimately adopted, we believe that the Board should provide examples or guidelines demonstrating the principles for identifying the foreseeable future that promote the objective of timely recognition of credit losses.

With regards to loans in the 'bad book', it is hard to predict the impact without guidance as to how losses on the bad book will be determined for open pools, when it would be appropriate for an asset to be moved out of the pool and evaluated individually and if and how the allowance will be adjusted upon movement from the good book to the bad book or out of the 'bad book' pool to an individual evaluation. Paragraph B3 of the supplementary document acknowledges that entities manage "bad" assets on an individual basis. It is not uncommon for assets that are reviewed individually to appear to be fully recoverable based on a strong collateral position that if evaluated as part of a pool would likely have allocated some level of expected loss. Absent this potential issue, we would anticipate additional upfront loss recognition given the elimination of the "probable" threshold for impairment.

With regards to the application of the proposed approach to debt securities, as noted in the supplementary document at paragraph BC24, the Board believes debt securities will more often be evaluated individually due to unique risk characteristics. We are in agreement with this viewpoint and are uncertain how this guidance would be applied to debt securities, which to date have been evaluated individually (or in lots of identical securities). As such, we believe that field testing would be warranted to determine if such an approach were applied to open portfolios of debt securities, the desired outcome would be achieved. If the decision is made that debt securities should be subject to the proposed approach, this is an area where implementation guidance would be useful in making the determination of when it would be appropriate to group certain securities and how to estimate expected losses on a pool basis.

Question 2: *Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?*

On the surface, it appears that the proposed model would be at least as operational for closed portfolios and other instruments as it is for open portfolios. We would recommend that field testing occur prior to the finalization of the standard to ascertain that any proposed method(s) is operational and achieves the desired objectives of reducing complexity and timely loss recognition.

Question 3: *Do you agree that for financial assets in the 'good book' it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or why not?*

As stated in our introduction and our response to Question 1, we believe that the use of a time proportional approach to establishing an allowance for impairment does not address the perceived issue of delayed recognition of losses and adds unnecessary complexities to the process of establishing the allowance for the 'good book' given that ultimately, a floor will be invoked to ensure losses for the foreseeable future are recognized.

We believe that the FASB preferred model of recognizing expected credit losses for the foreseeable future is more appropriate, assuming that guidelines and examples are provided with regards to the determination of the foreseeable future and when it may be appropriate to shorten or extend that time period. In addition to the computational complexities involved in estimating life time expected losses and recognizing them time proportionately, we do not believe that it is possible to estimate lifetime expected losses on long-term assets with the level of precision that would make such estimates meaningful. By definition, foreseeable future is the future time period for which reasonable and supportable information exists to support specific projections of events and conditions for that period. Therefore, the implication is that estimated expected losses beyond the foreseeable future are imprecise, making auditing such estimates extremely difficult and presenting opportunities for earnings management. Our views appear to be consistent with observations noted throughout the supplementary document including paragraph BC20 ("*FASB believed that entities could not feasibly forecast macroeconomic factors and economic cycles through the life of financial assets with a sufficient degree of reliability*") and paragraph BC 27 ("*Most investors...agreed that it is difficult, and some think impossible, to forecast total credit losses and the timing of those credit losses over long periods of time*"). Last but not least, we are concerned that a focus on lifetime expected losses considers losses that have not been incurred based on conditions and events occurring through the measurement date.

Question 4: *Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?*

We believe the mechanics of the calculation, as demonstrated on pages 51 and 54 of the supplementary document are easily understood. However, as noted in our response to Question 3, the difficulty would lie in forecasting losses throughout the life of a long-term asset with enough precision to make the estimate meaningful. We believe that any perceived benefits of time-proportional recognition do not justify the time and effort it would take to perform this separate computation for comparison to the expected credit losses for the foreseeable future in determining the impairment allowance for the 'good book'. As indicated in paragraph BC28 of the supplementary document, information indicates that losses tend to occur early in many assets' expected lives. Lastly, introduction of a time proportional approach for the 'good book' necessitates that a different approach be used for the 'bad book' as most agree that it is not appropriate to defer losses on the 'bad book'. One of the goals of the financial instruments project is to eliminate numerous methodologies for determining impairment.

Question 5: *Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?*

We do not believe that the proposed approach of using time-proportional recognition of credit losses would be useful for decision-making because (a) the information would not be sufficiently reliable and (b) recognizing the losses on a straight-line or annuity basis would simply be an arbitrary allocation of losses over the estimated life of the assets.

Question 6: *Is the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?*

The principle is clearly described in B2. A loan is included in the 'bad book' when the uncertainty about the collectability of an asset has taken precedence over its profitability from the interest charged. However, the guidance for applying the principle is less clear. Paragraph B3 states that an entity shall differentiate between the two groups on the basis of its internal credit risk management. Some community banks move loans to a special assets division when the loan is classified as "watch" while others would not move a loan to the special assets division until the loan is classified as "substandard". Paragraph B4 suggests that a loan would not be moved to the 'bad book' until it was classified as doubtful. We believe that this demonstrates that the proposed model would result in a divergence of comparability between reporting entities. Additionally, paragraph B3 provides examples of actions that would imply management's objective has changed to one of recovery of the asset, and hence the asset would be moved to the 'bad book'. Most of the actions listed such as enforcing security interest, debt restructuring and breach of debt covenants occur after we would consider a loan to be impaired under current guidance. Thus, we fear that the guidance as proposed may be interpreted in such a manner that loans considered impaired under existing guidance could be considered 'good book' loans under the proposed guidance. As such, we recommend consideration be given to retaining the FASB's current definition of loan impairment for purposes of identifying the 'bad book' ("probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement") with consideration given to changing the threshold from "probable" to "more likely than not".

Question 7: *Is the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?*

As noted in our response to Question 6, we believe that the differentiation will be interpreted in vastly diverging manners and believe it may be preferable to maintain the current definition of impaired rather than introduce a new methodology for distinguishing between the 'good book' and the 'bad book'. If the distinction is maintained as proposed in the common approach, guidelines and examples would help make differentiation more operational and auditable. Additionally, clearly articulated enhanced accounting policy disclosures would facilitate auditing adherence to the policy. Absent such guidelines, examples and requirements, we are concerned that the measurement process would be operationally challenging and extremely difficult to audit.

Question 8: *Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?*

We agree with the proposed requirement to differentiate. If a loan or debt security is not performing or collection has otherwise become uncertain, it has a much higher probability of loss and, therefore, the full expected loss should be recognized.

Question 9a: *Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?*

We agree with this proposal. If the allowance for the 'good book' was based solely on time proportional expected credit losses, it may be insufficient to cover expected losses in the early years, when they are most likely to occur.

Question 9b: *Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?*

We do not believe that it would be beneficial to make this distinction and that it would further complicate the process for arriving at the allowance for the 'good book'.

Question 9c: *If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?*

We agree that the minimum amount should be based on losses expected to occur within the foreseeable future, but that additional guidelines and examples should be provided to help define the foreseeable future for each asset type. Care would need to be exercised in developing such guidelines and examples to promote adherence to the fundamentally sound loss recognition tenet that a loss should be recognized when incurred.

Question 9d: *For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?*

We agree with establishing the expectation that the foreseeable future will remain fairly constant for each asset type as is conveyed in the exposure draft, paragraph B14. An ability to significantly lengthen or shorten the period defined as the foreseeable future can present significant opportunities for earnings management and for inconsistent determination of the allowance balance from period to period.

Question 9e: *Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not?*

We believe in general the foreseeable future can extend beyond twelve months. Using the most recent economic crisis as an example, expert predictions were readily available and general consensus was reached on key factors such as the expected duration of the recession, and when housing prices, delinquencies and unemployment would stabilize. While it is difficult to generalize and state that in all cases, the foreseeable future will be a minimum period of twelve months, we believe that not instituting a minimum of twelve months could have an undesired consequence of computed reserves on 'good book' loans being less under the proposed guidance than existing guidance as we indicated in our response to Question 1.

Question 9f: *If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognized under the 'floor' requirement (for example, no more than three years after an entity's reporting date)?*

We do not believe that a ceiling should be established. If the conclusion is reached that losses for the foreseeable future should be recognized, it would not be appropriate to establish an arbitrary ceiling that would not consider individual facts and circumstances.

Question 10: *Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)?*

We believe that this question would best be answered through field testing if the decision is made to potentially move forward with the time proportional allowance concept.

Question 11a: *Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in paragraph B8(a)? Why or why not?*

We believe that a single method would promote comparability between entities, however, given all the complexities in the proposed common approach and the various scenarios that would need to be considered in estimating the 'good book' allowance, this may be a desirable concession to minimize complexity.

Question 11b: *Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?*

We are in agreement with this proposed flexibility for pools of financial assets, but would not be in agreement with extending similar flexibility to individually evaluated assets. If such flexibility is permitted by the standard, we believe the standard should emphasize the need for consistency in the approach used to select a discount rate.

Question 12: *Would you prefer the IASB's approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB's approach (i.e. to recognize expected credit losses over the life of the assets)? Why or why not?*

We do not prefer the IASB's approach given that time proportional recognition of losses would not address the perceived issue of delayed recognition and given the difficulty of determining lifetime expected losses on long-term assets with meaningful precision.

Question 13: *Would you prefer the FASB's approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB's approach (i.e. to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?*

We prefer the FASB's approach as it results in timely recognition of foreseeable losses, is less complex and more easily auditable.

We would be pleased to respond to any questions the Board or its staff may have about any of the preceding comments. Please direct any questions to John Keyser (702.759.4046) or Faye Miller (410.246.9194).

Sincerely,



McGladrey & Pullen, LLP