May 31, 2013

By email to director@fasb.org
File Reference No. 2012-260

Thanks for considering my thoughts on your proposed changes to how a creditor accounts for credit risk.

Accounting for credit risk should be about recording a loss that has happened.\(^1\) It’s true that we can’t always know with certainty what loss has been suffered. The principles you have set previously focus on the likelihood that uncertainty about a suffered loss will be resolved.\(^2\) Your proposal effectively shifts that focus away from recording what has happened to recording what might happen in the future.\(^3\) That is troubling.

You shouldn’t go forward with your proposal. Instead, you should consider incrementally changing the existing model. Specifically, you should explore requiring that a loss be recorded if it’s more likely than not that the loss has, in fact, been suffered.\(^4\)

Some have suggested you’re willing to abandon the existing model in reaction to this decade’s financial crisis. But the truth is that any accounting principle you decide can only report—and never control—uncertainty. A principle should never give the false comfort that uncertainty can either be changed or fully captured by the process of accounting.

Abandoning the existing model would reverse your well-established past decisions about credit risk, the incurred loss principle, and other conclusions that depend on that principle. You also risk eviscerating the framework you created after the financial crisis as to the objectives of general purpose financial statements and the priority of users of those financial statements.\(^5\)

I think that, as an institution, the Financial Accounting Standards Board should obligate itself to stand by what it has decided—in this case, the grounding of the incurred loss principle that has been applied, challenged, and interpreted for nearly forty years. As an institution, the Board should change a past decision only when there is real evidence that the change will make financial information more obvious or easier to understand.\(^6\)

I am having difficulty seeing how any benefit of the proposal could outweigh its costs. In particular, the adoption of any new accounting principle is accompanied by a bit of disorder and confusion during which the practical consequences become real, are identified, recognized, and acted on. If you substitute new subjectivity and complexity about uncertainty for existing subjectivity and complexity about uncertainty, it will be at least a decade before we will know as a profession the true impact that substitution will have had. The underlying uncertainty will not have changed. I ask that you not proceed with the proposal as drafted.

Sincerely,

Jim Green
jim@jasgreen.com
1 In other words, if you are a creditor, you should record a loss that you have suffered. That should include losses that you have suffered but don’t necessarily know yet that you have suffered (incurred but not yet reported). You shouldn’t recognize a loss that you haven’t suffered (a loss that you might suffer in the next year). You shouldn’t record every loss that you might suffer (every loss that you might suffer in the next year or more distant future). You shouldn’t record a loss that someone else suffered—or thought they might suffer—on a financial asset you acquire from that someone (whether discretely or through a business combination).

2 The existing model deals with uncertainty about what loss, if any, has been suffered. If you’re a creditor, it requires that you record a loss as suffered if it’s probable that the loss has been suffered (and, implicitly, if it’s likely that an event will confirm the loss). There has been a lot of debate about how to deal with such uncertainty and whether probable means virtually certain. You have said that probable doesn’t mean virtually certain (paragraph 310-10-35-19) but that probable is a “significantly greater likelihood” than more likely than not (paragraph 815-20-25-16(e)).

3 The consequence of the proposal is that every financial asset is impaired at its inception—even if its exit price the instant after it is recorded exceeds the amount at which it is reported. That boggles the mind. What was true eighty years ago is true today: Delaying recognition of a suffered loss overstates income today and understates income tomorrow. Recognizing a loss before it is suffered underestimates income today and overstates income tomorrow.

4 In the early 1990s, the then U.S. General Accounting Office made the recommendation to change probable to more likely than not because probable was still being read as virtually certain (see the March 1991 report “Deposit Insurance: A Strategy for Reform” [GAO/GGD-91-26]). In a May 20, 1991, letter to you (File Reference No. 098-E), the GAO recounted their related concern that “accounting principles allow bank management too much discretion in recognizing and determining loss amounts reported in financial statements.”

5 You concluded that regulators are not the primary users of general-purpose financial statements and that controlling systemic risk is not an objective of general-purpose financial reports. You set out those conclusions in 2010 as part of Chapter 1 of your Conceptual Framework for Financial Reporting. See paragraphs BC1.20 and BC1.23, in particular.

6 You should stand by the objectives of general purpose financial reporting in this circumstance as you have in other circumstances over the last forty years. An example is the accounting for extraordinary items. Despite an understandably emotionally charged atmosphere in the aftermath of the events September 11, 2001, you stood by the principles you had set because the immediate facts were considered against your well-established thinking rather than against, for example, a new model that might have been adopted out of expediency.