June 3, 2013

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference No. 2012-260
Re: Proposed Accounting Standards Update, Financial Instruments — Credit Losses

Dear Ms. Cosper:

Deloitte & Touche LLP is pleased to comment on the FASB’s proposed Accounting Standards Update (ASU) Financial Instruments — Credit Losses.

We support the Board’s efforts to improve the guidance in U.S. GAAP on the impairment of financial assets measured at amortized cost or fair value with changes in fair value recognized in other comprehensive income (financial assets) by (1) addressing the weaknesses in the existing incurred loss model that were observed during the global financial crisis and (2) simplifying such guidance by reducing the number of impairment models. We agree with the Board’s objective of recognizing and measuring credit impairment of financial assets on the basis of an entity’s current expectations about the collectability of contractual cash flows. An impairment model that is based on expected credit losses that incorporates information about past events, current conditions, and expectations about future economic events and conditions avoids the practical difficulties of an incurred loss model, under which there may be delayed recognition of credit losses because of the complexities in identifying when a loss event has occurred. Further, we support the Board’s decision to develop an impairment approach that would equally apply to all forms of financial assets.

While we support the project’s objectives, we have significant concerns about the proposed ASU’s approach. One significant concern is that it differs in important aspects from the approach proposed by the IASB in ED/2013/3, Financial Instruments: Expected Credit Losses. We strongly encourage the boards to converge their guidance on expected credit losses because we believe that converged guidance on this topic is critical to supporting well-functioning global capital markets.

In addition, we have concerns about the requirement in the FASB’s proposed model to recognize full lifetime expected losses for all financial assets, particularly at inception of these financial assets. Full lifetime expected losses may be appropriate for individual financial assets (or a portfolio of financial assets with similar credit quality) that have a low credit quality because there is a higher likelihood that a loss will be experienced shortly. However, for other financial assets (whether evaluated individually or as a portfolio of assets with similar credit quality) requiring recognition of full lifetime expected losses at inception distorts the measurement of performance and comprehensive income of the entity for a particular period with respect to that asset or assets.
(i.e., financial statements would potentially not reflect decision-useful information about the timing of losses). It also requires entities, auditors, and regulators to consider forecasts about economic data and conditions for periods far into the future. Because the level of precision necessarily decreases in forecasts for distant periods, some parties are likely to encounter significant operational challenges and complexity when incorporating the forecasts into measurements reflected in the financial statements. These concerns would potentially be addressed by shortening the time horizon an entity would be required to consider as part of the measurement of the credit loss allowance for high-credit-quality assets.

The IASB’s proposed financial asset impairment model differentiates financial assets on the basis of credit quality and limits the forecast period for particular financial assets; however, we have some concerns with this model. In particular, we do not agree with its use of a relative credit quality assessment instead of an absolute evaluation of an asset’s credit quality. A relative credit deterioration model (1) creates accounting anomalies because a credit loss allowance for similar assets may be measured differently and (2) adds operational complexity by requiring entities to track movements in an asset’s credit quality relative to its initial credit standing. We will submit a comprehensive response to the IASB’s proposed model in a separate letter.

In light of our significant concerns with the FASB’s and IASB’s proposed models, we propose an alternative approach that we believe retains many aspects of both boards’ proposals and remains faithful to their objectives. This recommended approach is discussed below.

**Recommended Approach**

Our recommended approach (1) is based on expected credit losses, (2) distinguishes between financial assets that are of high credit quality and those that are not, and (3) uses an absolute assessment of credit quality (i.e., it is not an assessment of the current credit standing relative to that at the time of origination or purchase like the IASB’s proposed credit loss model). We understand that the boards had considered, and decided against, using an absolute assessment of credit quality when discussing the approach that has evolved into the IASB’s proposal. We believe, however, that an absolute assessment is more operational and avoids accounting anomalies when similar economics of financial assets are measured differently.

Under our alternative approach, an entity would continue to monitor the credit quality of its financial assets during the reporting period. We believe that when it becomes apparent for a financial asset or assets that, on the basis of credit indicators and other relevant factors, it is not highly probable that the entity will collect all contractual cash flows when due, the entity should recognize all expected credit losses estimated over the remaining life of the asset or over the average remaining life for the portfolio of assets. Generally, entities would assess at the most granular level reasonable and without undue cost and effort whether such indicators and relevant factors exist, which in some cases may result in their making such assessments on a portfolio basis (i.e., portfolio of similar assets). In addition to a measurement based on the present value of expected cash flows using the asset’s effective interest rate, the model would permit the allowance for credit losses on these assets to be calculated as the lifetime probability of default multiplied by

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1 Given that the asset or portfolio of assets is not of high credit quality, it would not be appropriate to use any period less than the full remaining expected term (i.e., lifetime losses), though it is likely that this period is relatively short and that more precise information is available for use in estimating expected credit losses.
the loss given default multiplied by the exposure at default with the objective of measuring expected value. Other estimation techniques that meet the objective would be permitted.

For financial assets or portfolios of assets for which it is highly probable that all contractual cash flows will be collected when due, the entity would still recognize an allowance for 12 months of expected credit losses (or another appropriate specific period that the boards deem appropriate). This allowance is necessary for the entity to account for the uncertainty associated with the credit evaluation process and the relatively smaller probability that a loss will occur over the next 12 months (or other specific period). Measurement of the allowance may be based on the present value of expected cash flows for those financial assets for which a credit event is expected in the next 12 months (or other specific period). Alternatively, an entity would be permitted to estimate the allowance on the basis of the 12-month (or other specific period) probability of default multiplied by the loss given default multiplied by the exposure at default, with the objective of measuring expected value. Other estimation techniques that meet the objective would be permitted.

On the basis of our outreach, 12 months appears to be a reasonable and supportable forecast period. We suggest that the boards perform additional research to determine whether longer periods may be appropriate. However, such forecast period should remain the same throughout financial reporting periods (i.e., it should not change because of changing economic circumstances).

The appendix to this letter includes our responses to the questions for respondents in the proposed ASU.

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Deloitte & Touche LLP appreciates your consideration of our comments on the proposed ASU. If you have any questions concerning our comments, please contact Adrian Mills at (203) 761-3208.

Yours truly,

Deloitte & Touche LLP

CC: Robert Uhl
Appendix
Deloitte & Touche LLP
Responses to the Proposed ASU’s Questions for Respondents

Scope

Questions for All 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. We recommend that the FASB explicitly address whether financial guarantee contracts that are indexed to credit and are not within the scope of other Codification topics (e.g., required to be accounted for as insurance contracts or at fair value through net income) are within the scope of the proposed guidance. We believe that a strong conceptual argument can be made for applying the proposed ASU’s financial asset measurement principles to such guarantees. The credit risk exposure inherent in a loan and a financial guarantee of a loan are the same and, therefore, the same impairment (i.e., credit loss) approach should be applied to such guarantees.

Questions for Preparers and Auditors

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?

Estimates of expected credit losses are most reliable and auditable when they are developed on the basis of past events; current conditions; and reasonable, supportable, and available forward-looking information about future economic circumstances. We are concerned that some entities (e.g., some smaller entities) may not have information systems for, and practical experience in, obtaining and analyzing relevant forecasted data to allow them to make reliable estimates over the entire life of assets with especially long lives. While we recognize that other accounting standards require similar long-term estimates, we do not believe that in this particular situation the cost (including costs related to any reduction in reliability of information) justifies the benefit, particularly for high-credit-quality assets, because recognition of full lifetime expected credit losses distorts an entity’s periodic performance with respect to these assets. Hence, we recommend that the Board require the use of a shorter period for expected credit loss measurement for high-credit-quality assets. See the discussion of the 12-month (or other specific period) expected credit loss estimate in our recommended approach discussed in the cover letter.

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?

Preparers that are most affected by the proposal would be in the best position to respond to this question.

**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?

We agree with the Board’s proposed requirement that an estimate of expected credit losses always reflect both the possibility that a credit loss will result and the possibility that no credit loss will result. The entity would use historical information, current conditions, and forward-looking information about economic events and conditions for the period over which the loss is expected to be realized to estimate the amount of expected cash flows.

**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 support the Board’s objective that in measuring credit impairments, entities should consider the time value of money for both individual assets and a portfolio of assets. We agree 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 and discounting those amounts to a present value by using the effective interest rate. We also agree with the proposed estimation techniques usually used for a portfolio of assets that are based on historical write-off experience (e.g., loss-rate, roll-rate, probability-of-default, and provision matrix methods). These estimation techniques implicitly incorporate the time value of money in a manner we believe sufficiently reflects the objective, and we do not foresee any auditing concerns as long as the estimates of expected credit losses made by
using these estimation techniques reflect past events, current conditions, and available forward-looking information that is reasonable and supportable.

**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?

We agree with the FASB’s proposal that entities should not recognize as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition of a purchased-credit-impaired (PCI) asset. From a presentation perspective, we also support recognizing an allowance both at initial recognition and subsequently that includes those cash flows not expected to be collected (i.e., including those embedded in the purchase price at acquisition). Changes in the allowance, even if they constitute an improvement in expectation from the initial expectation, should be reflected in earnings in the period of the change in expectation. This approach (1) better aligns the accounting for PCI assets and assets that are not PCI, (2) has some operational advantages without impairing financial statement users’ ability to analyze net interest margin, and (3) gives financial statement users decision-useful information about the amount of contractual cash flows, cash flows not expected to be collected, and the net of these amounts (i.e., the purchase price at acquisition). Disclosures about the amount of the current allowance embedded in the purchase price at acquisition should be considered so that financial statement users can understand what amount of the allowance has not been reflected in earnings.

**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?

While we do not object to the practical expedient, we struggle with its conceptual merits. For example, an entity that has a financial asset with a fair value that is $1 less than its carrying value (clearly due to general movements in interest rates since it was acquired) would be required to recognize an allowance for credit losses on the asset. However, if on a different date another entity acquires an identical financial asset, a loss allowance for the asset may not be recognized because the carrying value of the asset might be less than its fair value on that date.

**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 are aware that the FASB’s proposed nonaccrual requirement has been applied in practice already, primarily by regulated financial institutions in the United States, and we have not noted any significant operability or auditing concerns related to such application. However, we recognize that the nonaccrual requirement is inconsistent with the Board’s decisions in the revenue project, which focuses on the recognition of revenue for the amount the entity expects to be entitled and not on what it expects to receive. The core principle of the proposed revenue model is that “an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” As a result of this proposed principle, interest revenue from an entity’s contract with a customer related to a financial asset would be recognized inconsistently with an entity’s contracts with customers that are not related to financial assets (i.e., revenue would be recognized at the amount the entity is entitled for performance).

Thus, we encourage the Board to reconcile the practical benefits of the nonaccrual requirement with inconsistency in revenue recognition for financial and nonfinancial assets. If the Board decides to proceed with its nonaccrual proposal, we suggest that it clarify how the nonaccrual requirement would be applied to PCI assets given that for those assets, it may not be probable at initial recognition that substantially all of the principal or the interest will be received.

Questions for All Respondents

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?

We agree that the modified debt instrument that follows a troubled debt restructuring is a continuation of the original debt instrument, and we therefore support the FASB’s proposal to require entities to adjust the cost basis of the asset by the difference between the amortized cost basis before modification and the present value of the modified contractual cash flows, discounted at the original effective interest rate.

We believe that information provided in financial statements about financial assets that have been modified through a concession granted by a creditor because of the financial difficulty of the debtor (i.e., troubled debt restructuring) is important and decision-useful to users of financial statements. Therefore, we continue to believe that some amount of disclosure about troubled debt restructurings is warranted.
However, we would encourage the FASB to explore ways to simplify the guidance on the accounting by a creditor for a modification to an existing debt instrument to address issues related to applying the guidance. In particular, there are practical issues in determining whether a modification qualifies as a troubled debt restructuring and when it results in derecognition of an old instrument and recognition of a new instrument.

Disclosures

Questions for Preparers and Auditors

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

While we understand and agree with the need for transparent disclosures about the assumptions in and process of estimating credit losses, we are concerned about the extent and effectiveness of the proposed disclosures. We suggest that the Board compare the proposed disclosures to the objectives of the FASB’s disclosure framework project and consider field testing any incremental disclosures to those already required by U.S. GAAP.

Implementation Guidance and Illustrations

Questions for All Respondents

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 believe that the Board should consider adding examples illustrating the applicability of the credit impairment model to debt securities.

We also believe that the Board should clarify that the amount shown for the allowance for credit losses in Example 6 of the proposal reflects the time value of money. Further, we believe that the Board should expand on the example to address the subsequent accounting for PCI assets. Specifically, it should indicate how the release of the effect of the time value of money would be presented in the financial statements (e.g., whether the portion of the allowance not recognized at initial recognition because of the time value of money should be reflected as interest income and bad debt expense over the life of the asset (i.e., a nil effect on the financial statements but a gross-up of interest income and bad debt expense)).

Transition and Effective Date

Questions for All Respondents

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

The cumulative-effect method transition provisions appear appropriate.
Question 21: Do you agree that early adoption should not be permitted? If not, why?

We recommend that the Board allow entities to early adopt the proposed guidance if the Board decides to permit early adoption of the proposed guidance on classification and measurement of financial instruments.

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 believe that nonpublic entities should be given an additional year beyond the public-company effective date unless that date is set so far into the future that both public and nonpublic entities would have adequate time to implement the new requirements.

Questions for Preparers and Auditors

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

We generally do not have concerns about the operability of the transition provisions but would encourage the Board to obtain feedback from preparers of financial statements on this matter.

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 an implementation period of a minimum of two and a half years from release of the final standard is appropriate to allow information systems to be updated and implementation issues to be considered. We also believe that the transition and effective date for the final standard should be coordinated with those for the final standard on classification and measurement of financial instruments. We would not object if the effective date for this standard coincided with the effective dates for new standards related to revenue recognition or lease accounting.

Preparers that are most affected by this proposal are best suited to provide details about the type of system and process changes needed for implementation of the proposed guidance.