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Technical Director
File Reference No. 2012-260
FASB
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Dear Sir or Madam

Proposed Accounting Standards Update – Financial Instruments – Credit Losses

ICAEW is pleased to respond to your request for comments on your proposed accounting standards update on *Financial Instruments – Credit Losses*.

While we have not provided a detailed response to the individual questions posed by the board, we have provided an overall assessment of the proposals and our views on the relative merits of them and the proposals that were published by the IASB in March 2013.

We will be responding fully to the IASB's latest proposals in due course. We will provide you with a copy of this letter when it is finalised.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REPRESENTATION

FINANCIAL INSTRUMENTS: CREDIT LOSSES

Memorandum of comment submitted in May 2013 by ICAEW, in response to FASB's proposed accounting standards update on *Financial Instruments – Credit Losses* published in December 2012.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the proposed accounting standards update on *Financial Instruments: Credit Losses* published by the FASB on 20 December 2012, a copy of which is available from this [link](#).

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. ICAEW's Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.
5. Most of our constituents are IFRS or UK GAAP adopters. The faculty does not generally respond to proposals that will amend US GAAP. However, while considering the IASB's latest proposals on expected credit losses, we considered alternatives, including the FASB's approach. It was our serious concerns about the FASB's proposals, given the importance of convergence in this area, that have led us to comment directly to FASB on this occasion.

MAJOR POINTS

We have serious concerns about the FASB's proposals

6. In our view, the conceptual basis of recognising all expected credit losses upfront is highly questionable, calling into doubt whether such an approach meets the objectives of financial reporting. Such an approach does not reflect the economic substance of lending and would distort profit or loss as well as the initial recognition at fair value. The difficulties in measuring lifetime expected credit losses, particularly for long-lived performing financial assets, where the measurement differences to other approaches are greatest, are significant, including their sensitivity to judgements about the future, which is inherently uncertain. As a result, we are concerned about both the relevance and verifiability of such measurements and therefore whether they result in faithful representation that is able to meet the needs of users of financial statements.
7. These concerns raise questions about whether the proposed model could also have serious unintended commercial and broader economic consequences. For example, excessive initial recognition of losses could change incentives for new lending in some economic circumstances and in some jurisdictions. The approach could also encourage shorter-term loans and commitments which could have adverse consequences for some economies. We believe these questions about broader economic consequences are relevant since they are the result of accounting that may not be an accurate reflection of commercial lending practice.
8. Moreover, for longer-lived financial assets, determining lifetime credit expected losses in the absence of any deterioration will necessarily be highly subjective. Basing loss expectations on historical data does not reduce the subjectivity, since past experience does not necessarily reflect current or expected future performance and there are difficulties in linking macro-

economic factors directly to credit losses. The main drivers of impairment charges in these circumstances may be factors unrelated to credit risk, such as changes to the expected lives and the effects of discounting. Minor changes to assumptions and expectations of the future could have a major impact on earnings and it may be difficult to assert one assumption as being more reasonable and supportable than another. This would not be conducive to consistent application. We note that the Financial Crisis Advisory Group concluded in its final report in June 2009 that, although an expected loss model seems more prudent than the incurred loss model, the IASB and the FASB would have to take care to avoid facilitating earnings management, which would decrease transparency.

While no impairment model is without conceptual flaws, the IASB's current proposal offers a workable solution

9. In our view the solution to the conundrum of expected credit losses must find the right balance between having a supportable conceptual basis and being capable of practical application. In addition, we consider that an acceptable impairment model should:
- Incorporate a broader range of credit information, including forward-looking information, in order to allow an earlier identification of credit losses and not preclude the recognition of expected losses on loans that are currently performing.
 - Be consistent with the initial recognition of financial assets at fair value and with the notion of matching in interest receivable and credit losses.
 - Treat performing loans differently from non-performing loans so that all losses which have occurred are immediately recognised, facilitating links to risk management practices, thereby providing useful information about credit deterioration.
 - Be suitable for all types of entity, not just those in the financial sector.
10. We believe that, overall, the IASB's current proposals achieve these objectives. While the requirement to recognise all losses expected to result from default events within the 12 months after the reporting date has no conceptual basis, and results in some troubling outcomes (eg, for growing businesses and acquisitions) it can be accepted as part of the overall package to support earlier loss recognition in a simple manner. Moreover, by recognising life time expected credit losses when there is a significant deterioration in credit quality, the proposals better match interest receivable and credit losses and provide a closer link to risk management than previous proposals. This is likely to result in more relevant and understandable information.
11. For pragmatic reasons, we therefore support the IASB's proposals. They offer a solution that is operationally viable and potentially represents an improvement to existing practice. Impairment is of critical importance and, after four years of examining different options, including attempting converged solutions, we intend to urge the IASB to move as quickly as possible to finalise a standard based on their latest proposals, including clarifications as determined through its due process. Returning to the drawing board in search of a better solution is no longer an option.

Finding a converged solution

12. In an ideal world, we would very much like to see a converged impairment standard. Therefore, we urge the FASB to reconsider its position and to bring its proposals in line with those of the IASB.
13. Some may suggest recognising lifetime losses relating to loss events which are expected to occur over a 'foreseeable future' or some period which is reliably estimable and predictable as a possible compromise to achieve convergence. We do not support such views. As we noted in our response to the supplementary document published by the two boards in 2009, we do not think the future is foreseeable or that it would be possible to define such a period in an operational manner. While we agree that 12 months is arbitrary, an indefinable future horizon for loss events cannot result in an operational standard that would be consistently applied. We

have concerns about initial loss recognition, but can accept an arbitrary 12-month period as part of the wider IASB model because it is clearly defined, appropriately limited and relatively simple to apply.

- 14.** We also note that there are other important differences between the IASB and FASB approaches which would need to be resolved before even the measurement of life time expected loss could be said to be converged. For example, discounting is explicitly required by the IASB, albeit with a wide range of rates being acceptable. The FASB approach considers that discounting may be either explicit or implicit in the methodology adopted. We do not believe that discounting is implicitly included in some of the methods which the FASB's draft update would permit and we believe the non-accruals approach is also inconsistent with recognising the time value of money. We are therefore doubtful that a converged approach can be agreed on a timely basis, although we recognise the importance of convergence in this area.

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