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May 30, 2013

VIA EMAIL TO: director@FASB.org

Technical Director
File Reference No. 2012-260
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: *Financial Instruments—Credit Losses*

To Whom It May Concern:

We are responding to the request for comments on the FASB's Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*, dated December 20, 2012 (the "exposure draft" or "proposal" or "current proposal"). Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments.

General Comments on FASB Proposal

We have listened carefully to the discussions that have occurred throughout the course of this project. We have thought about the various criticisms of our current accounting model, the conceptual and operational challenges involved in accounting for credit losses, and the information needs of different users of historical financial statements. We have attempted to understand both the practical issues and the likely outcomes of the Board's current proposal. Our thinking has also incorporated other approaches to accounting for credit losses that have been suggested by various parties. Our significant interest in the accounting for credit losses is, we believe, reflective of the critical importance of this issue, not only to the financial reporting of financial institutions and other lenders but to the overall credibility and reliability of US accounting standards.

In developing a way forward, we firmly believe that changes to the current accounting model for credit losses should represent an improvement in financial reporting that will stand the test of time based on sound concepts that are consistent with the objective of general purpose, historical financial statements and that are responsive to the users of those financial statements. As alluded to in the FASB Staff Q&A on the current proposal, the FASB is not, and should not be placed in the position of becoming,

File Reference No. 2012-260
May 30, 2013
Page 2

an extension of the U.S. bank regulatory system. Regulators, while certainly informed by the results of generally accepted accounting principles (GAAP), have objectives that differ significantly from those of investors and creditors. Further, regulators are not dependent on GAAP for financial information: they have numerous other avenues to obtaining or requiring information they deem necessary to evaluate and improve the safety and soundness of the U.S. financial system.

We disagree with the FASB's current proposal. We believe the proposal is not an appropriate accounting model for credit losses because the conceptual underpinnings are not consistently grounded in the events that give rise to credit losses. We need a solution that we will not later regret. We also believe there are more conceptually sound and operationally effective ways to improve the accounting in this area.¹ As explained in some detail later in this letter, we believe that accounting for credit losses should be event-based so that the financial statements—both the balance sheet and the income statement—faithfully represent current economic events. Whether one calls this an improved or enhanced incurred loss model or an event-based loss model is unimportant to us. What is important is that the financial reporting of credit losses reflects existing market conditions as objectively as possible.

We have four principle criticisms of the FASB's current proposal:

1. *Divergence from underlying economics* – We believe the FASB's proposed accounting does not match the underlying economics. In our view, this is a significant, if not fatal, flaw. We believe this flaw is apparent from the fact that the Board's current proposal has the effect of recording a loss when a loan is originated or a debt instrument is purchased. This result, often referred to as a "Day 1" loss, is not representationally faithful (to use accounting terminology) of the underlying transaction. Further, the proposal essentially requires that a loss be recognized for every outstanding loan, no matter how creditworthy the counterparty, how recently the loan was made, or how the loan is performing. Yet there is not an economic loss on every loan.

Assuming appropriate underwriting procedures, no fraud or mistakes, a lender (be it a bank extending credit to a homebuyer or a manufacturer purchasing a debt security as an investment) does not incur an economic loss on the day a loan is made. The loan or debt security could be sold at the date of origination or purchase for approximately par value (amount loaned) or price paid. Yet the FASB's proposal contradicts that economic reality by producing a loss.

We acknowledge that the Board does not appear to agree with our view. Paragraph BC21 of the exposure draft says, in part,

"Some may believe that the Board's approach would recognize losses prematurely and in uneconomic amounts. Those views appear to focus on individual assets rather than groups of similar assets, which is inconsistent with how most financial institutions manage their assets, particularly loans, and how users analyze financial institutions. Specifically, financial institutions manage loans in a fluid, open-portfolio setting, wherein new loans are originated, existing loans are paid down, and some loans may be bought and some loans may be sold. The estimate of credit losses under the Board's proposal would be based on the current credit risk of the assets in that

¹ History is often a good teacher. In this regard, we recommend re-reading the article published by the FASB staff in August 1993, "A Fresh Look at Statement 5," written by Alice Schroeder and Wayne Upton. In part, the article addresses the assertion by the General Accounting Office in 1991 that "Statement 5's accounting provisions delayed recognition of loan losses in failing financial institutions."

File Reference No. 2012-260
May 30, 2013
Page 3

open-portfolio setting and the entity's loss experience (and expectation) with assets of similar risk characteristics.”

However, accounting is driven by individual transactions. The extension of credit is a transaction; the purchase of a portfolio of receivables or loans or an individual debt security is a transaction; the receipt of an interest or principal payment on a loan or bond is a transaction; the existence of a portfolio is not. Accordingly, even if the practical implementation of an accounting concept for credit losses allows an entity to define the unit of account as a portfolio rather than an individual loan, we believe the accounting concept for credit losses needs to acknowledge and be representative of the transaction, i.e., the economic event that we are reporting in the financial statements. Whether there are hundreds of homogenous loans in a bank's loan portfolio, a handful of dissimilar long-term notes in a manufacturing company's receivables register, or a single debt security in a technology company's investment book, the accounting needs to be both economically sound and operational.

The argument in paragraph B21 suggests that the accounting model in the proposed standard is acceptable because it reflects how “most financial institutions manage their assets.” That argument is troublesome for two reasons. First, the scope of the standard is broader than financial institutions. Second, while the operability of the model should not ignore the way in which loans and similar debt instruments are managed, we see no logic to the conclusion that the result of the Board's accounting model—the premature and uneconomic recognition of losses—is not present on a macro (“portfolio”) basis even though such losses would exist on a transactional basis. Is the argument that some type of “law of large numbers” would mitigate the effect of premature losses in a portfolio setting? Or is some degree of offsetting implicit in this argument, whereby the fluidity of the various pluses and minuses in the portfolio eliminates the loss? Or perhaps the argument is that the recording of the premature loss at origination is masked by its inclusion in the month end allowance estimate? In this regard we note that the arguments in paragraph BC15 (on the pricing of loans) and those in paragraph BC21 (on impairment recognition) seem inconsistent with each other. In paragraph BC21, the argument is based on the portfolio as the unit of account whereas the individual loan seems to be the focus of paragraph BC15. It seems to us that the exposure draft attempts to “ride two horses” in this regard.

However, even if we take the Board's admonition at face value and consider groups of similar assets, rather than individual assets, we still cannot come to the conclusion that the Board's proposal appropriately reflects the economics. This is because the proposal requires expected losses to be recognized with no regard to expected income (i.e., interest). This biased view of the portfolio results in recording losses on portfolios that are expected, on the whole, to be profitable. Thus, the losses are recognized early, while the income is recognized over time. This seems to us to be the equivalent of a manufacturer of goods recognizing costs of sales when it manufactures the goods to be sold, while revenue is only recognized upon actual shipment. Why the Board believes this is a useful result for lending activities and investments in debt securities is a mystery to us.

We also note that it is very difficult to understand economically why a lender would have an immediate loss from making a loan commitment on market terms. Under the proposal, the lender is unable to consider the future income; rather, the lender considers only future losses.

File Reference No. 2012-260
May 30, 2013
Page 4

Other anomalies arise as a result of what we view as a fundamental flaw in the proposed accounting model. Consider the following example.² 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 available for sale with unrealized gains and losses recorded in other comprehensive income (OCI). Also assume that industry-wide statistics show that over a long history, AA-rated bonds can lose 1%. Under the exposure draft, the technology company would recognize a Day 1 loss of \$10 in its income statement. However, because the bond has a fair value of \$1,000, the company would be required to write up the bond from \$990 back to \$1,000 with a credit to OCI. The net result is a charge to income and a credit to OCI. (We note that if a competitor purchased the exact same bond for the same price on the same day but classified the bond as trading, the competitor would recognize no loss on Day 1 even though it also carries its bonds at fair value.) These results do not make sense to us, are not consistent with the economics of the technology company's bond purchase, and are not representationally faithful. The technology company did not lose \$10 when it purchased the bond. The \$1,000 fair value incorporated the 1% likelihood of a loss on the bond. Whether that bond is accounted for individually or as part of a larger portfolio, the recognition of a \$10 loss for the purchase of the bond is misleading because it double counts the risk. The same logic extends to any loan origination or purchase of a debt security.

To vary the example, assume that the technology company acquired bonds that had been downgraded such that they are below investment grade at the time of purchase. Assuming the bonds qualify as "purchased credit-impaired financial assets" under the exposure draft, the technology company would avoid a Day 1 loss because the allowance for credit losses would be established as part of the purchase accounting. In contrast, had the technology company purchased newly issued below investment grade bonds, it would record a Day 1 loss. We do not understand this result either but believe it stems from the same underlying conceptual flaw in the proposed accounting model.

2. *Divergence from Conceptual Framework* – We believe the FASB's proposal is inconsistent with paragraph 41b of FASB Concepts Statement No. 7 (CON 7) dealing with present value (discounted) measures.³ Specifically, CON 7 indicates that it is inappropriate to reflect risk in both expected future cash flows and the discount rate. If estimates of future cash flows reflect the risk of nonpayment, then the discount rate should be closer to risk-free. If estimates of future cash flows are based on contractual amounts (and thus do not reflect a nonpayment risk), the discount rate should be higher to reflect assumptions about future defaults. In contrast, the FASB's proposal requires that contractual cash flows be adjusted for expected defaults and then discounted at the loan's original borrowing rate (which by definition reflects assumptions about future defaults). We were not able to identify a discussion in the basis for conclusions section explaining why this departure from CON 7 is appropriate.

We recognize that existing GAAP uses the effective rate in ASC 310-20 (originally FASB Statement No. 91) in doing impairment measures under ASC 310-10-35 (originally FASB Statement No. 114). Some might argue that the Board's proposal is similar to current GAAP in this regard. However, existing GAAP was written prior to CON 7. Additionally, existing GAAP waits

² In this example, we are not using the optional "practical expedient" for financial assets measured at fair value through other comprehensive income. Given our belief that the accounting model should be consistent with the underlying economics, the example illustrates our view that the FASB's concept is flawed.

³ See Attachment 1 for relevant excerpts from CON 7.

File Reference No. 2012-260
May 30, 2013
Page 5

until the losses have been incurred. The FASB's proposal seems to take this double counting of risk—once in the discount rate and once in the expected cash flow estimate—one step further than existing GAAP by requiring this approach on the date the loan is extended or purchased (hence the need to recognize a loss on every loan, not just those that actually have performed—or are now expected to perform—worse than originally predicted).

3. *Divergence from existing measurement models* – We believe the FASB's proposal effectively creates a third measurement model on initial recognition for certain financial instruments, a model that is neither historical cost nor fair value and, by design, results in a carrying value that is lower than both.

Because the proposal does not permit a company to assert that no loss will be incurred, the measurement of the loan or debt instrument does not represent historic cost. It also does not represent a fair value measure as defined in ASC 820 in two respects.⁴ First, ASC 820 indicates that the transaction price often will represent fair value at initial recognition. It gives examples where that may not be true but those examples identify differences in markets or other discrete, identifiable factors (such as transactions between related parties or a sale under duress) supporting what otherwise seems like a counterintuitive outcome. The most common example of transaction prices differing from fair value is where the asset was purchased in a market that differs from the one where it would be sold. Extending credit to a customer does not fit that example. Assuming that the lender's (seller's) underwriting standards are equivalent to that of any other market participant, we believe the amount loaned is likely to approximate fair value at origination. Second, the measurement guidance in ASC 820 would prohibit the double counting of risk, i.e., the discounting of a cash flows stream that anticipates future defaults at a discount rate that reflects assumptions about future defaults.

We note that the FASB argues that credit losses are a measurement issue, not a recognition issue. Paragraph BC20 of the exposure draft says, in part,

“... the Board believes that the concept of a ‘credit loss’ due to a shortfall in contractual cash flows is a measurement issue (as opposed to a recognition issue) and is consistent with paragraphs 85 and 87-89 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.”

Thus, by departing from the historical cost and fair value models, the exposure draft is creating yet another measurement model for certain financial instruments on initial recognition. That measurement model could be described as a hybrid of historical cost and expected future losses that are independent of both market expectations and expected future income. We do not believe a new, third, measurement model will improve financial reporting. In particular, we are concerned about a measurement model that is not consistent with market conditions at the balance sheet date. The proposed measurement model may be conservative and thus it may lead to additional reserves, but we are skeptical that it is understandable, representationally faithful and meaningful.

We would understand paragraph BC20 if fair value were the objective of accounting for credit losses. But fair value is not the intent of the proposed accounting model. We believe that, absent a fair value model, the appropriate alternative is an historical cost model with recognition of credit losses concurrent with the events that give rise to a loss. A hybrid measurement model that tries to

⁴ See Attachment 1 for excerpts from ASC 820.

File Reference No. 2012-260
May 30, 2013
Page 6

reflect some future events but not others and that ignores certain economic principles (such as the double counting of risks) is not, in our view, conceptually sound. It is also not operational: because it lacks objectivity and is not grounded in current market conditions, it is subject to wide interpretation and diversity in application.

4. *Divergence from other GAAP for loss recognition* – We believe it is inappropriate to account for credit losses differently from other losses. Our current accounting model, whether we are dealing with recognition or measurement, is event driven. When we report at historical cost, we wait to record losses until the event giving rise to the loss occurs, not before. When we deal with fair value, we wait until market participants conclude, based on current market conditions that incorporate all relevant facts (both “good” and “bad”), that fair value has declined.

Under both the historical cost model and the fair value model, there is no loss event when the loan is made or the debt security is purchased. The interest rate that is explicit or implicit in the financial instrument is a product of both the risk-free rate (time value of money) and a premium over that rate to reflect the risk that the borrower will be unable to repay. By definition, lenders anticipate a certain level of default when they make a loan. That is the business they are in and they charge for it. A loss can occur when there is a change in the borrower’s ability to repay, i.e., when the lender would made a different underwriting decision relative to the borrower. This is no different than a loss from a natural disaster (e.g., a hurricane), from product liability (e.g., the sale of defective product), or from a competitor’s introduction of new product or passage of new regulations (e.g., the obsolescence of inventory or the decline in usefulness of proprietary technology). In all cases, the loss is driven by an economic event that alters the market’s view of the asset’s economic potential.

We are not alone in our view that the FASB’s accounting model represents a significant departure from current GAAP and would require recording losses that have not yet occurred.⁵ We have significant concerns about the consequences of departing from an event-based model for accounting for credit losses. Our observations include the following:

- Once the “expected loss” door is opened, we see numerous possible analogies that would result in the current recording of future events. Examples include: future repairs and maintenance on existing assets, future uninsured accidents involving existing assets, future changes in tax laws or regulations involving existing deferred tax items, future exit activities affecting existing assets, future competitive pressures that lower demand or pricing for on-hand inventory and many more. None of these events have occurred yet they may be predictable and even probable. The FASB had indicated that a reason for recording expected losses at origination is to reflect the increase in risk, specifically credit risk, when a financial institution increases its loan portfolio. However, that additional risk is no different than the increase in risk from building more inventory, constructing a new facility, expanding the number of vehicles in a rental fleet or adding more storage capacity to the company’s datacenter. When a company purchases more inventory, its risk for obsolescence, excess

⁵ We note the headline in a December 20, 2012 CFO.com article—“FASB Wants Firms to Forecast Loan Losses.” Also, on January 15, 2013, *Compliance Week* reported “FASB Wants Companies to Predict and Book Future Credit Losses” and states that the proposal “will require companies to predict credit losses and book higher reserves, if needed, even before cash flow and earnings actually begin to suffer” and “long before they actually happen.” A January 2013 BDO *Flash Report* notes that “There is no recognition threshold for recording future losses.” Constituents seem to us to be calling it like it is.

File Reference No. 2012-260
May 30, 2013
Page 7

stock, pricing changes and theft losses increases. When an entity constructs or buys more fixed assets, its risk for repairs, accidents and sufficient utilization increases. Just as the underwriting judgment that led to the extension of credit could turn out less profitable than expected, so too could any other investment decision made by management. Lending money is not unique in this regard. To quote the views of a prior Board, “the mere existence of risk, at the date of an enterprise’s financial statements, does not mean that a loss should be accrued.”⁶

- There seems to be no conceptual basis for rejecting an event-based accounting model. Rather, rejection seems to be premised on an assertion that credit losses need to be reported “more timely,” along with the inverse assertion that the existing accounting model “delays recognition of losses.” More timely than what? Is accruing today for next year’s expected, uninsured hurricane loss more timely? Or is it premature and thus misleading? Is the objective of general purpose financial statements to forecast future losses and economic downturns by reserving now for “future bad stuff”? Management’s Discussion and Analysis is a mechanism for public companies to discuss the effect of known trends and uncertainties on the company’s financial position and operating results but even those disclosure requirements do not require management to provide its expectations of losses that may occur during the remaining useful life of existing assets, a life that, like some loans, could be as long as 20 to 30 years. So we ask ourselves, again, why critics of financial reporting single out credit losses as the line item that should be subject to an entirely different measurement or recognition model. Are they seeking “rainy day reserves” or a mechanism to “smooth the bumps” in our innately bumpy economic cycles?
- In the basis for conclusions section, the Board criticizes impairment approaches that have a “trigger” or a “cliff effect.” We find this criticism confusing. Many economic events, particularly loss generating events, are discrete occurrences. We recognize that it can be difficult to isolate the specific event that creates a credit loss, but that is a different issue. We believe there is often a “cliff” or “trigger” effect when a loss event occurs, but we are not troubled by that circumstance because it seems, to us, consistent with economic reality. Whether the borrower’s financial difficulties are the result of a hurricane, an accident, the loss of a job or major customer, or the introduction of a competitive product or technology, we believe financial statements are representationally faithful when reporting these events as they happen. To do otherwise is to report lower earnings when nothing bad happens and higher earnings when the hurricane hits or the customer takes its business elsewhere.⁷

⁶ See paragraph 86 of FASB Statement No. 5.

⁷ An opinion piece by Eugene A. Ludwig and Paul A. Volcker published in *The Wall Street Journal* on January 17, 2013 comments on the incurred loss model by saying, “The [FASB] board recognizes that its existing rules on the Allocation (sic) for Loan and Lease Losses may have worsened the 2008 financial crisis. These rules limited bank reserves to those that are already ‘incurred.’ This all but ensures that banks’ rainy day funds will be too skinny, particularly in periods when credit markets are under stress. Worse yet, limiting loss estimates to events that have already occurred makes the allowance for loan and lease losses procyclical—reported earnings are too high in good times and losses hit hardest in bad times.” We consider these comments to be complimentary, not critical, of an event-based model because they demonstrate that reported financial results are consistent with ebbs and flows—and ups and downs—of the economy. Losses that are reported when markets are weak—when people lose their jobs, when customers don’t place orders, when inventories can be sold only at deep discounts—merely reflect economic reality. We note that the accounting profession, via FASB Statement No. 5, did away with “rainy day reserves” in financial reporting in 1975. In today’s parlance, rainy day reserves are called “capital.”

File Reference No. 2012-260
May 30, 2013
Page 8

- As acknowledged in the FASB Staff Q&A, the goal of improving the accounting for credit losses is not to achieve a particular result, i.e., to make reserves bigger (or smaller). The goal is to establish a sound concept.⁸ If bank regulators conclude that bigger (or smaller) loan loss reserves are necessary for regulatory capital purposes, they have the authority to define capital adequacy or loan loss allowances so as to achieve that result. The objective of general purpose financial statements is to meet the needs of investors and creditors regardless of whether those needs are consistent with the needs of regulators, tax authorities, politicians or other third parties.

Our Recommendations⁹

As indicated earlier, we agree that the current accounting model for impairments of financial assets requires improvement. Two key, frequently cited concerns with the current model are (a) delayed recognition of losses and (b) difficulty in the identification of when a loss occurs, which leads to inconsistencies in application. Regardless of whether those criticisms are valid, the widespread perception that the current model is inadequate, particularly on so important and pervasive a topic, is sufficient to merit a complete reassessment by the Board. Standard setting is clearly needed. Accordingly, we are fully supportive of the Board's efforts.

In our view, an event-based (incurred) loss model should be the basis for recognizing impairments. The concept is consistent with the conceptual framework. It is consistent with an historical cost measurement. It is consistent with the underlying economics that drive the value of a financial instrument. The concept is understandable: recognizing a loss for something that has happened is an easy notion to grasp. It is consistent with the fundamental objective of historical financial statements: to communicate the effect that transactions and events occurring through a defined date have had on the financial position of the reporting entity.¹⁰ The principle of recording losses when they occur is similar to other areas of accounting. In addition, an event-based loss model can be applied to individual loans and securities as well as portfolios. The expected loss model, with its stated goal of recording losses before they occur, offers no improvement to financial reporting. As noted in our earlier comments, we believe it confuses reported results and can potentially mislead readers of financial statements, even when applied rigorously and in good faith by management.

We acknowledge that it can be difficult to implement an event-based loss model, despite the clear concept of being based on events that have occurred.¹¹ But that is not a sufficient reason to abandon

⁸ We do note, however, that the FASB Staff Q&A mentions several times that current GAAP results in "delayed recognition of credit losses." This sounds to us like the proposal is focused on an outcome of bigger reserves.

⁹ Our recommendations remain consistent with our comment letter dated March 31, 2011 on this project. The famous economist John Maynard Keynes was once asked why he changed his mind on a particular topic. He reportedly replied, "When somebody persuades me that I am wrong, I change my mind. What do you do?" While this has happened to us on other issues, we remain unpersuaded on this issue, even after listening to all the arguments and rethinking the issues.

¹⁰ We again recommend re-reading the article referred to in footnote 1.

¹¹ If implementing the existing incurred loss model, with its clear concept, has been a challenge and has resulted in inconsistencies in practice, one can only imagine the difficulties that will be encountered with the

File Reference No. 2012-260
May 30, 2013
Page 9

the model. In our view, an event-based loss model is difficult to apply to financial assets because it is hard to know when a loss occurs, i.e., to identify the specific event or circumstance that caused the loss. Further, because the current standard for recognizing losses is tied to a conclusion that it is probable¹² that the amounts will not be collected, we believe that practice may have tended to wait until the loss is essentially confirmed before recognizing a loss. In our view, this would explain the criticism of the current accounting model as “delaying” the recognition of losses. However, this bias toward delaying recognition is not a necessary by-product of an event-based loss model.

To address the current accounting model’s apparent bias towards delayed recognition of losses (“too little, too late”),¹³ we suggest the following:

1. We recommend lowering the threshold for loss recognition to “more likely than not.”¹⁴ That term is currently used in GAAP to represent “a likelihood of more than 50%”. Said differently, an impairment would be recognized when it is more likely than not that the remaining contractual cash flows will not be collected. The current threshold for recognizing losses, “probable will not collect,” is arguably too high and may create a bias towards late recognition of loss events that have, in fact, already occurred.
2. The revised standard should emphasize that loss recognition requires consideration of losses that have been incurred but have not been reported (IBNR). Further, the standard should provide guidance on the specific factors to consider in developing estimates of IBNR. This will address the inherent difficulty of identifying the specific event or events that created the change in expected cash flows and/or collectability.

Board’s current proposal, including the auditing challenges. Level 3 fair value estimates are also a challenge, but they have the anchors of entry prices, exit prices, some level of observable inputs and the view of market participants. In an interview published in the February 3, 2013 *Wall Street Journal* about his most recent book, former Federal Reserve Chairman, Alan Greenspan, said that he hopes the book will help readers “understand and sympathize with those making key economic decisions in the public arena. It’s a tough job. We can’t see over the horizon, but since we live in the future, we have no choice but to try to make forecasting judgments.” “Forecasting what will happen,” he added, “isn’t the same as saying what will happen.”

¹² In the U.S., the word “probable” is defined as “likely to occur.” In practice, as evidenced by various academic studies, “probable” is interpreted to require a 75-80% probability of occurrence. In contrast, “more likely than not” represents a likelihood of more than 50%.

¹³ We are uncertain as to whether the Board’s new model, if it had been in place a few years ago, would have resolved the perceived issue of recognizing losses too late. We think it is highly unlikely that many financial institutions saw the economic collapse coming and we think those that did foresee difficult times were not likely to have guessed correctly the extent and severity of the collapse. As such, even if the Board had adopted an expected loss model before the collapse, we think it is unlikely that financial institutions would have recognized reserves sufficient to absorb losses resulting from the collapse.

¹⁴ We note that the recent FASB exposure draft on the recognition and measurement of financial instruments uses a “more likely than not” threshold in a proposed impairment test for certain equity investments. We also note that a “more likely than not” threshold is used currently to assess impairment of goodwill, indefinite-lived intangible assets, and deferred tax assets, as well as for recognition of uncertain tax benefits.

File Reference No. 2012-260
May 30, 2013
Page 10

We believe lowering the threshold for loss recognition combined with a clear articulation of an IBNR element in both the recognition and measurement of the impairment allowance will improve the timeliness of reporting losses that have occurred while remaining faithful to the market conditions and economic events that should underlie the carrying amount of the loan or debt instrument.

The second concern expressed regarding our current model is that of diversity in practice. Our sense is that there is significant diversity with respect to quantifying the IBNR portion of the impairment allowance, perhaps because some are concerned about methodologies that seem to sweep in future events. We believe that the quantification of the IBNR portion of the impairment allowance necessarily incorporates somewhat forward looking information. In other words, we believe that under an event-based loss model, an entity's expectations about losses that will be specifically identified in the future should inform its analysis of what losses have already occurred, albeit not yet specifically identified, as of the reporting date. The use of a forward looking "emergence period" for estimating IBNR losses is wholly consistent with an event-based loss model and we believe that diversity in practice could be reduced by an expanded discussion of, and implementation guidance for, the IBNR element in an impairment standard.

We believe that many of the procedures and ideas (as well as the related research) developed in connection with the Board's project could be used or modified to aid the development of practical approaches in quantifying the losses that have been incurred but not yet specifically identified. But the stated objective would be to "recognize losses when they occur" vs. "recognize losses before they occur," as the proposal is currently framed.

In this same regard, recent discussions have revealed to us the diversity in views as to how the current loss model works. This diversity is inevitably affecting not only current financial reporting (and thus creating some of the problems with the existing model) but is also influencing views of constituents as to the way forward. It appears to us that some of this diversity stems from confusion about what qualifies as a loss event. Another contributor to this diversity arises from confusion between the recognition of a loss and its measurement. The current proposal thus appears to have an "advantage" over the existing model in that it requires no understanding of what constitutes a loss event because the "occurrence" of the loss does not drive recognition. Further, the current proposal does not require clarity between recognition and measurement for assets since expectations of future cash flows are incorporated in both. However, in our view, these "advantages" do not improve financial reporting for the reasons set forth earlier in this letter. In fact, we believe the Board's proposal will give rise to much broader diversity in the estimate of credit losses. There will be no anchor, no benchmark, no "fact set" against which to evaluate the objectivity and reliability of management's expectations of future losses.

Opponents of our current accounting model identify two additional problems with it in practice. First, it is asserted that an enterprise can manage earnings given the judgment required to determine when losses occur. We believe the same criticism can be made of the current proposal. In fact, as noted above, it will likely be even more difficult to evaluate the reasonableness of management's judgments about expected losses. At least an event-based loss model requires some level of evidence to support the existence of a loss. Second, opponents of the existing model assert that identifying the event of impairment is difficult. We agree. But we believe that specific challenge can be met by improving the guidance on the IBNR component of incurred losses as well as clarifying other areas. Ignoring the line between past and future events does not eliminate the line's existence, but it does muddy the information being presented and mask the economic effect of current events.

In summary, we believe our recommendations:

File Reference No. 2012-260
May 30, 2013
Page 11

- Address the criticisms of the current model and result in more timely recognition of impairment allowances consistent with the economics.
- Report the economic consequences of changes in market conditions, deterioration in credit quality and other negative events that give rise to impairment losses in the periods those events occur.
- Are consistent with the conceptual framework and will preserve the necessarily sharp distinction between past and future events.
- Will not create confusion with respect to the application of ASC 450 to contingencies other than loan losses.
- Will not result generally in the recognition of an impairment loss on the day loans are originated or securities purchased.¹⁵
- Can be applied to open portfolios, closed portfolios, individual loans/securities and trade receivables.

Other Comments

We have the following other comments if the Board continues on its current path.

1. We believe the FASB should include in its basis for conclusions:¹⁶
 - An explanation of why the proposed accounting is representationally faithful (see earlier comments under item 1 in the first section of this letter).
 - A discussion of the applicability of CON 7 and the issue of double counting (see earlier comments under item 2 in the first section of this letter). In this regard, the FASB should consider using a risk-adjusted rate (rather than the effective rate) in discounting cash flows expected to be collected to then measure the allowance for credit losses in order to avoid double counting the risk.
 - A more robust explanation of why the Board sees this issue as a measurement (not recognition) matter (see earlier comments under item 3 in the first section of this letter).
 - The rationale as to why credit losses are being treated differently for financial reporting purposes from other losses (see earlier comments under item 4 in the first section of this letter). If pragmatic/operational (vs. conceptual) issues are significant factors in driving the Board to its model, please say so.

¹⁵ We concur with the existing requirement to record an immediate loss “if a faulty credit granting decision has been made or loan credit review procedures are inadequate or overly aggressive.” ASC 942-310-25-1

¹⁶ We have read the FASB Staff Q&A which addresses some of the points below. While we compliment the FASB on trying to explain its proposal, we remain unconvinced and confused. But in any event, the explanations in the FASB Staff Q&A should be incorporated in the basis for conclusions of a final standard.

File Reference No. 2012-260
May 30, 2013
Page 12

- Additional explanation as to how percentage loss factors implicitly consider both the time value of money and probability weighting.
2. We recommend that the FASB add an implementation example dealing with a nonbank that has a handful of longer term receivables or perhaps a single receivable (or unrated debt security). The exposure draft mentions financial institutions quite a bit (most of the examples), but the proposal also applies to “regular” companies who may not have all of the historical statistics/experience of banks. In addition, on a single receivable, it seems like a natural inclination to expect that at origination all contractual cash flows will be collected assuming good “underwriting” and no fraud or mistakes. Otherwise, for a single receivable, one would presumably not have entered into the arrangement. However, the proposal requires reflection of a possibility of credit loss as well as no loss. Please provide an example as to practically how to do it. The exposure draft notes that a probability weighted approach is not required. So how is it done? Consider having two permutations—the company has no historical experience and the company has significant historical experience of no losses.
 3. We wonder whether a different name for the FASB’s proposed method—“current expected credit loss” (CECL) model—would be helpful in communicating, particularly with non-accountants. To illustrate, assume a company invests in a AA-rated bond. It “expects”—in the general sense of that word—to be repaid in full and does not “expect” any losses. Yet the CECL model produces an allowance for expected credit losses. We understand that this is the case even for investments in U.S. Treasury securities. Is there a better way for the FASB to articulate its concept that is not inconsistent with the plain English understanding of expectations? Also, would it be possible for the FASB to find a way to accept a “best estimate” or “most likely outcome” in its expected loss model when evaluating individual assets that are not part of a large portfolio of similar items?
 4. As an important editing point, we suggest the description of current GAAP be made clear—a loss is recorded when it is probable that an asset has been impaired. We believe it is not accurate and frankly misleading to say “... the existing ‘incurred loss’ model delays recognition until a credit loss is probable or has been incurred” (emphasis added) (see page 1 of the exposure draft).
 5. “Grossing up” on purchase of credit-impaired loans is a bad idea irrespective of the perceived pragmatics involved and is inconsistent with our traditional—and conceptually sound—accounting framework in this respect.
 - Should we gross up for accumulated depreciation on a purchase of used equipment?
 - Implementation question – In a business combination, there have been diverse views on the application of the exposure draft. Clarification would be helpful. We read the exposure draft to say: (1) set up an allowance for expected credit losses only on acquired credit-impaired loans (as defined) and (2) other loans are recorded “net” at fair value on the date of acquisition and then on the date of acquisition an allowance for expected credit losses is recorded through the acquiring company’s income statement (similar to what is done for originated loans) even though fair value at the acquisition date reflects the loans’ current creditworthiness. (Note that if one is bothered by this outcome, one should be bothered by the Board’s current proposal—see our point 1 in the first section of this letter.)
 6. We are confused by the “practical expedient” for financial assets carried at fair value through other comprehensive income (FV-OCI). If the fair value exceeds cost, we would think there is no

File Reference No. 2012-260
May 30, 2013
Page 13

impairment. Is there a need for the second criterion? Alternatively, if the asset has insignificant credit risk (e.g., AA-rated), perhaps the first criterion is not needed. Why is the practical expedient limited to assets carried at FV-OCI? Further explanation would be helpful.

7. The proposed interim disclosures seem excessive to us. The exposure draft is consistent with the FASB's current trend of requiring extensive quarterly disclosures (almost the same as annual) but inconsistent with the traditional view of quarterly reporting as being condensed (and thus more abbreviated) and what we sense is the hoped for result of the Disclosure Framework project. We believe the Disclosure Framework initiative should first run its course before continuing to require extensive quarterly disclosures.
8. We think there is an inconsistency between the guidance on nonaccrual status (do not accrue interest if there are probable collectibility issues) and the model for purchased credit-impaired financial assets (estimate cash flows and then compute and accrue yield even if some of the contractual cash flows will probably not be collected).
9. Does the proposal apply to intercompany receivables in standalone subsidiary or parent company financial statements?
10. Proposed paragraph 825-15-25-3 says, in part,

“Although an entity is required to estimate credit losses over the entire contractual term of the financial assets, as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses increases because the availability of detailed estimates for periods far in the future decreases. An entity shall consider information that is available without undue cost and effort that is relevant to the estimated collectibility of contractual cash flows.”

In all candor, one is not sure what to do next. The FASB Staff Q&A does provide some additional guidance that should be included in a final standard. In fact, the FASB Staff Q&A permits alternatives that could conceptually produce quite different results.

Once again we appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses*. If there are any questions, please contact John E. Stewart at 312-345-9104.

Sincerely,



Financial Reporting Advisors, LLC

Attachment 1

FASB Concepts Statement No. 7

General Principles

41. The techniques used to estimate future cash flows and interest rates will vary from one situation to another depending on the circumstances surrounding the asset or liability in question. However, certain general principles govern any application of present value techniques in measuring assets or liabilities:

- a. To the extent possible, estimated cash flows and interest rates should reflect assumptions about the future events and uncertainties that would be considered in deciding whether to acquire an asset or group of assets in an arm's-length transaction for cash.
- 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. For example, an interest rate of 12 percent might be applied to contractual cash flows of a loan. That rate reflects expectations about future defaults from loans with particular characteristics. That same 12 percent rate should not be used to discount expected cash flows because those cash flows already reflect assumptions about future defaults.
- c. Estimated cash flows and interest rates should be free from both bias and factors unrelated to the asset, liability, or group of assets or liabilities in question. For example, deliberately understating estimated net cash flows to enhance the apparent future profitability of an asset introduces a bias into the measurement.
- d. Estimated cash flows or interest rates should reflect the range of possible outcomes rather than a single most-likely, minimum, or maximum possible amount.

ASC 820-10-30 Initial Measurement

General

30-2 When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an **entry price**). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an **exit price**). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

30-3 In many cases, the transaction price will equal the fair value (for example, that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).

30-3A When determining whether fair value at initial recognition equals the transaction price, a reporting entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

- a. The transaction is between **related parties**, although the price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.

Attachment 1
Page 2

b. The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The **unit of account** represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (for example, in a **business combination**), the transaction includes unstated rights and privileges that are measured separately, in accordance with another Topic, or the transaction price includes **transaction costs**.

d. The market in which the transaction takes place is different from the **principal market** (or **most advantageous market**). For example, those markets might be different if the reporting entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the **dealer market**.