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31 May 2013

**Proposed Accounting Standards Update, *Financial Instruments—Credit Losses*  
(File Reference No. 2012-260)**

Dear Ms. Cospers,

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (the Proposed Update).

We recognize the challenges the Board faces in responding to the request to develop alternatives to the current incurred loss model. Standard setters have long struggled with this topic. Issues related to accounting for the allowance for credit losses are complex and have wide-ranging implications given the focus regulators place on the allowance for credit losses when evaluating the safety and soundness of a financial institution. We also recognize that the Proposed Update responds, in part, to constituents' concerns that the models the Board had previously proposed that would recognize losses over time would likely not be workable in practice.

However, we do not believe the Proposed Update should be finalized in its current form. First, we believe that convergence in this area between US GAAP and IFRS is needed. We observe that even though both sets of standards employed today use an incurred model to recognize credit losses, there is diversity in practice. The credit crisis has re-emphasized the need for more transparency and comparability with respect to the allowance for credit losses. We believe that the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) should work through any differences and arrive at a converged solution.

In addition, with respect to the key issue of determining when credit losses should be recognized, we believe the FASB has more work to do. In this letter, we suggest alternative approaches to the Proposed Update that would result in more timely recognition of losses without the immediate recognition of lifetime expected losses. We also have concerns about how credit losses would be measured and the scope of the proposal.

While we believe the Board has taken a thoughtful approach to this project thus far, we think the Board should further its outreach through roundtables and by robustly field testing any revised proposal. The Proposed Update would be a significant change to current practice and would introduce issues that need to be carefully addressed to provide for an orderly implementation.

### **Initial recognition trigger**

By requiring entities to recognize all lifetime expected credit losses at each reporting date, the Proposed Update would address the concern that today's incurred loss model delays the recognition of credit losses. Under current US GAAP, only past events and conditions existing at the balance sheet date should be considered in determining whether it is probable that a loss has been incurred. Because the Proposed Update does not include a recognition threshold, entities would now be required to record expected losses associated with all events, including future events.

On one hand, the Proposed Update's approach seems straightforward. The Proposed Update states that because the amortized cost balance represents the present value of the contractual cash flows to be received, the allowance should be the present value of the cash flows that management does not expect to collect. Otherwise, the receivable measured at amortized cost would be overstated.

We struggle, however, with the concept that losses associated with future events should be recognized at the balance sheet date. Predicting future events is inherently challenging and leads to questions about whether the Proposed Update can be implemented effectively in practice. Instead, we believe the Board should develop a model that better ties the recognition of losses to the credit deterioration of the instrument.

By requiring all expected losses associated with future events to be recognized at each balance sheet date, the Proposed Update would require entities to establish allowances for assets that have not exhibited any credit deterioration, which we believe would be premature. To be clear, we believe that accruing losses associated with future events is fundamentally different from accruing losses upon the initial recognition of an asset under current US GAAP because in the latter case the losses have already been incurred as a result of past events or conditions existing at the balance sheet date.

Instead of developing an entirely new credit impairment model, we suggest the Board amend the scope of ASC 450-20, *Contingencies—Loss Contingencies*, to exclude the recognition and measurement of credit losses for loans. We would not advocate amending ASC 450-20's loss recognition guidance for other transactions in its scope.

We believe that the Board should then eliminate today's requirement that the allowance for credit losses be determined based on whether it is probable that an asset has been impaired. Instead, we suggest creating a lower threshold that would in effect require losses to be recognized sooner than under today's guidance. This lower threshold could be stated in a number of different ways.

One way of lowering the threshold for recognition would be to employ a lower trigger based on whether it is "more likely than not" (rather than probable) that contractual cash flows will not be collected.

Under another approach, the trigger for recognizing credit losses could be based on whether the instrument continues to meet the definition of an asset. The FASB's Conceptual Framework defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of

past transactions or events.<sup>1</sup> Therefore, the trigger for recognizing credit losses could be whether an entity can assert that collection of an asset's contractual cash flows (i.e., future economic benefits) is probable.<sup>2</sup> If an entity cannot make such an assertion, it would recognize as a loss the cash flows that no longer meet the definition of an asset.

Under both of these triggers, the loss recognition threshold would be lower than the current US GAAP requirement under ASC 450-20. For example, using the definition of an asset (and a probable trigger), an entity that determined after initial recognition that it had only a 60% chance of collecting an asset's contractual cash flows would establish an allowance for credit losses sooner than under today's guidance.

A key difference between the approach we suggest and the Proposed Update is that we would retain the concept in current US GAAP that losses (for items carried at amortized cost) should be recognized based on past events and current conditions rather than future events. We believe that retaining this concept would better align the recognition of losses with an instrument's credit deterioration. This proposed change would help address concerns that the Proposed Update would require losses associated with future events to be recognized.

Entities using loss emergence periods to estimate credit losses would need to use longer loss emergence periods under our suggested approach than they use today. Using longer loss emergence periods would likely result in the more timely recognition of losses related to past events and current conditions than under current practice.

For example, in estimating probable credit losses under current US GAAP, a financial institution might develop an estimate of the receivables it expects to charge off during the 12 months after the balance sheet date (i.e., a 12-month loss emergence period). Replacing today's probable threshold with a lower loss recognition trigger would generally capture additional losses that, while associated with events that have occurred at the balance sheet date, may emerge as charge-offs beyond the next 12-month period. In this simple example, the financial institution would need to consider using a longer loss emergence period (e.g., 18 to 24 months) to capture the events that give rise to the additional losses it would recognize using a lower threshold.

### **Determining the amount of the allowance**

We believe the proposed requirement to consider two possible outcomes and thus recognize some amount of allowance for each debt instrument is confusing. We believe part of this confusion stems from wording in the proposal that indicates the allowance would be neither a best- nor a worst-case scenario. The requirement to recognize an allowance for credit losses on every debt instrument in the scope of the Proposed Update could be viewed as a worst-case scenario for some assets.

We believe the FASB staff's recent Frequently Asked Questions (FAQ) document on the Proposed Update in part adds to the confusion by emphasizing that the allowance for credit losses would reflect

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<sup>1</sup> FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25.

<sup>2</sup> We recognize that the term "probable" as used in defining an asset does not have the same meaning as it does in evaluating loss contingencies.

management's estimate of all credit losses that management currently expects to realize. The requirement to consider multiple possible outcomes, including at least one outcome that results in a loss, would override a reasonable assertion by management in situations where it expects to collect all amounts on an asset.

We're not sure why the Board decided not to continue to use the term "best estimate." While the FASB staff's FAQ document states that the term "best estimate" has different meanings and would detract from comparability, we're not aware of any significant practice issues with respect to that term and observe that it has been used in practice for many years. We believe that the replacement of that term with the requirement to consider at least two possible outcomes would be more confusing.

### **Putting the concepts together**

Under one of the approaches we suggest, assuming the unit of account was determined to be the individual loan, management would first determine whether the recognized asset continues to meet the definition of an asset. If it is probable that all amounts will be collected, no allowance for credit losses would be established for that individual asset. The asset would then be included in the appropriate pool to be evaluated collectively for impairment.

As part of that pool's impairment evaluation, an allowance for credit losses would be established for amounts at the pool level that are not expected to be collected based on past events and conditions at the balance sheet date. Future conditions would not be considered.

However, if management could not assert that it is probable that all amounts will be collected, an allowance for credit losses would be established for that asset. Impairment would be recorded based on the present value of management's best estimate of expected future cash flows, similar to current US GAAP.

We acknowledge that the approach we are suggesting the Board consider would need to be further developed, but we believe it would be a much simpler approach to improving today's incurred loss model.

### **Debt securities**

We support the Board's overall goal to reduce complexity but believe that debt securities should not be in the scope of the Proposed Update. We generally believe there are enough differences between loans and debt securities to warrant retaining today's credit impairment model for debt securities. Further, we believe the cost of applying the Proposed Update to debt securities outweighs the potential benefit to financial statement users.

Today's separate impairment models for loans and debt securities reflect key differences in how the credit risk associated with these instruments is managed. Financial institutions actively manage their credit risk and have relationships with their borrowers that enable them to modify loan terms, including before a borrower defaults. In contrast, holders of debt securities generally can't manage the credit risk associated with a debt security other than by selling it.

Applying the proposed guidance to debt securities would also create operational and audit challenges. The Proposed Update, through its requirement to consider at least two possible outcomes, would require an allowance to be recognized for every debt instrument in its scope. While banks generally have extensive data about the historical performance of their loans that they could use as a starting point to estimate expected losses, many entities that hold debt securities generally don't have this data. They would be forced to rely on data from third parties, including credit-rating agencies.

Many preparers would have little visibility into how that data was compiled, but would effectively be recognizing credit impairments based on this information. Entities would need to develop controls to verify that the ratings and data are accurate. Auditors would then have to test those controls.

We question whether the cost of these operational burdens is justified, particularly for entities that invest in higher-rated securities. Management might fully expect to collect all contractual cash flows and would have no supportable basis for developing a credit loss estimate, as would be required by the Proposed Update.

Also, it's not clear to us that financial statement users understand how the Proposed Update's nonaccrual principles would change how interest income is recognized. Under current US GAAP, interest income is recognized if the best estimate of expected cash flows is greater than the carrying value of the debt security. Under the Proposed Update, debt securities would be subject to the same nonaccrual principle that would be applied for loans, which would significantly change the timing of when interest income is recognized. We believe the Board should perform specific outreach with financial statement users on this issue.

We generally believe that today's credit impairment guidance for debt securities has not generated significant practice issues and should not be changed simply to create a single impairment model. The FASB developed the debt security model in response to concerns raised during the credit crisis about excessive loss recognition on these instruments. We believe the Proposed Update would be a step backward in this area.

If the Board concludes that debt securities should be in the scope of any final guidance, changes should be made to the proposed practical expedient feature. We believe that as proposed it would provide little relief in practice. The Board could make the practical expedient more relevant and useful by simply removing the fair value criterion (i.e., scoping out high credit quality debt securities).

### **Purchased credit impaired assets and interest income recognition**

While we support the Board's efforts to simplify the accounting for purchased credit impaired (PCI) assets, we believe several clarifications are needed. The Proposed Update would change the definition of a PCI asset, but it isn't clear whether the Board intended to change today's scope for PCI assets. We believe that absent specific concerns the Board should retain the existing definition.

In addition, while we understand that the Board wants to decouple the recognition of interest income from that of credit losses, it's not clear to us why interest income should be recognized on amounts not expected to be collected. If we correctly understand the Proposed Update, the PCI asset's effective interest rate would be applied to the gross carrying amount (which, under the proposal, is increased

by the initial allowance recorded at purchase) and the allowance, effectively grossing up both interest income and the provision for credit losses. While there would be no net effect on earnings, interest income would be recognized on amounts not expected to be collected.

While we understand that the Board was seeking to simplify the accounting for PCI assets, we're not sure why interest revenue would be recognized on amounts that by definition are not expected to be realized. On balance, it appears to us that interest revenue should be calculated only on the net carrying value of the asset, which is consistent with the IASB's credit impairment proposal. To be clear, we support the gross presentation on the balance sheet and believe the proposed changes would simplify the accounting in this area. We believe the Board should include an example of the subsequent accounting for PCI assets in any final guidance.

We also believe the Board should provide additional application guidance for the proposed nonaccrual principle. We believe the proposed guidance is too principles-based, particularly considering today's extensive nonaccrual rules from the bank regulators. It's unlikely that preparers would be able to consistently apply the proposed nonaccrual principle, which could impair comparability. As described previously, we also believe that the nonaccrual guidance should not be applied to debt securities.

The Proposed Update would remove interest income recognition guidance for certain beneficial interests under ASC 325-40, *Investments—Other—Beneficial Interests in Securitized Financial Assets*. We aren't sure why this guidance would be eliminated as part of the credit impairment project. As described in our comment letter to the Board on its separate project on classifying and measuring financial instruments, we believe this guidance should be retained because (1) all beneficial interests would not be required to be measured at fair value with changes recognized in earnings and (2) ASC 325-40 is also applicable in determining how interest income should be recognized for beneficial interests in ASC 325-40's scope that are measured at fair value with changes recognized in earnings.

### **More application guidance is needed**

While we understand and appreciate the Board's desire to promote the use of principles, we believe additional application guidance is needed because the Proposed Update would significantly change the accounting for credit losses. We also believe that the Proposed Update would eliminate certain helpful guidance, including on when credit losses should be measured for an individual asset and when they should be measured as part of a pool. As part of its outreach and field testing, the Board should identify practice issues for which application guidance is needed.

The Board should also consider providing more guidance on how an entity should consider reasonable and supportable forecasts, especially for pools of assets. This is important if the Board decides to move forward with the Proposed Update. We acknowledge that current US GAAP requires consideration of such information when measuring impairment for individual loans and securities. However, we have spoken with many preparers who have expressed concern about how to apply this requirement to pools of non-impaired assets. We provide examples of other areas where application guidance is needed in the Appendix to this letter.

### **Further field testing is necessary**

The allowance for credit losses is a complex estimate that requires significant professional judgment. Because there is diversity in the approaches that banks currently use to estimate incurred losses, we believe it's critical for the Board to perform extensive field testing before finalizing any new guidance. We strongly encourage this field testing to include large, midsize and small banks, as well as insurance companies and several nonfinancial institutions with varying degrees of sophistication in estimating credit losses. The proposal needs to be operable for each of these groups.

In our view, this field testing would involve applying the proposed model to estimate allowances for various asset classes at different entities. Preparers, auditors, users and regulators should be involved.

Robust field testing would give the FASB and other standard setters an opportunity to identify the need for additional implementation guidance, either in a final standard or in other accounting or auditing literature or standards, and would greatly improve the implementation of any final standard.

In addition, we believe the Board should provide sufficient time for stakeholders to fully understand any final guidance before requiring it to be adopted. We expect a number of auditing issues to be identified. By providing a reasonable implementation period, the Board would give auditors and audit standard setters enough time to identify any possible changes to the auditing guidance in this area.

The Appendix to this letter includes our detailed responses to the Board's specific *Questions for Respondents* about its Proposed Update. We have responded only to *Questions for All Respondents* and *Questions for Preparers and Auditors*.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

Responses to specific questions raised in the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses*

**Scope**

**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?

**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?

**Response:**

In developing the Proposed Update, the Board appeared to focus on its application to loans and did not spend as much time discussing how it would apply to other debt instruments. We believe the Proposed Update should be applied only to loans. We do not believe debt securities and trade, lease and reinsurance receivables should be subject to the Proposed Update.

***Debt securities***

As indicated in our cover letter, entities manage the credit risk associated with debt securities in a manner that is fundamentally different from the way they manage loans.

If the Board ultimately decides that debt securities should be included in the scope of the Proposed Update, we believe a final standard should expand and better define the proposed practical expedient. Specifically, we believe the Board should replace the proposed practical expedient with the following:

An entity would not recognize expected credit losses for an individual debt security when expected credit losses on the individual debt security are insignificant, which may be determined by considering the general expectation of the range of expected credit losses given the credit-quality indicator(s) for the security as of the reporting date.

Eliminating the criterion that the fair value of the individual financial asset must be greater than or equal to the amortized cost basis of the financial asset would eliminate the possibility of entities having to record expected credit losses solely due to a change in the risk-free rate, even when the

underlying credit risk for individual debt securities hasn't changed. Without this change, highly rated securities such as US Treasuries might qualify for the practical expedient in one period but fail to qualify in the next period.

We also recommend broadening the practical expedient to apply to all debt securities rather than just those measured at fair value through other comprehensive income. This would allow entities to use the practical expedient for debt securities measured at amortized cost. We believe this expansion would greatly increase the operability of the Proposed Update by significantly reducing the initial and ongoing costs of compliance.

The Board should also clarify what constitutes insignificant expected credit losses. It's unclear what threshold preparers and auditors would consider when evaluating whether expected credit losses are insignificant. Based on our discussions with preparers, interpretations vary widely. Some believe the threshold would be a credit rating of AA or above, which would be similar to the SEC staff's interpretation of the term "high credit quality."<sup>3</sup> Others believe it would be an investment-grade credit rating, which would broaden the scope of the practical expedient. If the Board decides debt securities are in the scope of any final guidance, we believe the AA or above threshold would be too narrow.

#### ***Trade receivables***

We believe the Proposed Update unnecessarily complicates the accounting for credit losses associated with typical trade accounts receivable. Many companies that are not financial institutions have expressed concerns to us about how to apply the key principles outlined in the Proposed Update (e.g., time value of money, multiple possible outcomes, reasonable and supportable forecasts) to their accounts receivable balances. While these principles may not have a significant effect on the size of the allowance, the effort required to consider and document them would increase the cost of compliance. We recommend the Board remove receivables due in less than one year from the proposal's scope.

If these receivables remain in the scope of the Proposed Update, we encourage the Board to consider providing a practical expedient that would permit entities to not consider forecasts and the time value of money when estimating the allowance for credit losses on trade receivables.

#### ***Lease and reinsurance receivables***

We believe the accounting for leases and insurance contracts should be excluded from the scope of the Proposed Update until the Board completes its redeliberations on its separate proposals involving those instruments and the interplay between those final standards and the Proposed Update is fully considered. The Board should also make sure the effective dates of the Proposed Update and these other proposals align appropriately to avoid any additional complexity.

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<sup>3</sup> In ASC 325-40, the term "high credit quality" is described as a security for which the possibility of a credit loss is remote.

## Recognition and measurement

### 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?

### Response:

As discussed in our cover letter, it may be easier for the Board to address constituents' concerns about the allowance for credit losses by replacing today's probable threshold with a lower loss recognition trigger, which could be stated in a number of different ways. With this change, credit losses would be recognized more timely. Losses would continue to be recognized only for past events and current conditions at the balance sheet date. Expected losses associated with future events would not be considered.

If the Board decides to proceed with an expected loss approach that requires losses associated with future events to be measured, we generally agree with the information set (past events, current conditions and forecasts) an entity would be required to consider when estimating expected credit losses. However, we believe that incorporating reasonable and supportable forecasts into estimates of expected credit losses and determining where the economy is with respect to the economic cycle will present challenges to both preparers and auditors, particularly for assets with longer maturities.

### *Estimating the expected life of assets*

The proposal would require an entity to record an estimate of contractual cash flows it does not expect to collect. For certain asset classes, such as traditional mortgage loans, estimating losses over the contractual life of the asset doesn't make sense when expected prepayments significantly reduce the contractual life.

The FASB staff's FAQ document clarifies that expectations about prepayment activity would be considered when estimating expected losses. We appreciate this clarification and believe that any final standard should clearly describe the factors an entity should or should not consider when estimating the life over which management would be estimating expected credit losses.

For example, it's unclear how a financial institution would consider loan renewals, particularly when there is an expectation and history of loans being extended or renewed. We generally believe expected extensions and renewals should not be considered because the lender has no contractual obligation to extend or renew. One exception might be when a lender expects to extend the maturity of a loan because the borrower is experiencing financial difficulties.

### ***Determining whether a forecast is reasonable and supportable***

Economic cycles are often influenced by forces that are difficult to model and predict, such as consumer and business confidence or unemployment rates. While entities have some experience considering very near-term forecasts under today's incurred loss model, incorporating longer-term forecasts would likely require reliance on historical information, adjusted for expected future trends. Entities also could arrive at very different conclusions about where in the cycle (relative to both short- and long-term cycles) the economy is at the reporting date.

The FASB staff's FAQ document provides additional guidance in questions 12 through 15. Preparers have asked us the same questions. We believe that many of these questions and answers should be further developed and included in any final standard.

- ▶ **Forecasting over longer periods** - While we note that management is currently required to consider reasonable and supportable forecasts to measure the impairment of individual loans (see ASC 310-10-35-26) and debt securities (see ASC 320-10-35-33G), we believe the Proposed Update would require more judgment. Today, entities forecast impairment on these instruments over a relatively short period because the assets have already been deemed to be impaired (i.e., the loss event has already occurred). Requiring consideration of reasonable and supportable forecasts for all assets would lengthen the forecast period considerably, resulting in the use of longer-term forecasts that could be less reliable.

We understand that the FASB staff's FAQ document attempted to address the concern many constituents have about forecasting economic conditions over longer periods. In particular, the FASB staff indicates that an entity would be required to forecast economic conditions only over the period the entity believes it can reasonably support such forecasts. For periods beyond an entity's ability to reasonably support a forecast, an entity would need to rely more on historical averages and adjust them as appropriate. This concept should be incorporated into any final standard.

- ▶ **Using management's forecast** - We understand that the Board intended to allow management to use its own forecast (without requiring that it be consistent with consensus views) and to provide support for that estimate through transparent disclosures. We are concerned that today's audit guidance may not be sufficiently robust for an accounting model based on management disclosures.

Auditing an entity's forecast would present challenges, particularly when entities base their conclusions on different forecasts. Both the proposal and the FAQ document indicate that an entity would use forecasts that reflect management's expectations. Auditors would then have to corroborate management's expectations with other sources. This could be difficult if management takes a view that is contrary to consensus views.

We believe the Board should consider this need for robust audit guidance in determining the effective date of any final standard. Enough time should be provided to auditors and regulators to develop audit guidance that is tailored to the new credit impairment standard.

### ***Converting a forecast into an adjustment to historical loss experience***

The Proposed Update doesn't clearly explain how an entity would adjust historical losses for reasonable and supportable forecasts. Proposed paragraph 825-15-55-3 indicates in the parenthetical comment that an entity would be required to adjust individual historical loss rates for reasonable and supportable forecasts before applying those loss rates to the amortized cost basis as of the reporting period. Yet paragraphs 825-15-55-25 through 55-27 seem to explicitly allow an entity to consider forecasts through an overlay, or credit risk adjustment, to the total allowance for credit losses rather than requiring an adjustment to base loss factors. The Board should clarify this point.

#### **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?**

#### **Response:**

##### ***Usefulness of incurred loss models***

While we appreciate the Board's efforts to permit the continued use of many models used today, it's important to note that these models were designed for the incurred loss model and not for an expected loss model that would estimate losses over the lifetime of an asset. As a result, we believe the Board may be oversimplifying the effort needed to implement the Proposed Update. The Board doesn't seem to have considered the possibility that regulators and others may require entities to develop new data gathering processes and models to conform to a fundamentally new accounting model.

For example, we understand that many smaller financial institutions use a simple annual historical loss rate to estimate incurred losses today. While the Proposed Update suggests an entity might be able to use an annual loss rate to estimate lifetime expected losses, it does not provide examples of how such a loss rate might be used. Instead, the proposal describes only when the use of an annual loss rate would be inappropriate. As a result, we believe significant effort may be required to adjust existing models or design new models to capture lifetime expected losses.

##### ***Availability of data***

The availability and usefulness of existing loan loss data will likely vary across entities. In most cases, we understand that loss data may need to be tagged and tracked differently than it is today. As a result, some preparers may face challenges. We strongly encourage the Board to carefully consider the feedback from preparers, particularly smaller entities, about the availability and usefulness of data before finalizing the proposal.

Most entities that hold debt securities don't have similar loss data. Instead, they would have to rely on rating agencies that track and compile this information. If preparers plan to rely on historical loss information from these third-party sources, we believe additional time and effort will be needed for preparers and auditors to get comfortable with such data. We also aren't sure whether probability-of-default and loss-given-default data available from rating agencies would be granular enough (e.g., geography, industry) to support an estimate of expected credit losses. As a result, the Board should perform outreach to assess whether appropriate data exists for debt securities and is available in a form that can be used to calculate lifetime losses in accordance with the proposal.

**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?

**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?

**Response:**

***Multiple possible outcomes***

As explained in our cover letter, we don't believe there should be a requirement to consider multiple possible outcomes, particularly when management expects to collect the debt instrument's contractual cash flows. The requirement to consider multiple possible outcomes may force management to record an allowance it (1) doesn't believe is needed and (2) cannot support. We believe this could result in misleading and inappropriate financial reporting about the losses an entity expects to experience.

Under the proposal, many companies would be required to record allowances for expected credit losses for high-quality assets for which there is no reasonable expectation of credit losses. Examples include US Treasury securities, repurchase agreements and certain trade receivables from government

or other entities for which there is no history of default. It's not clear what supporting evidence a company would provide to its auditor in these instances.

More importantly, this practice could lead to recorded allowances that are meaningless, would not provide investors with any additional clarity and would generally be disregarded by financial statement users. All of this underscores our recommendation to maintain the "best estimate" concepts in current US GAAP.

We're not sure why the Board decided not to continue to require the use of a best estimate in estimating credit losses (as is currently required for loans and debt securities). The FASB staff's FAQ document states that the term "best estimate" has different meanings and would detract from comparability. The term "best estimate" has long been applied in impairment accounting and we're not aware of any significant practice issues with respect to that term. We believe eliminating the "best estimate" concept and requiring at least two possible outcomes would be more confusing.

While we disagree with the concept of multiple possible outcomes as described in the Proposed Update, we agree with the Board's view that many loss models for loans implicitly consider multiple possible outcomes because they rely on an extensive history of various outcomes. Permitting the use of such models would make the proposal more operational for loans. However, if the Board retains this concept, we believe additional clarity is needed.

- ▶ The Proposed Update refers to the two outcomes as representing a credit loss and no credit loss. We understand this to mean the allowance for any given asset can never be zero. As such, the possibility of the credit loss occurring also cannot be zero. If this is the FASB's intent, it should make this clear. We believe there are instances where there is a probability of default, but the loss given default can be zero. This is the case with debt instruments that are over collateralized, including repurchase transactions (that are often over collateralized by US Treasury securities). We believe it would be inappropriate to record an allowance in such instances.
- ▶ The Proposed Update says that a probability-weighted calculation is not required (see ASC 825-15-25-5), but it's unclear how an entity would consider two outcomes without weighing the probability of each outcome. A final standard should provide illustrative guidance to help preparers and others understand how to make an estimate without a probability-weighted calculation.

### ***Time value of money***

We generally agree with the FASB's view that the amortized cost balance represents the present value of the contractual cash flows discounted back at the asset's effective interest rate. However, we acknowledge that this concept does not hold true once an entity applies the proposed nonaccrual principle.

We also believe that allowing entities to assume that most of the common models used today implicitly take into account the time value of money would make the standard more operational. However, we believe the FASB should more clearly describe what is required for an entity to be able to assert that a model it uses implicitly considers the time value of money. This is important because we believe that many entities would choose a simpler, more operational approach if it allowed them to avoid a detailed discounted cash flow analysis.

The FASB staff's FAQ document states clearly that entities would not have to prove that a method that implicitly considers the time value of money provides the same results as (or reconciles with) a method that explicitly reflects the time value of money. We believe this should be stated explicitly in the final standard, perhaps by calling these methods practical expedients or by replacing the second to last sentence in 825-15-55-3 of the Proposed Update with:

Such methods include those based on loss rates, roll rates, probability of defaults and provision matrices.

We believe rewording this sentence in this manner would provide the flexibility the FASB intended to give preparers. If this clarification isn't made, we believe entities would face significant pressure from regulators and others to reconcile implicit models with explicit ones.

**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?

**Response:**

While we support the Board's efforts to simplify the accounting for PCI assets, we have several concerns about the proposed guidance, including:

- ▶ **Definition of a PCI asset** - The Proposed Update would change the definition of a PCI asset from an asset with "evidence of deterioration of credit quality since origination . . . for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable"<sup>4</sup> to one that has "experienced a significant deterioration in credit quality since origination." It's unclear why the Board proposed this change. Specifically, we are unsure what the Board means by "significant deterioration" and whether the threshold would be higher, lower or the same as today's probable threshold. Said differently, it isn't clear to us whether the proposed definition is intended to be narrower or broader than the current definition.

If the Board chooses to finalize the proposed definition, it should clarify what "significant deterioration" means. While we understand it would be inappropriate for the Board to establish a

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<sup>4</sup> ASC 320-30-05-1.

bright-line definition of significant deterioration, we believe it should provide additional implementation guidance to help preparers and auditors apply the concept.

As an alternative, the Board should consider retaining the existing definition of PCI because we believe this definition is better understood than the proposed language.

- ▶ **Groups of financial assets with shared risk characteristics** - The Board should clarify whether the parenthetical phrase in the definition of a PCI asset referring to groups of financial assets is meant as an election or a requirement. Specifically, it's unclear whether an entity would be required to perform an analysis of groups of acquired financial assets after applying the definition to the individual assets. The Board should clarify its intention, particularly given practice issues associated with the AICPA's interpretation<sup>5</sup> of current US GAAP.

The Board should also provide application guidance about the concept of "shared risk characteristics." This would minimize the risk that a broad interpretation of "shared risk characteristics" would result in the application of PCI accounting to more assets than intended. That is, we believe the Board was trying to provide a practical way to apply the standard, and applying it at the "group" level should not materially change the result.

It's unclear why the Board proposed eliminating the current "common risk characteristics" guidance, which requires a similar risk rating in addition to consideration of other predominant risk characteristics. We believe the Board should retain this guidance because it is helpful in determining whether a pool of assets has shared risk characteristics.

Finally, it's also unclear whether a new unit of account would be created if an entity determined that a group of assets met the proposed definition of a PCI asset. This is an important distinction because many practice issues have arisen in connection with the concept of a group of assets or loans being accounted for as a single unit of account or asset.<sup>6</sup> The Board should clarify whether such assets should continue to be accounted for as individual assets or a single asset. If the Board didn't intend to require or allow treatment as a single asset, we believe it should consider whether ASC 320-10-35-15 and 35-16 could be used by a preparer to account for a group of PCI assets as a single asset. If the Board intended to require treatment as a single asset, we believe the Board should provide additional guidance or retain much of the current guidance on this topic.

We believe that regulators would likely scrutinize amounts entities initially recognize as allowances for expected credit losses on PCI assets because those amounts would not be recognized through earnings. Subsequent improvement in credit quality would result in an increase to income even though the initial allowance did not affect income. As a result, we believe the Board should consider whether it would be appropriate to include in the final standard any of the views expressed in SEC Staff Accounting Bulletin No. 61.

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<sup>5</sup> Refer to the practice issues associated with the AICPA Depository Institutions Expert Panel's letter to the SEC dated 18 December 2009.

<sup>6</sup> Refer to the practice issues that led to the issuance of ASU 2010-18, *Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset*.

### ***Interest income for PCI assets***

As described in the cover letter, we understand that the Board intends for interest income to be recognized based on the amortized cost basis of a PCI asset grossed up by the allowance recorded at acquisition. We believe this approach would effectively result in an entity recording interest income on amounts that it does not expect to collect. The Board should clarify its intention to avoid potential confusion in application. To be clear, we agree with the gross presentation on the balance sheet and believe the proposed changes would simplify the accounting in this area. Any final standard should include a full example to illustrate subsequent accounting, not just day one accounting as illustrated in 825-15-55-41 of the Proposed Update.

### ***Purchased non-credit impaired assets***

We recommend that the Board consider whether the proposed accounting for PCI assets should be extended to assets acquired without significant deterioration in credit.

#### **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?**

#### **Response:**

Current US GAAP is largely silent about when an entity should stop recognizing interest income on financial assets.<sup>7</sup> Further, in practice, the nonaccrual guidance is generally not applied to debt securities. This would be a big change and is another reason we encourage separate models for debt securities and loans.

Loans are subject to considerable bank regulatory guidance and interpretation. This guidance is largely prescriptive for consumer loan products (e.g., nonaccrual status begins at 90 days past due). Regulatory interpretations generally address fact-specific situations with prescriptive conclusions, which may not be consistent with the Proposed Update's definition of a nonaccrual asset or the subsequent accounting. As a result, we strongly encourage the Board to carefully consider feedback from bank regulators on the proposed nonaccrual principle.

We also believe the Board should provide additional application guidance for the proposed nonaccrual principle. We believe the proposed guidance is too principles-based, particularly considering today's extensive nonaccrual rules from the bank regulators. It's unlikely that preparers would be able to consistently apply the proposed nonaccrual principle, which could impair comparability.

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<sup>7</sup> US GAAP provides limited descriptions of possible interest income recognition approaches for loans (ASC 310-10-35-39 and 35-40) and debt securities (ASC 320-10-35-35).

Other aspects of the proposed nonaccrual principle that require additional clarity include:

- ▶ **Definition of nonaccrual** - The Proposed Update includes new terms that need clarity for consistent application.
  - ▶ **Substantially all** - The proposal indicates that an entity should determine whether it expects to collect “substantially all” of the principal and interest. The Board needs to clarify what “substantially all” means.
  - ▶ **Not probable** - The proposal also uses the term “not probable.” Given the well understood definition of the term probable under current US GAAP and to avoid confusion, we believe the Board should also clarify what it means by the term “not probable.”
- ▶ **Application to PCI assets** - The Board should clarify how the nonaccrual principle would be applied to PCI assets, which by definition have experienced significant credit deterioration that makes the likelihood of collection of substantially all of the instrument’s contractual principal and/or interest not probable. It is unclear from the proposal whether entities would recognize any income on those assets, given the nonaccrual provisions in the proposal. We believe it would be appropriate to recognize interest income on PCI assets (at least until expected cash flows decline significantly from those originally expected at purchase). The Board should provide guidance on when nonaccrual accounting might be appropriate for a PCI asset.
- ▶ **Application to troubled debt restructurings (TDRs)** - The Board needs to clarify whether a TDR’s modified or original contractual cash flows would have to be evaluated to apply the nonaccrual principle. We believe an entity should look to the modified cash flows, which effectively represent a new set of contractual cash flows.

**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?

**Response:**

We believe that the distinction between a TDR and a “nontroubled” debt restructuring would be less relevant than it is today because, under the proposal, the measurement of credit losses would be the same. We also believe the current TDR model and related disclosure requirements have resulted in diversity in practice that sometimes makes it difficult to compare entities’ financial statements.

We believe the Board should consider approaches that could result in more comparable information that would be easier for preparers to compile. This could be achieved, in part, by requiring entities to disclose information about the different modifications that occurred during a reporting period. The modifications could be disclosed separately for different types of loans or for borrowers within ranges of credit ratings or FICO scores.

If the Board decides to maintain the TDR designation, it should provide interpretive guidance on assessing when (1) a modification is a TDR and (2) the TDR label should be removed.

- ▶ **When a modification is a TDR** - Under current US GAAP, TDRs are defined as modifications provided to a borrower experiencing financial difficulty at terms that provide a concession. In practice, determining whether a modification provides a concession has proven to be much more subjective and cumbersome than identifying whether the borrower is experiencing financial difficulty. As a result, the Board may wish to consider eliminating the requirement that the modified terms result in a concession to the borrower.
- ▶ **When the TDR label should be removed** - Currently, many believe that once a debt instrument has been labeled a TDR, it remains a TDR until the instrument is derecognized. Clarifying this issue would address significant questions and diversity in current practice. The Board should also consider revising or supplementing the guidance on the determination of whether the modification represents a new loan or a continuation of the old loan,<sup>8</sup> including whether and how those provisions apply to TDRs. For example, we believe that an asset's TDR label should be removed if the terms are re-modified to a market rate of interest and no principal has been forgiven.

Finally, the mechanism to adjust the carrying amount of an asset that meets the definition of a TDR in the proposed amendments to ASC 310-40-35-10 should be clarified. The Board should consider whether an increase to the cost basis is appropriate on the rare occasion that a TDR results in an increase to the present value of contractual cash flows discounted at the asset's original effective interest rate and, if so, how the corresponding credit should be recognized and presented. We believe that only decreases to the cost basis should be recorded.

## Disclosures

### Question 18:

**Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the Proposed Update?**

### Response:

Although many of the proposed credit quality disclosures are largely consistent with those currently required under ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, providing these disclosures could be a significant undertaking, particularly for debt securities. Moreover, some of these disclosures may not be as relevant for debt securities.

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<sup>8</sup> See ASC 310-20-35-9 through 35-11.

For example, for debt securities, past due disclosures do not provide any decision-useful information to investors because, unlike loans and receivables, credit for debt securities is not managed based on past-due information. We believe the Board should carefully evaluate feedback received from preparers about the proposed disclosure requirements, including the potential costs associated with preparing the information.

### **Implementation guidance and illustrations**

**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?**

**Response:**

We generally believe the Proposed Update lacks sufficient implementation guidance and illustrative examples, given the subjectivity involved in estimating expected credit losses. We believe the Board should provide additional illustrative examples or interpretive guidance to ensure consistent application. In addition to items described in our other responses, areas where additional guidance or examples are needed include:

- ▶ Estimating expected credit losses for, among others:
  - ▶ Debt securities, both on a pool and individual basis
  - ▶ Revolving loans, such as credit card portfolios or lines of credit
- ▶ Accounting for purchased credit impaired assets after initial recognition – in particular, how interest income would be computed
- ▶ Accounting for purchased non-credit impaired assets
- ▶ Adjusting historical information to consider reasonable and supportable forecasts, including the appropriate disclosures

### **Transition and effective date**

**Question 20:**

**Do you agree with the transition provision in this Proposed Update? If not, why?**

**Question 21:**

**Do you agree that early adoption should not be permitted? If not, why?**

**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?

**Question 23:**

Do you believe that the transition provision in this Proposed Update is operable? If not, why?

**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?

**Response:**

We agree with the general transition provisions, but would like the Board to address specific transition issues involving purchased credit impaired assets, securities that currently have an other-than-temporary impairment (OTTI), troubled debt restructurings and nonaccrual assets. Specifically, we believe the Board should address the following issues:

- ▶ **PCI assets** - It's not clear whether an asset currently designated as PCI would continue to be designated that way under the proposal or would need to be reevaluated using the proposed definition of PCI. It's also not clear whether an asset that previously met the definition of a PCI asset but does not meet the proposed definition would continue to follow today's accounting requirements after adoption of the new standard. In addition, it is not clear how pools of PCI assets that have been deemed a single unit of account under the current models would be affected by the proposal.
- ▶ **Securities with previously recognized OTTI** - It's unclear whether the Board expects entities to write up the cost basis of debt securities for which an OTTI was previously recognized and record an allowance. If there has been improvement in credit quality since the OTTI, would those changes go through a cumulative effect adjustment, or would the Board expect entities to use their existing cost basis and apply the model based on that basis?
- ▶ **TDRs** - It's not clear whether an entity would need to record an adjustment to the cost basis for an asset that it considered to be a TDR if it had not previously done so, particularly if the TDR has been performing since modification.
- ▶ **Nonaccrual** - It is not clear how an entity should account for differences in interest income previously not recognized or recognized as a result of moving to a codified nonaccrual principle.

We believe the Board needs to consider these transition issues and provide appropriate guidance.

The proposal would likely require a significant amount of time for companies to make the necessary changes to their information systems and internal controls. We strongly encourage the Board to carefully consider feedback from preparers before finalizing an effective date.

We believe the Board should provide sufficient time before requiring any final guidance to be adopted. We expect a number of auditing issues to be identified. By providing a reasonable implementation period, the Board would give auditors and audit standard setters enough time to identify any possible changes to the auditing guidance in this area.

### **Other matters**

We believe the Board should also consider the following important issues in its redeliberations.

#### ***Collateral-dependent financial assets***

It's not clear why the Board proposed changing the definition of "collateral dependent." Some interpret the proposal's use of the phrase "primarily or substantially" as broadening today's definition, which indicates that repayment should come "solely" from the collateral. Others view the addition of the words "by the lender" as narrowing the definition of collateral dependent by restricting the use of the practical expedient only to situations in which the lender expects to foreclose. The latter view would change practice for some financial institutions that use collateral values to directly measure credit losses well before they expect to foreclose. We believe that the Board should not limit the circumstances under which an entity can look to the collateral value and should keep today's definition.

If the Board moves ahead with the proposal, we believe that it should explain why the change is necessary and how entities should consider collateral values when estimating credit losses, especially for debt instruments that are over-collateralized or collateralized with high-quality liquid assets (such as US Treasury securities).

#### ***Unit of measurement guidance***

We believe the Board should consider retaining certain guidance in ASC 310-10-35 on when to measure credit losses based on an individual asset and a group of assets. We believe this guidance would be helpful to preparers.

#### ***Reserve for unfunded lending commitments***

Consistent with current US GAAP, the Proposed Update would require the expected credit losses for unfunded loan commitments to be presented as a liability. But the Proposed Update seems to indicate that any changes in this liability should be presented along with other changes to the allowance for loan losses. This would be a change from current practice wherein changes to this liability are presented in other expenses and not with the provision for loan losses. As the proposal highlights the balance sheet presentation for the reserve for unfunded lending commitments, we believe the Board should also clarify its intent for the income statement presentation.

#### ***FASB staff's FAQ document***

We found the FAQ document helpful. If the Board agrees with the staff's views, we believe it should include the questions and answers in the final standard.