

May 31, 2013

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

Re: File Reference No. 2012-260

Dear Ms. Cospers:

McGladrey LLP is pleased to comment on the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* (the “proposed ASU”). We are appreciative of the extensive efforts put forth by the Financial Accounting Standards Board (the “Board”) over the course of the last few years to attempt to address the perceived issues with current generally accepted accounting principles and achieve convergence with International Accounting Standards. We recognize this has not been an easy task but believe continued efforts to achieve convergence are critical given the vast difference the two different proposed models would create when comparing the allowance for credit losses of financial institutions reporting in accordance with the FASB model as compared to the IASB proposed model.

As it pertains to the credit loss model that is presented in the proposed ASU, similar to the Board, we believe there are merits to carrying financial assets at a net amount that is reflective of cash flows that are expected to be collected at the reporting date. However, we do not believe it is appropriate to record a contractual life expected credit loss in net income at the initial recognition of a financial asset.

Additionally, we have concerns as to the practicability of applying and auditing the measurement and recognition of credit losses as would be required by the new guidance and the decrease in comparability of financial statements amongst entities this could introduce, particularly in the absence of more detailed guidance and examples. We therefore recommend that rather than requiring upfront recognition of lifetime expected losses, the Board should continue to work with the International Accounting Standards Board in developing a converged approach whereby loss recognition is limited to those losses expected to be incurred in the foreseeable future (or an otherwise defined limited timeframe for which an entity could forecast expected losses with some degree of certainty). We also recommend that the Board eliminate the requirement to consider multiple outcomes, including one in which a loss results, as it is not appropriate to force loss recognition when no loss is expected. Our concerns and suggestions are elaborated on in our responses to the specific questions raised in the proposed ASU that follow.

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?*

There are certain financial assets that we believe should be excluded from the scope based on the nature of the assets. This would include reinsurance receivables, since the accounting for the asset is so interrelated to the accounting for the contingent liability to pay claims. We also believe it would be appropriate to exclude policy loans in the insurance industry and participant loans related to employee benefit plans. If an individual does not pay back amounts borrowed, the impact is a reduction in the policy account balance or participant account balance as opposed to a loss to the insurance company or the benefit plan. As such, it does not seem appropriate to include these assets in the scope of an ASU on credit losses.

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?*

We agree that when estimating expected credited losses for financial assets, historical losses are generally the appropriate starting point, with adjustment for current and expected economic conditions and other factors. A movement to lifetime expected losses will introduce significant operational and auditing concerns particularly in those situations when a reporting entity does not have its own internal lifetime historical loss data or access to other relevant data to use as the base for the expected loss computation. Additionally, we believe that implementation guidance in the form of examples of how a reporting entity may develop and integrate reasonable and supportable forecasts about the future would be very beneficial. It would be helpful for these examples to address the type of information that the reporting entity may give consideration to as well as approaches to be taken when the expected life of the assets extends well beyond the period of time for which supportable forecasts can be developed. It would also be helpful to provide examples of how the forecasts could be integrated into the computation of expected credit losses. While we understand the Board does not want to be overly prescriptive, we believe that smaller, less sophisticated reporting entities will struggle to implement the ASU without additional implementation guidance in the form of practical examples. We are also concerned that in the absence of additional implementation guidance, there could potentially be a decrease in comparability among entities.

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?*

We believe in certain situations, it will be particularly challenging for entities to obtain access to historical loss data for expected losses over the contractual term. Consider for example, a start up entity engaged in lending activities that does not have a seasoned loan portfolio and therefore would not have a base of historical contractual term losses. Under current practice whereby generally the goal for homogeneous loan pools is to estimate losses that will be incurred in the next 12 months, such an entity can typically readily obtain one year loss ratios of similar lending institutions on similar loan types through publicly available quarterly reports financial institutions file with their regulators, however it would be difficult to derive lifetime loss rates from these reports. Additionally, while entities such as rating agencies may make long-term historical loss statistics available for certain types of debt instruments, we would expect that such statistics would be of limited usefulness because they would not be granular enough with regards to factors such as specific geographical area, loan type, industry of underlying borrowers, etc.

As it pertains to investment securities, we believe most entities will not have a sufficient base of their own historical loss data from which to develop an expectation for future losses. For example, it is the exception, not the norm, for community banks and credit unions to experience a credit loss on an investment security. As such, we anticipate that most entities will need to turn to whatever published historical loss data is readily available and most relevant for estimating contractual term expected losses for particular investment types. Given the requirement to consider multiple outcomes, including one in which a loss is incurred, we anticipate that it will also be challenging to develop the appropriate historical loss base as a starting point for those debt instruments that are of such high quality that thus far there have been no historical losses such as United States Government Agency Securities and loans fully secured by liquid assets.

Without a comprehensive base of historical loss data (to be evaluated in light of prevailing economic conditions at the time in question), it will also be difficult for reporting entities to have a reasonable basis to adjust the historical loss data for current conditions and reasonable and supportable forecasts of the future. Given the challenges associated with compiling contractual term historical losses as well as historical information regarding the relationship of historical losses to prevailing economic conditions at the time, we anticipate that many smaller reporting entities may need to outsource the determination of expected credit losses on entire loan and investment portfolios, which could significantly increase the compliance costs.

Question 11: *The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?*

We believe that such a requirement will not result in an entity's best estimate of expected credit losses, which should be the objective rather than forcing loss recognition when none are expected. For example, it seems illogical to force a reporting entity to recognize a day one loss on securities such as those issued by a United States Government Agency that to date have not incurred any losses. The statement is made in paragraph BC31 of the proposed ASU that entities expect some level of losses in a group of assets with similar risk characteristics as justification for the requirement to consider multiple outcomes. While that may hold true when an entity extends credit to customers in the form of loans and trade receivables, even in the recent credit crisis and recession, most types of debt securities held by community banks, credit unions and insurance companies experienced no credit losses. As such, we believe this requirement to consider more than one outcome including one in which a loss results should be eliminated from the ASU. We believe it would be preferable to simply state that even if an entity does not expect credit losses for an individual asset, consideration should be given to expected credit losses on assets with similar risk characteristics, before concluding that no allowance is necessary.

If this requirement is not eliminated, it would be beneficial to include examples in the ASU including a probability-weighted discounted cash flows analysis for an individual financial asset and an example of how a reporting entity would estimate expected credit losses for securities such as United States Government Agency, for which there is no historical loss base.

Question 12: *The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?*

We do not foresee any significant operability or auditing concerns or constraints with this aspect of the proposal given that entities would be permitted to use the above-mentioned methods that implicitly reflect the time value of money. We do however have concerns with the punitive outcome of using the effective interest rate to discount cash flows that have been reduced for lifetime expected credit losses and believe consideration should be given to requiring the use of a risk-free rate instead of the effective rate.

Question 13: *For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for expected credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?*

We do not foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition. We do however question the logic of the outcome of the application of the model to purchased credit impaired assets versus originated assets and purchased non-credit impaired assets in that no loss is recognized at the time a credit impaired asset is purchased yet a loss is recognized when a loan is originated and a non-credit impaired asset is purchased.

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?*

We believe that the practical expedient as proposed will be of little to no value, due to the requirement for the fair value of the financial asset to be greater than or equal to the amortized cost basis. Even fixed rate securities of the highest credit quality could become ineligible for the practical expedient for any given reporting period if, for example, interest rates increase, causing the fair value of the security to decline below the amortized cost amount. The proposed ASU does not address how such a situation would be accounted for. (If an allowance for credit losses is established on a particular security at a time when fair value was less than amortized cost, would that allowance be reversed through income if fair value subsequently increases above the amortized cost and the reporting entity takes advantage of this practical expedient, or would it be maintained at the level it was when the entity did not qualify for the practical expedient?) We believe that instead of moving forward with the practical expedient, as indicated in our response to Question 11, it would be preferable to eliminate the requirement to consider more than one outcome, including one in which a loss results. As is noted in paragraph BC38 of the proposed ASU, the reasoning behind the practical exception was to in part minimize the cost of compliance when expected credit losses are insignificant. We believe that eliminating the requirement to consider more than one outcome would be much more effective in minimizing cost of compliance when expected credit losses are insignificant.

Question 15: *The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?*

We believe this proposed amendment is similar to existing practice for loans (other than acquired loans with credit quality issues) but not debt securities, given that interest income recognition continues on debt securities even if a loss in principal is projected. We do not believe that the nonaccrual provisions of the ASU make sense under the proposed credit loss model, whereby contractual term expected credit losses

are recognized upfront. It seems to be double-counting to require the recognition of all expected credit losses on day one and also prohibit interest income recognition when it becomes probable that not all principal will be received. Additionally, the application of the nonaccrual provisions to troubled debt restructurings and purchased credit impaired assets needs to be clarified. (When assessing if substantially all of the principal and interest will be received on a purchased credit impaired asset, presumably this is not intended to mean the contractual principal as the outcome would be that substantially all purchased credit impaired assets would be accounted for through a cost-recovery method.)

Question 16: *Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor’s effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?*

We do not believe that the distinction between troubled debt restructurings and non-troubled debt restructurings remains relevant. An overriding objective of the ASU is to have one model for all financial assets subject to credit risk and as such, there appears to be no justification for the compliance costs to continue to require distinction. If information about modifications is of importance to the users of financial statements, we recommend that there be a disclosure requirement for factual information about modifications occurring during the reporting period, without making the distinction between those that constitute troubled debt restructurings and those that don’t.

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

We believe that clarification is necessary to explain how the required disclosures by segment and class would be fulfilled in situations where the reporting entity evaluates instruments such as debt securities on an individual basis. We anticipate that compliance with the debt rollforward requirements of paragraphs 825-15-50-12 and 13 may be problematic for less-sophisticated entities that do not have the system resources to capture data for loan activity in this manner. Additionally, recognizing that this is not a newly proposed disclosure requirement, tracking interest recognized on assets when they are on nonaccrual status generally requires a significant amount of manual effort for less sophisticated entities without the appropriate system resources.

Question 19: *Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?*

We believe additional guidance addressing situations like the following would be very beneficial:

- How a start up institution may estimate expected losses on loans in the absence of any base of historical loss data
- How a reporting entity would estimate expected credit losses for securities such as United States Government Agency, for which there is no historical loss base
- How a reporting entity may estimate contractual term expected losses for loans such as working capital lines that are renewed annually
- An example demonstrating the types of information an entity would consider in developing reasonable and supportable forecasts about the future and how that information would be integrated in to the computation of expected credit losses

- How the allowance balance should be adjusted when a financial asset is ineligible for the practical expedient to not recognize credit losses in one period but becomes eligible in the next
- Contrast the day one and ongoing accounting for purchased credit impaired assets with purchased assets that are not credit impaired
- How the nonaccrual provisions would be applied to a loan that was previously subject to a troubled debt restructuring and to a purchased credit impaired asset

In addition to the above suggestions, we believe clarification to paragraph 825-15-55-19 would be beneficial. The last sentence quoted below states that membership in the cohort remains constant while the preceding sentence states that the assignment to cohorts is made at the beginning of each period.

Entity A develops historical loss rates on the basis of its historical loss data for five-year commercial mortgage loans. Specifically, the entity forms cohorts (sometimes referred to as static pools) by grouping borrowers by risk rating at the beginning of each year. Each outstanding borrowing at the beginning of the period is assigned to a specific cohort. The entity then follows the cohort from that point forward through the life of the assets within the cohort, such that membership in the cohort remains constant.

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

We are in agreement that transition should be by means of a cumulative effect adjustment as of the beginning of the first reporting period in which the guidance is effective. As is elaborated on in our response to Question 23, we believe that additional guidance and/or special transition provisions are warranted to address certain scenarios.

Question 21: *Do you agree that early adoption should not be permitted? If not, why?*

We are in agreement with prohibiting early adoption given that it would significantly impair the comparability of financial statements between those entities that have early adopted and those that have not.

Question 22: *Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?*

We believe that nonpublic entities should be given at least one additional year to prepare for adoption.

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

We believe there are certain scenarios for which additional transition guidance may be called for and for which examples would be beneficial including transition for troubled debt restructurings and purchased credit impaired assets (including whether such assets existing at the adoption date need to be reassessed under the new definition).

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?*

In assessing how much time is needed, consideration should be given to the impact this and other proposed standards such as leasing and financial instrument recognition and measurement, as well as the proposed changes associated with Basel III, will have on the capital position of regulated entities so that the implementation period provides sufficient time for the regulators to understand the combined ramifications and formulate what changes, if any, need to be made to the regulatory capital requirements or related regulations. We believe minimally a period of two years from finalization of the standard to implementation is otherwise necessary to allow for training of staff, development of methodology,

Financial Accounting Standards Board
File Reference No. 2012-260
Page 7

processes, and controls as well as implement system changes and otherwise accumulate relevant historical data.

We appreciate this opportunity to provide feedback on the proposed guidance and would be pleased to respond to any questions the Board or its staff may have concerning our comments. Please direct any questions to Rick Day (563.888.4017) or Faye Miller (410.246.9194).

Sincerely,

A handwritten signature in black ink that reads "McGladrey LLP". The signature is written in a cursive, flowing style.

McGladrey LLP