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June 5, 2013

Susan M. Cospers, CPA  
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401 Merritt 7  
PO Box 5116  
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**Re: December 20, 2012 Exposure Draft of a Proposed Accounting Standards Update (ASU), *Financial Instruments—Credit Losses (Subtopic 825-15)* [File Reference No. 2012-260]**

Dear Ms. Cospers:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to represent the views of local and regional firms on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the ED and is providing the following comments for your consideration.

#### **GENERAL COMMENTS**

TIC objects to this proposal. It would apply broadly to all entities (public and private), yet there is no evidence that its provisions were filtered through the Private Company Decision-Making Framework (PCDMF) or discussed in a public meeting with the Private Company Council (PCC). It attempts to be a one-size-fits-all solution for an industry-specific financial reporting problem and fails to take into consideration the differential factors between public and private companies.

TIC believes the incurred-loss model is the most relevant and the most cost-effective impairment model for nonfinancial, nonpublic entities. Therefore, TIC recommends that the scope of the proposed standard be limited to financial institutions and other financial services entities.

However, if the Board decides to retain the current scope of this ED, the final standard should not be issued until private company exemptions or other practical expedients have been fully considered by the PCC based on the application of the PCDMF. Even though the PCDMF has not yet been finalized, TIC believes it should be applied to the

Board's current agenda topics. Implementing the PCDMF now will ensure that private company considerations are incorporated into new standards on a timely basis. Amending a standard after the fact is, by definition, a time-consuming, inefficient process that can be disruptive for preparers, practitioners and financial statement users. Applying the PCDMF to major new proposals now will also serve as an "acid test" of its efficacy and may reveal the need for additional amendments to the framework before it is finalized. TIC's specific comments below include relevant cross references to the PCDMF for the Board's consideration.

Considerations for private entities should also include reducing complexity and providing relevant implementation guidance for determining credit losses for private, nonfinancial services entities.

### **SPECIFIC COMMENTS**

This proposed standard focuses almost entirely on credit losses faced by the financial services industry, even though its scope is much broader. As a result, the ED is relevant to the perceived needs of only two types of financial statement users: public company investors and regulators.

The expected credit loss model is primarily designed for large portfolios of financial assets where estimation of credit risk is ongoing, highly subjective and therefore more difficult to estimate. The ED discusses complex measurement methods that are designed around publicly available statistical information on loss experience for various types of debt instruments. The proposed disclosures are written from the perspective of users who would have no direct access to management.

TIC believes the ED does not include sufficient evidence that the proposed expected loss model would represent an improvement over the incurred loss model for private entities. It does not improve financial reporting for entities that know their customers well or have smaller portfolios of debt instruments and fails to address the issues relevant to private entities. The incurred loss model already provides private company users with sufficient decision-useful information about the credit risk associated with the financial assets held by private companies. Based on the points discussed below, TIC believes a single model (i.e., the expected loss model) for assessing credit loss may not be a realistic objective.

The proposed methodology for assessing credit losses is not relevant to most creditors in the private company arena because they utilize their own methodology (PCDMF, paragraph 1.5[d]—*Consider whether users typically adjust financial statements by substituting an alternative accounting approach*) and have access to management (PCDMF—*Access to Management* differential factor). When determining borrowing capacity, lenders tend to ignore receivables over 120 days past due. Once a loan has been granted, they monitor the borrower's receivables by obtaining the aging analysis directly from the borrower and, using their own models and any necessary interaction with management, assess collectability. Although the concept of credit loss is certainly

relevant to all financial statement users, the GAAP methodology chosen may be less relevant for a user that applies an alternative accounting measure. In such cases, the GAAP financial statements are merely a secondary source of information which would mitigate the need for rigorous and costly estimation techniques.

The ED states that financial assets carried at amortized cost less an allowance would reflect the current estimate of the cash flows expected to be collected at the reporting date, and the income statement would reflect credit deterioration (or improvement) that has taken place during the period. The expected credit loss approach requires up-front loss recognition that may not result in any better approximation of losses over the life of the asset than the incurred loss model. It leads to potentially more subjective estimates and creates unnecessary period-to-period volatility in the income statement. If it is true that credit loss experience over time under the expected loss model would approximate the cumulative losses under the incurred loss model, TIC sees little benefit in asking private entities to change methodologies to achieve essentially the same end result if most financial statement users plan to use their own alternative methodology.

The expected credit loss model would be more costly for preparers. The methodology behind the expected credit loss approach is much more complex than current practice. In order to satisfy the requirement in paragraph 825-15-25-5, an entity would have to develop a sufficient historical loss history such that “the population of actual loss data reflects items within that population that ultimately resulted in a loss and those items within that population that resulted in no loss.” Preparers of private company financial statements do not maintain extensive historical loss data, such as over the last 5 years as illustrated in Example 5 on pages 32-33. Developing the data will be difficult, since many software packages (such as QuickBooks) used by small businesses, are not conducive to such analysis. Therefore, many preparers would not have the internal resources and expertise to develop this history on their own and would need outside resources to do so (PCDMF-*Accounting Resources* differential factor).

TIC also believes that the new requirements would increase the cost of an audit or review, since practitioners will have more data to evaluate and test. As estimates become more subjective, more client discussions over the assessment of the data may arise. These discussions may take considerable time to resolve especially among clients who fail to understand the theory behind the requirements.

One of the key differences between the incurred loss approach and the expected loss approach is that an estimate of expected credit losses must consider “reasonable and supportable forecasts that affect the expected collectability of the financial assets’ remaining contractual cash flows.” TIC believes private company management is generally not in a position to determine what economic conditions will be facing the entity in the future or analyze the economic conditions that existed during the entity’s historical loss experience period (assuming that period could be determined) with the ultimate objective of assessing how the future changes would affect past estimates. Such an estimate becomes increasingly difficult for receivables (such as lease receivables) with terms in excess of one year. For private companies that prepare financial statements on a

monthly or quarterly basis, such an exercise would be untenable. Many entities would have to incur the cost of outside assistance on a regular basis to accomplish the objectives of the expected loss model.

Paragraph 825-15-25-3 states that, in its estimates, an entity would only need to consider “information that is available without undue cost and effort.” That cost threshold would be very low for most private entities. After reading Q&A #13 in the FASB’s March 25, 2013 Frequently Asked Questions document for this ED, TIC concluded that the alternative approaches mentioned, which effectively permit the entity to either revert to unadjusted historical averages or assume stable economic conditions for the foreseeable future when reasonable and supportable forecasts cannot be made, would frequently apply in the private company arena.

The requirement to develop a reasonable and supportable forecast of future economic conditions that would affect collectability of financial assets represents a key differential factor between the incurred loss approach and the expected credit loss approach. Since management’s ability to develop expectations about the future may be quite limited, the two approaches may yield very similar measurements of estimated (expected) losses. TIC believes this possibility is worthy of further study as possible exceptions or practical expedients are considered for private entities.

The ED prohibits an entity from estimating expected credit losses solely on the basis of the most likely outcome and requires up-front recognition of all expected credit losses. These concepts will be viewed as counter-intuitive for many preparers, especially those with a small, stable customer base. In many situations, management knows its customer base well and can assess estimated credit losses on a specific-identification basis under the incurred loss model with reasonable accuracy. The proposal would appear to require a dramatic shift in the calculation of the allowance. Therefore, TIC believes, if finalized as written, the proposed standard would require an extensive education effort for both preparers and the CPA firms that will need to provide assistance with these calculations. This consideration, along with the extra work required and the additional judgment involved for the estimation process, will potentially affect the appropriate transition period for a final standard.

### **Related Parties**

The ED is clear that related party loans would fall within the scope of this proposed standard, but it fails to address special accounting considerations for credit losses relating to loans receivable from owners. At a minimum, the display requirements for writeoffs should differ from those of other credit losses, since uncollectible loans involving owners would be treated as dividends rather than as a loss provision in the income statement. In addition, the initial recognition provisions under the expected credit loss model would not seem appropriate for loans receivable from owners, since a dividend should not be recognized before it is realized. Additional guidance is needed on related party loans to adjust the model, as necessary, for this common transaction among private entities.

## **Disclosures**

Many of the proposed disclosures would be unnecessary and burdensome for private entities (for example, credit quality information for lease receivables, the detailed description and discussion of the factors that influenced management's current estimate of expected credit losses, descriptions by portfolio segment of factors that affected management's estimate, discussions of risk characteristics by portfolio segment, etc.). These details will not be relevant to users of private company financial statements since lenders typically have their own models for determining the quality of an entity's receivables (PCDMF, paragraph 2.3-*Determining Disclosure Requirements*). Given lenders' access to management, this information would be readily available if ever needed. TIC therefore believes additional exceptions are needed from the excessive disclosures proposed.

## **Other Issues**

### Terminology

Several paragraphs within the ED (e.g., paragraph 825-15-25-7) refer to the "statement of financial performance" as an apparent synonym for the income statement. However, this term is not defined in the Master Glossary of the *Accounting Standards Codification*<sup>TM</sup> (ASC). TIC also noticed that this term is used occasionally in ASC Topic 815 (Derivatives and Hedging) and Topic 470 (Debt). TIC suggests using consistent terminology to reduce complexity and mitigate potential confusion. If this statement title is to be retained, it should be defined.

TIC noticed that the ED includes new terminology for recognition of writeoffs. Existing standards (paragraph 310-10-35-41) state that writeoffs should be recognized when "trade receivables are deemed uncollectible." However, paragraph 825-15-35-1 of the ED states that the writeoff would occur when "the entity determines that it has no reasonable expectation of future recovery." TIC questions whether this change is meant to set a different threshold for writeoffs compared to the current Codification. If so, examples and implementation guidance should be provided.

## **Recommendations**

TIC recommends excluding all private, non-financial services entities from the scope of the final standard. The expected loss approach has less relevance outside of the financial services industries. The proposal also includes a level of complexity that is unnecessary and impractical for private entities. While TIC understands that the Board is seeking to develop one consistent set of principles pertaining to credit losses, TIC believes it is more important to ensure that the methodology adopted is relevant to users and cost effective for preparers.

If the Board decides that the standard should apply broadly without exempting private entities from its scope, then TIC recommends that the PCC review the proposal before it is finalized to assess its applicability to private entities. As part of its review, TIC believes the PCC should apply the PCDMF to the recognition, measurement and disclosure provisions of the ED. It appears that adequate consideration has not been given to the effect of the proposal on private entities, and TIC believes opportunities exist for possible exemptions or practical expedients for the benefit of private entities. Similar to the practical expedients that have been effective for assessing goodwill impairment, TIC believes certain expedients, if not exemptions, would also be appropriate for estimating credit loss allowances.

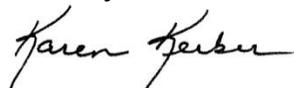
The issues that should be considered by the PCC include whether up-front recognition of all expected credit losses would provide decision-useful information to users of the financial statements of private entities, the measurement criteria for credit losses that would be most relevant to private company users, and the need for additional disclosures by private entities. Answers to these questions would determine whether a change from an incurred loss model to an expected loss model would be relevant to private company users and cost/beneficial for preparers. Even if the new concepts and disclosures are deemed relevant to users, every effort should be made to find practical expedients or selected exemptions, wherever possible. Exempting short-term trade receivables from the methodology and substituting certain qualitative disclosures is an alternative that should be considered.

At a minimum, however, implementation guidance (including more relevant examples) on the expected-credit-loss approach for financial assets held by private entities should be added to the proposed standard before it is finalized. The fact pattern and assumptions given in Example 5 are too simplistic to be useful. Examples are more effective if they match fact patterns that could occur in practice (i.e., incorporating unexpected volatility to demonstrate how the historical loss experience would be adjusted to reflect future expectations). If the standard is to be applied broadly, it needs to address private company issues and provide more helpful examples of real-life situations. The types of guidance needed by private entities would include:

- Acceptable, cost effective methods of developing the required historical credit loss experience;
- Acceptable approaches for developing reasonable and supportable forecasts about the future, including the types of “economic conditions” that private entities would be expected to identify;
- Acceptable methods for adjusting the historical credit loss rate for perceived changes in future economic conditions;
- Discounting short-term instruments—When, if ever, would this be necessary?
- Writeoffs of related party receivables from owners;
- Assessing expected credit losses on lease receivables.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

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

Karen Kerber, Chair  
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees