



College of Business & Economics  
Department of Accounting  
PO Box 443161  
Moscow, ID 83844-3161

208-885-6453

In State Toll Free 1-800-422-6013  
FAX 208-885-6296

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Financial Accounting Standards Board  
Technical Director  
401 Merritt 7  
P O Box 5116  
Norwalk CT 06856-5116

File Reference No. 2011-150 Supplementary Document on Impairment:  
Accounting for Financial Instruments and Revisions to the Accounting for Derivative  
Instruments and Hedging Activities: Impairment

Dear FASB:

I made extensive comments about the original exposure draft on financial instruments (File Ref. 1810-100) in September 2010. In general, I find myself in agreement with the simplified way of reporting an impairment allowance on financial instruments held as assets. I replicated the examples that begin on page 50 and found them understandable and relatively straight-forward to implement. There was one small error in the tables (discussed below). The overall approach balances the need for earlier reporting of credit losses without requiring the incredible complications of the approach described in FASB's 2010 ED.

For purposes of classifying comment letters, my title is professor of accounting and I am employed at the University of Idaho. I have held my CPA license since 1977. Prior to beginning my 28-year academic career, I held a variety of positions including staff accountant in a small public accounting firm, controller for several small to medium-size business entities, and as director of finance for a large not-for-profit entity. As an active donor and small investor, I have occasion to read the financial information of charities and publicly-traded companies.

**Question 1:** Do you believe the proposed approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

Yes. I believe the approach provides useful information and would result in earlier recognition of credit losses.

**Question 2.** Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not? [Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.]

I believe the guidance would work for closed portfolios. Closed portfolios can still be evaluated in two groups – those that are current and those that are in default. In addition, there is less probably less uncertainty over term and interest rates which would facilitate the determination of the time-proportional amounts (TPA). Please see comments under Question 10 and 11 related to the “differences” I discovered between the straight-line and annuity methods when applied to both open and closed portfolios.

**Question 3.** Do you agree that for financial assets in the ‘good book’ it is appropriate to recognize the impairment allowance using the proposed approach described above? Why or why not?

Yes. In my earlier comment letter to FASB, I “tried out” the proposed approach on several closed portfolios of hypothetical loans (student loans, RV loans, etc.). The proposed method was cumbersome and had several identified features which made me uncomfortable.

- (a) In my Sept. 2010 comment letter, I felt that an effective interest method approach would be theoretically superior to the method in the FASB ED. However, I also preferred a method that would keep credit losses separate from interest revenue to the method in the FASB ED. This supplemental proposal is seemingly along the lines of approach labeled #1 in my response to Question 48. It has the advantage of maintaining the underlying accounting records in a form that facilitates communication with customers and avoids the mathematical complications of actually implementing an effective interest method that would require frequent periodic adjustments to the effective rate as credit loss experience changes.
- (b) When the FASB ED approach was applied to a closed portfolio of loans, I found that the write-off of an actual bad debt required that the balance be reduced by an amount LARGER than the balance being written off. In other words, one had to write off all future cash flows (instead of the present value of future cash flows) to keep the books in balance. (See Appendix E in my earlier comment letter or excel versions posted on my website.) This made no sense to me. To quote myself (from comments under Question 37):

“After all, if I prepay a loan, I will not incur future interest costs. Yes, the lender will forgo those additional cash flows but I have repaid all the money I borrowed and the lender has not lost anything. With the cash the lender receives from me, a new loan can be made to earn additional interest revenue

from a new borrower. To write-off all future cash flows overstates the amount of the loss!”

- (c) The term “amortized cost” loses its traditional meaning in at least some scenarios when one follows the FASB ED approach to impairment losses. (See Appendix D1 in my earlier comment letter.)

In summary, the proposed method in the supplemental document appears to be both feasible and superior to the approach in the FASB ED on financial instruments.

**Question 4.** Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Yes. I believe the method to be operational based on my reconstruction of the two examples provided and the application of the two methods to closed portfolio scenarios. However, some clarification is needed with respect to amounts shown as expected losses (see Question 11).

**Question 5.** Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

Yes. It is inappropriate to assume that all loans not yet in arrears will be paid in full. It is also inappropriate to recognize undiscounted future cash flows (forgone) to measure credit losses anticipated many periods in the future. The proposed approach seems to be a good compromise between the original FASB and IASB positions.

**Question 6.** Is the proposed requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Separation into two groups is clearly described and the process makes sense. However, the strange terminology of “good book” and “bad book” leaves much to be desired! Performing versus nonperforming loan portfolios at least sounds more “professional.”

**Question 7.** Is the proposed requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Yes. It should be easy to decide that loans on which no payments have been received for two (three, four, etc.) periods are more problematic than loans that are being repaid each period as scheduled or at least not late enough to cause serious concerns. The guidance is sufficiently general to allow other criteria as used in the management of loan portfolios.

**Question 8.** Do you agree with the proposed requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

I agree. I think the two-portfolio approach makes perfect sense.

**Question 9.** The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this proposed model. Specifically, on the following issues:  
(a) Do you agree with the proposal to require a floor for the impairment allowance related to the ‘good book’? Why or why not?

I can’t speak to the practicality of estimating losses since that has not been in my portfolio of experiences. The idea of having a floor for the loss is logical because it is generally “silly” to assume that no defaults will happen. However, there could possibly be settings when experience indicates payment in full is a highly likely outcome for the “good book” loans. Although this scenario should be rare, I’m not sure it should be forbidden if grounded in legitimate analysis of loan losses.

9(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the ‘good book’ only in circumstances in which there is evidence of an early loss pattern?

I think the decision that no floor need be recognized should be based on careful analysis including industry experience with similar loans under various economic conditions or entity-specific experience. I’m not sure exactly what “early loss pattern” means – borrowers paying a month late???

9(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

I think I agree. Thought process: What if every loan in the portfolio is being paid on time? What if past experience suggests that defaults become less common with the passage of time (lower remaining balances) so that no additional losses are foreseeable after a certain point. Conversely, maybe defaults historically occur in the last third of the loan term. In either case, the foreseeable future losses within the next 12 months could be zero. In that case, the minimum allowance should be based on the “time proportional” losses expected over the full term of the loans given historical experience even if no losses at all are expected in the next twelve months. I think the rule about the floor really works out to recognizing the GREATER of the floor (foreseeable losses) or the time-proportional estimate of future losses. If this is the intent, it is a “traditionally conservative” approach and should be acceptable even though it possibly fails the “neutrality” criterion in the conceptual framework.

9(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

Existing economic conditions make loan defaults more or less likely so they should certainly be taken into consideration for the “foreseeable losses.” However, I don’t think we should get into trying to predict future economic conditions as part of determining loan losses.

9(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

I believe we should limit the “foreseeable” period to 12 months. To do otherwise, we would have to be making long-run predictions of economic events – a very uncertain science! However, we can see based on existing current conditions whether more people will be losing their jobs, paying off loans because interest rates are going down, etc. For home mortgages (15 to 30 year loans), we can know whether the market is currently in boom or bust conditions in particular geographic areas but predicting that these conditions will continue beyond 12 months seems fraught with risk. Maybe other people will claim they can do it – but going beyond 12 months seems like it opens the door to “cooking the books” based on very uncertain assumptions about the future. Even the 12 month foreseeable estimate will be subject to deliberate over- or under-estimation in the hands of the unscrupulous.

9(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a ‘ceiling’ should be established for determining the amount of credit impairment to be recognized under the ‘floor’ requirement (for example, no more than three years after an entity’s reporting date)? If so, please provide data and/or reasons to support your response.

Yes. There should be a ceiling. I simply wouldn’t believe that anyone could make reliable estimates more than one or two years out.

**Question 10.** Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

With one of my “closed portfolio” examples created earlier, I assume that one customer out of 100 would default each year over the ten-year term of a motorhome (RV) loan (9 defaults). Upon default, the repossessed asset could be sold for at least 50% of the balance due (first five years) and 2/3 of balance due (last five years). The foreseeable loss was determined as one RV repossessed in the next 12 months.

For the first version, it turned out that the “foreseeable loss” figure was identical to the percentage loss estimate applied to the balance due. Under this set of assumptions, the straight-line method time-proportional loss always exceeded the annuity method amount but the 12-month foreseeable loss was ALWAYS be higher than either time-proportional method – by an increasing amount. Please note that I used the same “expected loss” amount in the straight-line and annuity methods.

Closed Portfolio - 100 loans for \$50K each at 8%			
10 year RV Loan Example	Time proportional SL	Time proportional Annuity	12-month foreseeable loss
End of Yr 1	20,947	20,063	23,274
End of Yr 2	17,128	15,720	21,410
End of Yr 3	13,578	11,948	19,398
End of Yr 4	10,334	8,722	17,224
End of Yr 5	7,438	6,024	14,876
End of Yr 6	3,291	2,559	8,227
End of Yr 7	1,920	1,434	6,401
End of Yr 8	886	636	4,429
End of Yr 9	230	159	2,300
Foreseeable loss equal to estimated loss used to compute time-proportion loss			

For the second version, I used 1% of the balance due as the expected loss to determine time-proportional loss under the straight-line and annuity methods. The foreseeable loss was one motor-home repossessed in the next 12 months. In this case, TPA from the straight-line method was still greater than equivalent TPA using the annuity method, except for the last year. However, the TPA exceeded the foreseeable loss for the first 4 years after which the foreseeable loss (equaled or) exceeded the TPA loss.

Closed Portfolio - 100 loans for \$50K each at 8%			
10 year RV Loan Example	Time proportional SL	Time proportional Annuity	12-month foreseeable loss
End of Yr 1	41,894	40,125	23,274
End of Yr 2	34,257	31,441	21,410
End of Yr 3	27,157	23,895	19,398
End of Yr 4	20,668	17,444	17,224
End of Yr 5	14,876	12,048	14,876
End of Yr 6	9,872	7,677	8,227
End of Yr 7	5,761	4,303	6,401
End of Yr 8	2,658	1,908	4,429
End of Yr 9	690	476	2,300
Loss estimate at 1% of balance due Foreseeable loss = one RV repossessed in next year			

However, maybe my assumptions on re-sale values were unreasonable. Presumably for mortgage loans, the property might even be increasing in value so that the sale would easily cover all of the balance due. However, unsecured loans are much more problematic since there is nothing to repossess. In that case, the full balance due would be the loss which would DOUBLE the amounts shown in the first example above (first five years) and triple the amounts shown for years 6 through 9.

My next step was to create an “open portfolio” of 4-year automobile loans – with differing average balances and interest rates in the tranches. Again, I assumed that a repossessed automobile could be sold for at least half of the balance due. I used a 2% overall default rate (based on the portfolio balance due at year end) and a foreseeable loss of one loan default in each tranche during the following year.

Open Portfolio - 4-year auto loans at varying amts and rates			
4 year Auto Loan Example	Time proportional SL	Time proportional Annuity	12-month foreseeable loss
Year 1	11,571	11,228	7,714
Year 2	19,159	18,256	13,426
Year 3	17,796	16,754	17,927
Year 4	24,230	22,888	18,709
Loss estimate at 2% of balance due Foreseeable loss = one car per tranche repossessed in next 12 months			

Open portfolio assumptions:			
	Number of new loans	Average amount borrowed	Interest rate
Tranche 1	100	20,000	6%
Tranche 2	120	21,000	7%
Tranche 3	90	25,000	5%
Tranche 4	150	24,000	6%

In this example, the straight-line TPA exceeded both the annuity TPA and the foreseeable loss amounts except for the third year. So in one year out of three, the “floor” would have been reported. Note, however, that the difference was tiny. When I lowered the loss percentage to 1.5%, the pattern was similar to the second RV loan scenario – the floor becomes effective in the last two years. Note, however, that the straight-line TPA still exceeds the annuity TPA in every time period.

Open Portfolio - 4-year auto loans at varying amts and rates			
4 year Auto Loan Example	Time proportional SL	Time proportional Annuity	12-month foreseeable loss
Year 1	8,678	8,421	7,714
Year 2	14,369	13,692	13,426
Year 3	13,347	12,566	17,927
Year 4	18,173	17,166	18,709
Loss estimate at 1.5% of balance due Foreseeable loss = one car per tranche repossessed in next 12 months			

Open portfolio assumptions:			
	Number of new loans	Average amount borrowed	Interest rate
Tranche 1	100	20,000	6%
Tranche 2	120	21,000	7%
Tranche 3	90	25,000	5%
Tranche 4	150	24,000	6%

**CONCLUSION:** The floor will be in effect in some cases. However, the TPA is likely to be larger in many cases.

**Question 11.** The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:  
(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the proposed approach described in paragraph B8(a)? Why or why not?

After doing all the analysis to respond to Question 10, I'm now uncertain that I "did it right." The two examples in section "IE" use the exact same loss figures so I assumed they were "undiscounted amounts." In my examples, the loss estimate was based on a percentage of the balance due, not the remaining cash flows due. Is that why my straight-line TPAs above are uniformly coming out HIGHER than the annuity TPAs? But wait! **The balance due is a present value** using the contractual discount rate. Therefore, maybe I'm doing the annuity method incorrectly! I would suggest that the meaning of B8 is not at all clear and the examples did not help since they had the SAME expected loss amount in Columns A (so presumably cash flows rather than balances due or other discounted amounts?)

Open Portfolio - 4-year auto loans at varying amts and rates			
4 year Auto Loan Example	Time proportional SL	Time proportional Annuity	12-month foreseeable loss
Year 1	5,786	6,987	7,714
Year 2	9,579	10,137	13,426
Year 3	8,898	9,909	17,927
Year 4	12,115	21,229	18,709
Loss estimate at net 1/2% of balance due (SL) and cash flows forgone with 1% default rate for annuity method with recovery at 50% of balance due at default date Foreseeable loss = one car per tranche repossessed in next 12 months			

This table is a re-computation of the annuity method for the same open portfolio described under Question 10. To try to "equalize" the loss rates, the net loss is half of a percent of balance due for the straight line method with a 1% default rate for the annuity method less recovery at half of carrying value at date of default. I rounded to determine the number of defaults so that it is one loan per year from each tranche. Note that the TPA from the annuity method now EXCEEDS the TPA from the straight-line method in every year. However, the foreseeable loss is still greater than either TPA in all years except the last one. Please feel free to explore variations using the spreadsheet posted on my website.

11(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

I think that more guidance is warranted. If a company is basing the loss on a default rate applied to the carrying value of the debt securities, then the company is, in effect, using a present value estimate of the loss. This seems like the most logical method to estimate losses based on industry or entity-specific experience with losses on loans of similar type. So if 5% of customers default, 5% of the balance due at the end of each period is a reasonable estimate of the losses to be incurred and could be used in the straight-line method. If my "more advanced



understanding” of the annuity method is now correct, we could gather “cash flow” data instead of balance due data – however, it seems like a lot more work to me! Balance dues are “handy” in the accounting records; uncollected total future cash flows is a lot less easily obtained.

**Question 12.** Would you prefer the IASB’s approach for open portfolios of financial assets measured at amortized cost to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the IASB’s approach (ie to recognize expected credit losses over the life of the assets)? Why or why not?

No. The IASB approach has no “floor” which I think would be a useful concept. However, I didn’t spend time studying the IASB ED or standards when I wrote my comment letter to FASB. If I understand it correctly, the IASB method would report “time proportional losses” as in the examples in this supplemental ED. Presumably that means that an allowance or “provision” account was intended as a contra account to financial asset balances carried at amortized cost. If this statement is accurate, I would prefer this “original” IASB method over the FASB original ED method but I think I prefer the compromise method in the supplement to the original IASB method. In other words, the floor notion is reasonable to make sure entities have sufficiently provided for loan losses. In my experimentation, the TPA would often be greater than the foreseeable loss. However, in a few cases, the foreseeable credit loss would be greater than the TPA and in that case, it would make sense to accrue the larger figure. Auditors are conservative at heart – or maybe that is just a US bias. I have to admit, I believe conservatism has its place (regardless of its omission from the “desirable” qualities in the conceptual frameworks.

**Question 13.** Would you prefer the FASB’s approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific approach, do you prefer the general concept of the FASB’s approach (ie to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

No. I thought the method excessively complicated when I wrote my comment in September 2010 and my opinion has not changed. Accordingly, keeping credit losses in an “adjunct” or contra-account to the amortized cost account that reports balance due from borrowers is a much easier approach. I believe the proposed compromise of having at least foreseeable credit losses recognized (floor) is a reasonable approach. It seems to balance the concerns of the two boards nicely. I would object to commingling credit losses with interest revenues since that does not seem to sufficiently transparent and it was certainly confusing to understand or teach.

## In summary

I like the proposed compromise. The problems I’ve identified include the following:

- Portfolio W on the straight-line table has a 5-year average life. Portfolio W on the annuity method table has a 10-year average life. All other figures are the same so I presume that one or the other is an error that makes it harder to compare the methods – assuming life-time expected losses are defined in the same way (discounted or undiscounted).

- It is not apparent to me (from studying the two example tables) that one should only use total losses (undiscounted cash flows) in the annuity method. In other words, the straight-line table and the annuity method tables have the same expected losses in the second column. However, paragraph B8(a) says that the straight-line method could use (instead) the present value of expected future losses. Unless one uses discounted losses (for example a percentage of carrying value) in the straight-line method, the time proportional amount (TPA) will probably always exceed the TPA from the annuity method. More clarity in guidance should be provided (see comments under questions 10 and 11 above).
- The straight-line method is a good bit easier and since we can use discounted losses in that method, I would suggest that the annuity method might not be needed at all. That would serve to further simplify the inherent complexities in the recognition of impairment losses. I argue that computing expected losses as a percentage of carrying value (for “good book” loans) is a reasonable approach and simpler to apply than an approach that requires analysis of future cash flows to be forgone.
- The annuity method looks extremely complicated from the example (which requires a second computations table). However, a single formula in Excel or comparable spreadsheet program would produce the TPA in one step. Using the column labels from the annuity method table, the formula would be:

$$=-\text{PMT}(C,G,0,A,0)$$

Instead of cell references, I’ve shown the column labels from ED example so that C is the interest rate from Column C, G is the “n” or weighted average in years from Column G, the present value is zero, and A is the future value or the expected life-time loss from Column A. The final zero is for an ordinary annuity rather than an annuity due.

Thanks for the chance to look at this possible revision to the original FASB exposure draft. I hope my comments are useful. I will post the excel versions of the examples included above in case others would like to try more variations of open and closed loan portfolios.

Sincerely,

*Teresa P Gordon*

Teresa P. Gordon, CPA, PhD  
Professor of Accounting  
208-885-8960  
email: [tgordon@uidaho.edu](mailto:tgordon@uidaho.edu)

See the Excel files posted at my webpage: [www.cbe.uidaho.edu/tgordon/presentations\\_ncomltrs.htm](http://www.cbe.uidaho.edu/tgordon/presentations_ncomltrs.htm)