



April 26, 2013

Financial Accounting Standards Board ("FASB")
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116
Attn: Technical Director
(File Reference No. 2012-260)

Thank you for the opportunity to provide feedback on the proposed Accounting Standards Update, Financial Instruments – Credit Losses (hereafter referred to as the "Exposure Draft").

We understand and appreciate the Board's desire to revisit the accounting guidelines around credit losses. The contents of ASC 310-10-35, ASC 320-10-35, and other relevant Codification sections were developed piecemeal over time, may be difficult to apply in some cases, and were subject to vocal criticism following the global financial crisis.

While we support the decision to relook at this complex area of U.S. GAAP, we feel that the conclusions reached by the Board, and outlined in the Exposure Draft, would not improve existing practice.

In fact, we believe that in many cases, applying the "current expected credit loss" (CECL) model described in the Exposure Draft would fail to faithfully represent the commercial reality and economics of lending and investing activities. Our main concerns with the CECL model include the following:

1. The CECL model results in a Day 1 impairment loss for all originated loans and many purchased financial assets. This outcome does not represent the economic reality of commercial arms-length lending transactions.
2. The expected credit losses determined under the CECL model will rarely (if ever) be representative of the actual credit losses ultimately realized, resulting in a misleading measurement of financial assets at any balance sheet date. In fact, we believe that the application guidance contained in the Exposure Draft related to the CECL model would almost always result in an overstatement of credit losses, particularly at loan origination/acquisition and for many subsequent periods thereafter.
3. The Exposure Draft proposes to eliminate existing "unit of account" guidance within U.S. GAAP, which would reduce the precision currently employed by preparers today in performing impairment assessments.

Making the complex understandable



4. The application of the CECL model is inconsistent with certain core US GAAP principles outlined in the Statements of Financial Accounting Concepts.

Perhaps most importantly, we fundamentally disagree with the premise that an *incurred loss model* results in an “overstatement of assets caused by a delayed recognition of credit losses associated with loans (and other financial instruments)”.¹

Instead, we feel that a relatively minor modification to the incurred loss model would better accomplish the Board’s goal of accelerating the timing of recognizing credit losses in a more consistent and understandable manner versus adopting the CECL approach.

Our views are discussed in more detail throughout the remainder of this letter. If you have any questions or require further information, please contact Scott Ehrlich, President and Managing Director, at (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

1. The CECL model results in a Day 1 impairment loss for all originated loans and many purchased financial assets. This outcome does not represent the economic reality of commercial arms-length lending transactions.

Paragraph BC14 of the Exposure Draft states in part that the Board “understands from experts in the lending community that credit losses do not occur ratably through the life of a loan. Rather, many credit losses are very low shortly after origination...”

We concur with this view. However, the CECL model requires companies to record the present value of all future expected credit impairment losses at loan origination or acquisition². That is, the credit losses are recognized in a period in which they didn’t occur.

We don’t believe this accounting outcome reflects business reality, and actually provides misleading and inaccurate information to readers of the financial statements.

Recommendation: We understand the Board’s main intent in developing the CECL model was to accelerate the recognition of credit losses. We believe this goal could be accomplished in a simpler and more conceptually-sound way.

Specifically, we recommend that the existing incurred loss model be retained, but that credit losses for loans and debt securities be recognized when it is “**more-likely-than-not**” that

¹ Page 1 of Proposed Accounting Standards Update Financial Instruments—Credit Losses (Subtopic 825-15)

² Except for purchased credit-impaired (“PCI”) financial assets. Interestingly, the CECL model would not result in a “Day 1” impairment loss upon acquisition of a PCI financial asset. It does seem incongruous to us that under the CECL model, purchases of far less risky assets – such as AA- and AAA-rated securities – would almost always result in Day 1 impairment charges, whereas purchases of PCI assets would not.

Making the complex understandable

a creditor would be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement. We believe this approach is conceptually superior to the CECL model because losses would be recorded only once a loss event has actually occurred, rather than at origination/acquisition (which, as noted previously, bears no relationship to commercial reality). In addition, this approach is consistent with long-standing and analogous U.S. GAAP around establishing valuation allowances³ for deferred tax assets, as well as existing IFRS for recording provisions⁴. Please refer to Item 5 below for further discussion on these points.

2. The expected credit losses determined under the CECL model will rarely (if ever) be representative of the actual credit losses ultimately realized, resulting in a misleading measurement of financial assets at any balance sheet date.

To illustrate our concern, please consider the following simplistic example:

Lender agrees to issue a \$1,000,000 zero-coupon loan to a borrower. Specifically, Lender will distribute cash proceeds of \$950,000 at loan inception. The loan matures in 9 months' time.

At origination, Lender estimates that there is a 95% chance that the loan will be fully repaid, and a 5% chance that the borrower will completely default.

Ignoring the time value of money for simplicity, the lender would be obliged to record a Day 1 credit impairment reserve of \$50,000 under the CECL model, as shown in the table below.

	Likelihood of occurrence	Expected loss
Loan is fully repaid	95%	-
Borrower defaults in entirety	5%	\$50,000 (5% x \$1,000,000)
Allowance for credit loss		\$50,000

Therefore, the receivable would initially be reported at \$900,000 in the balance sheet (original amortized cost of \$950,000, less an allowance for expected credit losses of \$50,000).

This measurement does not provide any relevant information about the loan. Instead, we

³ See ASC 740-10-30-5(e)

⁴ See IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, paragraphs 15, 16, and 23

believe there are at least three better measurement alternatives that would furnish more decision-useful information to users of the financial statements:

- Amortized cost (\$950,000)
- Fair value (presumably \$950,000 as well, at least at inception)
- Net realizable value, which represents amortized cost less an allowance for incurred credit losses – again, at inception, this figure would likely be \$950,000

The measurement of the loan receivable derived from the CECL model is flawed because Lender – with close to 100% certainty – will ultimately recover an amount other than \$900,000. In the most likely case (no default), the loan balance is therefore understated by \$50,000 at inception and the income statement is burdened with a loss that has not been incurred by Lender. In addition, over the next few quarters, the income statement will reflect gains upon reversal of the allowance for credit losses, an outcome that has nothing to do with the Lender's collection efforts or commercial reality.

Even in a worst case scenario in which the borrower completely defaults, the CECL model doesn't achieve the Board's objective of recognizing credit losses sooner. Only \$50,000 of losses would be recognized at inception. The remaining portion would be recorded in subsequent periods, most likely at the same time that it would have been recorded anyway under existing U.S. GAAP.

In sum, we feel that the measurement of financial assets under the CECL model is confusing and misleading.

3. We believe that the application guidance contained in the Exposure Draft related to the CECL model would almost always result in an overstatement of credit losses, particularly at loan origination/acquisition and for many subsequent periods thereafter.

The CECL model would require in-scope financial assets to be presented at net amortized cost on the balance sheet, reflecting the present value of future cash flows expected to be collected for that asset, discounted at the effective interest rate.

While we recognize that the measurement of a financial asset under the CECL model is not intended to represent its fair value, the present value techniques discussed in the Exposure Draft are similar to those outlined in Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* and paragraphs B6-B19 of the basis for conclusion in Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, which has now been codified into ASC 820.

Both of the aforementioned documents caution against "double counting" by incorporating into a present value measurement both (a) expected cash flows as well as (b) risk premiums

Making the complex understandable



for cash flow uncertainties in the discount rate. Unfortunately, though, the CECL model proposed in the Exposure Draft seems to require just this very type of double counting.

For any originated loan or purchased debt investments, an investor/creditor will demand that the financial asset's effective yield reflect risk premiums for cash flow uncertainties. Said another way, the effective interest rate of a financial asset already reflects credit risk. Therefore, using this rate to discount expected cash flows – which also consider credit risk – appears to double count the potential effects of credit losses, therefore overstating the allowance for credit losses at loan inception and likely in the immediate periods thereafter.

4. The Exposure Draft proposes to eliminate existing “unit of account” guidance within U.S. GAAP, which would reduce the precision currently employed by preparers today in performing impairment assessments.

The Exposure Draft would permit – and in fact seems to encourage – companies to perform impairment assessments on pools of assets.

We believe that this would be a step backwards when compared to the requirements in current U.S. GAAP. At present, many financial assets are evaluated for impairment at an individual level⁵ (apart from loans and receivables within the scope of ASC 450-20). Thus, it's operationally possible to do so and in fact already a part of many companies' operating rhythms.

Perhaps more importantly, though, we believe that the individual asset is the most appropriate level to test originated loans and purchased debt securities for impairment, whenever possible. Grouping assets for purposes of an impairment assessment may actually delay the recognition of credit losses, as “good assets” may obfuscate “bad ones”. This outcome seems contrary to one of the objectives of promulgating the Exposure Draft in the first place.

In addition, by removing the existing unit-of-account guidance, we anticipate that impairment evaluations will become less rigorous and precise, resulting in less accurate allowance estimates.

We also refute the Board's view in BC 21-22 of the Exposure Draft that preparers manage their assets on a group rather than individual basis. While groups of assets may have similar risk profiles, the fact is that lenders make underwriting, origination, collections, and write-off decisions on a loan-by-loan basis. Investors make similar decisions on a security-by-security basis. And as noted above, lenders and investors have the ability, and are required by current GAAP, to evaluate other-than-temporary impairment at the level of each individual debt security in the scope of ASC 320-10. Therefore, we don't believe that removing these

⁵ See ASC 310-10-35-2 and ASC 320-10-35-20.



current requirements will improve financial reporting, but instead would introduce an extra layer of unnecessary judgment into the impairment analysis that is entirely avoidable.

5. The application of the CECL model is inconsistent with certain core US GAAP principles outlined in the Statements of Financial Accounting Concepts.

We believe that the CECL model is inconsistent with some of the core US GAAP principles outlined in the Statements of Financial Accounting Concepts. Specifically:

- The first sentence of paragraph 85 of Statement of Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* states: "Further guidance for recognition of expenses and losses is intended to recognize consumption (using up) of economic benefits or occurrence or ***discovery of loss of future economic benefits during a period.***" [emphasis added]
- Paragraph 87 states: "An expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits."

These two paragraphs encapsulate a long-standing principle of U.S. GAAP – that expenses and losses should be subject to recognition thresholds. The purpose of having a recognition threshold is to provide a disciplined and logical basis for recording expenses and losses (as well as revenues and gains for that matter) in the proper accounting period.

As noted previously, setting credit loss reserves on receivables and debt securities is, in many respects, conceptually similar to establishing valuation allowances for deferred tax assets or even provisioning for contingencies. In both situations, valuation allowances or liabilities are not established until certain recognition criteria are met. For instance, valuation allowances for deferred tax assets are not recorded unless it is more-likely-than-not that a deferred tax asset will not be realizable.

Based on these analogous guidelines, we do not agree with the Exposure Draft that determining a credit loss reserve is a measurement concern only. This view is inconsistent with the Statements of Financial Accounting Concepts mentioned above and the accounting for similar contra-assets, namely deferred tax asset valuation allowances.

6. Other items

- We do support having specific guidance around when a financial asset should be placed on nonaccrual status, documenting existing practice. However, we suggest that the threshold for nonaccrual status occur when it becomes more-likely-than-not that the lender will not receive substantially all of the contractual principal or interest due. Taken

Making the complex understandable



together with our recommendation in Item 1 above, this approach will align the timing of recording credit impairment loss with that for ceasing to record interest income.

- We fail to see the decision-usefulness of amortized cost disclosures for financial assets that are reported at fair value through other comprehensive income (FV-OCI). Since the Board has determined that FV-OCI is the most relevant measurement attribute for these assets, then it seems incongruous to require roll-forwards of amortized cost or reconciliations between fair value and amortized cost. If the Board strongly feels that amortized cost is such an important measurement attribute for these financial assets, perhaps it should consider revisiting why such assets are measured at fair value in the first place.
- The Board should clarify the scope of the practical expedient proposed in 825-15-55-4 for measuring impairment of collateral-dependent loans based on the fair value of the collateral. Of note, we are confused by the words “(by the lender)” in the definition of a collateral-dependent financial asset. We read this phrase as effectively limiting the use of this practical expedient until the moment that a lender has repossessed the collateral. If this is the case, the accommodation would provide many lenders with only limited period of time to actually take advantage of this accommodation. We don’t think that was the Board’s intent. Instead, we would hope that this practical expedient be available in all instances where the lender has the ability to repossess collateral to fully settle a loan.
- We believe the Board should broaden the practical expedient for financial instruments measured at FV-OCI. Specifically, we would eliminate the second criteria proposed in 825-15-25-2(b) of the Exposure Draft. Instead, we feel that if the fair value of the financial asset exceeds its amortized cost, it does not need to be further assessed for impairment – full stop. In our view, it would be extremely rare for a financial asset to meet the first criteria (fair value equal to or exceeding amortized cost), yet fail the second one (expected credit losses are insignificant), thereby rendering the second criteria unnecessary.
- We have a further comment related to the practical expedient in proposed in 825-15-25-2. To demonstrate our concern, assume that the criteria in that paragraph were met in prior reporting periods, meaning that no allowances were recorded against the debt instrument. However, in the current reporting period, interest rates rise, causing the fair value of a fixed-rate debt security to fall below its amortized cost basis. Further assume that there was no deterioration in credit quality. Under the proposed CECL model, the investor would now be forced to record an allowance for credit losses simply because of movements in interest rates, and not because of a deterioration in the credit quality of the issuer. We question whether this results in a desirable or useful accounting outcome.
- We don’t feel that the proposed accounting for purchased credit-impaired (PCI) assets is an improvement over current GAAP. Again, we share a simple example to outline our concern. Assume that an investor pays \$20 to acquire a PCI asset with a par value of

Making the complex understandable



\$100. On Day 1, the investor estimates that the credit loss embedded in the PCI asset is \$70, with a remaining \$10 representing the investor's assumed yield.

- As proposed, the acquired PCI asset would be grossed-up to \$90, with a corresponding allowance of \$70 for credit impairment. Both these amounts are estimates, which require judgment and time/resources on the investor's behalf. In contrast, under current GAAP, the acquired PCI asset is simply recorded at its observable purchase price of \$20.
- The performance of the PCI asset will look worse under the proposed method (\$10 interest income on a gross receivable basis of \$90), compared to current GAAP (\$10 interest income on a net receivable basis of \$20). Our view is that current GAAP better reflects how investors actually assess the performance of acquired distressed instruments.
- If actual cash flows differ from initial estimates, the Exposure Draft proposes recording these adjustments in the allowance account, thus immediately impacting income. Under current GAAP, expected improvements in cash flows adjust yield, but additional losses are provided for immediately. In our view, a prospective adjustment of yield (as opposed to immediate gain recognition) is a better reflection of improvements in the credit performance of PCI assets and how most investors would assess the performance of the purchased asset.
- In any event, we encourage the Board to field test the proposed PCI model with investors and preparers to ensure both constituencies are comfortable with the results of the proposed guidelines.

Making the complex understandable