

Technical Director
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FASB

Director:

I agree that replacing the incurred loss/derecognition approach for accounting for financial asset credit uncertainty with a measurement that includes forward-looking information will improve financial reporting. The question is whether the Board's proposed Expected Credit Loss (ECL) calculation or a Fair Value (FV) measurement of financial assets provides the most useful financial information.

The following is my analysis of the ECL calculation and a FV measurement using the "Qualitative Characteristics of Useful Financial Information" from Concept Statement No. 8. Concept Statement No. 8 was issued in 2010 and signed by four of the FASB Board members who agreed to propose the ECL approach – Leslie F. Seidman, Thomas S. Linsmeier, Marc A. Spiegel and Lawrence W. Smith. The qualitative characteristics of useful financial information were developed to assist the Board members in writing high quality accounting standards. However, the "Basis for Conclusions" in the Exposure Draft does not explain how the ECL calculation was selected using the qualitative characteristics (even though the Financial Accounting Foundation's first Post-Issuance Review Report recommended that the Board discuss how its decisions relate to the qualitative characteristics.) Nor does the Exposure Draft mentions the possible use of a FV measurement for accounting for credit uncertainty.

Fundamental Characteristics of Useful Financial Information

Relevance: – Relevant financial information is capable of making a difference in the decisions made by Users. (QC6)"

As I have written the FASB in the past, both Amortized Cost (AC) and FV measurement of financial assets provide relevant information. AC provides information about the assets' contractual cash flows and FV provides information as of the reporting date of the

value of the assets' expected future cash flows to be received from holding or exchanging the assets.

Using an entity-specific ECL to adjust AC to reflect credit risk incorporates limited forward-looking information into the net presentation of financial assets. I expect some financial statement Users will use this calculation to make decisions (much as they apparently do using the current AC less incurred loss calculation). But will the User be able to determine and evaluate the entity-specific bias that will be incorporated into this type of forward-looking information? As discussed later, will the User find the AC less ECL calculation to be comparable across reporting entities?

FV measurement of financial assets reflect an estimate of the capital markets' view of the value of the assets' expected future cash flows. FV incorporates forward-looking information about contractual cash flows that the market does not expect to receive as well as additional information about the assets' other risks and uncertainties. It produces a measurement of the assets' value. This value is relevant whether the reporting entity plans to hold the assets to maturity or to exchange the assets. FV is expected to reflect the price at which the assets could be used in a transaction at the reporting date. The AC less ECL calculation will not produce such an amount. As reported in a number of accounting standards, the FASB has found that Users use FV measurements of financial assets to make decisions. In fact, the FASB has increased the frequency of reporting financial assets' FV and, based on information on the FASB website, is expected to propose requiring FV measurements to be presented on the face of balance sheets for financial assets reported at AC less ECL.

Conclusion with respect to Relevance: Both AC less ECL calculations and FV measurements produce relevant financial information.

Faithful Representation: – “To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be **complete, neutral, and free from error.** (QC12):”

AC less ECL can be considered to be **complete** only with respect to a limited part of financial assets-- AC less a calculation (not a value or measurement) of cash flows not

expected to be received. However, financial assets include risks and uncertainties beyond contractual cash flows that are not expected to be received. Financial institutions have asserted in the past that they manage credit risk and the other risks and uncertainties (many times characterized as interest rate risk) separately. Many financial institutions claim that if financial assets were reported at FV their separate management of credit and interest rate risk would be distorted in the financial statements. I believe this claim of management of credit and interest rate risks separately and the distortion in financial statements is questionable. The amount of fair value and credit risk hedging and the constant call for the ability to do macro hedging of financial assets carried at AC and FV in other comprehensive income (OCI) seems to contradict these claims. Also, as discussed later, the current accounting treatment of hedges for financial assets carried at AC and FV in OCI is in itself questionable and confusing.

A FV measurement of financial assets includes forward-looking information about all facets of financial assets. This measurement is more **complete** than AC less ECL and produces an amount for the financial assets that is understandable and useful whether the assets are to be held or exchanged. I believe the Board members who approved the Exposure Draft acknowledge that separating credit and interest rate facets of financial assets at origination is “impractical (if not impossible) (BC15).” If such a separation is impractical when a financial asset (loan) is underwritten and priced, why is such separation in an AC less ECL approach not impractical, especially subsequent to origination? AC less ECL is an incomplete representation of financial assets.

An entity-specific forecast of the future can not be **neutral**. Expectations of future events and the affect those events will have on the collectability of contractual cash flows are quite disparate. Without a blending of these disparate expectations (which is done when the perspective is changed to a market view), the entity-specific view will represent only the single entity’s expectation.

Based on my experience, many factors such as changes in management, compensation plans, and a managements’ expectation of how the capital markets will react to reported financial results will influence how an individual entity will decide to determine their forecast of the future. I fear that because of these factors and others, entities will look to how their forecast will affect their reported financial results in deciding what their forecast will be. This is a “determine the desired outcome on the reported financial results and build the forecast to get to those results” outcome. It will be a biased result!

FV measurements blend the disparate forecasts of market participants about future events and how those future events will affect the collectability and value of future cash flows. Thus, a FV measurement will be **neutral**. Even if a level 1 and 2 fair value estimate is not available, a level 3 estimate will strive to be neutral since it reflects a market perspective.

Both an AC less ECL calculation and a FV measurement will not be **free of errors**. If an error is defined as being different from the ultimate amount of cash received from holding or exchanging a financial asset in the future, both the calculation and the measurement will be in error. Both the calculation and the measurement are based on point in time forecast of the future and both call for those forecasts to change as the point in time changes. As such both will reflect the volatility of changes in forecast of the future.

Conclusion with respect to Faithful Representation: The FV measurement approach is more **complete** and **neutral** than the AC less ECL approach. Both approaches will have errors and be volatile. FV is a more Faithful Representation of financial assets.

Enhancing Characteristics of Useful Financial Information

Comparability – “Comparability is the qualitative characteristic that enable users to identify and understand similarities in and differences among items (QC21).”

Because entity-specific ECLs are bias, comparability is lost. Even with disclosures about an entity’s ECL, it will be difficult (if not impossible) to compare the financial results of one entity to another. Also, as discussed later, the disclosures about the reporting entity’s entity-specific forecast of the future are inadequate.

FV measurements are not bias. They reflect a market perspective and thus are comparable from one entity to entity.

Verifiability –“Verifiability means that different knowledgeable and independent observers could reach consensus, although, not necessarily complete agreement, that a particular depiction is a faithful representation (QC26).”

Another way to express the enhancing qualitative characteristic of verifiability is whether the financial information is auditable. I do not believe entity-specific ECL is as auditable as a FV measurement. I question how an auditor with clients with financial assets of the same credit quality and subject to the same future events will be able to determine that the ECL of the individual clients are in accordance with GAAP if the entity-specific forecasts of the future are significantly different. How will the auditor determine that the significantly different forecasts are both “based on relevant financial information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the assets’ remaining contractual cash flows (from page 2 of the Exposure Draft)?

Auditing FV measurements is a challenge. However, such measurements are made based on much more observable information than an entity-specific forecast of the future. Also, I expect that the quantity and quality of observable information about financial assets will continue to increase. Thus, FV measurements are more verifiable than ECL calculations.

Timeliness – “Timeliness means having information available to decision makers in time to be capable of influencing their decisions (QC29).

Both ECL calculations and FV measurements will take time to develop. I do not see a difference with respect to **timeliness**.

Understandability – “Classifying, characterizing, and presenting information clearly and concisely makes it understandable (QC30). Financial reports are prepared for Users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently (QC32).”

I believe Users, Preparers and Auditors have developed significant knowledge about FV measurements since the issuance and application of Statement No. 157. Discussions of the levels of fair value measurements is common by Users. Analysis of level 3 measurements and changes therein by Users is significant. Thus, using the description of **Understandability** in Concept Statement No. 8 and how the term more broadly, I believe FV measurements are more understandable than the new and bias ECL calculations.

Conclusion with respect to the Fundamental and Enhancing characteristics of Useful Financial Information. I believe a FV measurement of financial assets is at least equally **relevant** as AC less ACL and a much more **Faithful Representation** of financial assets. Also, a FV measurement is supported by the enhancing characteristics of **Comparability, Verifiability and Understandability.**

Additional Comments and Issues

Complexity and Cost – FV measurement of financial assets is already required and is proposed to be required even with the AC less ECL approach. It includes forward-looking information about credit risks and other risks and uncertainties. Why require the complexity and cost of an entity-specific forecast of the future if a FV measurement already includes forward-looking information? The display of a FV measurement can be combined with AC. If a credit loss item is also desired, the display of AC less incurred losses adjusted to FV provides a complete picture.

Disclosures about Entity-Specific Forecasts is Needed- 825-15-50-8 and 9 in the Exposure Draft requires information that enables a financial statement User to understand how the Allowance for Credit Losses was determined. Only in item b of 825-15-50-9 is "reasonable and supportable forecasts about the future" mentioned. Because such forecasts are **required** by the proposed ECL approach, details of the entity-specific forecast must be required. Details, with time frame information, such as expected GDP, unemployment rates and real estate values are necessary for Users to evaluate a reporting entity's forecast of the future.

Separation of Credit and Other Changes in a FV Measurement

As discussed in the Exposure Draft in BC15 and discussed above about the “impractical (if not impossible)” ability to separate the affect of credit and other risks and uncertainties in pricing originated financial assets, how is the separation called for by FSP FAS115-2 and FAS124-2 and apparently carried forward from reading 825-15-25-1 and 2 in the Exposure Draft possible?

How is it possible to determine the affect of a hedged risk (including hedged credit risk) on the FV of a hedged financial asset to determine hedge effectiveness under Statement No. 133? How is it possible to determine the amount to adjust the AC for the hedged risk in the asset? How do you describe the adjusted AC amount in an understandable manner? I provided suggestions with respect to hedging financial assets in my comment letter on the initial Financial Instrument Exposure Draft. I believe the Board should reconsider these suggestions.

Definition of Fair Value – Why does the Exposure Draft include in its Glossary a definition of FV that is not that contained in Statement No. 157? Why does the Codifications Master Glossary include 2 definitions of fair value?

Complexity with respect to Financial Assets carried at FV – OCI

If a FV measurement can negate the need for an ECL calculation for financial assets carried at FV in OCI or overcome the need to recognize a calculate ECL for such assets, why have ECL at all?

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Please contact me at ewtrott@gmail.com if you would like to discuss these comments.

Sincerely,

Edward W. Trott