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May 31, 2013

Ms. Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Proposed ASU, *Financial Instruments - Credit Losses* (File Reference No. 2012-260)

Dear Ms. Seidman:

The Financial Reporting Committee of the Institute of Management Accountants (FRC) is writing to provide its views on the proposed ASU, *Accounting for Credit Losses on Certain Financial Instruments* (proposed ASU). We fully support the objective of improving the recognition and measurement principles related to impairment of financial assets. However, we believe that the central principle for loss recognition is faulty and that, as a result, the proposed guidance will not meet the objective. We believe that improvements in this area would be best accomplished through specific enhancements to existing requirements with particular emphasis on revising the recognition threshold and developing a robust framework for estimating “incurred but not reported” (IBNR) losses. Further, we are concerned that the introduction of the expected loss principle in this context raises difficult issues and potentially has implications for other parts of the accounting model (such as the accounting for contingencies). Accordingly, the sole focus of this response is to provide a more fulsome explanation of our recommendations and our concerns regarding that central tenet of the proposed model.

The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world’s largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.¹

Issues with the Proposed Model

The FRC agrees with the view that the financial crisis revealed flaws in the accounting for loan losses. We have considered the reports issued by special committees that were formed to provide advice on what should be done in response to the crisis as well as those issued by other organizations. However, the underlying recommendations from these bodies are rooted in a risk management perspective on measurement, which stands in sharp contrast to a view that would render good accounting for loss recognition. The FRC recognizes the utility and value of an expected loss model from the standpoint of assessing financial risk and we would agree with use of such a model in determining appropriate capital levels for purposes of prudential regulation of financial institutions. However, such concepts are an anathema to the accounting objective, as use of such a model will have the effect of causing the accounting and economics to diverge, which is not sustainable in the long run.

¹ Additional information about the IMA’s Financial Reporting Committee can be found at www.imafr.org



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The FRC believes that the principal accounting issue in this proposal is whether loss recognition should be based on the occurrence of a past event; specifically, an incurred loss. The proposed ASU does not retain that anchor but rather requires recognition of a loss that is expected to occur at some point in time in the future. As a result, the model will require recording of a “day one” loss that is not reflective of the economics underlying the transaction. This point can be illustrated with a simple example. Assume a debt instrument is acquired on the date it is originated in an arm’s length transaction. If that instrument is accounted for at fair value through net income, there would be no day one loss to recognize. If that instrument is accounted for under the proposed ASU, a loss would be recognized for the amount of future principal and interest not expected to be collected over the life of the instrument. The important point in comparing these two approaches is that the fair value of the acquired debt instrument already reflects the market’s expectation of losses over the life of the instrument. We believe that the incremental loss that would be recognized under the proposed ASU is not based on the economics of the transaction but rather on a prudential desire to have a higher level of loan loss reserves reflected in financial reports to investors. While we understand the latter objective and the role of the expected loss concept in fulfilling it, such an approach is not consistent with the FASB’s conceptual framework and other elements of our existing accounting model. We see similar conceptual and practical difficulties with a truncated version of the expected loss concept over some foreseeable future time horizon.

The FRC also understands that there is growing impatience with the delays in completing work on this project. However, we would observe that reserve levels among financial institutions in the United States have risen substantially over the past five years in response to actions taken by banking regulators. All of this has occurred without new or modified guidance on accounting for credit losses. This development underscores a central argument underlying our recommendation. The problem with the current model is not that the incurred loss concept cannot support a significantly higher level of reserves or that it cannot reflect losses quickly enough. Rather, we believe that the problem, in practice, is that the burden of proof (in the form of the recognition threshold and application guidance) has been, at times, set too high to permit timely recognition of all incurred losses, especially those incurred but not reported.

The FRC observes that, from a historical perspective, the overall level of loan loss reserves reported by financial institutions has been significantly affected by the way in which key stakeholders have interpreted and enforced the existing principles in US GAAP. Specifically, in the late 1990’s there was a heavy focus by securities regulators on the level of evidence necessary to support that losses had indeed been incurred. We believe that the effect of that scrutiny limited the degree to which preparers and auditors were willing to exercise judgment in providing for losses in response to adverse macro-economic developments and other similar types of evidence in raising reserves. As a result, we believe that principles of the existing incurred loss model were not able to be robustly applied and loan loss reserves were lower than they otherwise would have been heading into the financial crisis. We believe that this condition is correctable without completely superseding the existing model with a completely new set of principles.

Recommended Approach

The FRC believes that the current incurred loss model, with enhancements, will ensure that reporting entities recognize, at the reporting date, the full amount of credit impairment losses incurred at that date, including those losses that are incurred but not reported. In our view, assuming sound underwriting and no fraud, recognition of the loss must relate to a credit event that occurs at some point after the lender



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makes the loan. We also believe that an improved incurred loss model could fully meet the Board's fundamental objectives for a credit impairment model. Consequently, we believe that principles underlying the existing incurred loss model can be enhanced through modifications to provide the underlying basis for an improved impairment model. We believe this approach has much higher prospects for meeting the Board's objective than a completely new model, which we are concerned will inevitably create significant operational challenges and high implementation costs as well as the need for an extended transition period.

Thus, we believe the Boards should focus on developing an "enhanced incurred loss model" as the basis for measuring credit impairment. That enhanced incurred loss model would build on the existing impairment models within the respective accounting frameworks, but be modified to address the weaknesses within the current model.

We recommend the following modifications be made to the existing guidance.

- (1) Establish a lower threshold – perhaps “more likely than not” – for the recognition of impairment losses.
- (2) Develop more robust and understandable guidance for estimating IBNR.
- (3) Clarify the requirement for definitive evidence to support the recognition of impairment losses. We believe that an event gives rise to an incurred loss when there is a reasonable basis to believe the event would adversely affect a borrower's ability to make all remaining scheduled payments.
- (4) Permit consideration of current projections of economic conditions and emerging trends that are reasonably supportable in determining if a loan (or group of loans) is impaired and in measuring the amount of the impairment.

Although our recommended model would not have eliminated the need for companies to recognize losses during the financial crisis (nor would the proposed ASU, in our view), we believe financial institutions would have had higher reserves heading into the crisis and would have recognized impairment losses earlier.

The FRC believes that these targeted enhancements to the existing model can satisfactorily address the core issues with accounting for credit losses while also lowering complexity and implementation costs. We believe that the Board's goals for the project can be met through this approach and that it is unnecessary to introduce a set of completely new principles. Fundamental changes, particularly those as broad as the concept of expected losses, will create enormous uncertainty and interpretive churn in the financial reporting and user communities. Even though the FASB Staff indicates that many of our existing models and methodologies can be relied upon to comply, we expect that practice will be compelled to essentially start anew in developing frameworks, policies, interpretive guidance, procedures and controls at a cost that will far exceed the financial reporting benefits. As we move through that process, we will inevitably face difficulty in answering questions about whether our processes and policies have changed sufficiently and appropriately to comply with the new ASU.



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The FRC also expects that the level of diversity in practice under a completely new model could be significant and is particularly concerned about how an auditor will be able to opine on these judgments in the present environment and how the PCAOB will reach a conclusion that, in each case, the auditor had sufficient basis upon which to opine.

The FRC believes that the loss estimation methods used in practice today are well-understood and can be adapted to the enhanced model we describe above if appropriately supplemented with more specific guidance. If this approach was adopted, we believe the revised principles could be implemented more quickly and with substantially less interpretive effort than a complete change in the model's principles. If the Board were to decide to pursue this approach, members of the FRC would be pleased to provide expert resources to assist the Board in developing such guidance. Based on the fact that this approach would augment existing concepts and principles, we believe that it is reasonable to assume that there will likely be significantly less diversity in practice with lower potential for restatements and audit issues, as well as less confusion within the user community.

In summary, the FRC supports an incremental and targeted approach to changes in the accounting for the reasons explained above. We believe that these will yield improvements in financial reporting that will stand the test of time because they are based on sound concepts that are consistent with our accounting model, while also being responsive to the needs of users. We need a solution that will produce the highest quality financial reporting in this important area. We believe that our recommended approach will yield demonstrable benefits compared with the model in the Proposed ASU. These benefits include: the development of an operational and cost-effective models based on a sound concept; the ability to require an earlier effective date; streamlined transition provisions; and higher quality implementation with the potential for significantly less diversity in practice.

We appreciate the Board's consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder".

Nancy J. Schroeder
Chairman, Financial Reporting Committee
Institute of Management Accountants
nancy@beaconfinancialconsulting.com