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March 30 2011

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File Reference No. 2011-50- *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities-Impairment*

The Financial Reporting Executive Committee (FinREC) appreciates the opportunity to comment on the Supplementary Document, "Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities-Impairment." FinREC supports the efforts of both the FASB and the IASB to achieve convergence. We recognize that the proposal is an attempt by both Boards to solicit input on a compromise accounting model. We are happy to provide our input, but strongly recommend that a revised comprehensive financial instruments Exposure Draft (ED) be issued that addresses our concerns and recommendations, as well as those of other commenters, on classification and measurement, impairment, and hedge accounting.

We recommend that respondents be given more time to adequately study the issues and provide further detailed and meaningful commentary on this Supplementary Document (SD). More time is needed for field testing the proposal in order to determine whether or not there are any significant operational issues with the impairment model and whether it would actually achieve the Board's objective of providing more meaningful information and transparency. We doubt that most companies have been able to give significant consideration to the SD, because of the short time frame to respond, and the fact that preparers and auditors have been focused on year-end financials, the pending end of the first quarter, as well as the recent documents on hedging and offsetting that will require similar attention and analysis. Given the time of the year and the fact that comments on these proposals are all due within one month, we were not able to provide an in-depth analysis to these important proposals and evaluate all the implementation issues.

Regarding this SD, we continue to recommend changes to the proposed impairment model consistent with our September 30, 2010 letter to the Board on the more comprehensive ED on financial instruments. As previously communicated, we do not support the full life expected loss model that was originally proposed. Furthermore, as stated in our September 30 letter, "We believe that the incurred loss model for recognition of credit impairment should be retained since we believe losses should not be recognized until there is a triggering event." To achieve a more timely reporting of the incurred losses, we recommend lowering the threshold of when credit losses should be recognized from "probable" to "more likely than not," although we recognize that criteria may have to be developed for the "more likely than not" threshold for consistent application in this context.

While FinREC recognizes that the FASB and IASB are trying to find a compromise solution, the result could have an important impact on the concepts underlying the principles of accounting for impairment. We are concerned that the proposed impairment model would be a significant departure from the incurred loss model articulated in ASC 450, *Contingencies* (f/k/a FASB Statement No. 5), which is broadly applicable beyond the topic of loan loss reserves and the financial services industry (e.g., litigation loss contingencies and natural disasters). If the proposed model were analogized to in these situations, it would have the effect of compromising the principle that losses are recorded when incurred, rather than when they are estimated to occur in the future. We are also concerned about the objective of the current proposal to increase recognized losses, presumably to mitigate a financial crisis such as the one we recently experienced. The stated goal of increasing recognized losses is not an accounting principle and does not provide a basis for a financial reporting model, as such, there is no conceptual basis for constructing a financial reporting model intended to serve this objective. We do however, support more timely and accurate reporting of incurred losses.

The scope of the document only deals with open portfolios and many significant issues related to impairment have not yet been addressed. We do not think it is feasible to evaluate an impairment model fully without considering how it would be applied in the following areas:

1. Individual loans and closed loan portfolios
2. Measurement and recognition of interest income
3. Troubled debt restructurings (TDRs)
4. Purchased impaired loans
5. Methods for measuring credit losses
6. Definition of write-offs, and
7. The objective of amortized cost measurement and its link to the impairment model.

We also observe, that many issues seemingly resolved by the IASB still need to be deliberated by the FASB and their resolution may have a significant impact on any final standard. For example, the IASB has tentatively agreed to decouple interest income recognition from the allowance for credit losses, but that has not yet been deliberated by the FASB. We urge the FASB to reach the same conclusion as the IASB as this was a major concern of FinREC in its September 2010 letter.

As stated above we did not have sufficient time to adequately consider all issues raised by the SD, which is compounded by the fact that we need additional clarification of many of the issues raised (for example, whether or not to discount the loss reserve, whether it is possible to determine a weighted average life and weighted average remaining life of an open portfolio, whether the proposed model could be made operational for securities, et al) and improved definitions of many of the terms in the SD (for example, good book, bad book, foreseeable future, closed portfolios). However, recognizing that the Boards seem to be moving away from the incurred-loss-only model, we believe that in any model that requires estimation of the life-of-loan losses, such credit losses should at least be spread over the life of the loan. We do not believe they should be recognized on day 1, since as a factual matter all of a portfolio's losses do not occur at inception. If the Boards continue to support the SD's proposed life-of-loan model and decide to move forward with it, we have the following recommendations to mitigate our concerns:

- We recommend that instead of the "foreseeable future" floor, the floor should be based on incurred losses. In addition we agree that the current probable threshold should be replaced with other existing GAAP guidance for the recognition of impairment losses.

- If the Boards decide to retain the foreseeable future floor, in order for it to be operational, the concept of foreseeable future needs to be clearly defined and articulated. In current accounting literature, the term "foreseeable future" covers differing time horizons, depending on the industry and specific accounting standard. For example, ASC Topic 740-30-25-19 (formerly APB 23, paragraph 12) provides an exception to the requirement of a parent company accruing income taxes on undistributed earnings of a foreign subsidiary, and states, "If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity..." In addition, ASC Topic 948-310-25-1 (formerly FAS 65, paragraph 6) states, "A mortgage loan transferred to a long-term-investment classification shall be transferred on the transfer date. A mortgage loan shall not be classified as a long-term investment unless the **mortgage banking entity** has both the ability and the intent to hold the loan for the foreseeable future or until maturity."

- Furthermore, we observe that estimated losses during the "foreseeable future" may become increasingly subjective the farther they extend beyond 12 months.

While we recognize that under this model future events need to be considered in determining the allowance, we believe the horizon should be limited to minimize subjectivity and potential manipulation. We also observe that without a basis for management's conclusions, the information may not be auditable.

Because of the difference in the way banking regulators in the United States and internationally have defined the current incurred loss model (outside the U.S., we understand it is often less than 12 months, whereas we understand the U.S. banking regulators have generally required at least a 12-month incurred loss period), it becomes increasingly important to define the floor for credit losses, so as to avoid continuing or even widening the comparability gap.

- While discounting seems conceptually appropriate under the "full life-of-loan" approach originally proposed, we do not believe that the added complexity that discounting entails will yield meaningful financial reporting benefits to users. For shorter time frames such as incurred loss or the foreseeable future, discounting only adds complexity without a significant difference in results. However, if the Boards decide to permit discounting to be applied, the appropriate rate needs to be defined and articulated, rather than an unrestricted choice.

- We believe that the time-proportional approach to measuring impairment in the SD places a greater burden on smaller financial institutions and entities outside of the financial services industry which may lack operational capacity and sophistication to apply this complex model. We believe that, especially for those companies, the potential costs of compliance with this approach outweigh the likely benefits to financial statement users.

- More guidance is needed to clarify when a loan needs to be transferred from the good book to the bad book, as well as bad book to good book (e.g., TDRs classified as impaired but which subsequently become performing loans). The Board needs to clarify which activities/triggers comprise the credit cycle and when reclassification from "good book" to "bad book" should occur. Many of the examples in paragraph B3 illustrate activities/triggers that occur too late in the credit cycle (i.e., after reclassification) or too early in the cycle (e.g., contacting delinquent borrowers by mail or phone is a routine first step).

- We note BC54 states that "the timing of when a financial asset is transferred between the two groups that are differentiated for purpose of determining the impairment allowance would not affect the allowance amounts or profit or loss." The implications of that statement are unclear. In the good book, if the foreseeable future happens to encompass less than the entire amount of expected credit losses, only a subset of those losses can be recognized each period under the time-proportional approach. Moreover, the portion of unrecognized future losses presumably changes each period based on current information and expectations. Therefore, it appears the timing of a reclassification to the bad book necessarily affects earnings because all remaining future losses (which change each period) would be recognized.

  Conversely, practitioners might interpret BC54 to mean the periodic adjustment of the total allowance is unaffected by a reclassification between categories (or the timing of that reclassification) because the foreseeable future determined under the good book could encompass the entire amount of expected credit losses. In that scenario, the relevance of the bad book would seemingly be limited to presentation and disclosure, with no impact on recognition or measurement. As such, is bad book classification merely intended to signal to a user that management's collection efforts have intensified, without otherwise affecting the balance in the allowance?

  Given these uncertainties, we believe the Boards should clarify their intent through examples of the journal entries associated with a reclassification

- We do not believe that a single impairment model as proposed could be applied to all debt securities and loans. We observe that the proposal is not workable for either individual loans or debt securities, because of the idiosyncratic nature of the instruments. Debt securities are generally analyzed on an individual rather than a pooled basis, because the "relationship" is with a particular issuer, rather than a type of borrower. Debt terms are tailored to the unique facts and circumstances of the individual borrower and, therefore, credit risk is idiosyncratic. Further, the resolution (workout) for a debt security can take years and involves projecting cash flows for literally decades whereas for loans, the resolution typically occurs over a much shorter time horizon – either the loan is restructured or the collateral is seized by the lender. Therefore, we believe that securities should be treated differently. The current impairment guidance in ASC 320-10-35-17, *Impairment* *of Individual Available-for-Sale and Held-to-Maturity Securities* (f/k/a FASB Staff Position FAS 115-1 and FAS 124-1: *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*)) seems to work well for securities.

Again, we urge the Board not to finalize a standard on impairment of financial instruments before another ED is exposed for comment that addresses financial instruments comprehensively, including classification and measurement, providing guidance and clarity on the issues contained in the SD, as well as those issues that still need to be addressed and provides sufficient time for field testing. Although we recognize the need for convergence, the current proposal does not address many issues and may not be conceptually sound. Due to the short comment deadline, we do not have sufficient data to provide adequate input, which makes it difficult to determine whether this proposed Standard would work in practice.

Representatives of FinREC and the Impairment Task Force would be pleased to discuss our comments with you at your convenience.

Sincerely,

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