

September 1, 2009

International Accounting Standards Board
30 Cannon Street
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The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) is pleased to offer comments on the International Accounting Standards Board (IASB or Board) June 2009 Request for Information, *Impairment of Financial Assets: Expected Cash Flow Approach*. The Accounting Standards Executive Committee (AcSEC) is the senior technical committee of the Institute for financial reporting. It is authorized to make public statements on behalf of the Institute on financial reporting matters without the clearance of either the Council or the board of directors of the Institute and to clear statements of other committees that include references to financial reporting positions.

We support the Board's efforts to improve the accounting for impairment of financial assets. In general, we believe the expected cash flow approach has conceptual merit, and may result in an improvement in financial reporting when compared to the incurred loss impairment approach. However, we believe there will be significant implementation challenges involved in applying the expected cash flow approach that should be carefully evaluated by the board as it considers the specific requirements of the approach and potential transition and effective date provisions. There are a number of details regarding the approach that are not specified in the Request for Information. Although we have commented below on whether the approach is operational, it is difficult to adequately assess without this additional information. Our responses to the Request for Information follow.

Issue #1: Is the approach defined clearly? If not, what additional guidance is needed, and why?

The expected cash flow approach outlined in paragraphs 9 and 10 of the Request for Information makes repeated references to the impact on expected cash flows of changes in credit loss expectations, whereas the accompanying IASB Agenda Papers 5A and 5D make reference to the impact on expected cash flows from changes in *all* factors rather than just credit quality. AcSEC observes that it is unclear whether this difference is intentional. AcSEC further observes that some impacts on expected cash flows that are unrelated to credit may nevertheless have a significant impact on the value of financial assets (e.g., anticipated prepayments of loans receivable) and suggests that any approach include a more robust discussion of specifically which factors impacting cash flows and expectations of changes in cash flows should be considered, particularly since the potential adjustment to carrying value from factors other than credit quality may be significant.

There are a number of details regarding the approach that are not specified in the Request for Information, including when it would be appropriate to aggregate multiple financial assets for purposes of applying the approach on a pooled basis, whether the approach should be applied on a probability-weighted basis, whether the approach should be based on entity-specific factors rather than a market participant perspective,

and whether a valuation allowance (e.g., allowance for loan and lease losses or ALLL) would be used in applying the approach. AcSEC recommends that the IASB provide additional principles or guidelines as to how the approach would be applied. In addition, AcSEC suggests that the IASB study the possible need for enhanced disclosures, especially related to the ALLL as it further develops this approach.

Issue #2: Is the approach operational (i.e. capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

AcSEC believes that the approach may present fewer operational problems when applied to loans accounted for under the U.S. loan impairment guidance, *which is included in the FASB Codification at FASB ASC 310-10-35.n*, than when applied to pools of loans, for example, blocks of individually small consumer loans. However, AcSEC also agrees with the observation in paragraph 39 of Agenda Paper 5A that the approach is likely to result in better estimates when applied to pools of loans with similar risk characteristics than to individual loans because of the law of large numbers.

Additional systems would be needed to obtain the necessary data to apply the approach to either individual loans or pools of loans. AcSEC notes that because this approach is based on the life of the loan concept, an entity would have to develop a base of historical data. At least 2-3 years of historical experience would likely need to be developed and that would mean any adoption of this approach would require a sufficient transition period for companies to be able to accumulate the necessary data.

The IASB needs to consider how the approach would be applied to groups of small balance homogeneous loans. For example, would the pools be dynamic pools, where broad characteristics would define the pool and new loans would continuously be added to the pool, while old loans are removed as they are paid down or written off? Alternatively, if there were static pools, then the number of pools could grow dramatically as new pools are formed weekly or monthly or at some other frequency for groups of loans having various identifying characteristics. While dynamic pools might be hard to manage, a voluminous number of static pools would introduce significant recordkeeping concerns.

Finally, AcSEC noted that the operational challenges of applying the expected cash flow approach to variable rate loans are particularly great. Refer to response to Issue #4 for further discussion. AcSEC believes that the operational challenges of applying the expected cash flow approach will be greater for non-financial services organizations and smaller companies.

Issue #3: What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

Current U.S. GAAP is an incurred loss model. However, under the accounting guidance for loans acquired in a transfer with deteriorated credit quality, which is codified in FASB ASC 310-30 there is a limited

exception for purchased loans with impaired credit quality. There is a lack of systems currently available for its application and the accounting therefore is generally done on a manual basis. Therefore broader use of the expected loss model would require expanded systems and the development of software packages currently not available. AcSEC believes that the system changes would be extensive, additional software packages would need to be developed and the time it would take to develop such systems may be extensive. Software developers would have to consider the cost/benefits of developing such systems. The ability to acquire and disclose the data in the contemplated guidance does not currently exist in most financial institutions in the form that is necessary to apply this approach. This is because most risk systems for estimating the allowance are separate from the loan accounting systems. That is why AcSEC suggests that it would take 2-3 years to develop the information or take existing data and convert it to a useable form for this approach noted in our response to Issue #2.

Issue #4: How would you apply the approach to variable rate instruments, and why?

Amortization of upfront costs

Paragraph AG6 of IAS 39, *Financial Instruments: Recognition and Measurement*, requires that, “When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.” Approach A in the Appendix to the Request for Information would require amortization of upfront costs in a pattern similar to the amortization for a fixed rate instrument. Approach B in that Appendix would result in a different amortization pattern each period and would be operationally more complex and difficult to implement. AcSEC recommends that the Board permit companies to elect to amortize upfront costs of variable rate instruments using either Approach A or B, as AcSEC views both as acceptable and consistent with the literature. Both approaches achieve the goals of the effective interest method and thus are consistent with IAS 39.

As further justification for this recommendation, AcSEC references FASB ASC 310-10-35-38 which states that “if a loan’s contractual interest rate varies based on subsequent changes in an independent factor...”, the “...loan’s effective interest rate may be calculated based on the factor as it changes over the life of the loan **or** may be fixed at the rate in effect at the date the loan meets the impairment criterion in Paragraphs 16-17 of FASB ASC 310-10-35.” Accordingly, under the guidance in FASB ASC 310-10-35, upfront costs would be amortized using either the effective interest rate in effect at the date of the loan’s purchase/origination **or**, alternatively, the upfront costs could be amortized using the effective interest rate as it changes over the life of the loan. AcSEC does not believe that the pattern of amortization should be required to change just because interest receipts change over time. We believe that as a practical expedient, most lenders will choose Approach A. The Board should require an entity’s accounting policy choice to be applied consistently and be disclosed.

Impairment of variable rate instruments

The Appendix to the Request for Information outlines two approaches to the application of the expected

cash flow approach to variable rate instruments. Approach A would require the recalculation of the effective interest rates on a prospective basis so that the still expected future interest receipts and the still expected principal receipts are discounted to the carrying amount, consistent with paragraph AG7 of IAS 39. Thus, as AcSEC understands it, Approach A would never result in any change in a variable rate loan's carrying value as a result of a change in expected cash flows unless the expected cash flows are less than the loan's carrying value on an undiscounted basis. Approach B would keep the effective interest rate constant after impairment and adjust the carrying amount to reflect changes in the interest rate. AcSEC does not believe Approach A is appropriate because it would result in no recognition of impairment losses unless the impairment loss causes expected cash flows to be less than the variable rate loan's carrying value on an undiscounted basis. AcSEC does not believe Approach B is appropriate because it would result in accounting for variable rate loans as though their interest rate is fixed, which clearly does not reflect the economic arrangement between the debtor(s) and the creditor. Accordingly, AcSEC believes the Board should develop an alternative approach that results in an adjustment to the effective interest rate when the index on which a variable rate loan (or pool of loans) changes but that also requires an adjustment of the carrying value when a change in cash flows resulting from factors other than changes in interest rates occurs. AcSEC has identified an Alternative Approach (discussed below) that is designed to accomplish this outcome.

Under the Alternative Approach identified by AcSEC, creditors would follow a three step process in determining the level of impairment and the effective interest rate associated with variable rate loans. The first step would be to project cash flows upon a change in the variable interest rate (e.g., at the beginning of period 2), without taking the change in the variable interest rate into consideration (i.e., holding the loan's variable rate of interest constant from period 1 to period 2), such that any change in expected cash flows would not relate to changes in the variable interest rate (i.e., would be designed to isolate the effect of factors other than changes in interest rates on expected cash flows such as the probability of a loan's default and the severity of that default. This revised estimate of expected cash flows would be discounted at the effective interest rate existing just prior to the change in the loan's variable interest rate (i.e., period 1's effective interest rate) to determine the amount of impairment. Step two would be to recognize this impairment as an adjustment to the loan's carrying amount. Given the revised carrying amount for the loan calculated in step two, step three would involve estimating expected cash flows *inclusive of* the change in the variable interest rate and discounting those cash flows to derive an effective interest rate for period 2. The effective interest rate derived in step three would be used to accrue interest income for period 2.

The benefit of this approach is that it does not result in an impairment of the loan's carrying value solely because of a change in the rate of interest for a variable rate loan. This is consistent with the guidance in FASB ASC 310-30-35-14, FASB ASC 310-10-35, and securitized financial assets guidance, which is codified in the "Pending Content" of FASB ASC 325-40-35-4. AcSEC acknowledges that the Alternative Approach does not capture the nonperformance (i.e., credit risk) impact on a variable rate loan or pool of loans that is directly due to a change in the interest rate on the loan(s) because the impact on expected cash flows from changes in interest rates under the Alternative Approach affects only the prospective effective interest rate. However, AcSEC observes that the nonperformance impact captured in estimating the expected cash flows for purposes of establishing the initial effective interest rate under the board's approach

is based on the contractual interest rate at inception of a loan or pool of loans. This may suggest that capturing the nonperformance impact that is directly due to a change in interest rates solely through the prospective effective interest rate is appropriate.

There is substantial industry experience to indicate that increases in interest rates on variable rate loans increases the probability of the loans' default. As a result, AcSEC would encourage the Board to consider whether the Alternative Approach could be improved to better reflect the nonperformance impact of a change in interest rates without resorting to an approach that treats all impacts from changes in interest rates as an adjustment to carrying value (i.e., as a nonperformance impact). Given the circular relationship between a loan's carrying value and the effective interest rate based on the loan's expected cash flows, AcSEC believes this is a significant issue for variable rate loans that requires further analysis by the Board.

AcSEC also recommends that the IASB consider how a change in expected cash flows due solely to a change in estimated prepayment speeds should affect the carrying value of a loan under the expected cash flow approach. The existing guidance on this issue is not clear and should be addressed. AcSEC views the impact of changes in prepayment speed estimates on a loan's value as more similar to a change in interest rates than a change in credit risk and, accordingly, recommends that the Board develop guidance that such impacts on expected cash flows do not give rise to an adjustment of a loan's carrying value.

Issue #5: How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?**
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?**

AcSEC agreed that once a loan was evaluated for impairment on a collective basis, it should remain in the pool to be consistent with the estimation process. In such cases the pool becomes the unit of account. AcSEC believes that the key to applying the approach on a pooled basis is ensuring that all items in the pool have a high degree of similarity in their risk characteristics (e.g., nature of underlying collateral, geography of borrowers and collateral, tenor, etc.), and that in order for the expected cash flow approach to be operational in practice, to the extent a loan has been evaluated on a pool basis, the integrity of the pool should be maintained and the loan should remain in the pool to its maturity or settlement.

AcSEC discussed whether it would be easier to apply the expected loss model if all loans were put in pools and the model was applied to the pools, essentially making the pool the unit of account. AcSEC observed that it would be possible (and perhaps even preferable) for consumer loans but it would be more difficult for large commercial loans because the risk characteristics of such loans are more likely to be unique.

Issue #6: What simplifications to the approach should be considered to address implementation

issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

Please see our responses above.

Representatives of the Accounting Standards Executive Committee would be pleased to discuss our comments with you at your convenience.

Sincerely,

Kimber Bascom

Jay D. Hanson

Chairman, AcSEC Expected Cash Flow
Model Task Force

Chairman, AICPA Accounting Standards Executive
Committee