FASB Exposure Draft on Accounting for Credit Losses

Comment period ends May 31, 2013

By Bill Bosco, Leasing 101

The Financial Accounting Standards Board (FASB) issued an Exposure Draft on December 25, 2012 entitled Financial Instruments — Credit Losses (Subtopic 825-15), inviting the public to comment with a deadline that has now been extended to May 31, 2013. It is a potential rules change that would accelerate the recognition of credit losses on leases and loans. It will negatively affect the profitability of all lessors that write direct finance leases, sales type leases, leveraged leases and loans. Compliance with the proposed rule will be complex. I urge you all to read the ED and submit a comment letter from your company. It should be noted that the FASB broke away from the IASB on this as they could not agree on the approach, so this is a US only proposal. The IASB is working on their own proposal.

What is the FASB's proposal?

The FASB proposes to force lenders/lessors to book expected losses in their portfolio of assets on books that management expects to incur over its life (considering known facts on individual accounts, current conditions, past history, and an estimate of the impact of future conditions). Current U.S. Generally Accepted Accounting Principles (GAAP) accounts for credit impairment using an "incurred loss" model. Because the existing impairment model delays recognition of the credit loss until the loss is probable (or has been incurred), many have argued that the model fails to alert investors to expected credit losses in a timely manner. Some have recommended that standard setters explore alternatives to the incurred loss model that would use more forward-looking information. The proposed rule would be accomplished by charging current P&L and crediting a reserve on the balance sheet. Every reporting period the reserve would be adjusted by any changes in the estimate of future losses by a charge or credit to P&L. Actual losses would be charged to the reserve. Under current GAAP the charges to P&L are delayed until the losses are probable creating a better match of expense with lease or loan revenue.

How would the "current expected credit loss" model work?

This is how the FASB describes how the new current expected credit loss method would work: At every reporting period, a lessor, bank, other lending institution, or company would estimate expected credit losses on financial assets (include lease and loan receivables) held. That estimate would be neither a "worst case" nor a "best case" scenario, but rather would reflect management's current estimate of the contractual cash flows that the organization does not expect to collect. The organization could not

avoid recognizing a loss simply because it has not hit a probability threshold that it will collect all of the cash flows. Past events, current conditions, and reasonable and supportable forecasts about the future would factor into management's assessment. Further, these estimates would never be limited to losses expected over a specific period of time rather it would be over the entire life of the leases and loans.

Using the Current Expected Credit Loss (CECL) model, the credit deterioration (or improvement) reflected in the income statement would include changes in the estimate of expected credit losses resulting from, but not limited to:

Changes in the credit risk of assets held by the institution
Changes in conditions since the previous reporting date
Changes in reasonable and supportable forecasts about the future.

The balance sheet would reflect the current estimate of expected credit losses at the reporting date and the income statement would reflect the effects of credit deterioration (or improvement) that has taken place during the period.

What is wrong with this approach?

The proposed new method of accounting for possible credit losses forces immediate recognition in the P&L of future losses that are priced into the yield or lease/interest revenue recognized over the life of leases/loans (lessors/lenders include a factor for credit losses in their pricing so they have revenue to cover the losses if the occur). This means that costs are front loaded and the associated revenue is spread over time. The balance sheet is fine but the P&L is "lumpy" and not reflective of the lessors true "steady state" net revenue (revenue and expense are not matched). EPS is a measure used by investors to value entities and this accounting change will cause periodic earnings to be erratic and it follows that valuations will be erratic and not reflective of the earnings power of the lender/lessor entity.

Through April 18 the FASB have received 29 comment letters to this Exposure Draft. ***Only two*** letters support the ED. One asks the FASB to get back together with the IASB so we have one worldwide method. Sixteen letters asked for more time to comment (they did extend the deadline to May 31, 2013 to accommodate the comments). ***Most importantly ten letters oppose it.***

The issues cited by the comment letters that oppose the proposed ED generally include the following as problems with the proposed method and I have also included my commentary:

1) **The issue is a compliance issue** not a deficiency in rules issue - preparers have to be quicker in recognizing losses in a crisis situation and regulators have to change their rules and oversight. This another crisis that may result in

a “knee jerk” reaction, accounting changes that add to complexity and costs to comply , reduce the accuracy and comparability of financial statements and break time tested principles regarding what is an asset and a liability and accounting for contingencies.

2) The idea that one can **predict the future _possible_ losses will result in inaccurate values** on the balance sheet and there will be a **lack of comparability among peers as each preparer will have its own view** of the future. Methods of predicting losses will be complex and will need to be updated regularly which is costly. It will be difficult to audit the predictions and resulting reserve. If economists can’t accurately predict the future how can preparers do so?
3) We should maintain the time tested accounting principle in FAS 5 that ***one should only book losses/liabilities that are probable*** - this principle should be consistently applied across all accounting for all types of transactions - if we expanded the idea that we should present value expected costs why not apply that to expected revenues and then we would have a PV forecasted balance sheet??? It is more likely that preparers will turn on their lights or have the lawn mowed than they would incur a credit loss so should they PV and book their expected utility and landscaping costs immediately???
4) **Shouldn't capital be held in sufficient amounts for the possible losses that might exceed the probable losses that have been accrued for?** It seems to be the regulators job to set capital level requirements that preparers will have to comply with and to improve their own oversight. The regulatory purpose of agencies that oversee financial institutions is to help ensure the safety and soundness of the banking and payments systems and minimize losses to the deposit insurance fund. In this regard, regulators view capital as performing several important functions. It is there to absorb losses, thereby allowing banks to continue to operate as going concerns during periods when operating losses or other adverse financial results are being experienced. Capital also helps to promote public confidence, restrict excessive asset growth, and provide protection to depositors and the Bank Insurance Fund administered by FDIC. Basel 3 will increase capital requirements, add liquidity requirements and add required stress tests to force earlier recognition of credit losses. Will this rule create a double count as reserves are part of the regulatory required capital calculations (in simplistic terms reserves plus equity capital = regulatory capital)? Or, will Basel then adjust its capital requirements down (since reserves are a component of capital - so I think the answer is yes)? It is natural that BASEL would like the fact that the accounting rules require higher reserves but will users of financials have the most useful info as to values of financial instruments (loan and lease receivables) or will they see an overly conservative and inaccurate value?
5) **There are consequences to P&L and EPS** (lumpy - not matched - not reflective of steady state earnings) **and to deferred tax accounting** (large deferred tax assets caused by taking book losses before the IRS allows the deduction are hard for readers to understand and already a problem for

regulated financial institutions as there are special/negative capital requirements for deferred tax assets) that make financials less useful to users. We could argue for a method like Initial direct accost accounting where the reserve is booked when a new direct finance lease is booked with the offset to lease revenue and an equal amount of unearned lease recognized simultaneously (future earnings are recognized at a reduced rate) . Or we could argue for the use of OCI (other comprehensive Income) where the reserve is established with the contra entry to OCI on the balance sheet (I would not recommend this approach but it is better than a “hit” to P&L).

Conclusion

The proposed new credit loss accounting method bad for the industry and only through the power of comment letters can it be stopped. I urge you all to write comment letters by the May 31 deadline. Use the arguments I presented above, but in your own words. You can read the ED and comment letters received to date on http://www.fasb.org/home to help formulate your comment letter.

This article was written by Bill Bosco, President, Leasing 101, Tel: 914 522 3233. Email: wbleasing101@aol.com. Website: www.leasing-101.com.