Setting the global standard for investment professionals

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Ms. Leslie Seidman
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Re: Comment Letter on Impairment

Dear Sir David and Ms. Seidman,

The CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") Supplementary Document ("IASB Supplement" or "IASB SD"), *Financial Instruments: Impairment*, to its Exposure Draft, *Financial Instruments: Amortized Cost and Impairment*, and the Financial Accounting Standards Board's ("FASB") Supplementary Document ("FASB Supplement" or "FASB SD"), *Impairment,* to is Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* collectively referred to herein as the Impairment Supplements. The IASB and FASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

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1 With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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Previous Comments on Impairment
CFA Institute has consistently articulated our support for recognition and measurement principles for financial assets based on fair values. With a fair value based measurement method there would be no need for the determination of credit impairment estimates, interest income recognition pattern estimates, allowance accounts or changes in the definition of amortized cost as required by the FASB and/or IASB proposals.

As stated in our previous comment letters to the IASB and FASB we do not believe that the impairment methods – and interest income recognition methods – proposed by the Boards in their previously proposed models are less subjective or less complex than the use of fair value and we question whether they would more faithfully represent the underlying economics of the financial instruments to which they would apply. These methods appear to be "accounting constructs" rather than a measurement, or recognition, method which is premised upon reflecting the underlying economics of the transactions currently occurring in the marketplace.

The model proposed in these Impairment Supplements seeks to separate the credit impairment and interest income recognition decisions. It is our long-held view that the appropriate recognition and measurement of interest income is inextricably linked to the measurement of credit impairments and, therefore, their accounting treatment should be considered jointly. The cash outflow for an investment and the cash inflow for its repayment, or failure to repay, are equated through either credit impairment measurements or differences in the measurement of net interest income. The previous FASB and IASB models simply equated the cash inflows and outflows differently, but, in either case, interest income was impacted by the discounting of the expected credit losses.

General Considerations in Evaluating Proposed Impairment Model

Economic Relevance Should Be The Driving Principle Behind the Development of An Impairment Model
Our guiding principle is that accounting should reflect economic reality. Therefore, our review of the Impairment Supplements is performed with this in mind.

The Impairment Supplements are more focused on the *timing* of the recognition of credit losses than on the measurement of the *amount* of credit losses. There is no guidance in the Impairment Supplements on how to measure the expected losses, which is the most critical element of the proposal, as such measurements should determine the expected losses and the need for invoking the floor. As in the other key standards currently under development, the IASB and FASB have provided little guidance on how to make measurements under uncertainty. As can be seen from the illustrative examples, guidance is provided on how to apply the mechanics of the model, but there is a lack of guidance regarding how the expected losses should be determined or on how the floor should be measured. These amounts in the examples are "given" without showing how they are to be derived. Overall, we think more guidance is needed regarding how the expected losses and the related floor should be measured.

As it relates to the recognition pattern or timing of the expected losses, we do not find any empirical evidence which demonstrates that the proposed model would reflect the pattern of how credit losses emerge. Specifically, it is not clear how amortizing "remaining expected losses" into income using a ratio of existing weighted average age of the portfolio/total weighted average age reflects the actual emergence of credit losses. **For a portfolio which is growing and repaying at a fairly consistent rate, the method proposed would only record approximately 50%, on average, of the expected losses**. Before implementing such an important accounting construct, the Boards should seek empirical evidence of its ability to appropriately portray the underlying economics. **Our experience suggests that the emergence of losses is not as time proportionate as the model would suggest, and that the inclusion of the floor is evidence of this fact.**

Overall, we do not believe that this model reflects the underlying economics. We believe field testing with demonstrated efficacy or economic relevance of this model is necessary before adoption of the new standard.

Credit Impairment and Interest Income Recognition Decisions Need To Be Made Jointly

We believe that investment decisions are based on expectation of total return, not on interest income and principal payment (possible impairment) considered separately. **Because interest income and credit impairment are so closely related, we believe that a decision cannot be made on credit impairment without a decision on interest income as the economic relevance of the two concepts are interrelated**. The proposed model does not articulate or explain the related interest income recognition pattern for either the open portfolio, the "good book" or "bad book." As described previously, the notion of splitting interest income recognition and credit impairment recognition are accounting and not economic constructs. For this reason we question whether this model presents a realistic depiction of economic reality.

We would assume that interest income reported using the proposed standard will be based upon effective yield and measuring credit losses using a time proportionate method would have the impact of smoothing the credit losses to yield a level return. **Unfortunately, neither fair values nor cash flows related to financial assets are as level as this model pretends. As such, the income statements created from such accounting constructs may portray a picture very different from that which is being communicated to investors by economic variables such as cash flows or fair values**.

Decision Usefulness and Comparability

Decision-usefulness stems from the ability of financial information to depict economic reality and for it **to present quality, comparable results upon which investors can make informed decisions**. As described above, we do not see any evidence that this model is a faithful representation of the emergence of credit losses. Further, **there are many aspects of this model which act counter to creating a comparable result** including the following:

1) The use of the notion of foreseeable future without consistency in its definition or use among entities or asset classes;
2) The ability to determine expected losses on a discounted or undiscounted basis;
3) The ability to utilize a rate between the risk free rate and the effective interest rate in determining expected cash flows;
4) The requirement to make a "bad book" determination – whether assets are managed in this way or not – based upon a general definition which is not referenced to other common problem loan terminology (e.g. nonaccruals, write-offs, foreclosures, etc.)
5) An impairment approach which may differ depending upon asset classes and the manner in which they are managed (e.g. open vs. closed book, etc.)
6) The model does not require use of market based inputs, where available, to be utilized in the expected loss development.

Because the ability of the model to reflect economic results is undemonstrated and because of the lack of comparability which will occur as a result of the aforementioned model attributes, we cannot conclude that the model is decision-useful. Regardless, it will be important to require that firms disclose details about their judgements and assumptions.

Multiple Impairment Models

Users have struggled with the various impairment models (e.g. SFAS 03-3; SFAS 115; EITF 99-20; SFAS 114) over the years. As such, proposing this model for only "open portfolios" seems to be yet another piecemeal approach to impairment. It is challenging to determine how this model would be applied to asset classes including a closed blocked or loans with significant initial credit losses (i.e. without constant use of the floor) or how this model might be applied to marketable equity securities. **We believe an impairment model should be developed across asset classes to ensure consistency and comparability.**

Regulatory Considerations Should Not Drive Accounting Standards
We believe decisions regarding credit impairment provisions in financial statements intended to serve investor interests should not be predicated on the needs of prudential regulators. **It appears that this model is meant to accommodate regulatory interests, with the spreading of losses and the inclusion of the floor to ensure there are "enough" losses recorded. We believe that a model which tries to accommodate both investors and regulators under serves both constituencies as their objectives are not the same. The Boards should set aside regulatory interests in making their impairment decision**. Regulators can request, and mandate, different requirements, should they deem them necessary.

Is Model an Improvement? Is It More Relevant or More Reliable Than Fair Value?
In our view, an improved impairment model would: a) reflect economic reality, b) result in greater comparability among organizations; c) increase comparability among asset classes; d)incorporate expectations of the future; e) enable users to evaluate the quality of estimates; f) reduce complexity, and g) be readily understandable to users. As we noted above, we doubt the economic relevance of the model and whether it enhances comparability and we question whether all the mechanics around this proposal reduce complexity and results in a simplification for users.

As we compare the dimensions of this model to the arguments against fair value, we find it difficult for opponents of fair value to assert this model is more reliable or relevant than fair value. This impairment model proposes to utilize an expected loss approach, yet provides little guidance on how to arrive at such loss estimates. Fair value measurements, on the other hand, are based on expected loss techniques and reference to existing literature where there is more guidance on the specifics of such measurements. Fair value measurements, unlike this impairment model, also require the maximum use of observable market inputs. Further, fair value measurements do not use an artificial smoothing mechanism which spreads expected losses into future periods and, when this results in insufficient provisions, include the overlay of a "floor." Finally, this model allows expected losses to be discounted, or not discounted, at management's discretion and at rates that are not related to current market rates for similar credit risks. Fair value, on the other hand, references observable market interest rates that are used to discount expected cash flows. **Overall, we find no compelling argument that this model is more reliable, less complex or more representationally (or economically) faithful than fair value**.

Model Specific Considerations
Response to Specific Queries
We have not provided responses to specific questions posed in the Impairment Supplements. We see no reason to refine a model, as described above, that doesn't meet a conceptual underpinning of economic relevance and does not serve user interests. In general, we urge the Boards to provide greater clarity of the definitions and concepts so that greater consistency of results could be achieved. Examples might include: providing greater clarity on the definition of "bad book" or the term of foreseeable future; greater guidance on distinguishing "good book" vs. "bad book;" articulating our disagreement with the concept of a floor; or explaining why there is optionality in the ability to discount and at what rate.

Disclosures
We do, however, request that disclosures to added regarding the location and amount of the impairments, so that they will be readily evident to users of the financial statements. As the Boards consider disclosures jointly we would be happy to provide input on required disclosures.

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If you, other board members or your staff have questions or seek further elaboration of our views, please feel free to contact us.

Sincerely,

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/s/ Gerald I. White
Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council