Memorandum

Memo No.	**66 (IASB agenda reference 10A)**
Issue Date	**October 15, 2010**
Meeting Date	**ES October 21, 2010**

Project	**Accounting for Financial Instruments**
Topic	**Impairment—Key Issues for Redeliberations**

Introduction

1. The FASB proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* and the IASB Exposure Draft, *Financial Instruments: Amortized Cost and Impairment* (the EDs), propose new requirements for the recognition and measurement of credit impairment losses related to debt instruments that are not measured at fair value with changes in fair value recognized in net income. The purpose of this memorandum is to provide an analysis of the key components of a credit impairment model and the interdependencies among those components. This memorandum does not provide any staff recommendations and is not meant for decision-making purposes. Rather, it is to educate the Boards regarding issues that the staff believes should be considered in discussing the impairment model in redeliberations.

2. The discussion in this memorandum relates to all financial assets that would be subject to an impairment model whether evaluated individually or on a collective (pool) basis. However, this memorandum does not specifically discuss any methodology for measuring credit impairment losses in either scenario. In addition, this memorandum generally refers to *credit losses* rather than *cash flows expected to be collected* to avoid confusion between the recognition of credit

impairment losses and the measurement of such losses based on cash flows occurring over the life of a financial instrument.

Constituent Feedback

3. The IASB's comment period ended on June 30, 2010, and the IASB staff has summarized feedback received on the proposal in Agenda Papers 9A (July 2010) and 13A (September 2010). The FASB's comment period ended on September 30, 2010, and roundtable meetings will take place on October 12, 18, and 19, 2010. The FASB staff continues to review comment letters and will analyze feedback obtained at the roundtable meetings. Memorandum 65 is a summary of feedback received to date on the FASB's proposed credit impairment model.

4. Many constituents have asserted that the impairment guidance may be the most important issue to be addressed within the projects. The vast majority of constituents favor a change from current guidance that permits earlier recognition of credit losses than the incurred loss model in U.S. GAAP and IFRS. However, many constituents have communicated concerns regarding the divergence of the FASB's and the IASB's proposed impairment models. Based on communications with constituents and comment letters received to date, many constituents have provided suggestions to improve both the FASB's and the IASB's proposed models for impairment and some have provided alternative models or principles for the Boards' consideration with the goal of getting closer to a converged solution on the impairment issue.

5. Based on input received, users of financial statements are concerned with the timing of reporting credit impairment losses. They are also concerned with transparency into the inputs of an entity's impairment analysis, including assumptions, loss rates by class of financial asset, periods considered, and other information pertinent for developing credit impairment estimates. Users have generally expressed that they scrutinize an entity's credit impairment by analyzing the inputs, total expected losses, timing of recognition, and overall policies to form

their own independent estimates of the adequacy of an entity's allowance for credit losses and their estimates for the realization of losses.

6. The discussion in the next section of the main impairment model components incorporates the themes that have emerged based on an analysis of constituent feedback received to date.

Analysis of Impairment Model Components and Interdependencies

7. While there are numerous detailed components of an impairment model that would need to be discussed as part of redeliberations, the staff believes the following are the fundamental issues:

   (a) The information considered in determining whether a debt instrument is impaired, including forecasting assumptions

   (b) The approach for determining the amount of the credit impairment losses to be recognized (for example, whether the model should reflect losses expected at any time during the life of the financial assets or a portion of losses expected to occur in a specified time horizon)

   (c) The timing of recognition of credit impairment losses

   (d) Whether yields on impaired financial assets should reflect contractual yields or credit-risk adjusted yields.

8. The staff believes that in discussing the impairment model in redeliberations, the key components must be considered holistically to understand the interaction of the components of the model and whether together they represent an understandable principle. Ultimately, the components should form a coherent model that accomplishes the desired objectives for the credit impairment model as a whole. The staff believes it is important to consider the implications of potential guidance developed for both recognition and measurement of credit impairment losses and interest income recognition in relation to the high-level objective of the credit impairment model. The objective of the credit impairment model should be an

articulation of the concepts underlying the recognition and measurement of credit impairment losses. Furthermore, in articulating an objective for the model, the staff believes that there needs to be consideration of whether a single objective can be applicable to different types of financial assets (for example, purchased credit-impaired loans and highly liquid debt securities).

9. Table 1 depicts possible alternative credit impairment models based on the key model components. Numerous models are presented in an effort to capture various combinations of model components, but the table is not all inclusive as other permutations are possible. Table 1 includes the following four model components and alternatives for each, as summarized below:

   (a) Information considered:

      (i) Historical data plus events and conditions existing at the reporting date.

      (ii) Historical data, current information, and expected events and conditions in the foreseeable future (for example, one to two years).

      (iii) Historical experience, current information, and forecasted information—all data necessary to project loss expectations over the full effective life of the financial assets.

   (b) Amount of credit losses to be recognized:

      (i) Expected losses on the loan—those losses that the entity estimates, based on information considered, that may occur at any time during the life of the loan.

      (ii) A portion of expected losses that the entity expects will occur in a specified time period (for example, the forthcoming two years).

   (c) Timing of recognition:

      (i) Immediate—the loss would be recognized in the current reporting period.

      (ii) Over a specified time period.

(iii) Over the expected remaining life of the financial assets.

(iv) Over the life with a floor amount—the loss would be recognized over the expected remaining life of the financial assets (using an allocation methodology) with a floor amount (incurred loss floor or floor based on historical average loss rates).

(v) Combination approach—a component of the impairment loss would be allocated over the expected remaining life of the related loans and another component would be recognized immediately.

(d) Yields:

(i) Integrated yields—interest income recognized in the statement of financial performance would incorporate credit losses.

(ii) Non-integrated—interest income and credit losses would remain distinct in the statement of financial performance.

10. The sections below discuss each of those impairment model components, the interaction of the components, and the interdependencies among them.

Information considered

11. Both the FASB's and the IASB's EDs would permit an entity to consider both internal data (that is, entity-specific information) and external data to determine whether financial assets are impaired. Historical data, except for "new" entities, is generally available through prior loss experience in different economic environments and forms a basis for estimating credit losses. Constituents believe that they have adequate data and knowledge to determine which historical data is relevant for estimating credits losses at a given reporting date. Constituents generally believe that considering current economic data and trends along with forecasting future economic events is achievable for estimating credit losses.

12. Most constituents suggested that an entity's management should be permitted to apply judgment and consider historical data/statistics, current economic conditions

and indicators, and forecasts of future economic conditions to develop the amount of the credit impairment loss to be recognized at a given reporting date. Moreover, constituents want latitude in developing an estimate of credit impairment that would result in adequate reserves at different times during an economic cycle. Specifically, they want to avoid being under-reserved when coming out of the peak of an economic cycle and moving into a downward-trending cycle. They acknowledge that determining an economic cycle and where the economy is within the cycle involves significant judgment.

13. With regard to forecasting future economic events, most constituents are comfortable with forecasting events over the foreseeable future as opposed to the total estimated or contractual life of their financial assets. For illustrative purposes, some constituents indicated they would be comfortable with a one to two year time horizon, while other constituents suggested a slightly longer time horizon, up to three years. Consequently, constituents are less comfortable with forecasting credit losses for periods beyond the foreseeable future. Many constituents question the reliability of estimating credit impairment losses based on forecasts beyond the foreseeable future.

14. Three alternatives for information considered are presented above and in Table 1 (Row 1). The first alternative (Models 1-4) is consistent with the FASB ED, which would permit an entity to consider historical data and events and conditions known at the reporting date. The second alternative (Models 5-8) also would require consideration of events and conditions expected in the foreseeable future. A third alternative (Models 9-12) would require forecasting of conditions over the timeframe that corresponds to the remaining effective life or duration of the financial assets. With respect to the third alternative, some have suggested an approach that would use an average historical loss rate to develop loss estimates for the duration of the loan life beyond the foreseeable future period. This memorandum does not discuss approaches for developing loss rates based on the information to be considered in the impairment analysis.

15. The staff believes that within the impairment model, there is an interdependence of the information considered in the impairment analysis and the amount of the credit loss that would be recognized. The information to be considered determining the amount of credit impairment impacts the loss estimation process in that different inputs could result in significantly different estimates of loan losses. For example, in Table 1, Models 1, 5, and 9 would involve different types of information to be considered in estimating expected losses (with the loss being recognized immediately in all three models), but because the models consider different inputs, presumably the loss estimates would differ. The approach in the FASB's ED (Model 1) would require an entity to estimate credit losses at any time during the life of the financial assets considering historical information and current conditions. A second approach (Model 5) is to require an entity to estimate credit losses that will occur at any time during the life of the financial assets based on historical data, current conditions, and forecasted economic conditions and events over the foreseeable future. Another approach (Model 9) is to require the entity to estimate credit losses considering all available evidence and forecasts over the life of the financial assets.

16. In turn, the information considered and the amount of credit impairment to be recognized potentially affects decisions on the timing of loss recognition. The alternative periods over which forecasting may be permitted leads to the question of whether credit losses determined based on such forecasts should be recognized over the forecast period. For example, if the permitted forecast period is one to two years, the question is whether credit losses that are estimated based on economic events and conditions expected to occur during that forecast period should be recognized over that period. If the forecast period is the lifetime of the related financial assets, then this raises the question of whether credit losses determined based on such forecasts should be recognized over the life of those assets. In the latter case, if it is practical to forecast only for the foreseeable future, then an additional question is how to estimate credit losses for longer term assets.

17. Therefore, the information considered in assessing whether financial assets are impaired affects both the amount of credit impairment determined for financial assets and the timing of loss recognition.

Amount of credit impairment losses to be recognized

18. The objective of the impairment model selected will dictate the amount of the credit loss that would be captured. That is, the Boards will need to articulate the amount of the credit loss that should be recognized each period and, consequently, what the allowance for credit losses is supposed to represent. More specifically, the model would need to address whether the amount of loss considered in the analysis would cover the life of the related financial assets or whether it would be limited in some way. For example, the allowance could represent all expected losses on the related financial assets or losses expected to occur over a specific time horizon.

19. One way to look at this issue is whether the model should be based on a "balance-sheet" approach or an "income-statement" approach. A balance-sheet approach would focus on setting the allowance level, and would devise an approach for income statement recognition of credit losses (and, potentially, interest revenue) that would follow from that approach. An income-statement approach would focus on recognizing in current period income the amount of credit impairment losses deemed to appropriately represent the amount of credit losses that management believes should be recognized in that period, and would set the allowance based on that amount of losses. A potential difficulty is finding a model that reconciles the balance sheet approach with the income statement approach. For example, if using a balance-sheet approach and the view is that the model should establish an allowance that reflects the total expected credit impairments over the life of the assets, the balance sheet would reflect an allowance that contains a full life loss estimate. This could suggest the need to allocate losses in some manner over the expected life of the assets. If using an income-statement approach, this could suggest pursuing a model that would result in establishing an allowance based on

an amount of loss that does not approximate the entire life loss of the portfolio of loans.

20. Regarding the amount of loss to be recognized, there are two alternatives presented earlier in this memorandum and in Table 1 (Row 2). The first alternative is to recognize credit losses expected for the financial assets that are estimable based on the information considered, regardless of when they occur during the life of the financial assets. This is the basis for Models 1, 2, 3, 5, 6, and 9 through 12. The notion is that the measure of impairment losses would consider not only loss events that have occurred (as under the current incurred loss model) but also losses that are expected to emerge in the future. The intent of this type of model is to provide greater flexibility to capture expected losses as informed by the information considered. These models can be further differentiated by the information that would be considered in developing the loss estimate. Models 1–3 allow an entity to consider only historical and current data, while Models 5 and 6 allow the entity to forecast events and conditions over the foreseeable future, and Models 9 through 12 would consider all events and conditions over the life of the financial assets.

21. A second alternative is to recognize the amount of credit losses that are expected to occur in a shorter time period. Such a model could be crafted based on either a specific emergence period or the forecast period. For example, Model 4 would consider historical and current information to develop a loss amount to be recognized for a specific emergence period (a period for which it expects loss to occur). Models 7 and 8 would recognize losses expected to occur in a specified period based on a consideration of historical, current, and forecasted information. Under this type of model, the staff believes it would make sense to capture in each reporting period only those losses expected in the period that corresponds to the time horizon used by management for considering forecasted events and conditions to determine the amount of credit losses it expects to realize (for example, in the forthcoming one to two years).

22. Comment letters from various constituents have discussed the interdependence of the amount of the loss to be recognized and the timing of loss recognition. Many

constituents oppose recognizing a lifetime credit impairment loss for financial assets upon origination or purchase, with subsequent changes recognized immediately in net income. If a life loss approach is used, they conveyed a desire to allocate losses systematically over the life or expected life of a financial asset. Other constituents supported immediate recognition, although those constituents appeared to support the notion because of the short-term nature of the financial assets or because they did not advocate recognition of a full life loss.

23. Some believe that there is no significant difference between an approach that spreads the initial recognition of losses over the life of the financial assets and an approach that would recognize changes in the expected losses on the loans. Said another way, if an entity immediately recognizes only those impairment losses over the next two years following a reporting date, this would seem to indicate that allocating losses beyond that time period would not be required because the model would be updated every reporting period with losses recognized for changes in expectations. Because these issues are so intertwined, the staff believes that determining the amount of credit impairment losses to be recognized and the timing of the recognition of credit losses (and changes in the amount and timing) need to be addressed in concert.

24. Although it is not addressed in this memorandum, a critical element of the impairment model is implementing the conceptual approach for recognition of credit losses through a measurement model. Regardless of the approach selected, the measurement of losses under that approach will affect the amount of credit losses recognized. For example, if an approach that considers credit losses expected to occur over the life of a financial asset were to be required, there are specific measurement issues to be considered. Based on constituent feedback that estimates of losses over the long term introduce significantly unreliable estimates into the financial statements, a key question is how to reliably estimate and measure "expected" credit losses that relate to the latter portion of the term, or tail, of longer term assets. Some, including the Expert Advisory Panel (EAP), have suggested an approach that would use an average historical loss rate (described by some as "through the cycle" credit expectations) to develop loss estimates for the

duration of loan life beyond the foreseeable future period. The staff believes that the potential use of multiple loss rates or a "blended rate" considering historical, current, and forecasted data would need to be further explored.

Timing of recognition of credit impairment losses

25. There are several alternatives for the timing of recognition of impairment losses. The timing of recognition is inherently linked to the other factors within the selected model and would likely naturally follow from the nature of information that may be considered in the impairment analysis and the losses that would be captured by the model, as discussed above.

26. Five alternatives for the timing of credit loss recognition are presented in Table 1 (Row 3). One alternative is to recognize all credit impairment losses in the current period (immediate recognition). It requires that all subsequent changes in expectations also would be recognized immediately in the period of the change, thereby permitting recognition of both favorable and adverse changes in losses expected to occur. However, the amount of the change in losses expected to occur that can be recognized is bound by the existing balance of the allowance for credit losses (that is, credit impairment cannot be reversed unless it was previously recognized as a charge in net income). Models 1, 4, 5, 7, and 9 would involve immediate recognition of expected credit losses (both initial estimates and changes to the estimate).

27. Some view immediate recognition of credit impairment and establishing an allowance for loan losses at origination as inappropriate, even if there is history to support loss estimates on a pool basis. One reason cited in support of recognizing the impairment charge over the life of the financial assets is because that is the period over which losses occur. That is, on a pool basis, actual losses occur over the expected life of the pool, which argues against recognizing losses in the immediate period. Some believe that immediate recognition is contrary to the matching principle and that proper matching of revenue associated with the loan

and credit impairment expense would require the provision for loan losses to be spread out over the life of the loan.

28. A second alternative would be to recognize estimated credit losses over a specified period. There are several ways this could be implemented. For example, as discussed in paragraph 21, a loss amount could be estimated based on a specific emergence period; therefore, the loss could be recognized over that emergence period. Alternatively, losses expected in the forecast period corresponding to the time horizon used by management for considering forecasted events and conditions could be recognized over that forecast period. Model 8 would involve recognition of credit losses over the forecast period.

29. A third alternative is to recognize the estimated credit losses over the remaining expected life of the financial assets, using an allocation methodology. Models 2, 3, 6, and 10 would involve recognition of credit losses over the effective life. Based on discussions with constituents and review of comment letters, the method of allocation generally suggested is one that "matches" losses with contractual interest recognized under the interest method. However, some constituents have conveyed that there would be significant operational challenges to implement and apply this type of allocation model. Moreover, some constituents that advocate allocation of losses have expressed that their suggestions are preliminary because they have not considered the operational challenges associated with implementing a model that systematically recognizes losses and increases reserves.

30. A fourth alternative is to allocate the initial estimate of credit losses over the life of the asset but impose a "floor" amount, such that the allowance never falls below the level of "incurred" losses or statistical average losses. This alternative is included in Model 11 in Table 1. A fifth alternative is a model in which a component of the impairment loss would be allocated over the expected remaining life of the related loans and another component would be recognized immediately. One approach for implementing this is to separate financial assets into a "good book" and a "bad book." Losses expected over the life of financial assets within the good book would be recognized over their life. When an asset within the good

book is subsequently considered impaired, the asset would be transferred to the bad book and a loss for the expected loss to be realized on this asset would be recognized in total immediately. The estimated expected losses of the good book would be updated every reporting period and any changes in expected credit losses would be allocated prospectively over the remaining expected life of the financial assets within the good book. This model was originally proposed by the EAP, and is included in Model 12 in Table 1.

31. If a good book/bad book approach is adopted, numerous practical implementation questions exist and the staff believes that exploration and testing of this approach would be necessary. For example, one question is whether the amount to be allocated systematically from the good book would be determined based on a blended rate considering historical, current, and forecasted data (as discussed earlier related to determining a life loss amount). Additional questions are whether a loan transferred to the bad book would have impairment recognition based on discounted or undiscounted cash flows and whether the bad book requires individual assessment or allows impairment to be assessed on a collective basis. Also, this approach would have to address changes in status, that is, the accounting if the loan transferred to the bad book reverts to a performing loan and whether is it transferred back to the good book.

32. Some may view the timing of credit loss recognition and the objective of the model with respect to the presentation of yields as being interdependent. Some believe that recognizing the credit impairment loss over the life of the related financial asset would seem to be most justifiable if the goal of the model is presenting a credit-adjusted yield. Said another way, if the basis for spreading the impairment charge over the life of the instrument is that it should be consistent with the pattern of revenue recognition of the loans, then that seems to support presenting an adjusted yield. Furthermore, if the objective is to create a conceptual model of yield that links the recognition of credit impairment expense with the recognition of revenue related to the financial asset, then that would suggest that all credit losses (both initially expected losses and changes to the initial expectation) should be recognized over the expected life of the related financial assets. That would

suggest that models that involve allocation of credit losses over the life of the financial assets also would present an integrated yield (in Table 1, this would be Models 2, 6, and 10). The staff believes that this approach would inherently require forecasting both the amount and timing of credit losses to faithfully portray the yields on the related assets.

33. However, many constituents have communicated that they believe the interest and impairment calculations should be distinct from one another, and that the effect of coupon receipts (interest income) should be distinct from credit provisioning in the income statement. Many are concerned that credit-adjusted yields are not transparent, and users of financial statements indicated that they want to see yields based on contractual rates. These views are consistent with a model that focuses on the recognition and measurement of credit losses in isolation. If the objective centers on the timeframe in which management determines that a loss exists based on a consideration of relevant information, immediate recognition of the full credit impairment loss would seem appropriate. Similarly, changes in expectations about credit losses would be recognized in the periods that management believes the change occurs.

34. The staff believes there is also a potential linkage between the timing of recognition of credit impairment losses and the elimination of a loss recognition threshold. The absence of any recognition trigger (probable, under current U.S. GAAP and IFRS) means that there is more flexibility for management to apply judgment in determining when a credit loss exists. Linking back to the objective, if the impairment model is grounded in recognizing a credit loss when management determines that a loss exists, this may suggest that the credit loss should be recognized in the current period (immediate recognition).

Yield—Integrating Credit Losses and Interest Income Recognition

35. Both the FASB's and the IASB's EDs propose an integrated model in which estimated loan losses are incorporated into the determination of the amount of

interest income to be recognized. However, the models use different approaches for adjusting interest income.

36. Most constituents, including users, that have either commented on the FASB's ED or have communicated with the FASB through outreach efforts strongly oppose integrating credit impairment losses into the recognition of interest income on those financial assets. Constituents expressed their desire to have credit impairment recognized and presented separate from interest income. Although they acknowledge the theoretical arguments in favor of including credit impairment in the determination of interest income, constituents generally believe that including credit impairment amounts in this determination will distort the financial statements and users' analyses of net interest margin. Users have conveyed their preference for credit impairment to be recognized and classified separately from net interest margin (a key metric for users in analyzing financial institutions) primarily because they analyze the two items differently.

37. The staff believes that, in developing an overall objective for credit impairment, the Boards will need to determine whether credit losses should be integrated with interest income recognition. This decision will affect other components of the impairment model, including the timing of loss recognition and the potential need to address methods for allocating credit losses.

38. The previous section discussed the interdependence of yields and the timing of loss recognition. There is also a relationship between yield presentation and the amortized cost measure. If credit-adjusted yields are an objective of the model, the amortized cost measure could reflect the amount that an entity expects to collect, focusing on expected cash flows rather than contractual cash flows, including a consideration of expected credit losses. Then, the effective interest rate (based on expected cash flows) would link interest income to the amortized cost balance and net interest margin (return) would reflect a credit-adjusted effective interest rate. If credit-adjusted yields are not an objective of the model, then amortized cost and the effective interest rate would continue to reflect the amount that an entity is contractually owed—the principal and interest cash flows that are contractually

required for a debt instrument. Net interest margin (return) would then reflect the contractual interest rate and, therefore, the level of risk inherent in the related debt instrument.

39. The staff believes that the decision on whether credit losses and yields should be integrated or non-integrated also directly affects whether or not guidance on nonperforming loans and nonaccrual of interest should be reconsidered. If yields are presented reflecting credit losses on the related financial assets, then the need for guidance on when to cease accruing interest is largely eliminated. However, if yields and credit losses remain distinct, then there is a need to reconsider guidance on when an entity should cease accrual of interest on the related financial assets.

Discussion of Alternative Models

40. The staff believes that the Boards should comprehensively reconsider the proposed impairment guidance by considering various possible models, such as those proposed in Table 1, in their entirety to determine whether they align with the objectives for the model. Taking this approach, the staff believes that the Boards can consider high-level questions that may narrow the potential choices for an impairment approach.

41. The staff believes that first addressing the information to be considered in estimating credit losses facilitates the analysis because it appears to directly and indirectly affect the other model components. Table 1 presents 12 alternative models, which are broken down based on the information considered. There are four models for each of three alternatives for information that may be considered:

    (a) Historical data plus events and conditions existing at the reporting date (that is, no forecasting of events or economic conditions)—Models 1–4

    (b) Historical data, current information and expected events and conditions in foreseeable future (for example, one to two years)—Models 5–8

    (c) Historical experience and other data necessary to project loss expectations over the full effective life of the financial assets—Models 9–12.

42. If the FASB were to decide that the proposed model should be changed to permit some consideration of forecasted information, then Models 1–4 (based on no forecasting) would be eliminated. Table 2 shows the eight models that would remain. The next decision related to the information that could be considered relates to whether to require estimation of credit losses including events and economic conditions expected in the foreseeable future or to require a methodology that would incorporate forecasts of events and economic cycles over the full remaining expected life of the financial assets. If credit losses were required to be based on forecasted information over a period shorter than life of the financial assets, then Models 9–12 would be eliminated. Alternatively, if estimated loan losses are based on forecasts over the life of the financial assets, then Models 5–8 would be eliminated.

43. Focusing on the presentation of yields next would allow for further narrowing of the models. The two alternatives for yield presentation are an integrated presentation, such that yields would reflect the recognition of credit losses, and a non-integrated presentation. If the Boards were to decide on an objective that would require interest income recognition and credit losses to be integrated, then Models 3-5, 7–9, 11, and 12 would be eliminated. Alternatively, if the Boards were to decide on an objective that would require separate recognition and presentation of interest income and credit losses, then Models 1, 2, 6, and 10 would be eliminated. Table 3 shows the remaining models after eliminating those that would permit no forecasting and those that would require an integrated yield.

44. The issues that remain represent what the staff views as the crux of the impairment model—the amount of credit losses to be recognized and the timing of loss recognition. If it is decided that, conceptually, the loss to be recognized should represent an entity's estimate of losses based on total losses expected on the financial assets, then Models 5, 9, 11, and 12 are relevant. (It is important to note that Models 5 and 9 would estimate losses based on historical, current, and forecasted information over the foreseeable future, while Models 11 and 12 would require forecasting all events and conditions over the life of the assets in estimating credit losses.) If it is decided that the losses to be recognized should represent a

specified period (that is, a specific emergence period or corresponding to the period used for forecasting events and conditions), then Models 5, 9, 11, and 12 can be eliminated. Given the models presented, only Model 8 would remain.

45. Depending on the decisions made with respect to the amount of the loss, the alternatives that remain would have to be considered in light of whether the desired outcome is immediate recognition, recognition over a specific period (for example, the period used for the forecasting assumptions), recognition over the effective life of the financial assets, or a combination approach.

Other Issues

46. This memorandum has discussed four fundamental components of a credit impairment model. The staff believes that there are many other detailed issues, including those discussed below, that also would need to be addressed more fully in redeliberations.

Cash flows considered in impairment analysis

47. A key issue to be considered with respect to measuring the credit impairment loss is the nature of the cash flows that are considered in the analysis (discounted versus undiscounted cash flows). Constituents have conveyed that for credit risk management purposes, they view a loan as impaired only if the expectation is that the principal will not be returned. Many constituents opposed introducing a present value approach to the determination of credit impairment for pooled financial assets. They cited the overwhelming operational issues associated with discounting credit impairment amounts for pooled financial assets and disagreed with the inherent link to interest income that would arise from the discounting process. Moreover, many constituents asserted that a single measurement approach should be provided for all assets subject to credit impairment. As a result, some constituents support an undiscounted model for assets evaluated individually.

48. If the Boards provide a single impairment model for both assets evaluated individually or on a collective (pooled basis), interest income would be affected for assets evaluated individually because an entity would no longer be required to accrete a discounted loss immediately recognized to interest income throughout the remaining life of the asset. This also could be applicable to troubled debt restructurings.

49. If an undiscounted approach is the model for determining credit impairment for assets evaluated individually and on a collective basis, a question arises about whether the impairment model is targeted solely at principal and accrued interest as opposed to all contractual cash flows due. The staff believes this raises another conceptual question about whether a model that considers both principal and interest cash flows should or should not also require specific guidance on ceasing interest accruals. If an entity is required to cease accruing interest at a given point in time (for example, 90 days), the credit impairment analysis would appear to relate to only principal and accrued interest. However, if the entity were to be required to cease accruing interest at a given point in time and the credit impairment analysis were to be required to consider expectations about collection of both principal and interest cash flows, the staff believes those required elements may be overlapping. To address this issue, accounting for nonperforming assets and nonaccrual of interest would have to be revisited.

Purchased versus originated loans

50. Constituents have almost uniformly requested that both the impairment model and interest income model be consistent for originated and purchased loans. That is, constituents, including users, want to eliminate the separate interest income recognition guidance for purchased financial assets. Specifically, for a financial asset acquired at an amount that includes a discount related to credit quality, the acquirer recognizes income by accreting the difference between the purchase price and the expected undiscounted cash flows using the interest method. Any subsequent increases in expected undiscounted cash flows are only recognized in

net income immediately to the extent that an allowance for credit losses has been established for that asset after its acquisition.

51. The FASB ED proposed that if no allowance has been established for such a purchased loan subsequent to its acquisition, the favorable increase in cash flows expected to be collected is recognized by recalculating the initial effective interest rate on the basis of the revised cash flows expected to be collected. The effective interest rate on purchased loans is never decreased below its initial amount calculated at the acquisition date. In other words, an allowance for credit losses is only recognized to the extent that estimated collectible cash flows (undiscounted) deteriorate to an amount less than the amount estimated at the acquisition date. With the exception of the provision described in the previous sentence, the guidance proposed by the FASB in its ED is generally consistent with that in Subtopic 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality* (formerly SOP 03-3).

52. The staff has been informed about the pervasive operational issues with the application SOP 03-3 in prior acquisitions and transparency issues cited by users in determining what interest income amounts recognized in earnings relate to the SOP 03-3 model, along with how these amounts have been determined. Consequently, constituents have expressed significant opposition to retaining the guidance in Subtopic 310-10 for purchased credit impaired loans and the inclusion of adjustments to interest income recognized for credit impairment.

Unit of account and operational issues

53. As part of its redeliberations, the Boards will need to address whether to require a portfolio approach for all assets or whether to retain the approach in current U.S. GAAP and IFRS to permit both collective and individual assessment and measurement of credit impairment losses. In addition, the staff believes that in discussing the aspects of the impairment model that could be applied in a portfolio setting, Board members should consider whether the requirements would be operational for open pools of loans.

54. Constituents commented on the different units of account and the different impairment methods proposed for assets evaluated for impairment individually versus those identified on a collective or pooled basis. For example, some constituents have communicated that the FASB's proposed model is not compatible with the use of open pools, and that implicitly closed pools would be required to comply with requirement to determine interest revenue net of the allowance (due to the need to determine a composite effective interest rate on a pool), to comply with provisions for purchased loans (due to the need to track changes in cash flows expected to be collected and potential adjustments to yields), and to comply with the guidance on ceasing interest accruals (due to the need to track assets with negative yields).

Table 1—Alternative Impairment Models

Model component	Model 1 (FASB ED)	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10 (IASB ED)	Model 11	Model 12
Information considered	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life
Amount of loss	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified time period	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified period	Portion of expected losses on the loan expected to occur in a specified period	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan
Timing of recognition	Immediate	Over life	Over life	Immediate	Immediate	Over life	Immediate	Over the period considered in estimating the amount of the loss	Immediate	Over life (initial estimate only))	Over life (possible minimum "floor" amount at each reporting period)	Combination approach—immediate recognition for impaired loans and over life for non-impaired loans ("good book/bad book" approach)
Yield presentation	Integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated

Notes:

The following alternatives are presented for the amount of loss that would be recognized under the various models (methods for determining the amount of the loss not yet determined):

(1) Expected losses on the loan—those losses that the entity estimates, based on information considered, that may occur at any time during the life of the loan
(2) The portion of expected losses on the loan that the entity expects will occur in a specified time period (e.g., the forthcoming 2 years)

The following alternatives are presented for the timing of loss recognition:

(1) Immediate—The loss would be recognized in the current reporting period
(2) Over a specified period (e.g., over the period considered in estimating the amount of the loss-Model 8)
(3) Over the life—the loss would be allocated over the expected remaining life of the related financial assets. For the purposes of this analysis, the method of allocating losses over the life or period considered in estimating the amount of the loss is not yet determined.
(4) Over the life with a floor amount (Model 11)
(5) Combination approach (Model 12)—a component of the impairment loss would be allocated over the expected remaining life of the related loans and losses for impaired loans would be recognized immediately.

Table 2—Alternative Impairment Models—Assumes use of some forecasting assumptions

Model component	Model 1 (FASB ED)	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10 (IASB ED)	Model 11	Model 12
Information considered	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life
Amount of loss	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified time period	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified period	Portion of expected losses on the loan expected to occur in a specified period	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan
Timing of recognition	Immediate	Over life	Over life	Immediate	Immediate	Over life	Immediate	Over the period considered in estimating the amount of the loss	Immediate	Over life (initial estimate only))	Over life (possible minimum "floor" amount at each reporting period)	Combination approach—immediate recognition for impaired loans and over life for non-impaired loans ("good book/bad book" approach)
Yield presentation	Integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated

Table 3-Alternative Impairment Models—Assumes use of some forecasting assumptions AND Non-integrated yields

Model component	Model 1 (FASB ED)	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10 (IASB ED)	Model 11	Model 12
Information considered	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data plus events and conditions existing at the reporting date	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical data, current information & expected events and conditions in foreseeable future (e.g., 1-2 years)	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life	Historical experience & other data necessary to project loss expectations over full effective life
Amount of loss	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified time period	Expected losses on the loan	Expected losses on the loan	Portion of expected losses on the loan expected to occur in a specified period	Portion of expected losses on the loan expected to occur in a specified period	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan	Expected losses on the loan
Timing of recognition	Immediate	Over life	Over life	Immediate	Immediate	Over life	Immediate	Over the period considered in estimating the amount of the loss	Immediate	Over life (initial estimate only))	Over life (possible minimum "floor" amount at each reporting period)	Combination approach—immediate recognition for impaired loans and over life for non-impaired loans ("good book/bad book" approach)
Yield presentation	Integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated	Non-integrated	Integrated	Non-integrated	Non-integrated