



## Memorandum

Memo No. **65 (IASB Agenda reference 10)**  
Issue Date **October 15, 2010**  
Meeting Date **ES October 21, 2010**

---

Project **Accounting for Financial Instruments**  
Topic **Comment Letter Summary—Impairment and Interest Recognition**

---

### Purpose of This Memorandum

1. This purpose of this memorandum is to provide the Board with a summary of the feedback received from constituents regarding the proposed impairment and interest income recognition guidance in the proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. The comment letter deadline for the Exposure Draft ended on September 30, 2010. The feedback outlined in this memorandum encompasses the feedback contained in comment letters and meetings that the Board and staff have held with constituents. The FASB plans to conclude constituent outreach activities related to the Exposure Draft with public roundtable meetings to be held in October 2010. This paper does not contain the staff's views or recommendations.
2. The feedback reflected in this memorandum reflects input received from comment letters, field visits, and calls and meetings conducted with various constituent groups. Several comment letters, particularly those from smaller institutions, did not comment on impairment and interest recognition but, rather, focused on the measurement of loans and deposits at fair value.
3. The feedback in this memorandum is not representative of every comment letter submitted, but rather a sample of letters that contained a substantive discussion of impairment. The staff would like to highlight that additional views and suggestions

may arise from other comment letters recently received and the discussions at the upcoming roundtable meetings.

4. The sections below discuss topics related to the impairment and interest income models, first summarizing the main aspects of the topic in the Exposure Draft, then summarizing feedback from preparers, investors and users, auditors, and other constituents.

## **Overall**

### ***Convergence***

5. Many constituents commented on both the IASB's proposed impairment model and the model proposed by the FASB. Constituents believe that convergence of the impairment models is an important step toward converged accounting regimes. Yet the FASB's Exposure Draft and the IASB's current impairment and amortized cost exposure draft do not represent converged solutions.

### ***General Comments***

6. Constituents have provided much feedback on the guidance within the Exposure Draft related to impairment and interest income. However, many financial institutions, particularly those who participated in field visits, expressed significant concerns with the operability of the proposed guidance. Those constituents assert that sufficient time and field testing are imperative to ensure that the model both reflects the appropriate measurement and recognition of credit impairment (including a robust objective) and is tested for operability. Finally, many constituents have expressed their beliefs that developing effective impairment guidance may be the most important issue addressed in the overall financial instruments project.

## **Credit Impairment Objective**

7. The objective of the impairment guidance is in paragraph 36 of the Exposure Draft, and states the following:

The objective of the guidance related to credit impairment is to establish a model for recognition and measurement of credit

impairment of financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income on the basis of an entity's expectations about the collectibility of cash flows, including the determination of cash flows not expected to be collected. An entity's expectations about collectibility of cash flows shall include all available information relating to past events and current conditions but shall not consider potential future events beyond the reporting date.

***Objective of the Impairment Model***

8. Elimination of the current probability threshold for recognition of impairment is universally supported. Additionally, most constituents support having a single impairment model for all financial assets, purchased or originated. Many constituents commented that impairment is the most critical element of the proposed guidance and provides an opportunity to arrive at a converged solution with the IASB.

*Preparers*

9. Preparers generally supported creating a single impairment model for all financial assets, noting that they do not view purchased loans and originated loans differently for impairment purposes. Most preparers also supported the elimination of the probability threshold and moving toward an expected loss model (currently based on the IASB's Exposure Draft, which considers expected losses as losses to be realized over the life, or expected life, of a financial asset).
10. One preparer suggested retaining a recognition threshold and using the Subtopic 450-20 (formerly FAS 5) concept of *probable and estimable*. Another preparer suggested recording impairment when the measurement of losses is reliable. A key concern regarding the removal of any threshold was the subjectivity of the estimate coupled with supporting estimated credit losses with an entity's auditors. Some suggested a *reasonably possible* or *more likely than not* threshold, which would allow more flexibility for recognizing losses while being able to support assumptions with auditors and regulators.
11. Although they supported the objective, some preparers believe the Exposure Draft was unsuccessful at creating a single impairment model for all assets, one preparer

noted “It appears to retain three different loan impairment models (for pools, individual loans and purchased loans).”

*Auditors*

12. All auditors noted that having one impairment model for all financial assets would reduce complexity for preparers and users, the elimination of the probable threshold would result in more timely recognition of losses, and moving toward an expected loss is a more appropriate method to estimating credit losses. For example, one auditor supported an expected loss approach because it would “better reflect the economic effects of credit losses and recognize those losses on a timely basis.”
13. Some auditors expressed that the objective of the impairment model in the Exposure Draft was not clearly stated. Those auditors questioned whether it was the Board’s intention to create an allowance for every financial asset or whether pools could be considered the unit of account for impairment purposes.
14. One auditor did not support the elimination of the probable threshold or moving toward an expected loss model. This auditor would prefer an incurred loss model with the impairment threshold lowered; for example, to more likely than not.
15. Although it supported the elimination of the probable threshold, one auditor feared that the proposed guidance would result in an entity recording losses for events that have a low probability of occurring. It gave an example of a highly rated debt security, not included in a pool of similar assets, when “the chance of not collecting all cash flows may only be 1 percent.” In this auditor’s view, it is not reasonable to record an impairment that most likely will never be recognized. It believes that retaining some loss recognition threshold would reduce potential diversity in practice and prevent recognition of events that have a remote chance of occurring. In this auditor’s estimation, this threshold would be more relevant to assets evaluated individually rather than in a pool because the threshold would likely be met at the pool level.

*Investors/Users*

16. Most investors supported the removal of the probability threshold. Many investors believe this threshold prevented financial institutions from recognizing credit losses that were imminent in 2007 and 2008. All investors consulted understand there is significant subjectivity in management's credit loss estimates. Several said they typically spend vast amounts of time analyzing recognized credit losses each period and making adjustments to their own models and forecasts to reflect asset values and net income based on their own estimates of future expected losses. Transparency into the underlying assets, the estimates and assumptions used by management to establish credit loss estimates, and how credit loss estimates have changed from prior periods (at an adequately disaggregated level) helps them make their own assessments/adjustments of credit losses. Each quarter, sellside analysts' written reports and communications to the buy-side analysts involve extensive review of credit losses in which there is typically analyses of losses by category over time and a comparison of expected losses across firms. The level of attention paid to credit loss estimates gives both buy-side and sellside analysts confidence that market forces help to control subjectivity, or at the very least, make it more transparent.

*Other Constituents*

17. Certain other constituents support the elimination of the probability threshold and using an expected losses model, but assert that this concept needs to be more clearly defined.

**Recognition of Credit Impairment**

18. The current recognition guidance for impairment would be replaced by the following general principle in paragraph 38 of the Exposure Draft:

An entity shall recognize a credit impairment in net income for a financial asset (or group of financial assets) when it does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected upon acquisition for purchased financial asset(s).

19. The objective for the measurement impairment is outlined in paragraph 51 of the Exposure Draft:

An entity shall recognize in net income at the end of each financial reporting period the amount of credit impairment related to all contractual amounts due for originated financial asset(s) that the entity does not expect to collect and all amounts originally expected to be collected for purchased financial asset(s) that the entity does not expect to collect.

***Principal Only or Principal and Interest***

20. Most preparers commented that impairment should only represent principal amounts not expected to be collected. Preparers also noted that their current historical loss rates do not reflect losses of interest income and to do so would represent a significant change. This is primarily related to the current practice of ceasing accrual of interest at a particular point in time when a loan is not performing. For example, if a borrower is delinquent on its payments for three consecutive months, it would cease accruing interest (nonaccrual) on the particular loan. Consequently, nonaccrual policies generally negate the need to contemplate a principal and interest impairment model.

***Timing***

21. The guidance in paragraph 38 of the Exposure Draft would generally result in the recognition of the entire amount of expected lifetime losses in net income in the reporting period after purchase or origination.

***Preparers***

22. Certain preparers agreed that impairment should be based on expected cash flows not expected to be received throughout the effective or remaining contractual life of a loan. However, many opposed recognizing impairment “immediately” or in the first reporting period after loans are originated. In their view, the recognition of an impairment loss in the period after origination for a performing loan is “counterintuitive.” These constituents prefer to recognize these losses by allocating them in a systematic and rational manner throughout the remaining effective or contractual life of the instrument.

23. Of those preparers that supported an allocation of impairment, they reason that the costs related to loans should be recognized similarly to the related revenues of those assets.
24. Some preparers supported up-front recognition of lifetime credit losses. One preparer noted that “impairment losses should be recognized immediately. On the balance sheet, the allowance account for credit losses should always equal management’s best estimate of the portion of the book balance of loans and securities that the entity will be unable to collect.”
25. Another preparer noted that given a steady state (when an entity is not dramatically increasing or decreasing their lending book), the magnitude of the impairment charge would not differ if the losses were recognized up-front or allocated. This is because once the initial “catch-up” expense is taken; the only yearly and ongoing impairment charge would be due to changes in expectations and new loans. It asserted that this would not be materially different from the yearly allocated charge. Because up-front recognition would be operationally easier to implement over an allocated approach, this method would be preferable. This preparer particularly supported this for financial instruments with short lives because immediate recognition would not differ materially from any allocation method.
26. Preparers also noted that the allowance for impairment account should never be less than the losses incurred to date. Incurred losses are generally considered those that would be realized at a particular reporting date based on events that have occurred that suggest that cash flows due to the lender will not be received. Under a model that allocates expected impairment without an incurred loss floor, the reserve for credit impairment could potentially be less than what has been incurred.
27. Some preparers also supported a model that separates loan assets into a “good book” and a “bad book,” similar to an impairment model proposed by the Expert Advisory Panel (EAP) on impairment. Under this model, the impairment allowance for the bad book would equal lifetime expected losses and be recognized immediately. For the good book, expected losses would be allocated in some manner over the average life of the assets within the good book pool. Those supporters also propose that an

incurred loss floor be maintained in situations in which the allocation of expected losses appears to be inadequate.

*Auditors*

28. Auditors did not support immediate recognition of credit losses and would prefer a model that allocates the credit losses over the life of the asset or pool. Some were sympathetic to the Board's reasoning for recognizing lifetime losses up-front but did not agree with the outcome. They believe lenders are compensated for losses through the credit spread inherent in the pricing of the asset. Another noted that "immediate recognition of all expected losses ignores the business practices of pricing some level of credit risk into the terms of the financial asset and the economic reality that such losses do not occur immediately."
29. One auditor noted that it would prefer allocation of credit losses with an incurred loss floor. This auditor would support accelerated recognition if the asset is known to be impaired and after losses have been incurred, the remaining losses would be re-forecast and allocated over the remaining life. The staff notes that this has characteristics similar to the impairment model proposed by the EAP on credit losses.

*Investors/Users*

30. Most investors agreed with the recognition of the entire credit loss in the period estimated, while some said they would prefer an approach that allocates the loss over the remaining life of the asset. The latter approach was deemed appropriate because some of the losses come from amounts that had been expected to be earned in the future (i.e. interest payments) and, therefore, an entity should be allowed to recognize the losses over time as the losses are incurred. Some investors supported immediate recognition of the lifetime credit losses.

*Other Constituents*

31. One other constituent supported the immediate recognition of incurred losses and losses within a one to two year emergence period. They noted that there seemed to



be no consensus about how to treat expected losses past the emergence period. Other constituents supported the immediate recognition of the entire amount of impairment and noted that any allocation method would only defer loss recognition.

## **Measurement of Credit Impairment**

### ***Measurement Inputs***

32. Paragraph 42 of the ED outlines what a preparer can consider when measuring impairment, and states:

...an entity shall consider all available information relating to past events and existing conditions and their implications for the collectibility of cash flows... An entity shall incorporate into the impairment assessment the effect of those known conditions and factors in developing estimates of cash flows expected to be collected for financial asset(s) over the remaining life of the asset(s). In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets. An entity shall not forecast future events or economic conditions that did not exist at the reporting date in determining whether a credit impairment exists.

33. The vast majority of constituents did not support the limitations to the consideration of future events and advocated for some relaxation of this restriction.

### *Preparers*

34. Preparers would like the ability to include a loss forecasting period that is within a predictable time horizon as opposed to forecasting for the full life of financial assets. One preparer noted that restricting the ability to include future conditions would generate significant volatility in the income statement and the amount of reserves would be procyclical and, thus, would have severe, unfavorable effects on the overall economy (overstated reserves at the trough of a cycle and understated reserves at the peak of a cycle). However, these preparers acknowledge that the longer the loss forecasting period, the more uncertainty is introduced into the loss estimation. Consequently, these constituents believe that allowing forecasting of economic events for a predictable time period would appropriately provide an entity

with the ability to recognize expected impairment losses on a timelier basis and in a more representative manner.

35. Preparers noted that they would have to perform at least two cash flow analyses for assets subject to impairment: one for calculation of fair value (if fair value measurement of financial assets is retained in the final guidance issued) and another for impairment. Some preparers asserted that the estimate of cash flows not expected to be collected for impairment purposes will not represent actual losses expected to occur by management and will lag changes in market expectations because of the limitations to forecasting.
36. Some preparers were confused about what the Board intended with the wording in the objective of credit impairment that states that “an entity’s expectations about collectibility,” (paragraph 36 of the Exposure Draft). Some preparers questioned if an entity could include in its assessment of impairment a downward trend in an economic indicator if the current economic condition is that the indicator is declining. Another preparer noted that the proposed guidance in paragraph 42 of the Exposure Draft that would limit the information an entity can consider to “past events and current conditions” seemed to conflict with guidance in earlier paragraphs that outlined factors to consider when measuring impairment that do incorporate forward looking information. They also asserted that this guidance would contradict the current requirement of requiring an entity to base impairment on expected cash flows because the limitations to forecasting would not be a true representation of future cash flows.
37. Most preparers asserted that an appropriate time horizon for forecasting losses should be “a reasonable future period determined considering the availability and reliability of.” Additionally, these preparers would support disclosure of the time periods used in forecasting for major asset classes. Another suggestion was that impairment should “consider all the information that market participants consider when estimating credit losses.” In general, preparers asserted that they currently utilize a forecasting period of one to two years, depending on the type of asset. For

periods beyond what is encompassed by forecasted periods, some preparers supported measuring cash flows that are uncollectible based on historical averages.

38. Specific to measuring impairment to be recognized at a given reporting date, certain preparers supported measuring losses to be recognized based on only those expected to be realized during the reasonable future period (such as one to two years). These constituents would then periodically update their forecasts based on this limited period and amend the credit impairment allowance as deemed necessary. Others supported recognizing those expected to be realized over the forecasted period during that period with the remaining losses allocated based on historical averages. Finally, others supporting using all information available, including forecasts, to determine the amount of expected losses to be systematically recognized over the life of the financial asset.
39. At least one preparer supported an entity only considering past events and current conditions when estimating cash flows not expected to be collected because this would improve comparability across entities and implementation would not be a concern. Other preparers supported allowing recoveries of impairment in a manner similar to how losses are recorded.

*Auditors*

40. Most auditors did not support limitations to the inputs of measurement and would allow some degree of forward-looking information to be incorporated into the measurement of impairment. One auditor said that “this is inconsistent with how market participants typically assess future losses” and would “ignore forward-looking information that would likely be relevant to users and would be considered by management in pricing newly originated assets.” Another noted that impairment estimates are inherently forward looking and should not assume conditions will remain unchanged if there is evidence to the contrary.
41. Many suggested criteria for incorporating forward looking information, including the following:
  - (a) The information is reasonable and supportable.

- (b) The information “is currently available and objectively verifiable.”
- (c) The reasonably foreseeable future is defined as the “period during which management believes they can forecast economic conditions with a reasonable degree of reliability.”

One of these auditors would only include in the allowance losses within the forecasted period and disregard periods for which losses cannot be reliably forecasted.

- 42. Auditors generally did not support a model that would allow unlimited forecasting or simulations of future events or economic conditions due to the significant subjectivity and lack of comparability.
- 43. One auditor drew parallels to other areas of financial reporting; such as fair value determination, impairment of nonfinancial assets, and pension accounting. They believe with sufficient disclosure, forecasting could be included in this already subjective area of accounting and the information would be valuable to users.

*Investors/Users*

- 44. Most investors were concerned that limiting the inputs into the credit impairment calculation to current conditions would limit the usefulness of the impairment measurement because it would restrain management’s ability to fully reflect expected credit losses. For example, one preparer noted that current impairment guidance does not allow management to build reserves based on full-cycle losses and, therefore, reserves are at their lowest when they are most needed at the beginning of a downward cycle. Regardless of the extent to which past events and loss rates and current conditions and loss rates are weighed, investors believed that it is critical to disclose the inputs and assumptions that were used to determine the credit impairment calculation.
- 45. Some investors supported incorporating only past events and current conditions. They believe that allowing forecasting of economic conditions will result in less relevant information and too much subjectivity.
- 46. Most investors agree that it is difficult, and some think impossible, to forecast total credit losses and the timing of those credit losses over long periods of time. They

also questioned the ability to get transparent information on these inputs and assumptions at a sufficiently granular level. One investor group noted that any requirement to estimate losses over the life of an instrument “makes the loss estimation process comparatively malleable.” For this reason, these investors are uncomfortable with a model that reflects impairments based on initial expected losses throughout the instrument life, with adjustments when experience differs significantly from initial expectations.

47. Investors supported allowing recoveries of impairment charges. Investors suggested that if recoveries are allowed, they should be disclosed on a separate line item on the face of the financial statements.

#### *Other Constituents*

48. One regulator was concerned that the term *current conditions* was not sufficiently clear and does not provide a clear boundary between what would be considered and what would not be considered forecasting. This constituent echoed preparers’ concerns that, because of these limitations to the measurement of impairment, it would not be a true representation of management’s expectation of losses. Basel noted that the disclosure of the relevant information that was considered in estimating losses, including forecasted inputs, would provide decision-useful information for evaluating the adequacy of a credit impairment allowance. Another regulator did not support estimating losses over the life of an instrument because of operational concerns.

#### ***Individually Assessed Instruments***

49. Paragraph 65 of the ED outlines specific guidance for loans evaluated individually for impairment:

For a financial asset evaluated for impairment on an individual basis, where there are no past events or existing conditions indicating that the financial asset is impaired, an entity shall not automatically conclude that no credit impairment exists. The entity shall determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. If the entity determines that a credit impairment exists in that circumstance, the entity shall recognize a

credit impairment in net income. The amount of the credit impairment shall be measured by applying to that financial asset the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets referenced by the entity in its assessment.

*Preparers*

50. Certain preparers did not support the requirement to use the net present value of cash flows for individual loans. They noted that this does not provide useful information and could be confusing to the users of their financial statements. They would prefer individually impaired loans use the same “gross” method as pooled loans.
51. Some preparers noted that the proposed guidance is unclear and they were unsure how it would interact with current impairment guidance. For example, they noted that applying paragraph 310-10-35-34 (formerly FAS 114) and then applying Subtopic 450-30 (formerly FAS 5) to measure the same loss again as being inappropriate because it would double count impairment measurements. These preparers noted that subjecting a loan to two impairment measurements would result in an overstatement of impairment. The staff notes this is not what was intended by the proposed guidance but believes further clarification could be necessary.
52. Regardless of the application, some preparers believe this guidance is unnecessary. One preparer cited that “individual impairment of assets may be more precise than collective assessments due to the often unique cash flow characteristics...When credit impairment is not necessary based on a more precise individual assessment, an impairment based on collective assessment should not override such an assessment as it would produce a result that is not meaningful and will mislead financial statement users.”

*Auditors*

53. One auditor noted that it understands the Board’s reasoning for the specific guidance related to assessing impairment on individual loans but does not support the recognition of an initial loss on newly originated loans. This auditor noted that it is

unclear if an entity needs to consider third-party data for individual assets that do not have an indication of impairment when assessed individually.

54. Some auditors noted that it would be inappropriate to force a pooled method on an individually evaluated loan that has no impairment resulting from NPV analysis. One auditor noted that “It would appear that the notion of a second evaluation based on a pool calls into question whether the pool’s losses have been properly accounted for. If an entity attempts to avoid or manage the timing of losses by virtue of whether assets are evaluated individually or collectively, we believe this is more of a practice issue than it is a problem to be fixed through standard setting.”
55. Alternatively, other auditors agreed with the proposed guidance for individually evaluated assets when the entity has loss history for a similar pool. But, one auditor was unsure how the guidance would apply if the entity has no loss history or similar pools for individually evaluated assets.

*Other Constituents*

56. One regulator supported requiring consideration of losses realized for similar loans when an individual analysis indicates that no loss currently exists. It noted that “historical experience typically demonstrates that some loans within a group of loans with similar risk characteristics will not be repaid.”

***Pooled Loans***

57. Paragraphs 59 and 60 of the Exposure Draft outline how to measure impairment on pooled assets:

An appropriate historical loss rate (adjusted for existing economic factors and conditions) shall be determined for each individual pool of similar financial assets. Historical loss rates shall reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. An entity shall select a historical time period appropriate for the specific financial assets in the pool to determine a historical loss rate. This proposed guidance does not specify a particular methodology to be applied by an entity for determining historical loss rates. That methodology may vary depending on the size of the entity, the range of the entity’s activities, the nature of the entity’s pools of financial assets, and other factors.

The amount of credit impairment recognized for a particular pool of financial assets shall be based on a historical loss rate for that pool adjusted for existing economic factors and conditions. In each reporting period, the amount of credit impairment (or the reversal of a credit impairment recognized in a previous period) that shall be recognized in net income for a pool of financial assets is the difference between the allowance for credit losses for the pool determined by applying the historical loss rate adjusted for existing economic factors and conditions to the current principal balance of the pool at the reporting date and the existing balance of the allowance for credit losses attributable to the pool of financial assets.

*Preparers*

58. Some preparers were unsure if the credit impairment for pooled loans should be discounted, which is specified in both current and proposed guidance for individually evaluated assets. All preparers requested that the Board provide consistent (discounted or undiscounted) guidance for measuring credit impairment. Many preparers objected to requiring credit impairment to be measured based on discounted cash flows for both assets measured individually or collectively. If the Board amends its decision on nonaccrual accounting and provides specific guidance, it may be counterintuitive to discount cash flows while at the same time ceasing the accrual of interest. Moreover, these preparers cite significant operational issues associated with discounting and subsequently accounting for discounted impairment amounts. Others noted that the measurement of credit impairment should be based on discounted cash flows to reflect the time value of money.

*Auditors*

59. Auditors generally supported allowing management to develop an impairment method that reflects the economics of its business rather than using a prescribed method. Some auditors suggested providing more implementation guidance around the development of historical loss rates and what kind of information management can use in their development. Specifically, they were unsure if the phrase over the life of the financial assets” (paragraph 59 of the Exposure Draft) referred to the expected life or the contractual term.



60. One auditor noted that individual and pooled assets are currently and under the proposed guidance measured differently (discounted versus undiscounted) and that it does not agree with differing methods being used.

*Other Constituents*

61. One regulator agreed with not prescribing a method for developing a loss rate but would like further clarification about what the loss rate represents. For example, this regulator asked for clarification about whether the Board's intention is to establish a loss rate based on experience from a certain time horizon. Additionally, this regulator noted that disclosing the method used to determine the loss rate could provide information that would be useful when comparing entities' allowances for credit losses.

### **Impairment of Purchased Financial Assets**

62. Paragraphs 66 and 79 of the Exposure Draft outline specific guidance for determining the effective interest rate on purchased financial assets.

For financial assets acquired at an amount that includes a discount related to credit quality, the effective interest rate is the rate that equates the entity's estimate of cash flows expected to be collected with the purchase price of the financial asset.

If an allowance for credit losses had been established previously for that financial asset (after purchase of the financial asset), an increase in cash flows expected to be collected shall be recognized in net income as a reversal of credit impairment expense to the extent of the previously recognized allowance. If no allowance for credit losses had been established for that financial asset since acquisition, or if the amount of the increase in cash flow expected to be collected exceeds the allowance for credit losses, an entity shall recalculate the effective interest rate for the financial asset on the basis of the revised (increased) cash flows expected to be collected. If, subsequently, the entity expects a decrease in cash flows expected to be collected from the cash flows previously expected to be collected, an entity shall recalculate the effective interest rate for the financial asset on the basis of the revised (decreased) cash flows expected to be collected but shall not revise the rate below the original effective interest rate. If the revised estimate of cash flows expected to be collected is less than the original estimate of cash flows expected to be collected, after reversing the adjustment of the effective interest rate, the entity

shall recognize any additional decrease in cash flows expected to be collected as a credit impairment.

### ***Purchased Assets Impairment Model***

#### *Preparers*

63. Almost all preparers supported a single impairment model for both purchased and originated assets and do not see an advantage to have specific and separate guidance for purchased loans with evidence of credit impairment. Many preparers noted that this guidance retains elements of Subtopic 310-30 (formerly SOP 03-3) for purchased financial assets. These preparers cited the significant operational issues that have been experienced with implementation of Subtopic 310-30 and do not see an advantage to carrying forward any of elements of that guidance, particularly when a separate model exists for originated loans.
64. One preparer noted that it is unclear if substantially all purchased assets would be required to follow the proposed guidance in paragraph 66 of the Exposure Draft for calculating the effective interest rate and the treatment of changes in expectations of cash flows. This preparer believes that the scope of assets outlined in paragraph 66 encompasses a different population of assets to which Subtopic 310-30 applies, which is when it is probable that the investor will be unable to collect all contractually required payments. It noted that it frequently buys debt securities at a discount mostly due to interest but partially to credit. It is not certain if these securities would need to follow the guidance related to adjusting the effective interest rate rather than be assessed for impairment similar to other originated assets.

#### *Auditors*

65. Auditors did not support retaining elements of Subtopic 310-30 for purchased credit impaired loans, citing operational concerns and that the information provided to users is confusing. Auditors noted that they believe it is inappropriate to use the contractual rate to accrue interest income on purchased credit impaired assets because this would overstate the effective yield. They also would prefer any revision in expectations to be reflected as a yield adjustment, citing that this is more consistent with current guidance for purchased assets and because it does not

represent a recovery of any previously recognized impairment. Although this results in a difference of how recoveries are treated for purchased and originated loans, auditors view this as necessary because previous impairment was recognized on purchased assets.

66. One auditor supported subsequent increases in expected cash flows being recognized in net income when estimated. Similar to preparers' reasoning, it would like gains and losses to be treated symmetrically.
67. Auditors also raised the same concern as preparers related to the apparent expanded scope of this guidance outlined paragraph 66 in the Exposure Draft.

#### *Investors*

68. Investors generally desire a single impairment model for both originated and purchased loans. They cited significant concerns and lack of transparency when the model in Subtopic 310-30 is applied for purchased credit deteriorated loans. They perform significant analyses and require much additional data from entities required to apply this guidance to decipher whether what otherwise would have been reflected as an allowance is accounted for as a yield adjustment.

#### *Other Constituents*

69. One regulator agreed with the proposed guidance for purchased loans and did not support recognizing a gain for a subsequent change in expected cash flows on purchased loans.

### **Impairment of Debt Securities**

70. Under the proposed guidance, debt securities would be evaluated for impairment under the same model as all other financial assets. This would eliminate current impairment guidance that requires recognition of a loss for debt securities when the impairment is considered other than temporary.

#### *Preparers*

71. Some preparers cited the proposed guidance in paragraph 65 of the Exposure Draft concerning the measurement of impairment on individually evaluated assets when there is no indication of impairment using a net present value technique and then would require a loss rate method. They questioned how this would be applied to debt securities. Specifically, this preparer was unsure how to combine debt securities that do not have the same CUSIP number into similar pools to determine a historical loss rate.

*Auditors*

72. One auditor noted that prescribing the use of historical loss rates would represent a change in practice related to impairment of debt securities. Another noted that it is unclear how debt securities would be evaluated for impairment if an entity does not hold similar assets. The guidance for individually assessed instruments in paragraph 65 of the Exposure Draft suggested that a loss rate on hypothetical pool of assets, which the entity does not hold, would be applied. This auditor noted that it is unclear how to build or measure a loss rate for such a pool.

*Investors*

73. Most investors noted concern about how credit impairment for debt securities would be measured and what inputs would be used (Level 2 versus Level 3). However, most supported a single model for credit impairment and noted that this would be a significant improvement over existing other than temporary impairment guidance.

**Interest Income**

74. Paragraph 76 of the Exposure Draft states:

An entity shall include in net income an amount of interest income related to financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income. The amount of interest income to be recognized in net income for those financial assets shall be determined by applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses."

## **Objective**

75. Constituents strongly opposed the proposed changes to the recognition of interest income.

### *Preparers*

76. All preparers believe that the current model for interest income recognition is adequate and, thus, should not be amended. Many believe that the primary issue is “late” recognition of impairment losses in net income as opposed to the interest recognition model. One preparer noted that “If impairments are recognized on a timely basis, we do not understand how interest income could be perceived to be artificially high, as the amounts relating to credit would be transparently presented.”
77. These constituents believe that the proposed model would decrease transparency to users as they believe users generally want interest income and net interest margin (NIM) based on the effective interest method with credit losses reported separately. They assert that users make adjustments and projects using “gross” amounts, that is, gross interest income and bad debt expense. Certain preparers noted that this treatment is inconsistent with the treatment of other loan costs, such as servicing and funding costs that are presented gross.
78. Preparers also raised operational concerns because this model is inconsistent with current risk management practices. Current loan accounting systems generally determine the effective interest rate on a loan-by-loan basis. Determining interest income by multiplying the effective interest rate of a loan to its carrying amount less the allowance for credit losses would require daily calculations and topside entries to determine the appropriate interest income under the proposed guidance.
79. Because the Exposure Draft does not prescribe or require a model for interest income for instruments classified as FV-NI, some preparers were also concerned that two interest models would result based on classification.

*Auditors*

80. Some auditors were sympathetic to the theory underlying not recognizing interest on principal amounts deemed uncollectible. However, they believe that resulting operational issues do not outweigh the benefits of a superior conceptual approach. Specifically, they are concerned that useful information about contractual interest rates would be lost, NIM, and the required allocation of credit losses to pooled assets would be difficult to implement. At a minimum, auditors believe that the income statement presentation should separate gross contractual interest from credit impairment. Auditors also cited the operational concerns raised by preparers.
81. One auditor agreed with the proposed interest income model noting that “the measurement of impairment needs to consider all contractual cash flows (principal and interest).”

*Investors/Users*

82. Many investors do not support the proposed changes to interest income recognition and prefer that interest income reflect the effective interest rate associated with a financial instrument or pool thereof. Some investors stated that the proposal would negatively affect their ability to analyze NIM, a key metric for analysis of a financial institution’s performance. Additionally, most investors believe that reporting interest income after the consideration of credit losses would impair and complicate their ability to separately analyze interest income and credit losses. At a minimum, these investors believe that presentation of gross contractual interest and net reported interest would be warranted. Most investors have noted that the proposed method would make many products look the same based on their reported interest yield. Products that have a high effective contractual interest rate due to riskier credit and high expected credit impairment would reflect a similar NIM as that of products with a lower interest rate and little expected credit impairment. Current interest income recognition that reflects contractual effective contractual interest rates gives investors an indication of the risk characteristics of the underlying asset.

83. A few long-only investors, hedge funds, and one investor group support the proposed changes and agree with the Board's basis for conclusion that interest should not be recognized on amounts that management does not expect to collect. The investor group would also prefer disclosure of the contractual interest.
84. Regardless of the method of interest income, investors have noted that they would like more robust disclosure of interest rate exposure. This would include expected interest income and expense for future periods based on existing assets and liabilities and market interest rate expectations.

*Other Constituents*

85. One regular noted its support for the separate presentation of interest and credit because it would provide more information to users. Another regulator noted that the proposed interest income model would reduce transparency and, therefore, supported recognizing interest income based on a financial assets contractual or effective interest rate because this would provides user with better transparency into NIM as currently calculated.

***Excess Cash Issue***

86. As a result of the proposed interest income recognition model, entities could collect cash interest in excess of accrued amounts. Paragraph 81 of the Exposure Draft provides guidance for this situation:

If, as a result of applying the requirement in paragraph 80, the allowance for credit losses exceeds an entity's estimate of cash flows not expected to be collected related to its financial assets at the reporting date, the entity shall adjust the allowance for credit losses and shall recognize the adjustment in net income as a reversal of credit impairment expense.

*Preparers*

87. Most preparers found the treatment of excess cash from interest income amounts due to be operationally difficult and noted it would obscure the allowance account.

*Auditors*

88. Auditors did not agree with the proposed treatment of excess interest collected. They do not believe this would result in better information for users or a more appropriate treatment of interest. One auditor believed the guidance was unclear as to how entities should accrue interest income and how uncollectible interest payments should be reflected in the allowance account.
89. One auditor noted that “It appears more representationally faithful for an entity to recognize cash flows it receives when the cash flows exceed an amount the entity accrues as a reduction in the financial asset’s recorded amount.”

***Nonaccrual***

90. The Exposure Draft proposes new guidance for placing assets on nonaccrual and is outlined in paragraph 82:

An entity shall cease accruing interest income on a financial asset only if the entity’s expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative.

*Preparers*

91. All preparers opposed the proposed changes to “nonaccrual” accounting, pending amendment to the interest income recognition model (gross versus net). Preparers believe that the current accounting and disclosures for nonperforming assets and nonaccrual of interest is well understood and commonly used by users. This includes the additional information provided via disclosures about nonperforming assets and assets for which interest accrual has been ceased. Retaining the proposed definition would result in a difference between financial reporting and regulatory reporting and some preparers asserted that the definition used for regulatory reporting would be suitable for use in the financial statements.
92. There are also operational concerns with the proposed guidance. When considering if an asset will have a negative yield, one preparer noted it is unclear if entities should consider remaining principal or remaining principal and interest and another questioned if it should be based on total or remaining expected cash flows. Preparers also noted that it would be operationally difficult to apply this guidance to small,



homogenous pooled loans for which no individual cash flow analysis is otherwise performed. If the guidance was permitted to be applied at the pool level, the amount of loans that would be classified as nonaccrual would decrease compared to current reporting.

*Auditors*

93. Auditors did not support the proposed guidance on placing an asset on nonaccrual status. One auditor believed it would be appropriate to address nonaccrual status within a larger convergence discussion on impairment and interest income not in isolation as it seems to be presented within the proposed guidance. Another echoed preparer concerns that cash flow analyses would not be performed on pooled assets other than to determine nonaccrual status.

*Other Constituents*

94. One regulator noted that this change to nonaccrual status would permit interest to be accrued on collateral dependent assets and does not support this outcome. It noted that “interest income for loans with excess collateral will continue to be accrued up to the fair value of the collateral, even when the lender does not expected to collect the interest in cash.”