



Project

Accounting for Financial Instruments

Topic

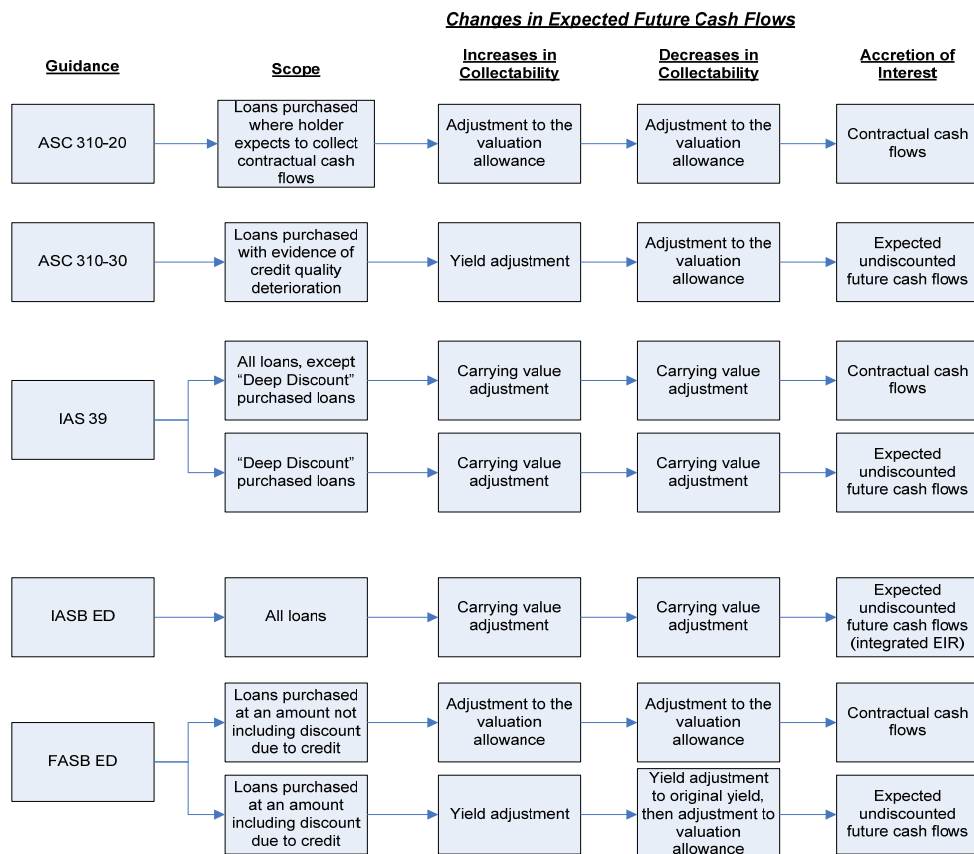
**Accounting for Purchased Debt Instruments subject to
Impairment Accounting**

Introduction and Purpose of This Memorandum

1. In January 2011, the FASB and IASB issued for public comment proposals for accounting for impairment of open portfolios of financial assets (supplementary document or “SD”). For the IASB, the proposals in the SD are limited to open portfolios of financial assets that are measured at amortised cost, excluding short-term receivables. For the FASB, the proposals would apply to open portfolios of loans and debt instruments that would not be measured at fair value with changes in value recognized in net income. While the SD focuses on the timing of recognition of expected credit losses for open portfolios, for those financial assets in the scope of the SD, the proposals identified the accounting issues related to the impairment and interest revenue recognition models for purchased financial assets as open issues for future deliberation by the Boards.
2. The purpose of this memorandum is to discuss the accounting for purchased financial assets that are subject to the impairment requirements, including purchased credit-impaired debt instruments. For simplicity, this paper refers throughout to those financial assets as ‘loans.’ Through the series of issues presented, this memorandum addresses whether or not a separate interest revenue recognition and impairment model is needed for all purchased loans or a subset of purchased loans (i.e., purchased credit-impaired loans or “problem” loans).
3. This memorandum does not discuss the measurement of credit impairment as this will be discussed at a future meeting.

Background

4. Under IFRS, originated and purchased loans (in asset acquisitions and in business combinations) are initially measured at fair value, interest on the loans accretes based on contractual cash flows (with one exception), and changes in collectibility result in direct adjustments to the carrying value of the loan. IFRS does have a specific requirement for financial assets acquired at a deep discount that reflects incurred credit losses (i.e., “problem” loans). Under IAS 39, these loans have a credit adjusted effective interest rate (EIR) which accretes interest based upon the cash flows that the asset holder expects to collect.
5. Existing interest income recognition and impairment models in U.S. GAAP vary on the basis of the nature of the financial asset, credit quality, and whether the financial asset was purchased or originated. The chart below provides a summary of existing and proposed models, in GAAP and IFRS, for handling accretion of interest and changes in cash flows expected to be collected over the life of the asset.



6. 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)*, also addressed the accounting for portfolios of purchased loans. The proposed guidance would have maintained the delineation in existing U.S. GAAP between loans acquired at a discount related in part to credit and all other loans.
7. Based on feedback received on the FASB ED, almost all preparers do not believe there is an advantage in having a distinct model for purchased loans with evidence of credit impairment. Users have expressed confusion in interpreting the different impairment models for credit-impaired loans and non-credit-impaired loans. Based on outreach and the feedback received through comment letters to the FASB ED, users have indicated that it is difficult to analyze the associated interest income recognized under the current model for purchased credit-impaired loans. In the U.S., the FASB has received significant feedback from constituents that the differing presentation of originated loans and purchased loans creates confusion and does not permit comparability between the two categories of loans.

Recognition of Credit Impairment Losses for Purchased Loans

8. In determining whether or not to pursue separate interest revenue and impairment models for purchased and originated loans, it is first necessary to establish whether the concept of expected credit losses differs for originated loans and purchased loans (either through an asset acquisition or a business combination). While the Boards' discussions during deliberations of the SD focused primarily on originated loans, the SD does not make a distinction between originated loans and purchased loans. Appendix A of the SD describes an open portfolio as one in which assets are added through its life by origination *or purchase*, and removed through its life by write offs, transfers to other portfolios, sales and repayments. That is, the Boards considered that the SD could apply equally to portfolios of originated loans and portfolios of purchased

loans, acknowledging that the full accounting model for purchased loans had not yet been deliberated.

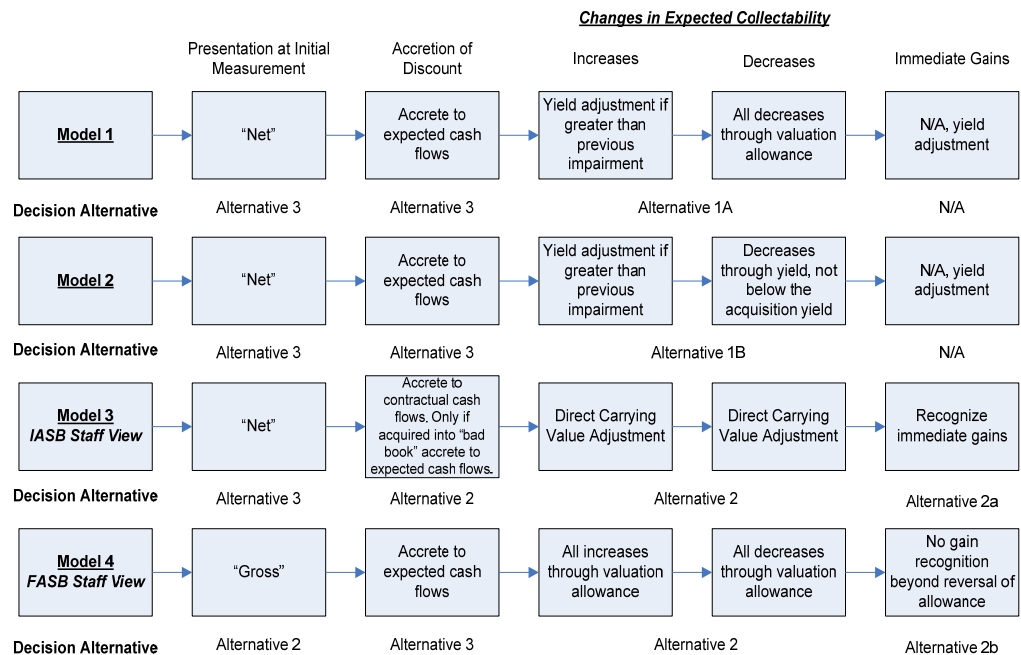
9. Therefore, the staff believes that irrespective of whether loans are originated or purchased (in an asset acquisition or business combination), the entity (i.e., the originator or purchaser) would determine expected credit losses consistently. The staff believes that this approach reflects the underlying economics of the transaction because assets are priced in both originations and purchases of loans so that the yield compensates for the estimated future expected credit losses at the transaction date. (However, some believe this effect would occur for an overall portfolio, but not necessarily on an individual loan basis.) For example, an Entity X could originate a new 5-year loan to Entity Y with a yield of x% or buy a one year old loan to Entity Y with identical terms and 5 years remaining to maturity, with a yield of x%. Upon initial recognition, Entity X's determination of the allowance should be consistent regardless of whether they originated the new loan to Entity Y or acquired the one-year-old loan.
10. With this discussion as a foundation, the memorandum presents additional issues related to the accounting for purchased loans that, when decisions on those issues are taken together, form a complete model for the accounting for those loans. While it is desirable to have a single model minimizing the differences between the accounting for originated and purchased loans, the staff believes that some distinction between various populations of loans is necessary. There are two views on which population of loans should have a different approach. Some staff members would have a different model for EIR and discount accretion only for loans acquired at a deep discount because of significant credit losses expected on the credit impaired loans. The IASB staff views these as loans that would be acquired directly into a bad book under the SD.
11. Other staff members would make a broad distinction between accounting for originated loans and purchased loans with respect to establishing the EIR upon acquisition and the amount of discount accretion. These staff members believe that this distinction makes sense as all purchased loans have to be evaluated based on cash flows expected to be collected rather than contractual cash flows in order to determine the transaction price for the acquisition.

Issues for Discussion

12. The remainder of this memorandum addresses the following issues:

- (a) Issue 1: Whether the transaction price for purchased loans should be presented on a gross basis reflecting the purchaser's allocation of the discount to a credit impairment reserve
- (b) Issue 2: When loans are purchased at a discount, establishing the effective interest rate and the amount of accretion to be recognized upon acquisition
- (c) Issue 3: The accounting for changes in initial expectations of cash flows expected to be collected for purchased loans subsequent to acquisition.

13. Various alternatives are presented for each of the above issues. In order to illustrate the interaction of the issues, the diagram below presents several combinations of decision alternatives to identify four models for interest income recognition and impairment of purchased loans and debt securities:



Models 3 & 4 – EIR is "locked" at the acquisition date.

Issue 1 - Presentation of purchased loans

Background

14. This issue addresses the acquisition-date accounting for purchased loans. The issue is whether an entity should establish an allowance for credit losses upon initial recognition of purchased loans (i.e., a “gross” presentation) that would reflect both the purchase price and the loss allowance inherent in that purchase price.
15. Currently, for a business combination transaction, ASC 805-10 and IFRS 3(R) provide that an acquiring entity record all assets at fair value. ASC 805-20-30-4 states, “The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure” (141R, A.57).
16. ASC 310-30 also indicates that recognition of a valuation allowance upon initial recognition of a purchased portfolio of loans (either through a business combination or asset acquisition) is inappropriate. The basis for conclusions of SOP 03-3 states, “...the price an investor is willing to pay for a loan and, accordingly, the resulting yield reflects the investor’s estimate of credit losses over the life of the loan. The use of a loss allowance to address the collectibility of cash flows the investor does not initially expect to receive (and, therefore, presumably did not pay for) would not faithfully represent the substance of the underlying event. The valuation allowance recorded by the investor should reflect only losses incurred by the investor, rather than losses incurred by the transferor or the investor’s estimate at acquisition of credit losses over the life of the loan” (SOP 03-3, B29).
17. Prior to FAS 141(R) and IFRS 3(R), FAS 141, paragraph 37(b) required an entity to record loans acquired in a business combination at present values of amounts to be received determined at the current interest rate, less an allowance for uncollectibility and collection costs, if necessary. IFRS 3 required financial assets to be initially recorded at fair value but explained

that for receivables not quoted in an active market initial measurement is the present values of amounts to be received determined at the current interest rate, less an allowance for uncollectibility and collection costs, if necessary. Under FAS 141, the acquiring entity would establish a valuation allowance against the loans upon initial measurement. With respect to the application of FAS 141 by SEC registrants, SEC Staff Accounting Bulletin (SAB) No. 61 required the acquiring entity to make adjustments to the valuation allowance upon acquisition if its plans for the ultimate recovery of those loans differed from the plans that served as the basis for the acquired bank's estimation of losses. However, SAB 61 acknowledged that the acquiring entity's valuation allowance should generally not change from the acquired entity's balance.

18. As part of its deliberations leading to the issuance of its Exposure Draft, the FASB discussed the issue of establishing an allowance for credit losses for purchased financial assets upon initial recognition. At the January 13, 2010 Board meeting, the FASB tentatively agreed to pursue presentation of purchased financial assets on a "gross basis" in the statement of financial position. That is, the Board preferred separate presentation of an allowance for an entity's expectations of credit losses inherent in the instrument at acquisition. The FASB acknowledged that this would be a change in business combination accounting and amendments of that guidance would be required to implement such a decision. Ultimately, the Board decided to propose the following disclosures rather than "gross" presentation on the face of the balance sheet for purchased financial assets:
 - (a) The principal amount of the financial assets
 - (b) The purchaser's assessment of the discount related to credit losses inherent in the financial assets at acquisition, if any, and qualitative information on how the purchaser determined the discount related to credit losses
 - (c) Any additional difference between amortized cost and the principal amount
 - (d) The amortized cost basis of the financial assets.

19. IFRS 9 requires all financial assets – whether originated or purchased – to be measured at fair value on initial recognition.
20. The following are alternatives for the presentation of purchased loans upon initial recognition:
 - (a) **Alternative 1:** Present the loan balance “gross,” with separate presentation of the principal amount, portion of the discount attributable to the allowance as determined by the impairment model in the SD, and a separate premium/discount representing the remaining difference between the acquisition price and the original principal amount.
 - (b) **Alternative 2:** Present the loan balance gross with separate presentation of the portion of the purchase discount attributable to the allowance as determined by the impairment model in the SD.
 - (c) **Alternative 3:** Present the loan balance at fair value less the allowance as determined based on the impairment model in the SD.

21. Below is a simple illustration of the above alternatives:

Entity A buys a portfolio of loans from Entity B for \$960. Entity B originated the loans for \$1000 (par). Entity A (the purchaser) assesses that the portion of the discount related to credit losses inherent in the financial assets at acquisition is \$30 (full expected lifetime losses). The expected losses in the foreseeable future period equal \$20. Entity A would record the loans on its books as follows at initial recognition of the portfolio:

<i>Alternative 1</i>		<i>Alternative 2</i>		<i>Alternative 3</i>	
Loans (principal amount)	1,000	Loans (principal amount)	980		
Allowance (Discount related to credit losses)	(20)	Allowance (Discount related to credit losses)	(20)		
Purchase price difference	(20)				
Loans (transaction price/fair value)	960	Loans (transaction price/fair value)	960	Loans (transaction price/fair value)	960
				Allowance (SD model)	(20)
				<i>Loans (carrying value)</i>	<i>940</i>

22. Each alternative involves an allowance being established at initial acquisition of the loans—albeit different under Alternative 3 for reasons to be explained later under a discussion of that Alternative.
23. Assuming the impairment accounting is in accordance with the SD, the staff believes that an allowance must be established upon initial recognition of the purchased portfolio of loans. This is because Boards' current objective is to develop an expected loss impairment model for all financial assets, which based on the model in the SD leads to establishing an allowance for credit losses upon initial recognition of a portfolio of purchased loans. Whereas under current GAAP, the allowance reflects incurred losses, such that it can be argued that the acquiring entity did not incur any losses at the point of acquisition and should record no allowance upon initial recognition, an expected loss model with a floor suggests that all loans should have an associated allowance for credit losses at all times. An entity's subsequent revisions to the expected credit losses on the purchased loans affect profit and loss and adjust the balance in the allowance.

Staff analysis and recommendation

24. Based on feedback received, the FASB staff believes Alternative 1 or 2 could eliminate some of the confusion in existing U.S. GAAP by aligning to some degree the presentation of originated and purchased loans and method for recognition of interest revenue and impairment for different populations of loans. U.S. users claimed, during deliberations of ASC 805-10, that recognition of an allowance upon initial measurement of loans was important for evaluating the credit assumptions built into loan valuations. They suggested that the fair value of receivables be split into three components: (1) the gross contractual amounts, (2) a separate discount or premium for changes in interest rates, and (3) a valuation allowance for credit risk, which would be based on the contractual cash flows expected to be uncollectible.
25. In evaluating that alternative presentation at the time of deliberating ASC 805-10 and IFRS 3(R), the FASB and IASB noted that the allowance presented would differ from the valuation allowance for receivables under Statement 5 and IAS 39, each of which is determined on the basis of incurred, rather than expected, losses. The Boards noted that if requirements for other receivables were applied, an immediate gain would be recognized for the difference between incurred losses and expected losses. In contrast, if the valuation allowance for receivables acquired by transfer, including in a business combination, rather than by origination was determined subsequently on an expected loss basis, the result would be a new accounting model for those receivables. Thus, at the time the boards concluded that the deliberations of ASC 805-10 and IFRS 3(R) were not the place to consider the broader issues of how best to determine the valuation allowance for those receivables (IFRS 3R, BC 257 and FAS 141(R), B257).
26. Staff members that support “gross” presentation (Alternative 1 or 2) believe that, particularly for an open pool of loans, recognizing a loss upon acquisition is consistent with the model developed in the SD for originated loans that are part of an open pool. Moreover, the staff believes, although the boards have not yet deliberated the application of the impairment model in the SD to individual loans, that if loans were permitted to be evaluated for impairment on an individual basis using a loss rate, such individual loans

would also require an allowance in situations in which loss experience for comparable loans is considered and factored into the impairment analysis, consistent with the FASB ED (which involved a pool overlay for assets evaluated for impairment on an individual basis) and the IASB ED (which noted that there should be no difference in the impact of applying the ED to single instruments or portfolios).

27. These staff members recommend a gross presentation because they believe that for purchased loans acquired at a discount, the transaction price reflects the amount of cash flows the entity expects to collect. As stated earlier, all staff members believe that in an expected loss model with a floor, all acquisitions of loans must have an associated allowance, because the portfolio reflects an inherent expected loss at all times from the moment of acquisition until close to maturity. The staff members supporting a gross presentation believe that the expected loss is part of the transaction price and that the transaction price should be “grossed up” to reflect that expected loss as well as the remaining discount. (Between Alternative 1 and 2, these staff members have a slight preference for Alternative 2 because the remaining purchase price discount does not provide much incremental information.)
28. These staff members are concerned that Alternative 3 reflects expected losses twice—once as part of the transaction price and once as a separate allowance that would be established upon initial acquisition of the loans. The purchase price reflects the amount of cash flows not expected to be collected by the entity at initial recognition, and the additional allowance (20 in the example) is the foreseeable future amount of expected credit losses under the SD. This is because the floor would establish the allowance.¹
29. Other staff recommend Alternative 3 for the following reasons:
 - (a) Alternative 3 is consistent with the application of the SD to originated loans. As these staff members do not view loss expectations differently for originated and purchased loans, they think the accounting should be consistent. For a portfolio of newly originated

¹ The IASB staff interprets the time proportionate calculation as having a weighted average age of zero for acquired pools.

loans with an amount lent of 960 at a market interest rate, the SD would result in the same presentation as Alternative 3.

- (b) There is no fundamental distinction between the notion of expected losses for originated versus acquired loans and therefore they do not support a gross presentation of the fair value of purchased loans on the basis of impairment accounting.
- (c) Gross presentation for acquired portfolios would create a major inconsistency in IFRSs where fair value measurement is required on initial recognition (such as for all financial instruments and also for various non-financial assets). The same logic would imply using gross presentation for all other assets and hence for example, presenting accumulated depreciation and amortisation for acquired property, plant and equipment as well as intangible assets and valuation reserves for acquired inventory. A different approach for financial assets would create an exception that contradicts fundamental accounting conventions.
- (d) An expected loss model does not support a move to gross presentation. An expected loss model does not always require that an allowance balance be recognised. The SD by incorporating a floor does inherently require an allowance at acquisition but a model that incorporates expected losses either through an adjustment to the EIR or on a time proportionate basis would not require that an allowance balance be immediately established for newly recognised loans. Also, the allowance balance reflected through the gross presentation is in effect a component of the fair value of the acquired loan. The SD would require an allowance balance to be established as an *adjustment* to fair value due to the operation of the floor. So the allowance balance reflected in Alternative 1 and 2 is not equivalent of applying the SD.
- (e) Economically, an acquirer of loans for a transaction price of 960 is different to a party who lent 1,000 originally. The accounting should

reflect that the acquirer is economically in a different position compared to a situation where it would have originated those assets.

- (f) The staff supporting Alternative 3 would prefer that user needs be met through disclosure requirements (to aid comparability between originated and acquired portfolios).

Question for the Boards

What presentation is appropriate for acquired portfolios of loans?

Issue 2 – Effective Interest Rate and Accretion of Discount on Purchased Loans

30. This issue addresses discount accretion (that is, accreting the difference between the purchase price and either estimated or contractual cash flows) on purchased loans. The issue is whether the effective interest rate should equate the acquisition price of the loan to contractual or expected cash flows.
31. When loans are purchased in an asset acquisition or as part of a business combination, the acquiring entity must develop its estimate of cash flows expected to be collected because it generally cannot be confident that the expected cash flows for each individual loan acquired is the contractually required cash flows. In some cases (for example, high credit-quality performing loans), even if the loans are purchased at a discount, the cash flows expected to be collected may be the majority of the remaining contractually required cash flows. In other cases (for example, credit-deteriorated loans) the loans are purchased at a discount partially or primarily attributable to credit concerns and the cash flows expected to be collected are a portion of the remaining contractually required cash flows. However, the staff notes that in most, if not all cases, loans purchased at a discount will inherently include a discount related to credit quality in the purchase price.

Current US GAAP and IFRSs

32. ASC 310-20 (formerly FASB Statement No. 91) provides guidance on the recognition of yields and applies to originated loans, acquisitions of loans and debt securities where contractual cash flows are expected to be collected (even if there is a purchase discount) and loans acquired shortly after origination where there has been no evidence of deterioration of credit quality since the date of origination. ASC 310-20 requires the accretion of discount on purchased loans and debt securities based on contractual cash flows. The EIR is the contractual rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the purchase or origination.
33. ASC 310-30 (formerly AICPA SOP 03-3) applies to loans with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. Under ASC 310-30 the amount of the discount that is accreted is based on the amount of expected undiscounted future cash flows. The EIR under this model is the rate that equates the purchase price and the cash flows expected to be collected by the acquiring entity. ASC 310-30 requires that actual loans with credit deteriorated qualities must be removed from an acquired portfolio and accounted for under its guidance. ASC 325-40 (formerly EITF 99-20) applies to loans and debt securities that are purchased or retained beneficial interests in a securitization transaction that are not of high credit quality or that have significant prepayment risk (this interest income recognition model is similar to ASC 310-30).
34. Currently, the FASB staff believes there is diversity in practice on this matter in the U.S. In a letter dated December 18, 2009 to the SEC staff, the AICPA documented the position of the SEC staff on the issue of whether subsequent to a purchase of loans in a business acquisition or asset purchase, an entity should accrete the discount based on contractual cash flows (ASC 310-20 or FAS 91 approach) or expected cash flows (ASC 310-30 or SOP 03-3 approach). This issue relates to portfolios of acquired assets, where an entity was not individually evaluating the assets to determine if they met the scope requirements of ASC 310-30, such that some loans in the portfolio may individually meet the scope criteria and others may not.

35. Based on this letter, the SEC staff's position on this issue is that, given the absence of further standard setting on this issue, an entity is permitted to make an accounting policy election to either accrete the discount based on contractual cash flows (ASC 310-20 or FAS 91 approach) or expected cash flows (ASC 310-30 or SOP 03-3 approach). Accordingly, the SEC does not object to applying the guidance in ASC 310-30 to non-credit deteriorated loans, as long as the entity discloses its policy to accrete to expected cash flows (instead of contractual cash flows). The SEC requires that entities apply that accounting policy election consistently.
36. IAS 39 acknowledges that, in some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. IAS 39 requires that entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate on initial recognition (IAS 39.AG5). IAS 39 does not provide a threshold for when the acquisition price is at a deep discount related to credit, or at a price in which expected credit losses are not significant enough to warrant accretion to expected collectible cash flows. In all other cases, IAS 39 requires an entity to base the effective interest rate on contractual cash flows.

Staff Analysis and Recommendation

37. The staff has identified four alternatives:
- (a) **Alternative 1:** Require all purchased loans to accrete a discount based on the contractual cash flows.
 - (b) **Alternative 2:** Require all purchased loans except for those acquired at a deep discount to accrete a discount based on the contractual cash flows. Loans acquired at a deep discount directly into the bad book would accrete a discount based on cash flows expected to be collected.
 - (c) **Alternative 3:** Require all purchased loans to accrete a discount based on cash flows expected to be collected.
 - (d) **Alternative 4:** Permit entities to make an accounting policy election in respect to Alternative 1 or 2.

38. Alternative 1 is the only model that does not result in separate models for originated and purchased loans. Some staff members support this alternative in concept because they do not generally see a basis to distinguish between originated versus purchased loans. They believe that in a conceptually pure model, for all loans, whether originated or purchased, the EIR should be calculated taking into account all expected cash flows, i.e. including expected losses (the integrated effective interest rate). This was what was proposed in the IASB's original ED. However, consistent with the SD, the staff members supporting Alternative 1 believe that the EIR does not need to incorporate the expected credit losses when using a time proportional approach for allocating expected credit losses over the life of the loans. This is because the time proportional approach approximates the allocation of the initial estimate of expected credit losses that is achieved through an integrated effective interest rate (and provides operational relief). As a result, the time proportional approach counters a higher effective interest rate based on contractual estimated cash flows.
39. However, these staff members support Alternative 2 because they believe that it would be appropriate to make a distinction for 'problem loans' to prevent inflated EIRs being calculated. For purchased *problem loans* (i.e., loans acquired at a deep discount reflecting incurred credit losses) entities already calculate an integrated effective interest rate under IFRSs today. The IASB staff is not aware of operational issues in applying these requirements. Thus, an approximation using the time proportional approach for purchased problem loans does not seem necessary and thus those staff members supporting Alternative 2 propose to keep the integrated effective interest rate for 'problem loans.' This treatment currently relies on identifying incurred losses on purchased loans. Some staff members believe it would seem unwieldy to retain an incurred loss notion simply to address this issue. The staff supporting this approach would propose that for loans that are acquired that go straight into the bad book, the EIR should be determined taking into consideration expected losses at the time of initial recognition.
40. These staff members do not support Alternative 3 because they think that it is inappropriate to have different impairment models generally for acquired and

originated loans. These staff members believe that for originated loans expected losses are considered in setting the interest rate charged to borrowers. For purchased loans expected losses are considered in determining the purchase price. These are different mechanisms but both achieve an effective interest rate aligned with the credit quality of the asset.

41. Other staff members support Alternative 3 because it eliminates separate models for credit impaired and non-credit impaired purchased loans. These staff members believe that the EIR for all purchased loans should be based on expectations about cash flows at the date of acquisition. Alternative 3 requires that the effective interest rate consider the expected collectibility given the events and circumstances at the acquisition date.
42. The staff supporting Alternative 3 do not support Alternative 1 or 2 because it could result in situations where an entity accretes to an amount it does not expect to collect. These staff members believe that it is not possible to accrete to the contractual cash flows when the acquiring entity clearly expects to collect some amount less than the remaining contractually required cash flows. Therefore, accretion to contractual cash flows is only possible for purchased portfolios of loans where an acquiring entity largely expects to collect all of the contractually required cash flows. The staff believes that permitting accretion of discount to contractual cash flows in any other case would result in artificially inflated yields and provisions, in a model where impairment losses do not counter this effect.
43. Some may argue that purchased loans are no different from originated loans in that the losses are typically expected to occur throughout the life of a loan. Consequently, accreting the purchase price to estimated collectible cash flows can be counterintuitive to not recognizing expected credit losses in originated loans. However, the staff members that support Alternative 3 believe that there is indeed a difference. When loans are originated, the initial cash outflow is the contractual principal amount and the amount of cash flows expected to be collected on the individual loan during its term is the contractually required cash flows. When loans are purchased, the initial cash outflow is generally not equal to the remaining contractual amounts and the amount expected to be collected is generally not the remaining

contractually required cash flows. Purchased loans, whether at a minimal or deep discount, have losses that are embedded within the portfolio and are assessed by the purchaser based on cash flows expected to be collected in the future. Unlike originated loans, purchased loans have an age that is not actually zero upon purchase. As opposed to originated loans whose fair value would typically equal to the funded amount, the fair value of these loans is not equal to the amount originally funded.

44. Also, staff members supporting Alternative 3 believe that a consistent interest income recognition model should be applied for all purchased loans, regardless of credit quality. Staff members supporting Alternative 3 believe that for all portfolios purchased at a discount, some component of the purchase discount is related to credit. Consequently, these staff question why the degree of credit deterioration should factor into the recognition of interest income for purchased loans.
45. Alternative 3 also avoids the complexity of having to define those loans that are considered problem loans as well as identifying those loans on an individual basis. These staff members believe that these aspects of Alternative 2 retain the operational complexities of ASC 310-30 in the U.S., which requires identification of loans that require accretion to expected cash flows versus contractual cash flows. Instead, the staff believes entities should be required to evaluate the quality of the portfolio as a whole and determine the appropriate cash flow expectations based on its evaluation.
46. No staff members support Alternative 4. In a conceptually sound and consistent model there is no benefit in permitting an accounting policy election. In addition, it would perpetuate the diversity in practice that currently exists in the U.S.
47. The staff highlights that there are some mechanical complexities that arise from the interaction of the discount accretion issue discussed in Issue 2 and the initial recognition issue discussed in Issue 1. Establishing the allowance for credit losses at initial recognition (under Alternative 1 or 2 of Issue 1) can be based on an amount that is the full amount of cash flows not expected to be collected (“lifetime expected loss”) or an amount based on the

supplementary document (“foreseeable future amount”). Establishing the allowance at acquisition based on an amount that is not the full expected remaining lifetime credit losses means that the “additional difference” between the purchase price and principal amount is not actually the discount that will be accreted. Instead, the discount that would be accreted would be some amount less than that difference. This is because the actual amounts expected to be collected will be less than the amount of the principal amount of the loans less the established allowance (since the allowance is not the full expected lifetime loss reserve). To illustrate this, the table from paragraph 16 is reproduced below:

<i>Alternative 1</i>		<i>Alternative 2</i>		<i>Alternative 3</i>	
Loans (principal amount)	1,000	Loans (principal amount)	980		
Allow ance (Discount related to credit losses)	(20)	Allow ance (Discount related to credit losses)	(20)		
Purchase price difference	(20)				
Loans (transaction price/fair value)	960	Loans (transaction price/fair value)	960	Loans (transaction price/fair value)	960
				Allow ance (SD model)	(20)
				<i>Loans (carrying value)</i>	<i>940</i>

48. As discussed earlier, the allowance for credit losses under Alternative 1 or 2 of Issue 1 in a “good book” under the SD would not be the full remaining lifetime expected loss. Therefore, a full lifetime loss allowance (reflecting actual amounts the entity does not expect to collect at acquisition) would be greater than 20, so that the actual discount to be accreted would be less than 20 (the acquisition date amount in the “purchase price discount” account). For example, if the lifetime loss allowance were 30, the actual amount of the discount to be accreted would be 10.
49. As part of joint redeliberations on impairment, the FASB and IASB agreed in concept to not integrate interest revenue and credit losses so as to allow interest recognition to be reported independently of credit losses. However, the boards did not specifically discuss purchased loans or, more specifically, purchased credit-impaired loans. In this context the boards therefore also did not discuss to which amount the effective interest rate is applied to determine the amount of interest revenue recognised each period. It is important to clarify that the above analysis only relates to the computation of the EIR, not

how an entity applies the EIR to an amount for interest revenue accrual. The staff plans to perform further analysis and bring this issue back to the Boards at a future date.

Questions for the Boards

Should an entity accrete discounts on portfolios of purchased loans to expected future cash flows or contractual cash flows?

If the Board supports Alternative 1 (accrete to contractual cash flows), should a distinction be made for loans that are acquired into the bad book?

Issue 3 - Changes in Collectibility Subsequent to Purchase

50. If the Boards agree that an entity should base the effective interest rate and discount accretion on expectations of future cash flows for all purchased loans or for problem loans only, the Boards must consider how an entity recognizes subsequent changes in expectations. The issue is to what extent changes in collectibility should be recognized through an effective interest rate adjustment, the allowance for credit losses, or some combination thereof.

Alternative Models

51. The staff has identified the following alternatives:
- (a) **Alternative 1:** Recognize certain changes in expectations as an adjustment of yield and certain changes as an impairment and adjustment of the allowance for credit losses.
 - (i) **Alternative 1A:** All increases in the amount of cash flows expected to be collected, beyond the reversal of existing impairment reserves, since acquisition or the prior period would be recognized through an increased yield. Decreases in the amount of cash flows expected to be collected would be recognized as an impairment expense.
 - (ii) **Alternative 1B:** All increases in the amount of cash flows expected to be collected, beyond the reversal of existing

impairment reserves, would increase yield, while decreases in the amount of cash flows expected to be collected would decrease the yield to the initial effective rate, with further decreases recognized as an impairment expense.

- (b) **Alternative 2:** Recognize no changes in expectations as an adjustment of yield. All changes in expectations would be recognized as adjustments of the allowance for credit losses. Under this alternative, the initial effective interest rate is “locked in” to accrete to the amount of cash flows expected to be collected upon acquisition.
52. If the Boards select Alternative 2, the Boards must consider whether an entity would be permitted to recognize an immediate gain if there is an increase in the amount of cash flows expected to be collected prior to recognizing a credit impairment charge in net income subsequent to acquisition. For example, if the Boards decide to require presentation of an allowance for credit losses for acquired portfolios but the entity did not recognize any impairment charge to establish that allowance, the issue is whether the entity would be permitted to recognize a reversal of that allowance (and an immediate gain) if there was an increase in cash flows expected to be collected after acquisition.
53. If Alternative 2 is selected, the staff has identified two alternatives for this subissue:
- (i) **Alternative 2a:** All changes in expectations are recognized through an allowance for credit losses (or carrying value adjustment) regardless of whether it is established at acquisition or subsequent to acquisition. Increases in cash flows expected to be collected may be recognized as gains even if there has not been previously recognized impairment charges by the acquiring entity.
 - (ii) **Alternative 2b:** Changes in expectations related to increases in cash flows expected to be collected may be recognized by reversing the allowance for credit losses until it reaches a zero balance, but not beyond that point. After that point, an entity

would not recognize increases in cash flows expected to be collected as gains prior to recognizing an impairment expense *subsequent to acquisition*.

- (iii) **Alternative 2c:** An entity would not recognize increases in cash flows expected to be collected as gains prior to recognizing an impairment expense *and* establishing an allowance for credit losses for the acquired portfolio *subsequent to acquisition*. Increases in cash flows expected to be collected may be recognized only as reversals of previously recognized impairment charges (and reversals of the allowance).

Staff Analysis and Recommendations

54. Alternative 1 reflects the concepts in the model in current U.S. GAAP for purchased credit-impaired loans. While there are several variations of this alternative, the common feature is that increases in cash flows expected to be collected are not recognized as immediate gains in net income but rather over time as a yield adjustment. Therefore, this model is both an income recognition model and an impairment model. Recognizing any significant increase in cash flows expected to be collected as an adjustment of the effective interest rate (yield) over time and recognizing any decrease in cash flows expected to be collected immediately as credit impairment has been viewed as a conservative approach.
55. Alternative 1A is generally consistent with the model in current U.S. GAAP for purchased credit-impaired loans in ASC 310-30 (formerly SOP 03-3). The guidance in ASC 310-30 acknowledges the uncertainty in basing interest income recognition on expected undiscounted future cash flows, and allows for adjustments to the effective interest rate to reflect an entity's favorable changes in expectations. Under ASC 310-30, the entity purchasing the portfolio of loans or debt securities recognizes the excess of all cash flows expected at acquisition over the investor's initial investment in the loan as interest income on a level-yield basis over the life of the loan (this is referred to as accretable yield). For portfolios of purchased debt securities, if, based

on current information and events, there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor recalculates the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of the initial investment less cash collected less other-than-temporary impairments plus amount of yield accreted to date. For portfolios of purchased loans, if, based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor first reduces any allowance for credit losses established after acquisition and then recalculates the amount of accretable yield as the excess of the revised cash flows expected to be collected over the sum of the initial investment less cash collected less write-downs plus amount of yield accreted to date.

56. However, for both portfolios of loans and debt securities, the guidance does not allow a yield adjustment for any decrease in cash flows expected to be collected. An entity recognizes all decreases through an impairment expense and allowance for loan loss.
57. Alternative 1B is most consistent with the proposed approach in the FASB ED for financial assets purchased at a discount where the discount is partially attributable to credit. In the case of loans purchased at an amount including a discount due to credit, an entity reflects increases in expectations of cash flows expected to be collected through a yield adjustment to the extent it exceeds previous impairments. Therefore, an entity must first reverse the allowance for credit losses before adjusting the yield above the original effective rate. The proposed guidance would have required an entity to reflect decreases in cash flows expected to be collected through a downward revision of yield, only to the extent of prior increases in yield. The proposed guidance would have required that an entity reflect decreases in cash flows expected to be collected beyond the yield at the acquisition date through an impairment expense and allowance for loan loss.

58. Another possibility that is not specifically set forth as an alternative is to permit the revised yield to drop below the yield at the acquisition date. This would be similar to AICPA Practice Bulletin (PB) No. 6, which was superseded by SOP 03-3. PB No. 6 allowed for the increase in yield to adjust for increased expectation of collectability on credit deteriorated loans; however, it required an entity to record impairment expense and an allowance for credit losses only after the effective yield fell below zero (i.e. the asset yields an amount below the acquisition price). One of the stated reasons for replacing the PB No. 6 model for changes in expected future cash flows was that it is not consistent with the concept articulated in FASB Statement No. 114 that a loan acquired at a discount related to credit quality has an effective interest rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan. In other words, this guidance ignored that any credit deterioration at acquisition was factored into the price. Therefore, the staff believes that allowing the yield to fall below the original effective yield without recognizing impairment does not have conceptual merit.
59. In providing feedback on the FASB Exposure Draft, many constituents conveyed that they do not support retaining elements of ASC 310-30, citing operational concerns and that the information provided to users is confusing. Investors cited significant concerns and lack of transparency when the model in ASC 310-30 is applied for purchased credit impaired loans. They perform significant analyses and require 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.
60. Some auditors responding to the FASB communicated that they would prefer any revision in expectations to be reflected as a yield adjustment, citing that this is more consistent with current U.S. 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 responding to the FASB view this as necessary because previous impairment was not recognized on purchased assets. However, 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.

61. Regarding Alternative 1B, many preparers noted that the FASB's proposed guidance retains elements of ASC 310-30 for purchased financial assets. These preparers cited the significant operational issues that have been experienced with implementation of ASC 310-30 and do not see an advantage to carrying forward any elements of that guidance. In its deliberations of the original EDs, the Boards decided to move away from models that would require retaining information from initial recognition because it is operationally too complex. In addition, preparers believe that the proposed guidance would continue to hinder transparency to users. Users have consistently communicated that they strongly prefer net interest margin (NIM) and credit losses reported separately.
62. Alternative 2 would seem to address many of the concerns expressed by constituents regarding the complexity of current U.S. GAAP for purchased credit-impaired loans and the lack of comparability in recognition, measurement, and presentation among originated loans, purchased non-credit-impaired loans, and purchased credit-impaired loans. Recognizing changes in expectations of amounts of cash flows expected to be collected through the allowance rather than as both yield adjustments and allowance adjustments creates greater symmetry for the recognition of increases and decreases in expected cash flows.
63. Alternative 2 is more consistent with the guidance in current U.S. GAAP for purchases of higher credit-quality financial assets. The guidance in ASC 310-20-30-15 explains that the initial effective rate should accrete the difference between the initial investment and the unpaid principal amount of the loan at the date of purchase. That is, the amount of discount accretion is to the contractually owed amounts. ASC 310-20 "locks-in" the effective interest rate at the date of purchase and any decreases in expectations regarding collectability are recognized through an allowance for credit losses.

64. The staff believes that current IFRSs are most similar in concept to Alternative 2 (based on subissue Alternative 2a). Current IFRSs differentiate between acquisitions of credit-impaired portfolios of financial assets and non-credit-impaired portfolios of financial assets by requiring for credit impaired loans that the original effective interest rate considers incurred credit losses. Generally, IAS 39 provides for recognition of changes in expected cash flows (both increases and decreases) through a direct carrying value adjustment for all loans including purchased loans. The IASB's original ED on impairment also would have required changes in expected cash flows for all financial assets measured at amortised cost, including purchased financial assets, to be recognized as direct carrying value adjustments. Therefore, both current and proposed IFRSs would result in locking in an effective interest rate upon the initial recognition of all financial assets measured at amortised costs, including purchased financial assets, (based on cash flows expected to be collected) and would require recognition of gains and losses in P&L for changes in expectations regarding collectability of cash flows.
65. All staff supports Alternative 2 because the model is convergent and addresses user and preparer concerns regarding the complexities of adjustments to the effective interest rate. This model also provides symmetrical treatment for both increases and decreases in expected future cash flows.

Subissue: Increases in Expected Cash Flows

66. Unlike the accounting for originated loans where the entity fully accretes the discount between the purchase price and the principal amount (and therefore, can only have decreases in estimates of cash flows expected to be collected accounted for as credit impairments), acquisitions of portfolios of impaired loans would involve accreting only the discount between the purchase price and the amount of cash flows expected to be collected. Therefore, this raises an additional issue for purchased impaired loans, because the acquiring entity can subsequently revise that estimate of cash flows it expects to collect upon acquisition either upward or downward. Therefore, the Boards must resolve

whether (and if so, when) an entity can recognize a gain related to an improved expectation of cash flows expected to be collected.

67. Alternative 2a would allow increases in cash flows expected to be collected to be recognized as gains *even if* there has not been previously recognized impairment charges by the acquiring entity. That is, if an entity has improved expectations regarding collectability, and the entity has not yet recognized any credit loss, the entity may recognize a gain in net income. If the gain resulted in fully reversing the allowance for credit losses for this portfolio of loans and exceeding the amount of the allowance, the debit would not be part of the allowance for credit losses but a different balance (increase to the carrying value of the loans). This is already a consequence of the requirements in both current and proposed IFRS (e.g., also as a result of revised prepayment estimates, which can give rise to an immediate loss or gain under IFRSs).
68. Alternative 2b would allow for fully reversing the allowance, and therefore does result in recognizing gains due to a favorable change in expectations. However, if changes in expectations were greater than the allowance balance, Alternative 2b would not permit the allowance to carry a debit balance or increase the carrying value of the loans directly.
69. In developing the FASB Exposure Draft, the FASB expressed concern regarding the potential for an immediate recognition of a gain in net income due to a subsequent increase in cash flow expectations. (ED, BC 199) Alternative 2c would allow entities to recognize a gain for increases in cash flows expected *only to the extent* that it had previously recognized an impairment charge. That is, only reversals of previously recognized impairment expense would be permissible. Thereby Alternative 2c reflects anti-abuse considerations, limiting earnings management. However, Alternative 2c may present operational complexities in separately tracking the credit impairment charges and reversals recognized by the acquiring entity in previous periods from the date of acquisition which creates the same problem that the IASB tried to resolve with the SD. More importantly, Alternative 2c is not symmetrical because gains may only be recognized in certain circumstances but all losses would be recognized. Thus, it is not

neutral and therefore arguably inconsistent with a faithful representation in accordance with the Framework (QC14).

70. Alternative 2c recognizes the FASB's concerns regarding immediate gain recognition based on an entity's increase in expected cash flows. While significant increases in expected cash flows may represent economic gains to the entity, some may be concerned that Alternatives 2a and 2b present opportunities for earnings management. Because Alternative 2c requires that an entity "recover" a previous impairment, entities would need to identify changes in previous events or circumstances that led to the increases in cash flow expectations. Alternative 2c may reduce pressure on auditors to gain comfort with increases in expected cash flows, especially those that might occur shortly after acquisition of a portfolio.
71. On balance, some staff members support Alternative 2b. Other staff recommend Alternative 2a for the following reasons:
- (a) Alternatives 2b and 2c would require entities to use information about loss estimates from the date of initial recognition which would create the same operational complexity that the Boards tried to resolve during the redeliberations of the IASB's original ED. Those alternatives would contradict the Boards's decision to move away from a model that would require retaining information from initial recognition.
 - (b) Those staff members consider it inappropriate to sacrifice the neutrality of the accounting model for anti-abuse rules. Omitting gains arguably means not faithfully representing the underlying economic phenomenon. Hence, Alternatives b and c would prevent many entities from using the most appropriate and useful accounting in order to manage earnings. That weighting of advantages versus disadvantages appears unjustifiable.
 - (c) It is unclear why the same concerns related to gains would not apply if the same item were measured at fair value through profit or loss with a level three fair value.
 - (d) Also, if earnings management were the issue,

- (i) It is unclear how to prevent entities from simply recognising the gain by moving the improving financial assets into a portfolio that has losses so that on a net basis the entity hides the gains by reducing the losses on a portfolio basis.
- (ii) The same opportunity for earnings management exists for the loss recognition. Entities could manipulate accounting by either choosing a too high starting allowance to create a cushion or a too low starting allowance and try to push out the revision in estimates.

Questions for the Boards

Should an entity recognize all subsequent changes in expected cash flows through a valuation allowance or should yields be adjusted in certain circumstances?

Should an entity recognize favorable changes in cash flows expected to be collected as gains in net income?