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Project	Impairment of financial assets		
Paper topic	Purchased financial assets, including lower credit quality		
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Purpose of the paper

1. The Cover Memo, IASB Agenda Paper 3/FASB Memorandum 112, provides a brief background to the topic addressed in this paper.
2. This paper addresses the treatment of purchased financial assets, including those acquired in a business combination.
3. This paper does NOT address the treatment of originated financial assets at lower credit quality levels. That discussion is included in IASB Agenda Paper 3A/FASB Memorandum 113.
4. This paper also does NOT address which credit qualities are included in the different buckets and at what point to transfer assets between Buckets 1, 2, and 3. That will continue to be discussed at a later meeting. However, the staff note that there is a direct link between where the lines between the buckets are drawn and the population of financial assets that will be included in each bucket and hence will be subject to the relevant recognition and measurement requirements.

Background

5. In March and April of 2011, the boards discussed the impairment accounting and interest income recognition for purchased financial assets¹. During those discussions, the boards tentatively decided that for purchased financial assets that do not have an explicit expectation of losses when analysed at the individual asset level (that is, assets recognised in the 'good book'² upon acquisition), even when acquired as part of a portfolio, an entity should account for impairment in the same way as for originated financial assets. Interest income for these assets would be recognised and the effective interest rate determined on the basis of contractual cash flows. The boards also decided that the effective interest rate would be applied to an amortised cost balance that is not reduced for credit impairment.
6. Those decisions effectively aligned impairment accounting and interest income recognition for originated and purchased financial assets that do not have an explicit expectation of losses at the individual asset level at acquisition. The boards noted during those discussions that economically there was no difference between a purchased and an originated financial asset, and therefore the accounting treatment should be the same for purchased and originated financial assets. However, the boards believed a different model should be required for purchased financial assets where an explicit expectation of loss exists at the individual assets level so as to avoid an overstatement of interest revenue in circumstances where, based on the entity's assessment upon acquisition, all contractual cash flows are not expected to be collected.
7. The boards tentatively decided that for purchased financial assets where such an explicit expectation of loss exists at the individual asset level (that is, where the financial asset goes into the 'bad book'³ at acquisition), interest income

¹ See IASB Agenda Papers 4-4C/FASB Memorandums 79-80 from the week commencing 21 March 2011 board meeting; IASB Agenda Paper 2/FASB Memorandum 79B and appendix from the week commencing 28 March 2011 board meeting; and IASB Agenda Papers 4-4C/FASB Memorandums 83(A)-85 from the week commencing 11 April 2011 board meeting.

² As defined in the supplementary document *Financial Instruments: Impairment* (SD).

³ As defined in the supplementary document *Financial Instruments: Impairment* (SD).

recognition should be based on expected collectible cash flows estimated at the date of acquisition (that is, to accrete purchase price to expected cash flows). This would be done by determining the effective interest rate based on the purchase price and the cash flows expected to be collected as at acquisition, as currently required by IAS 39 (for assets acquired at a deep discount with incurred credit losses) and ASC 310-30 (former SOP 03-3) (for acquired loans with evidence of deterioration of credit quality since origination for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable). As a result of the adjusted recognition of interest income for these loans purchased into the bad book, a separate impairment expense and allowance balance would not be recognised at the date of acquisition. For that population of loans, that decision meant that there would be no day 1 losses for 'bad book' loans under the impairment approach being developed by the boards at that time.

8. In reaching these tentative decisions, one key issue discussed by the boards was whether a consistent model for originated and purchased loans should be required or whether those models should be different in some circumstances. The desire for consistent models would be driven by the view that economically, purchased loans are no different from originated loans. In both cases, losses are typically expected to occur throughout the life of a loan. For both originated loans and purchased loans, expected losses are considered in pricing—through setting the interest rate charged to borrowers in originations or determining the purchase price when acquiring loans and hence in both cases transaction price typically represents the fair value. For loans with equivalent loss expectations pricing would be expected to be consistent for a purchased and an originated loan. This reasoning formed the foundation for the boards' tentative view in March 2011.
9. An alternative viewpoint is that originated loans and purchased loans should be subject to different models. This is driven by the belief that there is a difference between these loans that warrants different accounting treatment. That difference has to do with the ability to observe the past loss experience of the existing loans being purchased. When loans are originated, the amount of cash flows expected to be collected on the *individual* loan during its term is the contractually required

cash flows (opponents of this viewpoint would argue however that there is a statistical expectation of loss even on an individual loan basis). When loans are purchased, the credit has deteriorated since origination, the amount expected to be collected is generally not the remaining contractually required cash flows. This is because loans purchased at a discount, whether minimal or deep, have some level of loss embedded within the portfolio and specific to the acquired portfolio and are assessed by the purchaser based on cash flows expected to be collected in the future. Some view this as being different to originated loans where loss expectations are typically built on the past origination of similar loans updated for current expectations.

10. In effect, the decisions of the boards in March-April 2011 followed the line of thinking that purchased loans and originated loans should follow the same model to the extent possible, but at the same time acknowledged that recognizing interest revenue based on contractual cash flows for all purchased loans could result in situations where an entity accretes to an amount it does not expect to collect. This is true in the entire model in that the effective interest rate is generally established based on contractual rather than expected (credit adjusted) cashflows. However, accretion of purchase discount to contractual cash flows, particularly in cases when loans are purchased at a discount due to credit losses would result in artificially inflated yields and provisions. This is largely the reason for the specialised models that have developed in both US GAAP and IFRS for purchased-credit impaired loans or loans acquired at a deep discount.⁴ For this reason, accretion to contractual cash flows for purchased portfolios of loans only reflects the appropriate yield in situation in which an acquiring entity largely expects to collect all of the contractual cash flows. Besides the March-April 2011 decisions related to loans purchased into the ‘bad book’, reflected the view held

⁴ Practice has developed (and has been approved) in the US whereby an entity can either accrete to expected cash flows (ie apply the guidance in ASC 310-30, formerly SOP 03-3) or accrete to contractual cash flows (ie apply the guidance in ASC 310-20, formerly FAS 91) for *all* assets purchased without determining which loans acquired are credit-deteriorated. It was determined that such practice would be allowed until guidance on interest income recognition and impairment guidance was finalised in the FASB’s Accounting for Financial Instruments project.

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by some that recognition of day 1 impairment loss is incompatible with recognition of financial assets at fair value.

11. Contrary to the tentative decision on loans purchased into the bad book as discussed above, some may view it as desirable to eliminate separate models for credit impaired and non-credit impaired purchased loans and to apply a consistent interest income recognition model for all purchased loans, regardless of credit quality. This is because for portfolios purchased at a discount, some component of the purchase discount is typically related to credit considerations but the *degree* of credit deterioration will vary. Proponents of the consistent model for all purchased loans believe that it is not necessary to differentiate based on the degree of credit deterioration in determining how to recognise interest income for purchased loans. Others believe that due to the economic similarity between originated and purchased loans a consistent impairment and interest income recognition model should apply to all loans (both purchased and originated), regardless of credit quality.
12. Based on feedback received on the May 2010 FASB ED, almost all preparers believe there is no 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 recognised under the current model for purchased credit-impaired loans (ie, ASC 310-30, formerly SOP 03-3).
13. Feedback received on the joint supplementary document *Financial Instruments: Impairment* (SD) indicated that some respondents were concerned about application of the impairment model proposed by the SD to purchased financial assets. While the SD did not ask questions on purchased financial assets, some respondents specifically requested that the boards address the application of the proposed model to purchased financial assets, including those acquired in a business combination. Almost all of the respondents who commented on purchased financial assets were concerned about the recognition of a day 1 loss for these instruments.

14. This paper discusses the accounting for purchased loans in the context of the Credit Quality Approach that the boards are currently considering. The tentative decisions on purchased loans reached by the boards in March-April 2011 were made in the context of a two-bucket model (good book/bad book) and it was acknowledged at that time that those decisions may need refinement as the definitions of the good book/bad book were better developed. Subsequently the good book/bad book approach was abandoned in favour of the current three-bucket approach. At the last meeting the boards asked that the staff consider the application of the three-bucket approach to purchased loans due to concerns about the lifetime loss effect arising for loans purchased into Bucket 2. Some staff believe that the accounting for purchased loans needs to be reconsidered more broadly taking into account the previous decisions reached, in the context of the model currently being developed.
15. In the context of the model discussed in the SD, only loans purchased into the ‘good book’ and originated loans would have recognised interest revenue based on contractual cash flows. However, loans purchased into the ‘bad book’ would have recognised interest revenue based on cash flows expected to be collected. Presently, the boards will need to consider how these decisions tie into a three-bucket model. Some believe that the previous decision made by the boards with respect to purchased financial assets with no explicit expectation of loss at the individual asset level (ie those recognised in the ‘good book’) could be equated to purchases of financial assets into Bucket 1 and that the previous decision with respect to purchased problem loans could be equated to purchases into Bucket 3. However neither of these decisions immediately relates to purchases of financial assets into Bucket 2. However, because the ‘good book’ and ‘bad book’ were not clearly defined in the SD (as per the feedback received on the SD) and the lines between Buckets 1, 2, and 3 have not yet been drawn, it is unclear how the population of loans in the good book and bad book under those prior decisions would correspond to the current buckets.

Alternative approaches

16. The staff has identified the following broad alternative approaches to accounting for purchased financial assets in the context of the Credit Quality Approach:

- a. **Alternative 1 – Originated loans approach** – Originated and purchased loans should have *no distinction* for interest revenue recognition and recognition of impairment. This would result in recognition of impairment expense upon purchase commensurate with the relevant bucket, and interest would be recognised at the effective interest rate based on contractual cash flows.
- b. **Alternative 2 – Componentised approach** – Purchased loans should follow a different interest income recognition and impairment model. No impairment expense would be recognised on day one. The effective interest rate would be derived between the purchase price and contractual cash flows. Purchase price is thought to comprise an initial expected loss component which should be amortised over the life of the financial asset.
- c. **Alternative 3 – Gross up presentation** – Purchased loans should be presented on a “grossed up” basis with presentation of the allowance on the balance sheet. This would result in no recognition of impairment expense upon purchase and interest would be recognised at the effective interest rate based on cash flows expected to be collected as at initial recognition.
- d. **Alternative 4 – Credit-adjusted EIR approach** – Purchased loans would be recognised at fair value (ie on a net rather than gross basis). This would result in no recognition of impairment expense upon purchase and recognition of interest at the effective interest rate based on cash flows expected to be collected as at initial recognition. (Same as the previous ‘bad book’ decision but applied to all purchased loans.)

17. The table in paragraph 62 illustrates various permutations of these alternatives in the three-bucket model.

Alternative 1 – Originated loans approach

Description

18. This alternative aligns the impairment accounting and interest income recognition model for purchased and originated loans. This alternative would mean that initial expectations of credit losses on purchased loans should be treated in the same way as the initial expectations of credit losses on originated loans and changes in expectations should also be treated consistently. This results in purchased loans being recognised at fair value, with an allowance for credit losses established upon purchase consistent with the proposed treatment for originated loans. Accordingly, purchased loans would be recognised on a “net” basis; that is recognised at fair value less an allowance as determined based on the classification of the loans between the three buckets. Establishing an allowance for expected credit losses upon purchase results in a day 1 loss effect in the income statement. The same effect occurs for originated loans on which allowance balances must be established on initial recognition.
19. The effective interest rate for purchased loans under this alternative would be determined in the same way as for originated loans. By equating the contractual cash flows on the loan to the purchase price⁵. That is, interest would be recognised based on contractual cash flows rather than expected cash flows.

Advantages

20. **Consistency** – This alternative acknowledges the argument that purchased loans and originated loans, whether of high, medium or low credit quality, are conceptually the same. In other words, whether it is reflected at origination in yield or in an acquisition in a reduced price, both transactions are consummated at fair value that takes into account expected credit loss. The impact and presentation of purchased and originated loans in the balance sheet and income statement would be consistent.

⁵ Assuming that the purchase price is fair value.

21. **Simplicity** – This alternative does not involve operational complexities and would be easy to apply and to understand.

Challenges

22. **Day 1 loss** – This alternative does not address the concern about recognising day 1 impairment losses for financial assets purchased at fair value. The day 1 loss effect would be the same as the effect on origination of loans of like quality. However, the day 1 loss effect is of most concern for purchased loans that may have a credit quality worse than that which is typical on origination. This is most notable in a business combination for loans that would be classified into a bucket that requires recognition of a lifetime impairment loss.
23. **Inflated yield** – This alternative requires an entity to accrete interest to contractual cash flows, rather than expected cash flows. Hence if this alternative were to be applied to all purchased financial assets that would lead to inflated yields and inflated impairment expense for those financial assets for which an entity does not expect to collect all contractual cash flows. This effect also occurs for originated loans. However it will be more pronounced if loans are purchased (for example in a business combination) at a credit quality below that which is typical for an entity's originated loans and in particular for lower quality financial assets acquired with a deep discount.

Alternative 2 – Componentised approach

Description

24. This alternative would recognise purchased loans at fair value (plus directly attributable transaction costs). Under this alternative, upon acquisition the fair value of the financial assets comprises the following elements:
- a. The face value
 - b. Plus premium / less discount for the difference between the purchase price (ie fair value) and the face value
 - c. Less allowance for credit losses

- d. Plus initial expected loss adjustment (equal to allowance for credit losses)
25. The initial expected loss adjustment account is created against and for the same amount as the allowance account, therefore there is no day 1 loss. The initial expected loss adjustment account would function in a manner that is mechanically similar to loan origination costs or a premium or discount account recognised today for the difference between the purchase price and the face value of the financial asset. The initial expected loss adjustment would be amortised to the income statement over the life of the financial asset.
26. As an example, consider a loan with a face value of CU1,000 that is purchased for CU900. The CU100 purchase discount is attributable to CU70 of expected losses and CU30 of a change in interest rates. The carrying value of the loan at purchase would be calculated as follows:
- a. 1,000 – the face value
 - b. (100) – less the purchase discount
 - c. (70) – less the allowance for credit losses
 - d. 70 – plus the initial expected loss adjustment
 - e. 900 – equals the fair value
27. The purchase discount of (100) and the initial expected loss adjustment of 70 would be subsequently amortised/unwound through net income.
28. The effective interest rate under this approach is the rate that would equate contractual cash flows with the initial cash outflow (fair value/purchase price). Interest would be accrued at that EIR on the fair value of the financial asset on initial recognition, ie the purchase price.
29. The allowance account would be updated at each reporting date to reflect current estimate of expected losses. Changes in the allowance account would be recognised in the income statement. Hence the impairment allowance account for purchased loans under this alternative would function in exactly the same manner as for originated loans, absent the requirement to immediately recognizing an impairment amount in Bucket 1.
30. The initial expected loss adjustment account, as well as any purchase price premium or discount and loan origination costs, would not be affected by changes in credit loss expectations and would be amortised over the life of the financial

assets in the income statement using the same effective interest rate methodology as under IAS 39 or Topic 310-20 (formerly FAS 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*)

31. It is important to note that this alternative does not concern itself with particular presentation or geography of purchase price components (ie gross versus disaggregated on the face of the balance sheet) and subsequent allocations⁶. Presentation and disclosure requirements under this alternative could be considered at a later stage. Rather, this alternative pursues a componentised approach as decoupled accounting for components might help to leverage existing systems to a degree.

Advantages

32. **No day 1 loss**—this alternative recognises that expectations of losses at the acquisition date are embedded into the purchase price and avoids recognition of a day 1 loss. Instead, impairment losses will only be recognised in the income statement as a result of changes in initial expectations.
33. **Potentially building on current systems**—the initial expected loss will be recognised over the life of the financial assets under the same effective interest rate methodology that is applied today under IAS 39 and Topic 310-20 (FAS 91) to purchase price premium or discount and loan origination costs. Existing systems could be leveraged to the extent that entities account for loan origination costs on a loan-by-loan basis. Outreach activity showed that some, although not all, entities have systems in place that can account for loan origination costs on a loan-by-loan basis. With respect to the accounting for loan origination costs, the systems assign loan origination costs to the individual loans or the entire portfolio and those costs remain fixed and are accounted for as a yield adjustment until the loan is derecognised. However, some banks, mainly smaller ones, do not have such systems in place and account for all loan origination costs off line. Others do

⁶ One way to present subsequent allocations in the income statement would be to present amortisation of the initial expected loss adjustment outside of interest income line item and outside impairment loss line item.

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not even apply the effective interest rate method because the complex system requirements outweigh the materiality of the numbers. Finally, as discussed above, some institutions apply the effective interest rate method at a portfolio level (see challenges “Allocating initial expected credit losses”). With respect to purchased portfolios of loans and the accounting for the purchase discount/premium, it is important to note that in US GAAP, a choice exists such that for loans purchased as a group, entities may allocate the initial investment (ie the amount paid to the seller plus any fees paid or less any fees received) to the individual loans or may account for the initial investment in the aggregate. In other words, entities may currently apply the effective interest rate method to portfolios of acquired loans rather than individual loans.

34. **Information about credit assumptions**—Separate disclosure of the credit assumptions built into a purchase price is important to users for loan valuations. Respondents to the exposure drafts of ASC 805-10 *Business Combinations – Overall* in the *FASB Accounting Standards Codification*[®] and IFRS 3(R) *Business Combinations* had raised this issue, but at the time the boards had concluded that it was not the right place to consider the broader issues on how best to determine the valuation allowance for those assets.

Challenges

35. **May not achieve a goal of the project**—this alternative may not address the ‘too little too late’ criticism of the current incurred loss model. This is because while the allowance balance fully reflects all loss expectations, the initial loss expectation would be recognised in the income statement over the life of the financial asset and only changes in expectations would be reflected immediately.
36. **Allocating initial expected credit losses** – According to Topic 310-20 (FAS 91), purchased loans may be accounted for (for yield purposes) at a portfolio level. Alternatively, they can be accounted for on an individual loan basis. In these cases, systems assign the acquisition costs automatically on a pro-rata basis to the loans in the portfolio. While the acquisition cost can easily be divided equally across all loans in a portfolio, expected credit losses cannot. If expected losses

were allocated in this way it would imply that all loans in the portfolio have the same credit risk which, in most cases, does not reflect the underlying economics. Moreover, most institutions we have spoken to have consistently asserted that the accounting for interest-rate-driven purchase premiums/discounts is fundamentally different to assigning expected losses on a loan by loan basis at the date of origination or purchase. While institutions are able to assign fees/costs and premium/discount on an individual loan basis and no updates to the initial amounts are tracked throughout a financial instrument's life, assigning credit losses to individual financial assets is considered in a different manner. Specifically, there is a commonly held perspective that losses are not expected on an individual loan basis but rather on a portfolio basis.

37. **Tracking Problem** – Many argue that changes in expectations would need to be tracked on a loan by loan basis to distinguish those that should be debited to the allowance account and those that should be recorded in the income statement. Hence this approach will be challenging to apply on an open portfolio which was the major criticism of the original IASB exposure draft *Amortised cost and impairment*. The proponents of this approach however disagree that there is a tracking issue. They argue that all entities would need to do is to create a record of expected losses on initial recognition of the financial assets and to subsequently amortise this amount in accounting systems. Changes in credit loss expectations from one reporting period to another would all flow through the income statement.
38. **Inflated interest yields**—because interest revenue would be recognised based on contractual cash flows, rather than expected cash flows, interest yields would be inflated for those loans for which the expectation upon purchase is not to collect all contractual cash flows. (However, the overall effect in the income statement would not be inflated as all impairment losses would eventually be recognised). In addition, impairment expense related to initial expected losses would be recognised rateably over the life of the loans, which is neither the period in which the losses are expected or actually incurred.
39. **Inconsistent with originated loan model**—the focus of this alternative is to avoid recognising impairment expense upon purchase in accordance with the

model discussed for originated loans. This is inconsistent with the view that economically originated loans and purchased loans are the same.

Alternative 3 – Gross presentation approach

Gross versus net presentation for purchased loans

40. Currently, for a business combination transaction, ASC 805-10 *Business Combinations – Overall* in the *FASB Accounting Standards Codification*[®] and IFRS 3(R) *Business Combinations* require that an acquiring entity record all assets at fair value⁷. 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 the present value of the amounts to be received determined at the current interest rate, less an allowance for uncollectability 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 uncollectability and collection costs, if necessary. Under FAS 141, the acquiring entity would establish a valuation allowance against the loans upon initial measurement.
41. 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 ASC 450-20 (FAS 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 to calculating the allowance in the context of a business combination, an immediate gain would be recognised for the difference between incurred losses and expected losses. In contrast, if the valuation allowance for receivables acquired in a business combination was determined on an expected loss basis, the

⁷ ASC 805-20-30-4 states, ‘The acquirer shall not recognise 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’ (FAS 141R, A.57).

result would be a new accounting model for those receivables. Thus, at that 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).

42. The FASB has received significant feedback from constituents that the differing presentation on the balance sheet of allowance balances for originated loans and purchased loans creates confusion and does not permit comparability between the two categories of loans⁸. Originated loans would have an incurred loss recognised in the allowance balance once impaired. On the other hand, purchased loans (both in business combinations as required in FAS 141(R) and portfolio acquisitions) would have no allowance balance recognised for incurred losses that existed upon purchase. One possible way to rectify this is through a ‘gross’ presentation (that is, a grossing up of the fair value to present the face value of the loan, the implicit allowance, remaining discount, and the fair value of the loans). However, some believe that recognition of a valuation allowance upon initial recognition of a purchased portfolio of loans is inappropriate because the use of a loss allowance to address the collectability 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.

⁸ In an effort to address this concern, as part of its deliberations leading to the issuance of its May 2010 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 FASB meeting, the FASB tentatively agreed to pursue presentation of purchased financial assets on a ‘gross basis’ in the balance sheet. That is, the FASB 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 FASB 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 amortised cost and the principal amount
- (d) The amortised cost basis of the financial assets.

Description

43. This alternative was considered during the March 2011 discussions regarding the impairment accounting for purchased loans.
44. Under this alternative, initial expectations of credit losses would *not* be recognised as an impairment loss. Instead an allowance for credit losses, through a ‘gross up’ of the loan balance, would be established upon initial recognition (because remaining expected losses attributable to the purchased loans are implicit in the purchase price). The amount of the purchase discount that would be accreted as interest revenue would reflect only the amount of cash flows expected to be collected as of the acquisition date. The effective interest rate would be determined by equating the expected cash flows to the purchase price. This alternative would adopt the pre-FAS 141(R)/IFRS 3(R) model for business combinations (ie recognition of an allowance balance upon purchase, although the allowances in the pre-FAS 141(R)/IFRS3(R) model were incurred losses, and these would be based on expected losses).
45. As an example, consider a loan with a face value of CU1,000 that is purchased for CU900. The CU100 purchase discount is attributable to CU70 of expected losses and CU30 of a change in interest rates. The initial recognition of the loan would occur as follows:
- a. 1,000 – the face value
 - b. (30) – less the purchase discount
 - c. (70) – less the allowance for credit losses
 - d. 900 – equals the purchase price
46. The primary difference between approaches 3 and 4 is the presentation of the allowance balance on the balance sheet. Alternative 3 requires the allowance balance to be shown separately, whereas Alternative 4 does not.
47. This approach, as well as others based on expected cash flows like Alternative 4, would require consideration of the accounting for changes in expectations after the acquisition date. The staff would envision that the EIR established at acquisition would not change and unfavourable changes in expectations would increase the allowance for credit losses with a corresponding impairment loss. In

particular, the boards would need to consider the method of accounting for favourable changes in expectations, which may exceed the allowance for credit losses. The question in that case is whether entities can only reverse the allowance to a zero balance or whether entities can recognise a gain from favourable changes in expectations.

Advantages

48. **No day 1 loss** – The boards asked the staff to consider the accounting for purchased loans, expressing concern for the potential impact of the day 1 loss, especially for loans purchased below Bucket 1. This alternative addresses the day 1 loss issue by presenting the allowance through the gross up of the acquisition price (providing information to users about future expected losses), but subsequently recognising the initial expected losses in the income statement through the life of the instrument. This addresses the day 1 effect for purchased loans.
49. **Information about credit assumptions** – Separate disclosure of the credit assumptions built into a purchase price is important to users for loan valuations. Respondents, including US users, to the exposure drafts of ASC 805-10 and IFRS 3(R) had raised this issue, but at the time the boards had concluded that it was not the right place to consider the broader issues on how best to determine the valuation allowance for those assets. Preparers have also told us that they find it difficult to explain to users why the allowance balances for loans acquired in business combinations are not comparable with those of other loans on their balance sheet. Users 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 (see IFRS 3(R), paragraph BC257; FAS 141(R), paragraph B257).

Challenges

- 50. Operational feasibility** – This approach was required in the past for loans acquired in a business combination (and an approach based on expected cash flows is required in current US GAAP for purchased credit-impaired loans and IFRSs for assets acquired at a deep discount due to incurred credit losses). Hence it should be operationally possible to apply, at least for some populations of purchases (including business combinations). The staff believes that current accounting is performed on a portfolio basis (in business combinations, those would likely be closed portfolios), rather than an individual unit of account. If this approach was required for open portfolios, the complexity may increase. Likewise, if this approach were to require entities to sift through purchased portfolios and business combinations in order to identify each individual bad loan, this approach would be very operationally difficult.
- 51. Inconsistency with other acquired assets** – Arguably if it is appropriate to present acquired assets through a gross up of fair values that approach should be taken for other assets. For example, by 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 arguably create an exception that contradicts fundamental accounting conventions.
- 52. Inconsistency** – This alternative does not align the accounting treatment for originated and purchased loans. Based on feedback received by the FASB on its May 2010 Exposure Draft, which carried forward a method similar to the method in Subtopic 310-30 (formerly SOP 03-3), investors generally desire a single impairment model for both originated and purchased loans.

Alternative 4 – Credit-adjusted EIR approach

- 53.** Under this alternative, purchased loans would be recognised and presented in the balance sheet at fair value (ie not on a gross basis). No day 1 loss would be recognised in the income statement upon initial recognition. Interest revenue would be recognised based on cash flows expected to be collected as at initial

recognition. The effective interest rate will be locked in on initial recognition and would not change. Similar to Alternative 3, as discussed in paragraph 47, this alternative would require consideration of the accounting for changes in expectations after the acquisition date. All changes in credit loss expectations will flow through the income statement. This alternative is consistent with the decision reached by the boards in March 2011 for financial assets purchased into the bad book.

Advantages

54. **No day 1 loss** – the proposed approach would not result in an impairment loss at initial recognition. That is because interest income is based on expected cash flows. Rather, the impairment inherent in the purchased loans on initial recognition would effectively be recognised during the remaining life of the loan by reducing the amount of interest income recognised.
55. **Not new** – a similar approach is already required today under IAS 39 and ASC 310-30 (formerly SOP 03-3) for financial assets acquired at a deep discount and hence arguably it does not create new operational challenges (see however *Unit of account* discussion in paragraph 57). In addition, this alternative could help to simplify some specific operational complexities that exist under US GAAP today and have been a source of concern with the US model over time⁹.
56. **Interest recognition** – this alternative avoids inflated yields so should provide more useful information. Accreting to the full contractual cash flows may not have the conceptual merit when the acquiring entity clearly expects to collect less than the remaining contractual cash flows. This approach is consistent with the original IASB ED (although in that case it would have been applied to all assets rather than just purchased ones).

⁹ Currently under ASC 310-30 (formerly SOP 03-3) favourable changes in expectations result in adjustments to yield whereas unfavourable changes in expectations result in recognition of impairment loss. This has been a major source of confusion for users and a major operational complexity for preparers. The proposed alternative would not perpetuate this treatment.

Challenges

57. **Unit of account** – existing requirements in IAS 39 and ASC 310-30 (formerly SOP 03-3) to base interest revenue recognition and impairment on expected cash flows already present operational challenges to preparers as they require granular calculations and record keeping. Under US GAAP, the scope of ASC 310-30 applies to individually impaired purchased loans (ie individual unit of account). However, given the difficulty of applying that scope requirement to large acquired portfolios, the staff understands that there is an accepted practice in the US of applying either ASC 310-10 (FAS 91) or ASC 310-30 (SOP 03-3) as a policy choice on a portfolio basis. IAS 39 is not specific with respect to the unit of account. Based on limited outreach, the staff understands that in practice at least some entities determine the credit adjusted EIR for financial assets acquired at a deep discount with incurred credit losses on a portfolio basis or by segmenting a portfolio rather than on an individual asset basis. A requirement to apply the model on an individual asset basis would lead to additional operational complexities that do not exist today¹⁰.
58. **Operational complexity** – the universe of assets to which this approach is applied today under IAS 39 is limited to those acquired at a deep discount with incurred credit losses. The assets to which this approach is applied today under US GAAP (Subtopic 310-30, formerly SOP 03-3) is limited to those acquired loans with evidence of deterioration of credit quality since origination for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. To require this to apply to all purchased loans would significantly increase the scope of this calculation requirement. Given its similarity with the original IASB ED significant operational complexities would be anticipated.
59. **Inconsistency** – This alternative does not align the accounting treatment for originated and purchased loans. Based on feedback received by the FASB on its May 2010 Exposure Draft, which carried forward a method similar to the method

¹⁰ The staff will bring to the boards a more detailed discussion of unit of account in the context of recognition of interest income at a future meeting.

in Subtopic 310-30 (formerly SOP 03-3), investors generally desire a single impairment model for both originated and purchased loans.

60. **US users' concerns** – Based on feedback received by the FASB on its May 2010 Exposure Draft, which carried forward a method similar to the method in Subtopic 310-30 (formerly SOP 03-3), investors generally cited significant concerns and lack of transparency when the model in Subtopic 310-30 is applied for purchased credit deteriorated loans. They stated 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. Whereas the proposed alternative represents a simplification compared to Subtopic 310-30 (formerly SOP 03-3), it remains complex and may not fully address users' concerns.

Comparison between the alternatives

61. The following table provides a high level comparison between the four alternatives:

	Alternative 1 Originated Loan Approach	Alternative 2 Componentised Approach	Alternative 3 Gross up Presentation	Alternative 4- Credit- adjusted EIR
Day 1 loss	Yes	No	No	No
Fair value on day 1	No ¹¹	Yes	Yes	Yes
EIR calculation based on	Contractual CF	Contractual CF ¹²	Expected CF	Expected CF
Initial EL amortised	No	Yes ¹³	No	No

¹¹ As a consequence of recognising the day 1 loss.

¹² Interest income is recognised using the EIR based on contractual cash flows, however, the initial expected loss adjustment would need to be unwound using either the EIR based on expected cash flows or another method (eg straight-line).

through income				
Allowance established on day 1	Yes	Yes	Yes ¹⁴	No

Staff Analysis of Potential Application of Alternatives to Individual Buckets

62. There are several ways in which the alternative approaches discussed in this paper can be mapped to the three buckets for purchased loans under the Credit Quality Approach. For originated loans Alternative 1 is applied to all buckets. These possibilities are outlined in the table below along with high level staff observations.

	Bucket 1	Bucket 2	Bucket 3	Observations
1	Alternative 1 (12-24 month loss ¹⁵)	Alternative 1 (lifetime loss (OR less than lifetime loss, eg 24 months ¹⁶))	Alternative 1 (lifetime loss)	Purchased loans and originated loans accounted for consistently in each bucket
2	Alternative 2 (amortise initial 12-24 month loss)	Alternative 2 (amortise initial lifetime loss)	Alternative 2 (amortise initial lifetime loss)	All <u>purchased</u> loans accounted for consistently
3	Alternative 3 (gross up)	Alternative 3 (gross up)	Alternative 3 (gross up)	All <u>purchased</u> loans accounted for consistently
4	Alternative 4 (adjusted EIR)	Alternative 4 (adjusted EIR)	Alternative 4 (adjusted EIR)	All <u>purchased</u> loans accounted for consistently
5	Alternative 1 (12-24 month loss)	Alternative 1 (lifetime loss OR less than lifetime loss, eg 24 months ¹⁷)	Alternative 3/4 (adjusted EIR)	Arguably consistent with originated loans because loans typically are not originated into Bucket 3

¹³ If amortised using the EIR based on expected cash flows, the result of netting this amortisation with the gross interest income produces the same effect as recognising interest income net of expected losses.

¹⁴ The presentation of the gross loan amount and the allowance balance on the balance sheet is an integral component of this approach.

¹⁵ The discussion in the table reflects tentative decisions made to date with respect to measurement of expected loss in each of the buckets.

¹⁶ This reflects a scenario if the boards were to adopt Alternative C – Non lifetime measurement in Bucket 2 discussed in AP 3A/FASB Memo 113.

				Some view as consistent with earlier decisions if Alternative 4 is applied to Bucket 3 Multiple models for purchased loans
6	Alternative 1 (12-24 month loss)	Alternative 3/4 (adjusted EIR)	Alternative 3/4 (adjusted EIR)	Some view as consistent with earlier decisions if Alternative 4 is applied to Bucket 3
7	Alternative 1 (12-24 month loss)	Alternative 1 (lifetime loss OR less than lifetime loss, eg 24 months ¹⁸)	Alternative 2 (amortise initial lifetime loss)	Arguably consistent with originated loans because loans typically are not originated into Bucket 3
8	Alternative 1 (12-24 month loss)	Alternative 2 (amortise initial lifetime loss)	Alternative 2 (amortise initial lifetime loss)	

63. Variation 1 would be easy to understand and apply and it would result in consistent accounting for originated and purchased loans. A single model for originated and purchased loans would result in recognizing credit loss expectations consistently both initially and subsequently according to the three-bucket approach. In an approach in which all loans would have impairment losses based on the Credit Quality Approach, this would result in the recognition of an impairment loss at the date of initial recognition for all originated and purchased loans. For loans classified in Bucket 1, entities would recognise a 12-month expected loss, while entities would recognise a lifetime credit loss for loans classified in Buckets 2 and 3. Alternatively, with regard to Bucket 2, one possibility is that the measure of impairment could be less than a lifetime loss, consistent with Alternative C – Non lifetime measurement in Bucket 2 discussed in AP 3A/FASB Memo 113. This would reduce the impairment loss recognised in Bucket 2 relative to Bucket 3.

64. Taking this approach, interest revenue would be recognised for all purchased loans based on remaining contractual cash flows rather than expected cash flows at the date of acquisition. Many believe that recognition of day 1 lifetime losses

¹⁷ This reflects a scenario if the boards were to adopt Alternative C – Non lifetime measurement in Bucket 2 discussed in AP 3A/FASB Memo 113.

¹⁸ This reflects a scenario if the boards were to adopt Alternative C – Non lifetime measurement in Bucket 2 discussed in AP 3A/FASB Memo 113.

on financial assets purchased into Buckets 2 and 3, which would occur under this variation, is incompatible with the notion of initial recognition at fair value.

Others believe that the model has this effect for all loans including originated loans so would not make a distinction on this basis. Further, this variation would be inconsistent with the earlier tentative decision for purchased financial assets where an explicit expectation of losses exists at the individual asset level where the boards decide to adjust the EIR (Alternative 4).

65. Variations 2-4 are similar in that purchased loans would follow a single consistent model, which would be different from the accounting treatment for originated loans. This reduces the number of accounting models for purchased loans. Alternative 2 would amortise the initial expected loss (being an amount determined based on the bucket to which the purchased loans are allocated). Alternatives 3 and 4 would involve no recognition of impairment upon acquisition of the loans, but instead would recognise a reduced yield on the loans based on expected cash flows. The difference between Alternatives 3 and 4 is that allowance balance is separately presented on the face of the balance sheet under Alternative 3 but not under Alternative 4. Similar to Variation 1, these variations are contrary to the view held by some, that originated and purchased loans are essentially economically equivalent and the previous tentative decisions that purchased and originated loans should be treated the same way except for financial assets where an explicit expectation on losses exists on an individual asset level. As such, some may believe that Alternatives 2, 3, and 4 would be more appropriate for consideration for Bucket 3 and potentially for Bucket 2 depending upon how close the credit quality of that bucket is to Bucket 3.
66. Variation 5 considers Bucket 2 loans to be more akin to Bucket 1 loans than Bucket 3 loans. Therefore, a different approach would be applied for loans in Bucket 3, in which no impairment expense would be recognised upon initial acquisition of the loans and yields would be based on cash flows expected to be collected rather than contractual cash flows, but the same model would be applied for loans purchased into Buckets 1 and 2. By using the same model for Bucket 1 and 2, this variation arguably results in a more consistent accounting model for purchased and originated loans because loans are not typically originated into

- Bucket 3. This variation can also be viewed as consistent with the previous decisions as long as Bucket 3 is viewed as including the 'bad book' population under the SD. The challenge of this variation is that it potentially entails recognition of day 1 lifetime credit losses for purchased financial assets in Bucket 2 which some believe is incompatible with initial recognition at fair value. Alternatively, with regard to Bucket 2, one possibility is that the measure of impairment could be less than a lifetime loss, consistent with Alternative C – Non lifetime measurement in Bucket 2 discussed in AP 3A/FASB Memo 113. This would reduce the impairment loss recognised in Bucket 2 relative to Bucket 3.
67. Variation 6 considers Bucket 2 loans to be more akin to Bucket 3 loans rather than Bucket 1 loans. Therefore, a different approach would be applied for loans in Buckets 2 and 3, in which no impairment expense would be recognised upon initial acquisition of the loans and yields would be based on cash flows expected to be collected rather than contractual cash flows. Some believe this is consistent with the boards' previous decisions on purchased loans in March 2011. Under the SD model, the bad book could have contained individually impaired loans (comparable to Bucket 3) and portfolios of 'bad' loans (comparable to at least a portion of Bucket 2).
68. Even though Variation 6 results in inconsistent accounting treatment for purchased and originated loans except in Bucket 1, some staff believe that this outcome has conceptual merit. As discussed above, arguably there is no practical reason for consistent accounting models for originated and purchased loans in Bucket 3 because loans are typically not originated into Bucket 3. With respect to Bucket 2, these staff recognise that there is no economic difference between origination of financial assets into Bucket 2 and purchase of financial assets into Bucket 2. However they note that there is a difference between purchase of financial assets into Bucket 2 and *deterioration* of financial assets into Bucket 2, ie there is a difference for a subset of the population in Bucket 2. This is because purchase price would reflect current credit loss expectations and hence there is no economic loss at the time of purchase whereas deterioration into Bucket 2 involves an economic loss. The economic loss results from the fact that current credit loss expectation have not been factored into the pricing of the financial

assets. For this reason, these staff believe that there is an argument for different accounting models for originated *deteriorated* assets and purchased financial assets in Bucket 2. However based on the feedback we received in investigating the Bucket 1 Approach we know that this part of the population cannot be separately identified (at least not on a cost effective basis) so we do not believe the treatment could be aligned without applying it to all of Bucket 2.

69. Some believe there is merit in extending credit-adjusted EIR treatment (ie Alternative 3 or Alternative 4) to both Buckets 2 and 3. This is because this approach results in more realistic interest income recognition (rather than inflated interest income on loans where an entity does not expect to collect all contractual cash flows), and does not lead to recognition of day 1 lifetime impairment losses for financial assets purchased at fair value. The downside of this approach is that it extends the operational complexity to a wider population of assets. The feedback received on the original IASB ED that would have applied Alternative 4 to all assets highlighted this complexity. Some believe that this approach would be most appropriate if the line between Buckets 2 and 3 is drawn at a low level so that the population of loans captured by Bucket 2 is comparable in credit quality to Bucket 3.
70. Variation 7 is similar to Variation 5 in that it applies a different model to loans purchased only into Bucket 3. It can be viewed as arguably consistent with the treatment of originated loans because loans are typically not originated into Bucket 3. However it is inconsistent with the earlier decision by the board to recognise interest on purchased loans where explicit expectation of losses exists on the individual assets level based on the expected cash flows. Furthermore, this variation entails recognition of day 1 lifetime credit losses on purchased financial assets in Bucket 2 which some believe is incompatible with the initial recognition of financial assets at fair value¹⁹.
71. Variation 8 is similar to Variation 6 in that it creates a single model for loans purchased into Buckets 2 and 3. This alternative is inconsistent with the earlier decision with respect to acquisitions in the bad book in that it accretes to

¹⁹ Some believe the same issue exists for originated loans.

contractual cash flows rather than expected cash flows and results in recognition of an initial expected loss over the life of the purchased assets. Otherwise it maintains the benefit of consistent accounting treatment of originated and purchased financial assets into Bucket 1 and it does not entail recognition of day 1 lifetime losses on purchased financial assets, which some believe is incompatible with the notion of initial recognition at fair value²⁰. Likewise, Variation 8 maintains operational complexity of Variation 6. The degree of the complexity will depend on where the line is drawn between Buckets 1 and 2. The staff believes if the line between Bucket 1 and 2 is drawn at a high level the benefits of this variation would be outweighed by the operational complexities.

Staff analysis

72. On balance staff believe that accounting for purchased and originated loans in Bucket 1 should be consistent. Therefore the staff would eliminate Variations 2-4.
73. The staff also believe that there is no reason to reverse the previous decision on loans purchased in the bad book. On this basis the staff would eliminate Variation 1. Some staff also believe that the boards only need to consider targeted solution for purchases in Bucket 2 where the day-1 loss effect is most pronounced and where the previous boards' decision for acquisitions into the bad book may not be applicable.
74. Whether Variation 6 is preferred over Variation 5 and Variation 8 over Variation 7 depends, in staff's view, on the magnitude of population in Bucket 2 and resulting degree of operational complexity. In addition, selecting between those broad categories of alternatives will depend on views regarding the interplay between interest income recognition and recognition of impairment expense upon acquisition of lower credit quality assets. That is, those alternatives differ in terms of whether all purchased loans should recognise interest revenue based on contractually promised cash flows, regardless of credit quality of the asset, but

²⁰ Some believe the same issue exits for originated loans.

recognise impairment expense (upon acquisition or over time) or instead, recognise a reduced yield to reflect expectations upon purchase.

75. Another consideration is the population of purchased loans to which a variation would be applied. Although there is no conceptual distinction between purchases of loans within or outside a business combination, one way to limit the degree of operational complexity of Variation 6 and 8 would be to limit the approach for purchased loans to a subset of acquired loans, for example, to loans acquired in a business combination. Some staff also believe that this may be more practical as they are concerned that it will be difficult from a systems perspective to isolate loan purchases from originations in the ordinary course of business.

Questions to the boards

1. Do the boards agree with the staff analysis?
2. Do the boards agree that Variations 1-4 should not be pursued? Do the boards agree that the choice between Variations 5 or 7 as opposed to Variations 6 or 8 is dependent on where the line between Buckets 1 and 2 is drawn?
3. Do the boards believe that the solution selected should be applied to all purchased loans or only those acquired in a business combination?