

STAFF PAPER

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Project	Financial Instruments: Impairment		
Paper topic	Application of credit deterioration model to purchased financial assets with credit deterioration		
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Purpose of the paper

- The purpose of the paper is to discuss the application of the impairment model based on credit deterioration to financial assets that are purchased at a discount attributable to credit concerns. Purchasing financial assets at a discount due to credit concerns can occur on an individual basis (for example, publicly tradable debt instruments referred to herein as “debt securities”) or on a portfolio basis through an asset acquisition or business combination.

Background

Previous decisions related to purchased credit-impaired loans

- In March and April of 2011, the boards discussed impairment and interest revenue recognition for purchased financial assets in the context of the model described in the joint Supplementary Document *Financial Assets: Impairment* published in January 2011 (SD)¹. During those discussions, the boards tentatively decided the following:

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

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- a. An entity should account for credit impairment of purchased financial assets for which the entity has no explicit expectation of losses at the individual asset level, even when acquired as part of a portfolio, in the same way as for originated financial assets. Interest income for these financial assets would be recognized on the basis of contractual cash flows, thus aligning credit impairment accounting and interest income recognition for originated financial assets and purchased financial assets (those for which the entity has no explicit expectation of losses at the individual asset level at acquisition).
 - b. For purchased financial assets for which the entity has an explicit expectation of loss at the individual financial asset level (that is, for financial assets that are purchased at a “deep discount”²), interest income recognized should be based on expected collectible cash flows estimated at the date of acquisition (that is, the purchase price should be accreted to expected cash flows). A separate credit impairment expense would not be recognized at the date of acquisition as a result of limiting the recognition of interest income for these credit-deteriorated financial assets by basing interest income on expected cash flows as opposed to contractual cash flows.
3. The staff notes that the approach selected by the boards in (b) is currently required by IAS 39 (for assets acquired at a deep discount with incurred credit losses) and by ASC 310-30 (formerly SOP 03-3, for acquired financial assets with evidence of deterioration in credit quality since origination for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable).
 4. In making this decision in March and April 2011 in the context of a “good book” / “bad book” delineation as described in the SD, the boards believed that purchased assets and originated assets should follow the same model to the extent possible. At the same time the

board meeting; and IASB Agenda Papers 4-4C/FASB Memorandums 83(A)-85 from the week commencing 11 April 2011 board meeting.

² For the remainder of this paper the phrase “financial assets with an explicit expectation of losses” as discussed in the boards’ tentative decision is used to describe loans for which purchase discount should be accreted to expected cash flows. This population is described in current IFRS as “assets being acquired at a deep discount with incurred credit losses” and described in U.S. GAAP as “acquired financial assets 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.” Issue 2 of this paper discusses whether the scope needs further definition. The summary of decisions for March and April 2011 indicated that the boards’ decisions were subject to future discussions on related issues, including determining what constitutes a “deep discount” to differentiate purchased portfolios of assets.

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boards acknowledged that recognizing interest revenue based on contractual cash flows for all purchased assets could result in situations where an entity accretes to an amount it does not expect to collect, resulting in artificially inflated yields and provisions. For this reason, accretion to expected cash flows for purchased portfolios of credit-impaired assets was viewed as reflecting the appropriate yield for those assets. This is the basis for the specialized models in US GAAP for purchased-credit impaired assets and in IFRS for assets acquired at a deep discount reflecting incurred credit losses. Also, the boards acknowledged that recognising lifetime expected credit losses immediately at acquisition of financial assets acquired on market terms (i.e., at the price that already reflects the expectation of credit losses at the time of acquisition) does not reflect the economics of the transaction.

Decisions related to general credit impairment model

5. At the October 2011 joint Board meeting, the boards decided to pursue an impairment model in which the overall objective is to reflect the deterioration in the credit quality of financial assets. Under this approach, generally on initial recognition all financial assets start in Bucket 1.
6. At the December 2011 joint Board meeting, the boards decided the following with respect to the principles of the credit deterioration model:
 - (a) The objective and measurement in Bucket 1 would be to capture the losses on financial assets expected in the next twelve months. The losses being measured are not just the cash shortfalls over the next twelve months; rather, they are the lifetime expected losses on the portion of financial assets on which a loss event is expected over the next twelve months. The losses expected to occur in the next twelve months will be determined using all reasonable and supportable information, including forward-looking data, which will reflect updated estimates as expectations change.
 - (b) Recognition of lifetime losses would be appropriate (that is, financial assets would move out of Bucket 1) when there has been a more than insignificant deterioration in credit quality since initial recognition and the likelihood of

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default is such that it is at least reasonably possible that the contractual cash flows may not be recoverable.³

7. To be very clear, the issues in this paper are premised on the boards' tentative decision in March-April 2011 that an entity should account for credit impairment of purchased financial assets for which the entity has no explicit expectation of credit losses in the same way as for originated financial assets. The result of that decision is to have two approaches:
 - (a) An approach for purchased financial assets with an explicit expectation of credit losses (which are the issues discussed in this paper) and
 - (b) An approach for originated financial assets and purchased financial assets with no explicit expectation of credit losses.
8. Some may be concerned about the previous decision to align the model for purchased financial assets with no explicit expectation of credit losses with the model for originated assets because of the potential magnitude of day 1 loss to be recorded at the time of acquisition. The day 1 loss would be required to be recorded whether the loans are purchased individually, as a portfolio or through a business combination. Further, some staff believe a stronger model may result from **not** distinguishing between purchased financial assets that do, and that do not, have an explicit expectation of credit losses. Such an approach would instead have the following two approaches:
 - (a) An approach for purchased financial assets and
 - (b) An approach for originated financial assets.
9. For purposes of this paper and the discussion that follows, the staff have followed the direction from the boards' previous tentative decision as described in paragraph 2. To the extent the boards would like the staff to consider issues and alternatives that may result from instead having a single approach for all purchased financial assets, the staff would welcome such direction from the boards.

³ Per the summary of decisions for the December 2011 joint Board meeting on Impairment. The boards asked the staff to develop examples to illustrate that the "reasonably possible" criterion differs from how it may currently be interpreted in GAAP (particularly in the U.S.), and primarily refers to when the likelihood of cash shortfalls begins to increase at an accelerated rate as an asset deteriorates.

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Interaction of the impairment model decisions and the previous decisions for purchased credit-impaired assets

10. The key issue in this paper is how the decisions on the “three-bucket” impairment model currently being developed based on credit deterioration affect the past decisions about the accounting for purchased financial assets with an explicit expectation of losses.
11. Under the general credit deterioration model now being developed, loss expectations *at acquisition* are not considered in determining the initial classification of financial assets into a given bucket. Conversely, under the “good book / bad book” approach discussed in March and April 2011, the approach to interest revenue recognition was determined based on loss expectations at initial acquisition (i.e., based on whether the assets were of a quality consistent with the “bad book”).
12. Some might argue that it would be consistent with application of the “three-bucket” deterioration model to originated loans to initially include all purchased financial assets (including purchased credit-impaired loans) in Bucket 1, immediately recognizing an impairment expense using the Bucket 1 measure. However, recognition of an impairment loss based on the Bucket 1 measure for these assets seems to some to be inconsistent with the past decision to address initial loss expectations by adjusting the effective interest rate (EIR)/accreting the discount based on expected cash flows rather than recognizing an impairment expense at acquisition (as discussed in paragraphs 2-4).
13. The staff believes the boards’ fundamental decision that interest revenue recognition for purchased financial assets with an explicit expectation of losses should be based on expected cash flows is valid (that is, that discount accretion should be from purchase price to cash flows expected to be collected or, put another way, the EIR should be determined based on expected rather than contractual cash flows). Therefore, the discussion of the issues below and alternatives presented are based on that premise.

Issues for Discussion

14. The following issues are addressed in this paper.
 - (a) **Issue 1:** How to apply the “three-bucket” impairment model based on credit deterioration for purchased financial assets (the general impairment

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model) that have an explicit expectation of losses upon acquisition (purchased credit-impaired assets/purchased at a deep discount due to incurred losses)

- (b) **Issue 2:** Definition of the scope of assets for which the EIR/accretion of the discount would be based on expected cash flows on initial recognition (i.e., what is an “explicit expectation of losses”)
- (c) **Issue 3:** How to account for changes in expectations about collectible cash flows; that is, whether favorable changes would or would not adjust the EIR determined at acquisition of the financial assets
- (d) **Issue 4:** Presentation of purchased financial assets with an explicit expectation of losses in the statement of financial position.

Issue 1: Application of the general impairment model to financial assets with an explicit expectation of losses at acquisition

- 15. Based on the boards’ previous decision that purchased financial assets that *do not* have an explicit expectation of losses at acquisition would be treated consistently with originated loans for interest revenue recognition and impairment recognition purposes, those financial assets are not considered in Issue 1. The effect is that for those assets – whether purchased individually or in a business combination – a 12 month expected loss measure will be recognised as the impairment expense and a corresponding allowance balance at initial recognition (i.e., the usual Bucket 1-3 model will apply).
- 16. For purchased financial assets with an explicit expectation of losses, interest revenue recognition and impairment recognition are intertwined (i.e., initial loss expectations are recognized through a reduced yield in accreting the discount from the purchase price to the expected cash flows and no impairment loss is recognized at acquisition). As a result, for these assets, the staff has not considered an alternative that results in the immediate recognition of impairment loss and a corresponding allowance upon acquisition. Not recognising an impairment loss and a corresponding allowance upon acquisition would result in creating a separate model for purchased financial assets with an explicit expectation of losses, such that those assets would accrete the purchase discount to expected cash flows (whereas revenue recognition for all other financial assets are based on

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contractual cash flows). Under this separate model, impairment losses are based on changes in expectations since the acquisition date. The original lifetime expected losses that are used in calculating the EIR are never separately recognized as an impairment loss; rather, they are recognized over time through the yield being lower than the contractual yield.

17. The key question being asked in Issue 1, and the main difference between the two alternatives presented, is whether *changes in* expectations from the amount estimated at acquisition should be based on a Bucket 1 style measure (that is, changes in expected losses in the next 12 months) or whether *changes in* expectations should be based on a Bucket 2/Bucket 3 style measure (that is, changes in lifetime expected losses). In other words, the issue considers whether the initial classification of the assets should be into Bucket 1 (consistent with the general impairment model) or into Bucket 2 or 3.
18. The two alternatives are as follows:
 - (a) **Alternative 1: Recognition of credit impairment losses would be based on application of the deterioration model, as it relates to initial classification of the assets and when transfers occur, in the same manner as for all other originated and purchased financial assets.** Purchased financial assets with an explicit expectation of losses would initially be included in Bucket 1 upon acquisition. No impairment loss would be recognized at acquisition (reflecting accretion of purchase discount to expected cash flows/adjustment of EIR). While remaining classified in Bucket 1, *changes in* expectations compared with those at acquisition would be based on the Bucket 1 measure (losses expected to occur in the next 12 months) consistent with all other originated and purchased financial assets. If deterioration occurs that requires a transfer out of Bucket 1, *changes in* expectations compared with those at acquisition would be based on *changes in* lifetime expected losses.
 - (b) **Alternative 2: Recognition of credit impairment losses would be based on a different approach (as it relates to initial classification of the assets) from all other originated and purchased financial assets.** Purchased financial assets with an explicit expectation of losses would not

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be included in Bucket 1 upon acquisition, which is different from all other purchased and originated assets. Consistent with Alternative 1, no impairment loss would be recognized at acquisition (reflecting accretion of purchase discount to expected cash flows/adjustment of EIR). *Changes* in expectations compared with those at acquisition would be based on *changes* in lifetime expected losses.

Staff analysis of alternatives

Alternative 1

19. In applying the impairment model, purchased financial assets with an explicit expectation of losses would be initially classified in Bucket 1 consistent with the initial classification of all other originated and purchased financial assets.
20. The staff believes that, in most cases, because such assets are already impaired, they would likely be transferred to Bucket 2 or 3 in response to *any* unfavorable change (i.e., assuming it is other than insignificant) in expectations of collectibility. If the assets transfer to Bucket 2 or 3 based on *any* deterioration in credit quality *from* acquisition, Alternatives 1 and 2 generally do not result in a different application⁴. Given this, it would seem unduly burdensome to require these assets to first be allocated to Bucket 1 with the associated requirement to monitor the need to subsequently transfer them out of Bucket 1. To the extent that some deterioration occurs, but does not trigger a transfer of these assets to Bucket 2 or 3, the allowance balance would continue to be adjusted based on *changes* in a 12 month impairment measure.
21. To the extent that an unfavorable change in expected losses occurs after acquisition and the assets remain in Bucket 1, the allowance balance would continue to be adjusted. There may be a number of ways this approach could be devised, as follows:
 - (a) An approach where, even if there is no unfavorable change in lifetime expected losses, an increase in the 12-month impairment measure would be possible because the 12 month expected losses could change.

⁴ However, in fact patterns where there had been a previous improvement in expectations since acquisition, it may not be the case that *any* deterioration would result in transfer to Bucket 2 or 3. Improvements in credit quality may result in different application, as assets in Bucket 1 would use a 12 month measure for improvements in credit quality, whereas assets in Buckets 2 or 3 would use the lifetime measure.

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- (b) An approach where there would *only* be an impairment loss recorded to the extent that there is (a) an unfavorable change in the lifetime expected losses resulting in (b) an increase in the 12 month expected losses. The basis for this approach is that the full difference between initial expected cash flows and contractual cash flows is reflected in the discount inherent in the purchase price.
22. As a simple example, assume at acquisition a financial asset was expected to have losses in Year 1 of CU50 and in Year 2 of CU75 (total lifetime loss expectation of CU125). Under both approaches, no Bucket 1 measure of impairment would be recognized at acquisition. Assume that the CU50 of losses are actually realized (as expected) in Year 1, and at the end of Year 1 the 12 month expectation of loss (for what was formerly “Year 2”) increases to CU77. Under the first approach, an impairment expense (and allowance) of CU27 would be recognized. Under the second approach, an impairment expense (and allowance) of CU2 would be recognized.
23. To be clear, both approaches described above would create an exception to the Bucket 1 measurement approach tentatively agreed to for originated assets (because neither approach recognizes a Bucket 1 allowance based on the entire expected loss in the next 12 months). Additionally, some staff believe the second approach creates a further exception because it limits the recognition of an allowance after acquisition only to scenarios where the 12 months expected losses *and* its lifetime expectation of loss change. However, other staff are concerned that the first approach would permit the recognition of impairment losses (or alternatively, gains) when there has been no change in the expectation of lifetime loss since acquisition. Regardless, none of the staff ultimately recommend either of these approaches.
24. Some may believe that given the objective of Bucket 1 to capture 12 months of expected losses on financial assets that have not experienced an other than insignificant deterioration (effectively, recognizing a “buffer” for these financial assets), there should be no requirement to isolate these financial assets to avoid calculating a reserve. Rather, these assets should be able to be integrated into the entity’s processes for estimating the allowance in a manner consistent with all other assets. Others believe that because the impairment expense and corresponding allowance balance is intended to capture only changes relative to initial expectations, which is different to all other assets where the

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impairment expense and corresponding allowance balance include initial expected losses, these assets would need to be separately considered.

Alternative 2

25. Under Alternative 2, the financial assets are classified in Bucket 2 or 3 upon acquisition (based on whether the impairment assessment is performed at the pool or individual level). A subsequent unfavorable change in expected losses would be captured based on *changes in* expected lifetime losses. To the extent that there was no change in expectations regarding collectibility subsequent to acquisition, there would be no impairment expense recognized and the assets would remain in the bucket in which they were initially classified (i.e., Bucket 2 or 3 for Alternative 2).
26. Some believe that conceptually an impairment measure based on the *change* in lifetime expected losses seems appropriate for these assets because an assessment of explicit expected lifetime losses at acquisition is reflected in the purchase price and the EIR at acquisition, and thus is the starting point for the analysis. This leads towards the idea that there should be no recognition of impairment losses for such assets until the asset has deteriorated since acquisition and any subsequent changes in expectations should be based on lifetime losses.
27. This alternative could be implemented within the “three-bucket” model by requiring that entities include such financial assets with an explicit expectation of losses at acquisition in Bucket 3 (if entities would be required to individually identify purchased financial assets with an explicit expectation of losses) or in Bucket 2 (if entities could assess overall purchased portfolios as having an explicit expectation of losses) since Buckets 2 and 3 have an impairment measure based on lifetime expected losses for all other originated and purchased assets. Then, purchased financial assets with an explicit expectation of losses at acquisition would be a subset of those assets in Bucket 2 or 3, and only *changes* in lifetime expected losses would be recognized. This would require the boards to explicitly require this treatment for financial assets purchased with an explicit expectation of losses.
28. In the context of the decisions reached around the “three-bucket” model, some may be concerned that Alternative 2 would compromise the “three-bucket” credit deterioration model as it relates to starting all assets in Bucket 1. It may also call into question why all assets should not be classified in Bucket 2 or Bucket 3 upon acquisition or origination if

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their credit quality characteristics would be in line with such a classification. The boards have already discussed, and dismissed, a model that would require classification of assets into the various buckets solely on the basis of a particular credit quality level.

29. A counter view to those concerns is that, because no impairment expense is recognised upon acquisition, this Alternative still follows a deterioration model in that impairment expense is only recognised once a change in expectations occurs from acquisition and the treatment for these loans (with an adjusted EIR) can be clearly distinguished from others providing a basis for a different treatment. In addition, the staff believes that given that these assets are already credit impaired at acquisition, virtually any deterioration would likely result in a transfer from Bucket 1 to Bucket 2 or 3 so that the practical application of Alternative 1 would probably not significantly differ from Alternative 2. Also, some might consider the model not to be compromised because purchased credit-impaired assets have experienced deterioration that, if experienced for originated assets, would lead to transfer to Bucket 2 or Bucket 3. This makes these assets distinguishable from originated loans and other purchased financial assets because they are purchased having incurred losses evidencing such deterioration. That is, the assets themselves have deteriorated since origination as evidenced by the credit discount reflecting the past performance of the assets, notwithstanding the fact that the deterioration was not a loss suffered by the current holder of the assets. If those assets had been originated by the entity now holding them, they would have been transferred to Bucket 2 or Bucket 3 due to credit deterioration since the time of origination.
30. Some might view Alternative 2 as a practical solution for application issues that might arise when applying the pure credit deterioration model to these types of financial assets. For example, if an entity acquires credit-impaired assets that are already considerably past due (and if held by a banking institution, based on bank regulatory requirements in some jurisdictions, the assets not accruing interest), and the assets are included in Bucket 1 at acquisition, a question is what type of event would trigger a transfer of these individual assets into Bucket 3. The assets already have deteriorated significantly, the borrowers are not performing, and it is unclear how much deterioration must occur beyond this point in order to justify transfer to Bucket 2 or 3 and recognize *changes* in lifetime expected losses.

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Practical Implications / Level of aggregation

31. With respect to recognition of impairment losses, neither Alternative 1 nor Alternative 2 would involve recognition of an impairment loss at acquisition. This is because unlike other assets, on initial recognition the boards have tentatively decided to adjust the EIR to reflect the initial loss expectations. Accretion of the discount from the purchase price to the expected cash flows recognizes this expected loss through a reduced yield (as compared to accreting to contractual cash flows). As a practical matter, this outcome may be achievable only by isolating these purchased financial assets with an explicit expectation of losses for purposes of assessment and measurement of impairment through assessing expected cash flows in closed pools or on an individual basis.
32. Some staff believe that absent isolation of these assets to apply a separate process for impairment measurement, mechanically, the process of adding newly acquired financial assets with an explicit expectation of losses to open pools of existing assets (with similar risk characteristics, if such an existing pool was held by the acquiring entity) would result in a calculated allowance balance for the pool reflecting the initial estimate on new assets and changes in estimates on existing assets. As a result, that calculated allowance balance could be considered “double counting” the initial estimate of lifetime expected losses on newly acquired assets because it is already taken into account when determining EIR.
33. This leads to a question about the level of aggregation for impairment evaluation and measurement of purchased financial assets with an explicit expectation of losses. At the December joint meeting, the boards decided that if a financial asset shares risk characteristics with other assets held by the entity, an entity is permitted (but not required) to evaluate those assets individually or within a group of financial assets with shared risk characteristics *for impairment evaluation* purposes. An additional question would be whether these assets would be grouped with other assets held by the entity *for impairment measurement* purposes (for example, for application of a loss rate methodology), or whether these assets would be maintained in closed pools or evaluated individually for the reasons discussed in the prior paragraph. The boards will discuss practical application of the expected value objective as a follow-on issue, and this issue may or may not need to be resolved as part of that discussion.

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Staff recommendation

34. For the reasons discussed in paragraph 20-24, the staff does not believe Alternative 1 is an alternative that should be pursued.
35. The staff believes Alternative 2 is more conceptually appealing than Alternative 1 because it is based on recognition of *changes* in lifetime losses, consistent with the purchase discount contemplating lifetime expected losses being reflected in a credit-adjusted EIR.
36. The staff acknowledges that some could view Alternative 2 as contrary to the underpinnings of the “three-bucket” credit deterioration model as it relates to initial classification of the assets (i.e., in the “three-bucket” general model, all assets are initially classified in Bucket 1). However, for reasons discussed in several earlier paragraphs, this alternative can still be viewed as following a deterioration concept. This is because of the accretion to expected cash flows where an impairment expense (and corresponding increase to the allowance) is only recognised if these assets have experienced deterioration since acquisition. However, both alternatives create a separate model from that being developed by the boards for purchased non-credit-impaired and originated assets. In addition, some staff believes that Alternative 1 may be more operationally difficult than Alternative 2.

Question 1 to the Boards

Do the boards agree with the staff recommendation that purchased financial assets with an explicit expectation of losses should be initially classified in Bucket 2 or 3 (depending on the level of impairment assessment performed), and recognize an impairment allowance based on the *changes* in lifetime expected cash flows (i.e., Alternative 2)? If not, what would the boards prefer to do, and why?

Issue 2: Scope

37. If the model selected for purchased financial assets that have an explicit expectation of losses upon acquisition is based on expected cash flows (for interest recognition purposes), a follow-on question is how to define the scope of that population of assets. A further question is at what level of aggregation (that is, individual asset level or purchased portfolio level) an entity should determine the financial assets meet the scope requirements.

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Defining the scope

38. Current IFRSs and U.S. GAAP define the population of purchased assets that accrete to expected cash flows differently.
- (a) 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 EIR 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 EIR on contractual cash flows.
 - (b) ASC 310-30 (formerly SOP 03-3) applies to loans and securities 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*. Further, 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” (with an interest revenue recognition model similar to ASC 310-30).
39. In describing the decision reached in March and April 2011, the boards selected the phrase “purchased financial assets where an explicit expectation of losses exists [when analysed at the individual asset level]” in describing those assets that would accrete to expected cash flows. The issue is whether that type of descriptive language is sufficient for identifying the scope of assets for which accretion to expected cash flows is appropriate.
40. There are several possibilities the boards could consider. This issue is asking for direction (rather than a decision).
41. For example, the boards could retain the division previously expressed by the boards, and interpret “*financial assets with an explicit expectation of losses at acquisition*” as the same narrow populations of purchased assets captured by current IFRSs and / U.S. GAAP.

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These concepts have been applied in practice and should be well understood. However, the term “deep discount” is not defined currently and raises the question (as the boards noted in the March and April 2011 discussions) that further definition of this term might be needed, for example, to ensure consistent application. In addition, the concepts would need to be reconciled.

42. Conversely, the boards could retain the division previously expressed by the boards, and interpret “*financial assets with an explicit expectation of losses at acquisition*” as capturing a broader population of financial assets. This population might be those acquired with any discount attributable to credit concerns.
43. As a further possibility, referring back to the discussion in paragraphs 7-8, the boards could choose not to differentiate between subsets of purchased financial assets based on loss expectations at acquisition and thus to accrete to expected cash flows for all purchased financial assets. However, this would be reopening the previous tentative decision reached by the boards and significant operational complexities are anticipated (see paragraph below).
44. Widening the scope relative to current U.S. GAAP and IFRSs would reduce the day one loss effect in acquisitions, including acquisitions through business combinations. This would be similar to the population contemplated in the FASB’s May 2010 Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, in that proposed guidance related to interest recognition and impairment of purchased financial assets. Some constituents questioned whether this meant that substantially all purchased assets (that is, a much broader population than is captured currently under Subtopic 310-30) would be required to follow an expected cash flows model. Some constituents noted that debt securities are frequently bought at a discount mostly due to interest but partially to credit. In addition, it is noted that given the similarity of the treatment for credit-impaired financial assets with the accounting treatment of the original IASB ED and under Subtopic 310-30 (that is, a model based on expected cash flows) significant operational complexities would be anticipated, if the scope from today’s population was significantly increased.

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Meeting the scope guidance

45. Depending on the definition of the scope, a related issue is how such financial assets would be identified if purchased as part of a pool of financial assets. If an entity acquired a portfolio of mixed quality assets, such that some were performing assets and some were nonperforming assets having an explicit expectation of losses, to be consistent with the boards' previous decisions, the acquiring entity would have to assess which purchased assets in the portfolio would apply the model for originated loans (that is, accretion to contractual cash flows and recognition of impairment losses consistent with the model for originated loans) and which purchased assets would apply the model based on expected cash flows.
46. Currently, under U.S. GAAP, ASC 310-30 requires that acquired assets *individually* meet the scope criteria such that actual assets with credit deteriorated qualities must be removed from an acquired portfolio and accounted for under its guidance. However, the FASB staff believes there has been some diversity in practice with respect to the scope application of SOP 03-3 in the U.S.⁵ 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 today under IFRSs.
47. The staff expects that for purchases of pools of commercial loans, an individual assessment would be a natural consequence of the loans being risk graded individually by the acquiring entity. For purchases of consumer loans, an individual assessment to determine whether the loans have an explicit expectation of losses may be based on past due or nonaccrual status for regulatory purposes or other characteristics of the loans. Assessment at higher

⁵ 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). Based on this letter, 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) for portfolios of acquired assets, where an entity does not individually evaluate the assets to determine if they meet the scope requirements of ASC 310-30, such that some loans in the portfolio may individually meet the scope criteria and others may not. The SEC requires that entities apply that accounting policy election consistently and disclose its policy.

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level (such as an overall portfolio or segment of a portfolio) might be possible when the characteristics of the individual loans do not vary significantly.

Request for Direction

48. The staff is seeking direction from the boards on the following two issues:
- (a) Approach for scope clarification
 - (b) Approach for assessment of acquired financial assets to determine whether they meet the scope criteria.

Question 2 to the boards
What direction do the boards want to provide on items (a) and (b) in paragraph 48?

Issue 3: Changes in expectations subsequent to acquisition

49. If accretion is based on expected cash flows for purchased credit-impaired assets, an additional issue to be considered is whether favorable changes in expectations about collectibility of cash flows ever adjust the EIR established at acquisition.⁶
50. In current U.S. GAAP (ASC 310-30, formerly SOP 03-3) favorable changes in expected cash flows since acquisition of purchased credit-impaired loans or securities are recognized as yield adjustments (after reduction of allowances), while unfavorable changes are recognized as credit impairments. Under current IFRSs, for fixed rate assets⁷, the EIR is “locked” at acquisition, so that any changes in expectations are recognized as changes in the impairment measure (or carrying value changes if no allowance exists).
51. The staff has identified the following alternatives:
- (a) **Alternative 1** – The initial EIR would not be “locked in” under this alternative. All increases in the amount of cash flows expected to be

⁶ The staff will address as a follow-on issue the symmetrical nature of the impairment model and how to assess when financial assets transferred to Bucket 2 or Bucket 3 due to credit deterioration can be transferred back to Bucket 1. This issue more fundamentally asks how to reflect improvements in expected cash flows—either as a reversal of impairment (or a gain), as a change in the initial EIR, or to have no recognition of such changes until actual cash flows are received.

⁷ There are different requirements for variable rate assets, which the staff intends to address with the board at a later date.

collected, beyond the reversal of existing impairment reserves since acquisition or the prior period, would be recognized over time through an increased yield (i.e., adjust the EIR).

(b) **Alternative 2** – The initial EIR is “locked in” to accrete to the amount of cash flows expected to be collected upon acquisition. Below are two possible alternatives for recognizing changes in expectations related to increases in cash flows expected to be collected:

- (i) **Alternative 2a:** Increases in cash flows expected to be collected are recognized immediately as gains. This is the case even if they exceed the amount of impairment losses recognized by the acquiring entity or the amount of the allowance for credit losses.
- (ii) **Alternative 2b** – Increases in cash flows expected to be collected would be recognized by reversing previously recognized impairment expense but not beyond that point. After that point, an entity would account for the improvement as a deferred gain (that is, recognize the improvement in earnings only when it has been realized via receipt of cash flows in excess of the original expected cash flows).

Staff analysis of alternatives

- 52. Alternative 1 reflects the concepts in the model in current U.S. GAAP for purchased credit-impaired loans. 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. There are several possible variations of this alternative, which the staff could further explore if the boards are interested in pursuing this alternative.
- 53. In the May 2010 FASB ED, the proposed guidance would have required an entity to reflect increases in cash flows expected to be collected through a yield adjustment to the extent it

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exceeds previous impairments and subsequent 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.

54. 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. Users of financial statements cited significant concerns and lack of transparency when the model in ASC 310-30 is applied for purchased credit-impaired loans. They note a need to perform significant analyses and require much additional data from entities that apply this guidance to purchased portfolios to decipher whether amounts that otherwise would have been reflected as an allowance are being accounted for as a yield adjustment. Based on feedback received, users of financial statements generally desire a single impairment model for both originated and purchased assets (which, in this context, the staff is interpreting as a desire for favorable and unfavorable changes in expectations to be treated consistently).
55. Alternative 2 (not adjusting the original EIR) creates greater symmetry for the recognition of increases and decreases in expected cash flows. Also, it would seem to address a concern expressed by constituents regarding the complexity of current U.S. GAAP for purchased credit-impaired loans.
56. The staff believes that current IFRSs are most similar in concept to 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 permits recognition of changes in estimates (both increases and decreases) through a direct carrying value adjustment for all loans including purchased loans.
57. Alternative 2a is based on the idea of symmetry; that is, that improved expectations about collectibility subsequent to acquisition of the financial assets represent an economic gain to the entity and should be permitted to be recognized in the same way as decreased expectations of cash flows expected to be collected represent an economic loss to the entity and require recognition of an impairment loss.

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58. Therefore, some may view Alternative 2a as appropriately reflecting the economics that have taken place. That is, an actual improvement in the expected cash flows has occurred since original recognition and therefore a gain is appropriate. Others may be concerned about this alternative because it could create incentives for entities to underestimate the expected cash flows upon initial recognition.
59. Alternative 2b would allow entities to recognize a gain for increases in cash flows expected *only to the extent* that it had previously recognized an impairment loss. That is, only reversals of previously recognized impairment expense would be permissible. Therefore, Alternative 2b reflects anti-abuse considerations, limiting earnings management. However, Alternative 2b 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.
60. Only Alternative 2a would allow all gains attributable to favorable changes in expectations to be recognized. Alternative 2b is not symmetrical because not all gains would be recognized but all losses would be recognized.
61. However, Alternative 2b is seen by some as a practical approach to maintain a consistent yield trend over time while not recognizing gains in excess of the amount of previously recognized impairment losses. To the extent there is an improvement in the expected cash flows in excess of previously recognized impairment losses, that “gain” is only recognized once realized, consistent with contingent gain accounting. Those who favor this approach believe there is important informational content in the improvement in expected cash flows, so believe disclosure of such amounts would be appropriate.

Staff recommendation

62. All staff supports Alternative 2 because the model is convergent and addresses user and preparer concerns regarding the complexities of adjustments to the EIR. Some staff recommend Alternative 2a, while other staff recommend Alternative 2b.
63. Those staff members who support Alternative 2a 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 and some believe shows an inappropriate bias towards prudence. To these staff members, it is unclear why the same concerns related to gains would not apply if the same item were measured at fair value

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through profit or loss with a Level 3 fair value. Also, these staff members believe the same opportunity for earnings management exists for the loss recognition. Entities could manipulate the accounting by either estimating too high initial expected losses to create a cushion or too low initial expected losses and try to push out the revision in estimates.

64. Those staff members who support Alternative 2b believe favorable changes in expectations should not be recognized beyond previously recognized impairment expense. While significant increases in expected cash flows may represent economic gains to the entity, as mentioned in the paragraph above, those that support Alternative 2b are concerned that Alternative 2a presents opportunities for earnings management. Because Alternative 2b 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. This would seem to help to justify increases in expected cash flows, especially those that might occur shortly after acquisition of a portfolio.

Question 3 to the boards

If the expected cash flows improve subsequent to initial recognition, do the boards agree with either staff recommendation as follows:

Alternative 2a: Increases in cash flows expected to be collected are recognized immediately as gains; or

Alternative 2b: Increases in cash flows expected to be collected would be recognized by reversing previously recognized impairment expense, and any additional increase as a deferred gain to be recognized over the life of the asset?

If the board does not agree with either staff recommendation, what would the boards like to do, and why?

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Issue 4: Presentation of purchased financial assets with an explicit expectation of losses

65. This issue discusses the presentation of purchased financial assets with an explicit expectation of losses measured at amortized cost⁸ in the statement of financial position.
66. 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 value. 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 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 have established a valuation allowance against the loans upon initial measurement.
67. Over time, 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 loans. Originated loans would have an allowance balance (currently based on incurred losses) recognized once the loans are impaired. On the other hand, purchased loans (both in business combinations as required in FAS 141(R) and IFRS 3(R) and portfolio acquisitions) would have no allowance balance recognized for incurred losses that existed at the time of purchase.
68. This difference is most pronounced when comparing originated loans to purchased credit-impaired loans. Consider the following example:
- (a) On 1/1/X1, an entity originates 100 loans with substantially identical loan characteristics (e.g., interest rate and borrower risk characteristics). On

⁸ The presentation of financial assets carried at fair value with changes in value recognized in other comprehensive income in the statement of financial position will be addressed separately when remaining presentation issues are discussed with the boards.

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6/30/X1, the entity sells 50 of these loans to another entity. At 6/30/X1, all 100 loans have an explicit expectation of losses. Although both entities' loan portfolios are substantially identical, the acquiring entity's loans will have a lower allowance for credit losses and the acquiring entity's ratio of reserves to non-performing loans will differ from the originating entity's metrics. As a result, it is difficult to compare the financial position of the two entities based on the information reported in the financial statements. (However, some believe that this is appropriate because the economic position of the entities is different, one entity originated at par, while the other subsequently acquired the assets at fair value).

69. As a result, many constituents have advocated recording purchased loans at the borrower's outstanding balance, net of an allowance for credit losses.⁹
70. The staff has identified two alternatives for the presentation of purchased financial assets with an explicit expectation of losses:
- (a) **Alternative 1:** Net presentation
 - (b) **Alternative 2:** Gross presentation
71. For purposes of illustrating the alternatives, consider the following example:
- (a) An entity purchases a portfolio of amortising loans with a remaining life of four years for CU800. The purchase price of CU800 represents the fair value of the portfolio with a discount of CU200 associated with two factors: (a) CU120 due to credit and (b) CU80 due to changes in the general level of interest rates. The remaining contractual cash flows at the

⁹ In an effort to address this concern, as part of the 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 disclosure rather than requiring "gross" presentation on the face of the balance sheet for purchased financial assets. The May 2010 FASB ED proposed the following disclosures 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.

time of purchase are CU1,000. At the time of purchase the entity expects not to collect CU120.¹⁰

72. The alternative methods of presentation of purchased financial assets with an explicit expectation of losses would result in the journal entries presented in the following table. The example reflects interest income based on an EIR determined based on the initial purchase price and cash flows expected to be collected. It is noted for clarity that the allowance balance shown in Alternative 2 below is not a result of recognizing impairment expense and a corresponding allowance measured in accordance with the model for originated assets. Rather the allowance reflects the credit discount inherent in the purchase price of the asset.

	Alternative 1 NET BASIS	Alternative 2 GROSS BASIS
Initial Recognition	DR Loans CU800 CR Cash CU800	DR Loans CU920* CR Allowance CU120* CR Cash CU800
End of Period 1	DR Cash CU220 CR Interest Income CU31 CR Loans CU189	DR Cash CU220 DR Allowance CU30 CR Interest Income CU31 CR Loans CU219**

**Under the gross presentation, the loan balance reflects face value of CU1000 less purchase discount of CU80 (not attributable to credit) and the allowance reflects a lifetime measure of losses expected to occur.*

*** At the end of Period 1 under Alternative2, the loan balance is decreased by CU189 reflecting the receipt of cash and by CU30 reflecting the reversal of the allowance. In this example, the allowance balance is reduced as cash flows are received as initially expected.*

73. At the end of Period 1, the gross loan balance is CU611 under Alternative 1 (net basis) and CU701 under Alternative 2 (gross basis). However, the net carrying value of the loan on the balance sheet is the same under both alternatives at the end of Period 1 (CU 611) and throughout the remaining life of the loans.
74. Under Alternative 2, entities would have to determine the subsequent accounting for the allowance balance presented at initial acquisition of the assets. The staff believes entities would consider their collection experience for the purchased financial assets to determine the subsequent accounting for the allowance balance. For example, if cash collections

¹⁰ For purposes of illustration the amounts do not include the effect of discounting.

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reflected initial expectations, the entity would reduce the allowance and loan balance over the remaining life of the loans reflecting that collection experience.

Staff recommendation

75. Some staff recommend Alternative 1 while other staff recommend Alternative 2.
76. The staff that support Alternative 1 may be concerned about presenting an allowance for credit losses without a corresponding charge to the provision for credit losses in earnings. Some of the staff who support Alternative 1 also believe Alternative 2 results in two different types of allowance balances being calculated—some inherent in the purchase price of credit-impaired loans and some through the application of the general impairment model—which adds complexity. They believe that the allowance for credit losses should reflect expected losses the acquirer believes will occur subsequent to acquisition, not losses built into the acquisition-date fair value that have been experienced by another entity.
77. Because the acquirer does not have any (economic) losses, some are concerned about a gross presentation because financial reporting is meant to represent the losses of the acquirer. The accounting should reflect that the acquirer is economically in a different position compared to a situation where it would have originated those assets. In addition, 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.
78. Therefore, some staff believe that the user needs should be met through disclosure requirements (to aid comparability between originated and acquired portfolios) rather than gross presentation in the statement of financial position.
79. The staff that support Alternative 2 note that a gross presentation would present the credit loss that is inherent in the assets from the time of origination up to the point of acquisition, thereby resulting in a consistent presentation of these financial assets as compared to originated financial assets in the statement of financial position.

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80. Some believe that a gross presentation approach aligns best with Alternative 2 in Issue 1 (purchased financial assets with an explicit expectation of losses would be initially classified in Bucket 2 or 3, have no impairment expense at acquisition and recognize changes in expectations based on changes in lifetime losses). Presentation of an allowance based on expected losses over the lifetime of the purchased financial assets seems less consistent with all purchased financial assets entering Bucket 1, because a model based on expected cash flows (such as that selected by the boards in March-April 2011 for purchased financial assets with an explicit expectation of credit losses) inherently accounts for the expectation of lifetime losses in the transaction price for purchased assets.
81. Those that advocate a gross up approach believe that any concerns about presenting an allowance without a corresponding provision for impairment recognized in earnings can be overcome through disclosure, such as specifically identifying such balances through the roll-forward of the allowance for credit losses.

Question 4 to the boards

Which alternative for presentation of purchased financial assets with an explicit expectation of losses do the boards prefer:

Alternative 1 – Net presentation; or

Alternative 2 – Gross presentation?