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Accounting for certain loans or debt securities acquired in a transfer; Statement of position 03-03

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF
POSITION 03-3

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

December 12, 2003

Accounting for Certain Loans or Debt Securities Acquired in a Transfer

Issued by the
Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. This SOP does not apply to loans originated by the entity. This SOP limits the yield that may be accreted (accretable yield) to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. This SOP requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. This SOP prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

This SOP prohibits "carrying over" or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of this SOP. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination.

This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Early adoption is encouraged. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6, paragraphs 7 and 8 of this SOP, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four* of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, before clearance, the FASB will propose suggestions, many of which are included in the documents.

* At the time the Accounting Standards Executive Committee developed the prospectus and exposure draft for this project, at least five of the seven Financial Accounting Standards Board members were required to not object.

Accounting for Certain Loans or Debt Securities Acquired in a Transfer

Introduction and Background

1. A loan or group of loans (**loan**[1]) is always transferred at a price less than its **contractually required payments receivable**. The difference between the price and the contractually required payments receivable is attributable to the time value of money and may also be attributable to (*a*) changes in interest rates between the loan's origination and transfer dates, (*b*) changes in credit quality of the borrower between the loan's origination and transfer dates, (*c*) other factors, or (*d*) some combination of all three reasons.

2. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, and related FASB Emerging Issues Task Force (EITF) consensuses address accounting for differences in prepayments and interest rates that are not attributable to credit quality. Some accounting issues involving differences attributable to credit quality were addressed in Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*. However, as outlined in paragraph B.3 of this Statement of Position (SOP), the accounting for loss contingencies attributable to credit quality has subsequently changed. Accordingly, the Accounting Standards Executive Committee (AcSEC) undertook this project to (*a*) identify those objectives of Practice Bulletin 6 that continue to be relevant and (*b*) update and elevate the authority of related guidance. This SOP supersedes Practice Bulletin 6 for transactions entered into after this SOP's initial application. For loans acquired in fiscal years prior to the effective date of this SOP and within the scope of Practice Bulletin

1. Terms defined in the Glossary are set in **boldface type** the first time they appear.

6, this SOP amends the application of Practice Bulletin 6 with regard to accounting for decreases in cash flows expected to be collected.

Scope

3. This SOP applies to all nongovernmental entities, including not-for-profit organizations, that acquire loans (investors). It applies to a loan[2] 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,[3] except:

   a. Loans that are measured at **fair value** if all changes in fair value are included in earnings or, for a not-for-profit organization, loans that are measured at fair value if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented. Examples include those loans classified as trading securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[4] and FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained*

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2. For an acquisition of a pool of loans, each loan first should be determined individually to meet the scope criteria of paragraph 3 of this Statement of Position (SOP). In other words, the pool may not be evaluated as a pool to determine the applicability of the scope criteria of paragraph 3.

3. Investors should consider the significance of delays and shortfalls for a loan so the SOP is not applied when such delays and shortfalls are insignificant with regard to the contractually required payments.

4. Certain loans that do not meet the definition of a debt security may be accounted for as trading securities. Paragraph 14 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, states:

   > Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of [FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*], shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under [FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*], as amended (paragraph 362).

after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise[5]

b. Mortgage loans classified as held for sale under paragraph 4 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

c. Leases as defined in FASB Statement No. 13, *Accounting for Leases*[6]

d. Loans acquired in a business combination accounted for at historical cost[7]

e. Loans held by liquidating banks[8]

f. Revolving credit agreements, such as credit cards and home equity loans, if at the acquisition date the borrower has **revolving privileges**

g. Loans that are retained interests[9]

This SOP does not apply to loans that are derivative instruments subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If a loan would otherwise be in the scope of this paragraph of this SOP and has within it an embedded derivative that is subject to FASB Statement No. 133, the host instrument (as described in FASB Statement No. 133) re-

5. Paragraph 6 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, requires that a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

6. Only contracts that are classified by the purchaser as leases under FASB Statement No. 13, *Accounting for Leases*, meet this exclusion. The distinction between purchasing a lease and purchasing a stream of cash flows must be drawn to determine applicability of this SOP.

7. In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises, requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001.

8. The Emerging Issues Task Force (EITF) discussed financial reporting by liquidating banks in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank.*

9. The EITF discussed accounting for loans that are retained interests in EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

mains within the scope of this paragraph of this SOP if it satisfies the conditions in this paragraph.

Conclusions

Recognition, Measurement, and Display

4. *Loss accruals or valuation allowance.* Valuation allowances should reflect only those losses incurred by the investor after acquisition—that is, the present value of all **cash flows expected at acquisition**[10] that ultimately are not to be received. For loans that are acquired by completion of a transfer, it is not appropriate, at acquisition, to establish a loss allowance. For loans acquired in a purchase business combination, the initial recognition of those loans should be the present value of amounts to be received.

5. Upon completion of a transfer of a loan, this SOP requires that the investor (transferee) should recognize the excess of all cash flows expected at acquisition over the investor's **initial investment** in the loan as interest income on a level-yield basis over the life of the loan (**accretable yield**).[11] The amount of accretable yield should not be displayed in the balance sheet. The loan's contractually required payments receivable in excess of the amount of its cash flows expected at acquisition (**nonaccretable difference**) should not be displayed in the balance sheet or recognized as an adjustment of yield, a loss accrual, or a valuation allowance for credit risk.

6. *Income recognition.* Recognition of income under this SOP is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected. Subsequent to acquisition, this SOP does not prohibit placing loans on nonaccrual status, including use of the cost recovery method or cash basis method of income recog-

10. See footnote 3.

11. Footnote 3 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states:

> A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

nition, when appropriate. For example, if the timing of either a sale of the loan into the secondary market or a sale of loan collateral in essentially the same condition as received upon foreclosure is indeterminate, the investor likely does not have the information necessary to reasonably estimate cash flows expected to be collected to compute its yield and should cease recognizing income on the loan. However, the ability to place a loan on nonaccrual should not be used to circumvent the loss recognition guidance contained in paragraphs 7(a) and 8(a). Alternatively, if the timing and amount of cash flows expected to be collected from those sales are reasonably estimable, the investor should use those cash flows to apply the interest method under this SOP. Consistent with paragraph 18 of FASB Statement No. 91, interest income should not be recognized to the extent that the net investment in the loan would increase to an amount greater than the payoff amount. If the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or improving the collateral for resale.

Changes in Cash Flows Expected to Be Collected

7. *Loan accounted for as a debt security*. An investor should continue to estimate cash flows expected to be collected over the life of the loan. If, upon subsequent evaluation:

   a. The fair value of the debt security has declined below its **amortized cost** basis, an entity should determine whether the decline is other than temporary. An entity should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115. For example, if it is probable, based on current information and events, that the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 7(b) of this SOP), an other-than-temporary impairment should be considered to have occurred. The investor should consider both the timing and amount of cash flows expected to be collected in making a determination about whether it is probable that the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows arising from changes in estimates after acquisition.

b. 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 should recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment *less* (2) cash collected *less* (3) other-than-temporary impairments *plus* (4) amount of yield accreted to date. The investor should adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment should be accounted for as a change in estimate in conformity with Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, with the amount of periodic accretion adjusted over the remaining life of the loan.

8. *Loan not accounted for as a debt security.*[12] An investor should continue to estimate cash flows expected to be collected over the life of the loan. If, upon subsequent evaluation:

a. Based on current information and events, it is probable that the investor is unable to collect all cash flows expected at acquisition plus additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 8(b)(2) of this SOP), the condition in paragraph 8(a) of FASB Statement No. 5, *Accounting for Contingencies*, is met.[13] The loan should be considered impaired

12. On June 19, 2003, AcSEC issued an exposure draft of a proposed SOP, *Allowance for Credit Losses*, that addresses certain issues related to the allowance for credit losses. Readers should be alert to any final pronouncement.

13. For purposes of applying paragraph 23 of FASB Statement No. 5, *Accounting for Contingencies*, to a loan within the scope of this SOP, the phrase "all amounts due according to the contractual terms" should be read "all cash flows originally expected to be collected by the investor plus any additional cash flows expected to be collected arising from changes in estimate after acquisition."

for purposes of applying the measurement and other provisions of FASB Statement No. 5 or, if applicable, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.*[14]

b. 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 should:

   (1) Reduce any remaining valuation allowance (or allowance for loan losses) for the loan established after its acquisition for the increase in the present value of cash flows expected to be collected, *and*

   (2) Recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of (*a*) the initial investment *less* (*b*) cash collected *less* (c) write-downs *plus* (*d*) amount of yield accreted to date. The investor should adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment should be accounted for as a change in estimate in conformity with APB Opinion No. 20 with the amount of periodic accretion adjusted over the remaining life of the loan. The resulting yield should be used as the effective interest rate in any subsequent application of paragraph 8(a) of this SOP.

Prepayments

9. Expected prepayments should be treated consistently for cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments should not affect the nonaccretable difference.

14. See footnote 11.

Restructured or Refinanced Loan

10. If an investor subsequently refinances or restructures the loan, other than through a troubled debt restructuring,[15] the refinanced or restructured loan should not be accounted for as a new loan, and this SOP, including paragraphs 7 and 8, continues to apply.

Variable Rate Loans

11. If a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's contractually required payments receivable should be calculated based on the factor as it changes over the life of the loan. Projections of future changes in the factor should not be made for purposes of determining the effective interest rate or estimating cash flows expected to be collected. At the acquisition date, the amount of cash flows expected to be collected should be based on the index rate in effect at acquisition. Increases in cash flows expected to be collected should be accounted for according to paragraph 7(b) or 8(b). Decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate should be recognized prospectively as a change in estimate in conformity with APB Opinion No. 20 by reducing, for purposes of applying paragraphs 7(a) and 8(a), all cash flows expected to be collected at acquisition and the accretable yield. The investor should decrease the amount of accretable yield and the cash flows expected to be collected. Thus, for decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate, the effect will be to reduce prospectively the yield recognized rather than recognize a loss.

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15. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, establishes the accounting for troubled debt restructurings (TDRs). For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans. Outstanding loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114 or FASB Statement No. 115, as applicable.

Multiple Loans Accounted for as a Single Asset

12. For purposes of applying the recognition, measurement, and disclosure provisions of this SOP for loans that are not accounted for as debt securities, investors may aggregate loans acquired in the same fiscal quarter that have **common risk characteristics** and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. To be eligible for aggregation, each loan first should be determined individually to meet the scope criteria of paragraph 3 of this SOP. After determining that certain acquired loans are within the scope as defined in paragraph 3 of this SOP, the investor may evaluate whether such loans have common risk characteristics, thus permitting the aggregation of such loans into one or more pools. A portion of the total cost of acquired assets should be assigned to each individual asset acquired on the basis of its relative fair value at the date of acquisition. The excess of the contractually required payments receivable over the investor's initial investment (whether accretable yield or nonaccretable difference) for a specific loan or a pool of loans with one set of common risk characteristics should not be considered available to "offset" changes in cash flows expected to be collected from a different loan or an assembled pool of loans with another set of common risk characteristics.

13. Once a pool is assembled, the integrity of the pool should be maintained. A loan should be removed from a pool of loans only if the investor sells, forecloses, or otherwise receives assets in satisfaction of the loan, or the loan is written off, and it should be removed at its carrying amount. The difference between the loan's carrying amount and the fair value of the collateral or other assets received should not affect the percentage yield calculation used to recognize accretable yield on the pool of loans.

Disclosures

14. The notes to financial statements should describe how prepayments are considered in the determination of contractual cash flows and cash flows expected to be collected.

15. Information about loans meeting the scope criteria of paragraph 3 of this SOP should be included in the disclosures required by paragraphs 20(a) and 20(b) of FASB Statement No. 114, if the condition in paragraph 16 of FASB Statement No. 115 or paragraph 8(a) of FASB Statement No. 5 (as discussed in paragraphs 7(a) and 8(a) of this SOP) is met.

16. In addition to disclosures required by other generally accepted accounting principles, for each balance sheet presented, an investor should disclose the following information about loans within the scope of this SOP:

   a. Separately for both those loans that are accounted for as debt securities and those loans that are not accounted for as debt securities:

      (1) The **outstanding balance** and related carrying amount at the beginning and end of the period.

      (2) The amount of accretable yield at the beginning and end of the period, reconciled for additions, accretion, disposals of loans, and reclassifications to or from nonaccretable difference during the period.

      (3) For loans acquired during the period, the contractually required payments receivable, cash flows expected to be collected, and fair value at the acquisition date.

      (4) For those loans within the scope of this SOP for which the income recognition model in this SOP is not applied in accordance with paragraph 6, the carrying amount at the acquisition date for loans acquired during the period and the carrying amount of all loans at the end of the period.

   b. Further, for those loans that are not accounted for as debt securities, an investor should disclose:

      (1) The amount of (*a*) any expense recognized pursuant to paragraph 8(a) of this SOP and (*b*) any reductions of the allowance recognized pursuant to paragraph 8(b)(1) of this SOP for each

period for which an income statement is presented.

(2) The amount of the allowance for uncollectible accounts at the beginning and end of the period.

Amendments to Existing Literature

17. Amendments to Practice Bulletin 6 are contained in Appendix C.

Effective Date and Transition

18. This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Previously issued annual financial statements should not be restated. Early application of this SOP is encouraged, but not required, for transfers of loans subsequent to the issuance of this SOP but prior to the effective date.

19. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6, paragraphs 7 and 8 of this SOP, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

The provisions of this Statement of Position need not be applied to immaterial items.

APPENDIX A

Implementation Guidance

A.1. This appendix illustrates how this Statement of Position (SOP) should be applied in certain generalized situations. The facts and circumstances of specific transactions need to be considered carefully in applying this SOP. The appendix does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. This appendix does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations. The illustration below was developed considering the acquisition of a pool of loans in which all loans individually met the scope criteria of paragraph 3 of this SOP. For ease of description in the illustrative example, references to this acquisition of a pool of loans are depicted as a single loan or debt security. In addition, for purposes of simplifying the illustration, additional interest that would accrue under the contractual terms of the loan or debt security for the debtor's failure to make timely payments of the contractual principal and interest is not illustrated. The illustration presents the write-off of the uncollectible investment in the loans receivable at the end of the loan's term. This SOP does not address when a loan should be written off.

Illustration—Base Case

A.2. Company A acquires a loan with a principal balance of $5,046,686 and accrued delinquent interest of $500,000 (see paragraph A.1) at a discount due to concerns about the debtor's credit quality that have occurred since the loan's origination. Company A pays $4,000,000 for the loan on December 31, 20X0. No fees were paid or received as part of the acquisition. The contractual interest rate is 12 percent per year. In addition to the delinquent interest, annual payments of $1,400,000 are due in each of the five remaining years to maturity. Company A determines it is probable that it will be unable to collect all amounts due according to the loan's contractual terms. Rather, Company A expects to collect only $1,165,134 per year for five years. In Company A's balance sheet, the loan will initially be displayed at its net carrying amount (for example, $4,000,000 at December 31, 20X0).

Year Ended December 31	A Beginning Carrying Amount	B Cash Flows Expected to Be Collected	C Interest Income[1]	D Reduction of Carrying Amount B – C	E Ending Carrying Amount A – D
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	689,853	2,705,013
20X3	2,705,013	1,165,134	378,702	786,432	1,918,581
20X4	1,918,581	1,165,134	268,601	896,533	1,022,048
20X5	1,022,048	1,165,134	143,086	1,022,048	—
		$5,825,670	$1,825,670	$4,000,000	

Initial Calculation of Nonaccretable Difference

Contractually required payments receivable (includes delinquent interest)	$ 7,500,000
Less: Cash flows expected to be collected	(5,825,670)
Nonaccretable difference	$ 1,674,330

Initial Calculation of Accretable Yield

Cash flows expected to be collected	$ 5,825,670
Less: Initial investment	(4,000,000)
Accretable yield	$ 1,825,670

As noted in paragraph A.1, the summary of activity presented in the illustrations in paragraphs A.3, A.5, A.7(a), A.7(b), A.9(a)(2), A.9(b)(2), A.11(a)(2), and A.11(b)(2) omits additional interest that would accrue on unpaid amounts under the contractual terms of the loan or debt security. Given the assumptions in the illustrations, any additional accrued interest would increase both the contractually required payments receivable and nonaccretable difference.

1. The effective interest rate in this example is the discount rate that, at acquisition, equates all cash flows expected to be collected with the purchase price of the loan. This Statement of Position (SOP) does not address whether the investor should or should not accrue income. However, for purposes of this illustration, it is assumed that the investor can reasonably estimate cash flows expected to be collected. The yield recognized is 14.00 percent for years 20X1 through 20X5.

Illustration—Scenario A
Actual Cash Flows Equal Cash Flows Expected for Years 20X1–X5

A.3. If Company A receives all the cash flows that it expected to be collected, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Balance	5,169,732	3,495,402	1,674,330	790,389	2,705,013
20X3 collections	(1,165,134)	(1,165,134)		(378,702)	(786,432)
Balance	4,004,598	2,330,268	1,674,330	411,687	1,918,581
20X4 collections	(1,165,134)	(1,165,134)		(268,601)	(896,533)
Balance	2,839,464	1,165,134	1,674,330	143,086	1,022,048
20X5 collections	(1,165,134)	(1,165,134)		(143,086)	(1,022,048)
Balance	1,674,330	$ —	1,674,330	$ —	$ —
Disposition[2]	(1,674,330)		(1,674,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 collections	(786,432)		(786,432)		1,165,134	378,702
Balance	1,918,581		1,918,581			
20X4 collections	(896,533)		(896,533)		1,165,134	268,601
Balance	1,022,048		1,022,048			
20X5 collections	(1,022,048)		(1,022,048)		1,165,134	143,086
Balance	$ —		$ —		$ 1,825,670	$1,825,670

2. For illustrative purposes, the removal of the contractual amounts and nonaccretable difference is presented at the end of the period. In this illustration, Company A wrote off the uncollectible portion of the contractually required payments receivable at the maturity of the loan. This SOP does not address when a loan should be written off.

Illustration—Scenario B
Base Case With Increase in Cash Flows Expected for Year 20X3

A.4. ***Change in Expectations.*** Assume that, at December 31, 20X2, Company A determines it is probable that cash flows expected to be collected will be $250,000 more in 20X3 than previously expected but does not change its expectations of cash flows in years 20X4 and 20X5. Following are the resulting calculations.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[3]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	689,853	2,705,013
Totals for years 20X1–X2		$2,330,268	$1,035,281	$1,294,987	
20X3	$2,705,013	$1,415,134	$ 512,878	$ 902,256	$1,802,757
20X4	1,802,757	1,165,134	341,808	823,326	979,431
20X5	979,431	1,165,134	185,703	979,431	—
Totals for years 20X3–X5		$3,745,402	$1,040,389	$2,705,013	
Totals for years 20X1–X5		$6,075,670	$2,075,670	$4,000,000	

Recalculation of Accretable Yield

Remaining cash flows expected to be collected, December 31, 20X2		$3,745,402
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(2,330,268)	
Less: Write-downs and allowance	—	
Plus: Yield accreted to date	1,035,281	
		2,705,013
Remaining accretable yield as recalculated		1,040,389
Less: Unadjusted balance at December 31, 20X2		(790,389)
Adjustment needed		$ 250,000

3. The yield recognized is 14.00 percent for years 20X1 and 20X2 and 18.9603 percent for years 20X3 through 20X5.

A.5. If Company A receives all the cash flows that it expected to be collected (including the increase of $250,000 in 20X3), the following is a summary of the effects of that activity.

	A Required Payments Receivable	B Contractually Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Balance	5,169,732	3,495,402	1,674,330	790,389	2,705,013
Increase in cash flows expected		250,000[4]	(250,000)	250,000	
20X3 collections	(1,415,134)	(1,415,134)		(512,878)	(902,256)
Balance	3,754,598	2,330,268	1,424,330	527,511	1,802,757
20X4 collections	(1,165,134)	(1,165,134)		(341,808)	(823,326)
Balance	2,589,464	1,165,134	1,424,330	185,703	979,431
20X5 collections	(1,165,134)	(1,165,134)		(185,703)	(979,431)
Balance	1,424,330	$ —	1,424,330	$ —	$ —
Disposition	(1,424,330)		(1,424,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income[5]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 collections	(902,256)		(902,256)		1,415,134	512,878
Balance	1,802,757		1,802,757			
20X4 collections	(823,326)		(823,326)		1,165,134	341,808
Balance	979,431		979,431			
20X5 collections	(979,431)		(979,431)		1,165,134	185,703
Balance	$ —		$ —		$ 2,075,670	$2,075,670

4. The $250,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

5. The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X3 through 20X5 from 14.00 percent to 18.9603 percent.

Illustration—Scenario C
Base Case With Decrease in Cash Flows Expected for Years 20X3–X5

A.6. ***Change in Expectations.*** Assume instead that, at December 31, 20X2, Company A determines it is probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years than expected at acquisition. Using the effective interest rate of 14 percent, the present value of the remaining cash flows expected to be collected is calculated as $2,472,850. Following are the resulting calculations.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[6]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[7]	2,472,850
Totals for years 20X1–X2		$2,330,268	$1,035,281	$1,527,150	
20X3	$2,472,850	$1,065,134	$ 346,199	$ 718,935	$1,753,915
20X4	1,753,915	1,065,134	245,548	819,586	934,329
20X5	934,329	1,065,134	130,805	934,329	—
Totals for years 20X3–X5		$3,195,402	$ 722,552	$2,472,850	
Totals for years 20X1–X5		$5,525,670	$1,757,833	$4,000,000	

Measurement of Impairment

Recorded amount prior to change in estimate		$ 2,705,013
Less: Present value of cash flows expected to be collected		(2,472,850)
Measured impairment at December 31, 20X2		$ 232,163

Recalculation of Accretable Yield

Remaining cash flows expected to be collected, December 31, 20X2		$ 3,195,402
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(2,330,268)	
Less: Write-downs and allowance	(232,163)	
Plus: Yield accreted to date	1,035,281	
		2,472,850
Remaining accretable yield as recalculated		722,552
Less: Unadjusted balance at December 31, 20X2		(790,389)
Adjustment needed to accretable yield		$ (67,837)

Proof:

Total decrease in cash flows expected to be collected	$ 300,000
Present value of total decrease (current period loss)	(232,163)
Future accretable yield no longer expected	$ 67,837

6. The yield recognized is 14.00 percent for years 20X1 through 20X5.
7. The reduction of carrying amount includes an allowance for loan losses of $232,163 for a loan not accounted for as a debt security and a write-down of $232,163 for a loan accounted for as a debt security.

Accounted for as a Debt Security

A.7(a). If Company A receives the cash flows as expected in years 20X1 and 20X2 but at the end of 20X2 determines cash flows will be $100,000 less in each of years 20X3 through 20X5, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Debt Security B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)[8]	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
20X4 collections	(1,065,134)	(1,065,134)		(245,548)	(819,586)
Balance	3,039,464	1,065,134	1,974,330	130,805	934,329
20X5 collections	(1,065,134)	(1,065,134)		(130,805)	(934,329)
Balance	1,974,330	$ —	1,974,330	$ —	$ —
Disposition	(1,974,330)		(1,974,330)		
	$ —		$ —		

	Debt Security	Allowance	Debt Security	Loss	Cash	Interest Income[9]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(819,586)		(819,586)		1,065,134	245,548
Balance	934,329		934,329			
20X5 collections	(934,329)		(934,329)		1,065,134	130,805
Balance	$ —		$ —	$232,163	$ 1,525,670	$1,757,833

8. The $300,000 decrease in cash flows expected to be collected represents $67,837 of interest income (accretable yield) foregone that had been expected at acquisition to be earned and $232,163 of carrying amount that will not be recovered. The $300,000 decrease in cash flows expected to be collected results in a loss of $232,163 (recorded as a write-off) and foregone interest income in future years of $67,837.

9. The accretable yield recognized as interest income for years 20X3 through 20X5 remains at 14.00 percent.

Accounted for as a Loan

A.7(b). If Company A receives the cash flows as expected in years 20X1 and 20X2 but at the end of 20X2 determines cash flows will be $100,000 less in each of years 20X3 through 20X5, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)[10]	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850[11]
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
20X4 collections	(1,065,134)	(1,065,134)		(245,548)	(819,586)
Balance	3,039,464	1,065,134	1,974,330	130,805	934,329
20X5 collections	(1,065,134)	(1,065,134)		(130,805)	(934,329)
Balance	1,974,330	$ —	1,974,330	$ —	$ —
Disposition	(1,974,330)		(1,974,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income[12]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
20X4 collections	(819,586)		(819,586)		1,065,134	245,548
Balance	1,166,492	(232,163)	934,329			
20X5 collections	(934,329)		(934,329)		1,065,134	130,805
Balance	232,163	(232,163)	$ —	$232,163	$ 1,525,670	$1,757,833
Disposition	(232,163)	232,163				
	$ —	$ —				

10. The $300,000 decrease in cash flows expected to be collected represents $67,837 of interest income (accretable yield) foregone that had been expected at acquisition to be earned and $232,163 of carrying amount that will not be recovered. The $300,000 decrease in cash flows expected to be collected results in a loss of $232,163 (recorded as an allowance for loan loss) and foregone interest income in future years of $67,837.

11. For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.

12. The accretable yield recognized as interest income for years 20X3 through 20X5 remains at 14.00 percent.

Illustration—Scenario D
Cash Flows Expected for Years 20X4–X5 Are Greater Than the Revised Cash Flows Expected for Years 20X4–X5 But Cumulative Expected Cash Flows Are Less Than Cash Flows Originally Expected at Acquisition

A.8. ***Change in Cash Collections and Expectations.*** At December 31, 20X2, Company A determined it was probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years (20X3–X5) than expected at acquisition. Actual cash flows for 20X3 collected were the revised decrease in expected cash flows to be collected. At January 1, 20X4, Company A determines it is probable that cash flows will be $50,000 more in each of 20X4 and 20X5.

Loan Accounted for as a Debt Security

A.9(a)(1). If the loan is accounted for as a debt security, the entire subsequent increase in cash flows expected to be collected is recorded as a yield adjustment on a prospective basis because the earlier write-down may not be reversed. Following is a summary of activity.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[13]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[14]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,115,134	$ 309,219	$ 805,915	$ 948,000
20X5	948,000	1,115,134	167,134	948,000	—
Totals for years 20X4–X5		$2,230,268	$ 476,353	$1,753,915	
Totals for years 20X1–X5		$5,625,670	$1,857,833	$4,000,000	

13. The yield recognized is 14.00 percent for years 20X1 through 20X3 and 17.6302 percent for years 20X4 and 20X5.
14. The reduction of carrying amount includes a write-down of $232,163.

A.9(a)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Debt Security B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		100,000[15]	(100,000)	100,000	
20X4 collections	(1,115,134)	(1,115,134)		(309,219)	(805,915)
Balance	2,989,464	1,115,134	1,874,330	167,134	948,000
20X5 collections	(1,115,134)	(1,115,134)		(167,134)	(948,000)
Balance	1,874,330	$ —	1,874,330	$ —	$ —
Disposition	(1,874,330)		(1,874,330)		
	$ —		$ —		

	Debt Security	Allowance	Debt Security	Loss	Cash	Interest Income[16]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(805,915)		(805,915)		1,115,134	309,219
Balance	948,000		948,000			
20X5 collections	(948,000)		(948,000)		1,115,134	167,134
Balance	$ —		$ —	$232,163	$ 1,625,670	$1,857,833

15. The $100,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

16. Because the loan is accounted for as a debt security, the reduction in cash flows evaluated at the end of 20X2 resulted in an impairment that may not be reversed. The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 17.6302 percent.

Accounted for as a Loan

A.9(b)(1). Alternatively, if the loan is *not* accounted for as a debt security, the increase in cash flows expected to be collected is first used to reverse the amount of any related allowance for loan losses before the yield is adjusted. Following are the resulting calculations.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[17]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[18]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,115,134	$ 257,075	$ 775,726[19]	$ 978,189
20X5	978,189	1,115,134	136,945	978,189	—
Totals for years 20X4–X5		$2,230,268	$ 394,020	$1,753,915	
Totals for years 20X1–X5		$5,625,670	$1,775,500	$4,000,000	

Reversal of Valuation Allowance

Recorded amount, January 1, 20X4	$ 1,986,078
Allowance for loan losses	(232,163)
Carrying amount, January 1, 20X4	$ 1,753,915
Less: Present value of cash flows expected to be collected	(1,836,248)
Reversal of valuation allowance	$ (82,333)

Rollforward of Accretable Yield

Balance, at acquisition		$ 1,825,670
20X1 accretion	(560,000)	
20X2 accretion	(475,281)	
20X3 accretion	(346,199)	
		(1,381,480)
20X2 reclassification to nonaccretable difference		(67,837)
Balance, at December 31, 20X3		$ 376,353

Recalculation of Accretable Yield

Remaining cash flows expected to be collected, January 1, 20X4		$ 2,230,268
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(3,395,402)	
Less: Write-downs and allowance	(149,830)	
Plus: Yield accreted to date	1,381,480	
		1,836,248
Remaining accretable yield as recalculated		394,020
Less: Unadjusted balance		(376,353)
Adjustment needed to accretable yield		$ 17,667
Proof:		
Total increase in cash flows expected to be collected		$ 100,000
Present value of total increase (current period reversal of allowance)		(82,333)
Additional income expected		$ 17,667

17. The yield recognized is 14.00 percent for years 20X1 through 20X5.
18. The reduction of carrying amount includes an allowance for loan losses of $232,163.
19. The reduction of carrying amount includes a reversal of valuation allowance of $82,333.

A.9(b)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		100,000[20]	(100,000)	100,000	
Reversal of prior allowance				(82,333)	82,333
20X4 collections	(1,115,134)	(1,115,134)		(257,075)	(858,059)
Balance	2,989,464	1,115,134	1,874,330	136,945	978,189[21]
20X5 collections	(1,115,134)	(1,115,134)	—	(136,945)	(978,189)
Balance	1,874,330	$ —	1,874,330	$ —	$ —
Disposition	(1,874,330)		(1,874,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income[22]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
Reversal of prior allowance		82,333	82,333	(82,333)		
20X4 collections	(858,059)		(858,059)		1,115,134	257,075
Balance	1,128,019	(149,830)	978,189			
20X5 collections	(978,189)		(978,189)		1,115,134	136,945
Balance	149,830	(149,830)	$ —	$149,830	$ 1,625,670	$1,775,500
Disposition	(149,830)	149,830				
	$ —	$ —				

20. The $100,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.
21. For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.
22. The accretable yield recognized as interest income for years 20X4 and 20X5 remains at 14.00 percent.

Illustration—Scenario E

Cash Flows Expected for Years 20X4–X5 Are Greater Than the Revised Cash Flows Expected for Years 20X4–X5 and Cumulative Expected Cash Flows Are Greater Than Cash Flows Originally Expected at Acquisition

A.10. *Change in Expectations.* At December 31, 20X2, Company A determined it was probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years (20X3–X5) than expected at acquisition. Actual cash flows for 20X3 collected were the revised decrease in expected cash flows to be collected. At January 1, 20X4, Company A determines it is probable that, in both 20X4 and 20X5, Company A will collect $250,000 more in cash flows than previously expected.

Accounted for as a Debt Security

A.11(a)(1). If the loan is accounted for a debt security, the entire subsequent increase in cash flows expected to be collected is recorded as a yield adjustment on a prospective basis because the earlier write-down may not be reversed. Following is a summary of the activity.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[23]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[24]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,315,134	$ 558,653	$ 756,481	$ 997,434
20X5	997,434	1,315,134	317,700	997,434	—
Totals for years 20X4–X5		$2,630,268	$ 876,353	$1,753,915	
Totals for years 20X1–X5		$6,025,670	$2,257,833	$4,000,000	

23. The yield recognized is 14.00 percent for years 20X1 through 20X3 and 31.8518 percent for years 20X4 and 20X5. Interest income exceeds the difference in cash flows expected to be collected and the acquisition price by $232,163, which is the amount of the impairment recognized in 20X2 that may not be reversed.

24. The reduction of carrying amount includes a write-down of $232,163.

A.11(a)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Debt Security B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		500,000[25]	(500,000)	500,000	
20X4 collections	(1,315,134)	(1,315,134)		(558,653)	(756,481)
Balance	2,789,464	1,315,134	1,474,330	317,700	997,434
20X5 collections	(1,315,134)	(1,315,134)		(317,700)	(997,434)
Balance	1,474,330	$ —	1,474,330	$ —	$ —
Disposition	(1,474,330)		(1,474,330)		
	$ —		$ —		

	Debt Security	Allowance	Debt Security	Loss	Cash	Interest Income[26]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(756,481)		(756,481)		1,315,134	558,653
Balance	997,434		997,434			
20X5 collections	(997,434)		(997,434)		1,315,134	317,700
	$ —		$ —	$232,163	$ 2,025,670	$2,257,833

25. The $500,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

26. Because the loan is accounted for as a debt security, the reduction in cash flows expected to be collected at the end of 20X2 resulted in an impairment that may not be reversed. The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 31.8518 percent.

Accounted for as a Loan

A.11(b)(1). If the loan is *not* accounted for as a debt security, then following are resulting calculations. The present value of cash flows expected to be collected exceeds the recorded amount. Accordingly, the allowance for loan losses will be reversed in its entirety and the amount of yield to be accreted must be adjusted.

Year Ended December 31	Beginning Carrying Amount	Cash Flows Expected to Be Collected	Interest Income[27]	Reduction of Carrying Amount	Ending Carrying Amount
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[28]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,315,134	$ 416,296	$ 666,675[29]	$1,087,240
20X5	1,087,240	1,315,134	227,894	1,087,240	—
Totals for years 20X4–X5		$2,630,268	$ 644,190	$1,753,195	
Totals for years 20X1–X5		$6,025,670	$2,025,670	$4,000,000	

Rollforward of Accretable Yield

Balance, at acquisition		$ 1,825,670
20X1 accretion	(560,000)	
20X2 accretion	(475,281)	
20X2 impairment	(67,837)	
20X3 accretion	(346,199)	
		1,449,317
Balance, at December 31, 20X3		$ 376,353

Recalculation of Accretable Yield

Remaining cash flows expected to be collected at January 1, 20X4		$ 2,630,268
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(3,395,402)	
Plus: Yield accreted to date	1,381,480	
		1,986,078
Remaining accretable yield as recalculated		644,190
Less: Unadjusted balance		(376,353)
Adjustment needed to accretable yield		$ 267,837

Proof:

Total increase in cash flows expected to be collected	$ 500,000
Current period reversal of valuation allowance	(232,163)
Additional income expected	$ 267,837

27. The yield recognized is 14.00 percent for years 20X1 through 20X3 and 20.9607 percent for years 20X4 and 20X5.
28. The reduction of carrying amount includes an allowance for loan losses of $232,163.
29. The reduction of carrying amount includes a reversal of valuation allowance of $232,163.

A.11(b)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	B Cash Expected to Be Collected	C Nonaccretable Difference A – B	D Accretable Yield	E Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		500,000[30]	(500,000)	500,000	
Reversal of prior allowance				(232,163)	232,163
20X4 collections	(1,315,134)	(1,315,134)		(416,296)	(898,838)
Balance	2,789,464	1,315,134	1,474,330	227,894	1,087,240[31]
20X5 collections	(1,315,134)	(1,315,134)		(227,894)	(1,087,240)
Balance	1,474,330	$ —	1,474,330	$ —	$ —
Disposition	(1,474,330)		(1,474,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income[32]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
Increase in cash flows expected						
Reversal of prior allowance		232,163	232,163	(232,163)		
20X4 collections	(898,838)		(898,838)		1,315,134	416,296
Balance	1,087,240	$ —	1,087,240	$ —		
20X5 collections	(1,087,240)		(1,087,240)		1,315,134	227,894
Balance	$ —		$ —		$ 2,025,670	$2,025,670

30. The $500,000 increase in cash flows expected to be collected results in the reversal of the entire allowance previously established and a reclassification of nonaccretable difference to accretable yield.

31. For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.

32. Because the loan is not accounted for as a debt security, the reduction in cash flows expected to be collected at the end of 20X2 resulted in an establishment of an allowance. The example assumes no write-downs of the loan occurred and no subsequent entries were made to the allowance. The entire allowance previously established is reversed and the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 20.9607 percent.

Illustration—Disclosures

A.12. Following is an illustrative note disclosure of Company A's accounting policy.

Acquired Loans (Including Debt Securities)

Company A's valuation allowances for all acquired loans subject to SOP 03-3 reflect only those losses incurred after acquisition—that is, the present value of cash flows expected at acquisition that are not expected to be collected. Valuation allowances are established only subsequent to acquisition of the loans.

Company A acquires loans (including debt securities) individually and in groups or portfolios. For certain acquired loans that have experienced deterioration of credit quality between *origination and* the Company's acquisition of the loans, the amount paid for a loan reflects Company A's determination that it is probable Company A will be unable to collect all amounts due according to the loan's contractual terms. At acquisition, Company A reviews each loan to determine whether there is evidence of deterioration of credit quality since origination and if it is probable that Company A will be *unable to collect all amounts* due according to the loan's contractual terms. If both conditions exist, Company A determines whether each such loan is to be accounted for individually or whether such loans will be assembled into pools of loans based on common risk characteristics (credit score, loan type, and date of origination). Company A considers expected prepayments, and estimates the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan and subsequently aggregated pool of loans. Company A determines the excess of the loan's or pool's scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount—representing the excess of the loan's cash flows expected to be collected over the amount paid—is accreted into interest income over the remaining life of the loan or pool (*accretable yield*).

Over the life of the loan or pool, Company A continues to estimate cash flows expected to be collected. Company A evaluates at the balance sheet date whether the present value of its loans determined using the effective interest rates has decreased and if so, recognizes a loss. For loans or pools that are not accounted for as debt securities, the present value of any subsequent increase in the loan's or pool's actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan or pool. For any remaining increases in cash flows expected to be collected, or for loans or pools accounted for as debt securities, Company A adjusts the amount of accretable yield recognized on a prospective basis over the loan's or pool's remaining life.

A.13. Following is illustrative wording that includes the disclosures required by this SOP.

For loans accounted for as debt securities (amounts in thousands):

Company A has acquired loans accounted for as debt securities, for which there was, prior to their being acquired in a transfer, evidence of deterioration of credit quality since origination. It was probable, at acquisition, that all contractually required payments for those loans would not be collected.

The carrying amount of those loans accounted for as debt securities is included in the balance sheet amounts at December 31. The outstanding balance (representing amounts owed to the company at the balance sheet date) and carrying amounts of those loans classified as held-to-maturity securities and available-for-sale securities at December 31 are as follows:

	20X5	20X4	20X3
Held-to-maturity:			
Outstanding balance	$41,362	$42,362	$39,093
Carrying amount, net	21,921	23,299	21,892
Available-for-sale securities:			
Outstanding balance	$43,726	$43,162	$42,063
Carrying amount, net	23,612	23,523	22,503

	Held-to-Maturity Securities	Available-for-Sale Securities
Accretable yield:		
Balance at December 31, 20X3	$ 9,562	$ 9,392
Additions	948	829
Accretion	(1,869)	(1,966)
Disposals	—	—
Balance at December 31, 20X4	8,641	8,255
Additions	1,447	968
Accretion	(1,594)	(1,776)
Reclassifications from nonaccretable difference	1,231	902
Disposals	—	—
Balance at December 31, 20X5	$ 9,725	$ 8,349

During the years ended December 31, 20X5 and 20X4, Company A recognized other-than-temporary impairment of $15 and $3, respectively.

Debt securities acquired each year for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

	20X5	20X4	20X3
Held-to-maturity:			
Contractually required payments receivable	$4,936	$3,362	$3,093
Cash flows expected to be collected	4,134	2,708	2,475
Basis in acquired securities	2,687	1,760	1,701
Available-for-sale:			
Contractually required payments receivable	$3,726	$2,562	$2,063
Cash flows expected to be collected	2,979	2,086	1,577
Basis in acquired securities	2,011	1,257	1,062

Certain of the debt securities acquired by Company A that are within the scope of SOP 03-3 are not accounted for using the income recognition model of the SOP because Company A cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such debt securities, all of which are classified as available-for-sale securities, are as follows:

	20X5	20X4	20X3
Debt securities acquired during the year	$ 422	230	145
Debt securities at end of year	659	794	810

A.14. Following is illustrative wording that includes the disclosures required by this SOP.

For loans not accounted for as debt securities (amounts in thousands):

Company A has loans that were acquired in a transfer, for which there was, at acquisition, evidence of deterioration of credit quality since origination and for which it was probable, at acquisition, that all contractually required payments would not be collected.

The carrying amount of those loans is included in the balance sheet amounts of loans receivable at December 31. The amounts of loans at December 31 are as follows:

	20X5	20X4	20X3
Commercial	$28,273	$27,894	$26,777
Consumer	8,021	7,008	6,011
Outstanding balance	36,294	34,902	32,788
Carrying amount, net of allowance of $878, $860, and $850	$23,732	$23,472	$21,918

	Accretable Yield
Balance at December 31, 20X3	$10,193
Additions	998
Accretion	(426)
Reclassifications from (to) nonaccretable difference	—
Disposals	—
Balance at December 31, 20X4	10,765
Additions	1,084
Accretion	(454)
Reclassifications from nonaccretable difference	57
Disposals	—
Balance at December 31, 20X5	$11,452

During the years ended December 31, 20X5 and 20X4, Company A increased the allowance for loan losses by a charge to the income statement by $18 and $10, respectively. No allowances for loan losses were reversed in 20X5 or 20X4.

Loans acquired during each year for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

	20X5	20X4	20X3
Contractually required payments receivable at acquisition:			
Commercial	$3,273	$2,894	$2,778
Consumer	1,021	1,108	1,011
Subtotal	4,294	4,002	3,789
Cash flows expected to be collected at acquisition	3,490	3,284	3,036
Basis in acquired loans at acquisition	2,406	2,286	2,101

Certain of the loans acquired by Company A that are within the scope of SOP 03-3 are not accounted for using the income recognition model of the SOP because Company A cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such loans (which are included in the carrying amount, net of allowance, described above) are as follows:

	20X5	20X4	20X3
Loans acquired during the year	$ 320	240	158
Loans at end of year	749	902	930

APPENDIX B

Basis for Conclusions

Introduction and Background

B.1. The Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed Statement of Position (SOP), *Accounting for Discounts Related to Credit Quality*, on December 30, 1998. AcSEC received 33 comment letters in response to the exposure draft during the exposure period ending April 29, 1999.

B.2. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires that discounts be recognized as an adjustment of yield over the instrument's life (see paragraphs 18, 19, and 53 of FASB Statement No. 91). Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, was issued in August 1989 and further addressed accretion of discounts, which involves intertwining issues of accretion of yield, measurement of credit losses, and recognition of interest income. Specifically, Practice Bulletin 6:

a. Provides guidance on when to and when not to accrete discounts on acquired loans (paragraph 13).

b. Limits the accretion of discount on loans within its scope to amounts expected to be collected (paragraph 13).

c. Addresses the effects on accretion of changes in the amounts, estimability, and probability of cash collections (paragraph 15). Specifically, when estimated (expected) cash flows decrease, Practice Bulletin 6 permitted the yield to decrease below the initial yield and to fall ultimately to zero, spreading the effect of the change in the estimate.

d. Explains how to apply the cost-recovery method to certain loans (paragraphs 16 and 17).

e. Sets out factors to be considered in assessing collectibility (paragraph 18).

Also, appendixes to Practice Bulletin 6 (*a*) flowchart Practice Bulletin 6's provisions and (*b*) illustrate and give conclusions on specific scenarios.

B.3. The following pronouncements have been issued or amended since August 1989 to address various related issues:

a. FASB Statement No. 5, *Accounting for Contingencies*, was amended to clarify that enterprises should consider collectibility of both principal and interest for all receivables.

b. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was issued, which requires that an impaired loan, including a loan that has been restructured in a troubled debt restructuring involving a modification of terms, be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent. Further, footnote 3 of FASB Statement No. 114 states, "When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan." FASB Statement No. 114 also eliminated "in-substance foreclosures" by amending paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

c. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, was issued, paragraph 16 of which requires an enterprise to determine whether a decline in the fair value of an individual available-for-sale or held-to-maturity security below its amortized cost basis is other than temporary.

For example, if it is probable that an investor is unable to collect all amounts due according to the contractual terms of the security, an other-than-temporary impairment shall be considered to have occurred.

d. FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, was issued, paragraph 11 of which says FASB considered income recognition to be secondary in importance to the issue of measurement of impairment. Recognizing the importance of knowing how an enterprise recognizes interest and records cash receipts related to impaired loans, FASB required, in paragraph 20 of FASB Statement No. 114, that an enterprise disclose its accounting policies for recognizing interest income on impaired loans, including its policy for recording cash receipts.

B.4. AcSEC undertook this SOP project to identify those objectives of Practice Bulletin 6 that continue to be relevant and to update and elevate the authority of related guidance.

Scope

B.5. The scope of Practice Bulletin 6 includes loans, which were defined to include "loans and other debt securities." Practice Bulletin 6 discusses the concept of a discount related to credit quality and further defined loans within its scope by reference to (*a*) how the loan was acquired and (*b*) the probability of cash collections. Certain collateralized loans and loans carried at fair value or the lower of cost or fair value are excluded from the scope of Practice Bulletin 6. Loans held by liquidating banks were excluded because the related accounting was discussed in the FASB's Emerging Issues Task Force (EITF) Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*.

B.6. *Collectibility of contractual amounts*. AcSEC believes it is appropriate to focus one element of the scope criteria of paragraph 3 of this SOP on whether it is probable, at acquisition, that the investor will be unable to collect all amounts due according to the contractual terms of the loan. AcSEC believes the concepts of contractually required payments receivable, initial investment, and cash flows expected to be collected are more understandable and workable than the face amount concept discussed in paragraph 4 of Practice Bulletin 6 and more consistent with the guidance in FASB Statement No. 114. AcSEC intends for this element of the scope criteria of paragraph 3 to exclude loans for which it is possible, but not probable, that the investor will be unable to collect all amounts due according to the contractual terms of the loan. Further, AcSEC intends that investors should consider the significance of delays and shortfalls for a loan such that this SOP would not be applied when such delays and shortfalls are insignificant with regard to the contractually required payments.

B.7. AcSEC intends for this SOP to be applied to loans individually determined to meet the scope criteria of paragraph 3 of this SOP. AcSEC provided in paragraph 12 that loans may be aggregated for purposes of applying the guidance on initial and subsequent accounting. Individual loans are not to be aggregated for determining whether they, as a group, are within the scope defined in paragraph 3 of this SOP. Because the use of aggregation may result in a different scope applicability, AcSEC decided to allow aggregation only for recognition, measurement, and disclosure purposes.

B.8. Paragraph 3 includes as a scope criterion "for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable." AcSEC intends for investors to consider collectibility of contractual amounts due regardless of whether the acquisition price is greater than (premium) or less than (discount) the face amount of the loan. For example, a loan may be acquired at a small, net premium. The pricing of that small premium could actually be the net of a premium for an above-market contractual interest rate and a discount for credit quality. Based on this scenario, AcSEC concluded that the existence of a premium or a discount is not sufficient to determine whether the loan meets the scope criteria of paragraph 3 of this SOP.

B.9. *Evidence of deterioration of credit quality since origination*. AcSEC excluded from the scope defined in paragraph 3 of this SOP acquired loans or debt securities for which there has been no evidence of deterioration of credit quality from the date of origination. Deterioration may be evidenced by such sources as Fair Isaac Company (FICO) scores (an automated rating process for credit reports), downgrading, decline in value of collateral, or past-due status. Without evidence of deterioration of credit quality since origination, AcSEC determined that the accounting prescribed by this SOP would conflict with FASB Statements No. 5 and No. 91. Further, without evidence of deterioration of credit quality since origination added to the scope criteria in paragraph 3, a difference in recognition of interest income and impairment accounting would exist when there has been no intervening change in the credit quality of the debtor for an originated loan versus a loan acquired shortly after origination or at any subsequent time. This difference could result in selective accounting practices between investors and, therefore, diminish comparability to readers of financial statements.

B.10. *Exclusion of originated loans*. The scope defined in paragraph 3 of this SOP excludes originated loans (for which related discounts are addressed by FASB Statement No. 91). The income recognition provisions of this SOP apply only to loans with evidence of deterioration of credit quality that occurred between origination and acquisition by completion of a transfer (*a*) that satisfies the conditions in paragraph 9 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to be accounted for as a sale; (*b*) in a purchase business combination; (c) to a newly created subsidiary if the transferee has written the loan down to its fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company;[1] or (*d*) that is a contribution receivable or a transfer that satisfies a prior promise to give. The exposure draft of the proposed SOP proposed defining "completion of a transfer" to exclude transactions in which the investor

1. Emerging Issues Task Force (EITF) Issue No. 87-17, *Spinoffs or Other Distributions of Loans Receivable to Shareholders*, requires that such loans (received as dividends-in-kind) initially be measured at fair value. This Statement of Position (SOP) provides additional guidance on recognition, measurement (including subsequent measurement), and display of such loans.

acquires loans from the transferor through an agency relationship. Most respondents to the exposure draft were supportive of the FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, criteria (later replaced by FASB Statement No. 140). However, some respondents indicated the "agency relationship" concept in the glossary definition of "completion of transfer" was not operational. AcSEC agreed and removed the agency relationship concept from the definition and inserted the criterion for deterioration in credit quality as discussed in paragraph B.25.

B.11. *Fair value*. Practice Bulletin 6 excludes from its scope loans and debt securities that are measured at fair value or at the lower of cost or fair value. Consistent with Practice Bulletin 6 and paragraphs 3 and 34 of FASB Statement No. 91, AcSEC concluded that carrying loans within the scope criteria in paragraph 3 of this SOP at fair value with changes in fair value included in earnings obviates the need for accounting guidance on recognition of discounts associated with those loans.[2] However, AcSEC has clarified exclusions in Practice Bulletin 6 to address changes in related standards.

B.12. First, AcSEC concluded that loans whose changes in value are reported in other comprehensive income should not be excluded from the scope of this SOP. Some respondents to the exposure draft suggested that all loans held for sale should be excluded. AcSEC reasoned that some loans held

2. Paragraph 116 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, states:

> Amendment of [FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*]
>
> Some respondents noted that the change from LOCOM to fair value for reporting available-for-sale securities would cause [FASB Statement No. 91] to no longer apply to those securities. Paragraph 3 of Statement 91 indicates that it does not apply to loans and securities reported at fair value. The Board noted that the intent of that provision was to exclude only the loans and securities whose changes in value were included in earnings, not those loans and securities whose changes in value are reported in [other comprehensive income]. Consequently, the Board agreed to amend Statement 91 to clarify that only loans and securities reported at fair value with changes in value reported in earnings are excluded from that Statement's scope. Thus, Statement 91 would continue to apply to available-for-sale securities that previously were reported at amortized cost or LOCOM.

for sale are held for an extended time and such guidance was necessary for those situations. Accordingly, paragraph 3(a) of this SOP excludes only loans that are measured at fair value with changes in value reported in earnings, for example, mortgage-backed and other securities classified as trading securities in conformity with FASB Statement No. 115. For a not-for-profit organization, loans that are measured at fair value, if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented, are also excluded from paragraph 3 of this SOP. (Paragraph 130(a) of FASB Statement No. 115 similarly amended the scope [paragraph 3] of FASB Statement No. 91 to clarify that only loans reported at fair value with changes in value reported in earnings are excluded from FASB Statement No. 91.) AcSEC recognizes that the AICPA Audit and Accounting Guide *Audits of Investments Companies* (the Guide) requires the amortization of discounts on loans and debt instruments carried at fair value. AcSEC considered applying the guidance in this SOP to such loans but decided, for several reasons, not to expand the scope defined in paragraph 3 to apply to loans whose changes in fair value are reported in earnings. The applicability to such loans would expand the scope defined in paragraph 3 of this SOP, change the Guide, and for such loans, only result in income statement classification changes between interest income and unrealized gains and losses. Further, AcSEC received no comments asking that this guidance be applied to such loans. For these reasons, AcSEC decided to exclude from the scope of this SOP those loans whose changes in value are reported in earnings or the statement of activities, as applicable.

B.13. Second, AcSEC concluded that only mortgage loans held for sale (rather than any loan accounted for using the lower-of-cost-or-market-value [LOCOM] method), should be excluded from the scope set forth in paragraph 3 of this SOP. Paragraph 5 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, prohibits the accretion of discounts on mortgage loans held for sale:

> Purchase discounts on mortgage loans shall not be amortized as interest revenue during the period the loans or securities are held for sale.

AcSEC concluded that this prohibition should not be extended to other loans within the scope defined in paragraph 3 of this SOP that are being held for sale. Further, FASB Statement No. 115 eliminated the acceptability of the LOCOM method for debt securities held for sale.

B.14. *Leases*. Consistent with FASB Statement No. 114, this SOP does not apply to leases as defined in FASB Statement No. 13, *Accounting for Leases.*

B.15. *Historical cost.* The scope defined in paragraph 3 of this SOP excludes loans acquired in a business combination accounted for at historical cost in conformity with Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*,[3] because the existing basis of accounting for such assets generally continues for the combined entity.

B.16. *Business combinations.* Several respondents to the exposure draft suggested the exclusion be extended to purchase business combinations. AcSEC found no conceptual reason to exclude such loans, while at the same time including in the scope of this SOP individual or "bulk" loan acquisitions of loans whose credit quality has deteriorated.

B.17. *Liquidating banks*. This SOP retains the Practice Bulletin 6 exclusion of loans held by liquidating banks because related accounting matters are discussed in EITF Issue No. 88-25.

B.18. *Revolving privileges.* In revolving credit agreements, such as credit cards and home equity loans and other lines of credit, the borrower will typically have "revolving privileges" that allow it to pay down and then reborrow additional funds up to a maximum approved amount. The creditor in certain cases, such as borrower default, may revoke these revolving privileges. Respondents suggested excluding revolving credits when the customer has revolving privileges at the acquisition date because, from a

3. In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises, requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001.

practicality standpoint, it would be difficult to account for the acquisition balance separately from new advances and payments on revolving credit. Accordingly, AcSEC does not intend for the scope defined in paragraph 3 of this SOP to include situations in which credit is still being offered, and the entire relationship is excluded if, at the acquisition date, the borrower has revolving privileges. AcSEC believes this scope exclusion is appropriate because lenders generally will not continue to make credit available to borrowers from whom it is probable that the lender will not collect all contractually required payments receivable.

B.19. *Retained interests*. Under FASB Statement No. 140, a transferor allocates the previous carrying amount of transferred assets to interests sold and interests retained based on their relative fair values. That allocation could result in a significant difference between a retained interest's carrying amount and its contractually required payments receivable. Loans that are retained interests are not within the scope defined in paragraph 3 of this SOP. Rather, the EITF addressed the accounting for loans that are retained interests in EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

B.20. *Certain collateralized loans other than troubled debt restructurings.* Paragraph 3 of Practice Bulletin 6 requires that "enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan." This SOP omits that requirement, which paralleled the "insubstance foreclosure" accounting that effectively has been superseded by FASB Statement No. 114. Specifically, the FASB concluded that:

> Paragraph 34 [of FASB Statement No. 15] was intended to apply to a narrow set of circumstances; that is, a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor and the creditor was in possession of the asset with or without having to go through formal foreclosure procedures. [FASB Statement No. 114, paragraph 70]

B.21. As a result of that conclusion, paragraph 22(d) of FASB Statement No. 114 amended paragraph 34 of FASB Statement No. 15 to require that:

> A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to paragraphs 28 and 33 and, if appropriate, 39 [of FASB Statement No. 15].

B.22. Consistent with this clarification of FASB Statement No. 15, AcSEC believes loans meeting the scope criteria of paragraph 3 of this SOP should be accounted for as loans until the creditor is in possession of the collateral, with or without having to go through formal foreclosure procedures. However, as described in paragraph B.35, if the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or significantly improving the collateral for resale.

B.23. *Recently originated loans.* The scope set forth in paragraph 3 of this SOP excludes originated loans (for which related discounts are addressed by FASB Statement No. 91) because this SOP applies only to loans acquired by completion of a transfer that have experienced deterioration of credit quality between origination and the acquisition date.

B.24. The exposure draft of this SOP proposed defining "completion of a transfer" to exclude transactions in which the investor acquires loans from the transferor through an "agency" relationship. The FASB and AcSEC were concerned that without the "agency concept," two entities, for example, one originating its own loans and the other purchasing loans within hours after origination, would have different accounting treatments. Respondents to the exposure draft indicated that FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, criteria (later replaced by FASB Statement No. 140) were appropriate but the agency relationship definition was not operational. AcSEC agreed and concluded that the criteria in FASB Statement No. 140 eliminated the need to establish other criteria that distinguish between loans originated and loans acquired.

B.25. Without the agency concept, the original concern of different accounting treatments still existed. AcSEC discussed this concern and added the third criterion, evidence of deterioration of credit quality between origination and acquisition of the loan, to the scope criteria of paragraph 3 of this SOP. AcSEC considered whether reexposure was needed based on the additional criterion added. AcSEC concluded that questions about scope were highlighted in the exposure draft and that the scope, although different, was not sufficiently changed from the exposure draft to warrant reexposure.

B.26. *Smaller balance homogenous loans*. Several respondents to the exposure draft suggested that the scope exclude smaller balance homogenous loans. AcSEC found no conceptual reason to exclude such loans and further noted that the exclusion of such loans would significantly reduce the applicability of this SOP.

B.27. *Acquisition, development, or construction (ADC) arrangements*. AcSEC observes that the AICPA's third Notice to Practitioners on ADC arrangements (which appears as Exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*) requires that certain ADC arrangements be accounted for as investments in real estate (in conformity with FASB Statements No. 66, *Accounting for Sales of Real Estate*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*) or real estate joint ventures (in conformity with SOP 78-9, *Accounting for Investments in Real Estate Ventures*, and FASB Statement No. 34, *Capitalization of Interest Cost*) rather than as loans. As discussed in that Notice, whether acquired or originated, ADC arrangements accounted for as investments in real estate or real estate joint ventures should not be reported as loans in the balance sheet.

B.28. One of the objectives of this SOP is to prohibit the seller's allowances related to loan losses on loans subject to this

SOP from being carried over by the investor to recognize an allowance on its books in accounting for an acquisition. In paragraphs 5 and B.31 of the exposure draft of this SOP, AcSEC took the position that "it would never be necessary, at acquisition, to establish a loss allowance." AcSEC was concerned that this guidance would not be considered for all acquisitions of loans, including those with no evidence of deterioration of credit quality. To remedy that concern, AcSEC had agreed to add an additional scope paragraph to apply this prohibition to *all* acquisitions of loans, including those in a purchase business combination. However, AcSEC and FASB ultimately concluded that the issue related to acquired loans that are not within the scope of this SOP should be addressed by FASB. Again, AcSEC considered the need for reexposure for this issue. Several respondents from the exposure draft process did comment on the inability to carry over the seller's allowance. As this issue had been considered by respondents, AcSEC concluded that reexposure was not necessary.

Conclusions

Recognition, Measurement, and Display

B.29. *Loss accrual or valuation allowance.* Paragraph 5 of this SOP prohibits the recognition of the nonaccretable difference related to a loan as an adjustment of yield, a loss accrual, or a valuation of the loan for credit risk (loss allowance). The price an investor is willing to pay for a loan—and accordingly, the resulting yield—reflects the investor's estimate of credit losses over the life of the loan. Further, the acquisition price of—and the investor's expected yield on—the loan does not reflect losses measured and recognized by the transferor in conformity with FASB Statement No. 5. Using a loss allowance to address the collectibility of cash flows the investor does not initially expect to receive (and, therefore, presumably did not pay for) would not faithfully represent the substance of the underlying event. Rather, credit valuations should reflect only those losses incurred by the investor after acquisition—that is, the present value of cash flows expected at acquisition that ultimately are not to be received. The loss accrual or valuation allowance recorded by the investor should reflect only losses incurred by the investor, rather than losses incurred by the transferor or the investor's estimate at acquisition of credit losses over the life of the loan.

B.30. AcSEC noted differences in practice for establishing or carrying over a seller's allowance upon acquisition of a loan or a pool of loans. Some interpreted paragraph 88(b) of APB Opinion No. 16 and paragraph 37(b) of FASB Statement No. 141 to suggest that acquired loans should be evaluated in a two-step process: first, measuring the effects of changes in interest rates and second, measuring the effect of changes in collectibility. Another interpretation of those paragraphs was to consider changes in interest rates and changes in collectibility to be embedded into the loan valuation. AcSEC endorses the latter interpretation such that for loans that are acquired in a purchase business combination and recorded at fair value, AcSEC believes it would never be appropriate, at acquisition, to establish a loss allowance. AcSEC believes this interpretation is supported by paragraphs 68 and 87 of APB Opinion No. 16 and paragraphs 7 and 35 of FASB Statement No. 141, which require that a portion of the total cost of a group of acquired assets be assigned to each individual asset acquired on the basis of its fair value at the date of acquisition. Paragraphs 88(b) of APB Opinion No. 16 and 37(b) of FASB Statement No. 141 limit initial recognition of such receivables to the present values of amounts to be received:

> Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary

This interpretation applies to all loans within the scope of this SOP that are acquired by completion of a transfer and includes an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination.

B.31. Paragraph 15 of FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. FASB Statement No. 91 gives guidance on accounting for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. Paragraph 13 of Practice Bulletin 6 limits the recognition and measurement of discount (at acquisition of a loan) to amounts expected to be collected. Paragraph 6 of this SOP similarly defines the amount of accretable yield and prohibits recognition of nonaccretable difference as an adjustment of yield. This approach is consistent with the concept stated in footnote 3 to paragraph 14 of FASB Statement No. 114:

> When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the acquisition price of the loan.

B.32. *Recording assets acquired in a group.* For guidance on allocation of cost for a group of assets acquired, FASB Statement No. 141 provides the following guidance for allocating the cost of a company acquired in a purchase business combination to loans acquired:

> Acquiring assets in groups requires not only ascertaining the cost of the asset group but also allocating the cost to the individual assets that make up the group. The cost of such a group is determined using the concepts described in paragraphs 5 and 6. A portion of the cost of the group is then assigned to each individual asset acquired on the basis of its fair value. [Paragraph 7]

> . . . [A]n acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. Prior to that allocation, the acquiring entity shall (a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20–23 and (b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity. [Paragraph 35]

B.33. Loans subject to this SOP that are acquired individually and in pools in arm's-length transactions should be recorded at their acquisition price, presumed to be fair value. Loans subject to this SOP that are acquired in business combinations accounted for as purchase business combinations should be recorded, as a result of the allocation of the acquisition price pursuant to FASB Statement No. 141, at their fair value. Fair value should be estimated using reliable measures considering FASB Statements of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, and No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.* AcSEC believes one acceptable method of making this estimate is described in paragraphs 42 through 54 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which address the use of an expected cash flow approach. The face amount of the loans may be substantially different from the acquisition-date fair value of the loans due to changes in market interest rates, credit risk, and expected prepayments.

B.34. *Loan fees*. Paragraph 5 of this SOP addresses the effect of loan fees on the initial investment, consistent with paragraph 15 of FASB Statement No. 91, which states, "[T]he initial investment in a purchased loan or pool of loans shall include the amount paid to the seller plus any fees paid or less any fees received."

B.35. *Income recognition*. Recognition of income on a loan under this SOP is dependent on having a reasonable expectation about the timing and amount of cash flows to be collected. Subsequent to acquisition, this SOP does not prohibit placing loans on nonaccrual status, including use of the cost recovery method or cash basis method of income recognition, if appropriate. For example, if the timing of either a sale of the loan into the secondary market or a sale of loan collateral is indeterminate, the investor may not have the information necessary to reasonably estimate cash flows to compute its yield and should cease recognizing income on the loan. However, the ability to place a loan on nonaccrual status should not circumvent the loss recognition guidance contained in paragraphs 7(a) and 8(a) of this SOP. Alternatively, if the timing and amount of cash flows expected to be collected from such sales are reasonably estimable, the investor should be using those cash flows to apply the interest method under this SOP. For example, if the investor determines that foreclosure is probable, paragraph 13 of FASB Statement No. 114 requires that the investor measure impairment of the loan based on the fair value of the collateral. In that circumstance, the loan's cash flows expected to be collected presumably would include the fair value of the collateral less estimated selling costs rather than expected collections of interest and principal. If the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Rewards of ownership would include use of the collateral in operations of the entity or significantly improving the collateral for resale. AcSEC reasoned that although the asset should be accounted for as a loan (a monetary asset), there are instances in which the ultimate disposition would result in a nonmonetary asset type of transaction and that in those instances, there should be no accrual of income.

B.36. *Prohibition of offset.* AcSEC recognizes that some loans have common risk characteristics and may be aggregated for purposes of applying this SOP (see paragraphs B.50 through B.54 of this SOP). However, in either case, the application of this SOP results in a measurement of accretable yields, nonaccretable difference, and impairment identified to the particular loan or pool of loans.

B.37. AcSEC concluded that accretable yields and nonaccretable difference for a specific loan or a pool of loans with common risk characteristics should not be considered available to "offset" changes in cash flows from a different loan or a pool of loans with another set of common characteristics. In conformity with this SOP and FASB Statements No. 5, No. 114, and No. 115, measurement and recognition of accretable yields and nonaccretable difference, and any subsequent impairment of a specific loan or pool of loans, are to be made by reference to specific characteristics, cash flows expected to be collected, contractually required payments receivable, and pricing assumptions thereof.

B.38. *Display.* Paragraph 5 of this SOP prohibits the investor from displaying accretable yield or nonaccretable difference in the balance sheet. This SOP requires that an investor disclose information about accretable yield in the notes to the financial statements. It does not prohibit the investor from discussing the relationship between nonaccretable difference and contractually required payments receivable and the related effect of nonaccretable difference on the measurement of credit risk (for example, that nonaccretable difference reflects contractually required payments receivable that are not expected to be collected).

Changes in Cash Flows Expected to Be Collected

B.39. *Decreases in cash flows expected to be collected.* Paragraph 15 of Practice Bulletin 6 addresses the effects on accretion of changes in the amounts, estimability, and probability of future cash collections. Specifically, if estimated (expected) cash flows decreased, Practice Bulletin 6 permitted the yield to decrease below the initial yield and to fall ultimately to zero, thereby spreading the effect of the change in the estimate. This SOP addresses subsequent recognition and measurement based on whether the investor's initial cash flow estimate subsequently decreases (paragraphs 7(a) and 8(a)) or increases (paragraphs 7(b) and 8(b)).

B.40. Paragraph 8(a) of this SOP addresses the application of FASB Statement No. 5 to subsequent recognition and measurement of impairment of loans not accounted for as debt securities. Paragraph 8 of FASB Statement No. 5 establishes conditions that must be met for an estimated loss from a loss contingency to be accrued by a charge to income. Paragraph 23 of FASB Statement No. 5 provides an example of the application of the paragraph 8 conditions to the collectibility of receivables. The first two sentences of paragraph 23 of FASB Statement No. 5 state:

> If, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in paragraph 8(a) is met. As used here, *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms.

B.41. Footnote 13 of this SOP explains that, for purposes of applying paragraph 23 of FASB Statement No. 5 to a loan meeting the scope criteria in paragraph 3 of this SOP, the phrase "all amounts due according to the contractual terms" should be read "all cash flows originally expected to be collected by the investor plus any additional cash flows expected to be collected arising from changes in estimate after acquisition." If that condition is met, the subsequent recognition and measurement is governed by FASB Statement No. 5 and other authoritative pronouncements governing the application of FASB Statement No. 5 to loans.

B.42. This change from Practice Bulletin 6 in accounting for decreases in cash flows expected to be collected is needed also to reflect the concept in footnote 3 to FASB Statement No. 114 that "when a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan."

B.43. Accordingly, a decrease in the cash flows expected to be collected from a loan meeting the scope of this SOP would result in accrual of a loss contingency rather than a prospective change in yield as previously required by Practice Bulletin 6.

B.44. *Increases in cash flows expected to be collected.* Paragraph 15 of Practice Bulletin 6 requires certain increases in cash flows expected to be collected to result in an increase in the amount of yield to be accreted. Paragraphs 7(b) and 8(b) of this SOP similarly require an increase in the amount of accretable yield, after such an adjustment first reverses any existing valuation allowance for the loan, if applicable, established after acquisition. Consistent with Practice Bulletin 6, paragraphs 7(b) and 8(b)(2) of this SOP require that the amount of any increase in accretable yield be accounted for as a change in estimate in accordance with APB Opinion No. 20, *Accounting Changes*, with the amount of periodic accretion adjusted over the remaining life of the loan. AcSEC acknowledges the potential for a high effective yield prospectively if, under FASB Statement No. 115, an other-than-temporary impairment has been recognized, or a write-down has been recorded. As this SOP does not address the timing of write-downs, AcSEC acknowledges this scenario and notes that this treatment is consistent with FASB Statements No. 114 and No. 115. Consistent with paragraphs 7(a) and 8(a), paragraphs 7(b) and 8(b) of this SOP require that an investor, when considering whether the yield should be adjusted upward or the allowance reversed, would consider the impact of current information and events on the cash flow expectation and thus would not anticipate future events that might also cause recognition of a change in the cash flow expectation. This SOP does not address or provide any guidance on when an entity should recognize a write-down on a loan (referred to in some industries as a charge-off). As indicated above, FASB Statement No. 115 provides that if an entity recognizes an other-than-temporary impairment, that recognition results in a new cost basis for the security. Any subsequent appreciation in fair value is recognized in other comprehensive income. Likewise, if a write-down of a *loan* occurs, AcSEC believes that recognition establishes a new cost basis for the loan. If a subsequent upward revision occurs in the loan's cash flows expected to be collected, prior write-downs should not be reversed, but rather, that increase in cash flows expected to be collected is recognized pursuant to paragraph 8(b)(2) of this SOP on a prospective basis even if that income recognition results in an unusually high effective rate for the loan. The example in paragraph A.11(b)(1) and footnote 32 of Appendix A of this SOP illustrate this concept for a loan.

B.45. An increase in accretable yield establishes a higher effective interest rate and a different threshold for any subsequent impairment determination. Paragraph 8(b)(2) of this SOP requires that the higher effective interest rate (established by an adjustment of accretable yield) be used in any later valuation of the loan for impairment. Further, paragraphs 7(a) and 8(a) of this SOP require that the threshold for recognizing and measuring impairment include the incremental cash flows that resulted in any previous increase in cash flows expected to be collected.

Prepayments

B.46. Prepayments were not addressed in the exposure draft. Because FASB Statement No. 91 does not require consideration of prepayments, AcSEC does not give guidance in this SOP on whether or how to consider prepayments. However, this SOP does require that prepayments be treated consistently for contractual cash flows and cash flows expected to be collected such that the nonaccretable difference is not affected.

Restructured or Refinanced Loan

B.47. *Refinancing and restructuring after acquisition.* As discussed in paragraphs 7(b) and 8(b), this SOP requires that the amount of any increase in accretable yield be accounted for as a change in estimate that is recognized prospectively. Paragraph 10 provides that a loan meeting the scope criteria of paragraph 3 of this SOP that is refinanced or restructured, other than through a troubled debt restructuring,[4] should not be accounted for as a new loan. AcSEC believes accounting for such a loan as a new loan would impair comparability between entities. For example, assume that two investors hold similar loans that fall within the scope of this SOP. There is a significant increase in cash flows expected to be collected for each loan. Investor A revises the contractual terms of the loan to make them consistent with the revised estimate of cash flows expected to be collected. Absent the guidance in paragraph 10 of this SOP, Investor A, following paragraph 12 of FASB Statement No. 91, would recognize the income upon refinancing. Investor B, instead of refinancing the loan, revises the cash flows expected to be collected and, as required by paragraphs 7(b) and 8(b) of this SOP, recognizes an increased yield prospectively. AcSEC believes that both loans should continue to be accounted for in conformity with paragraphs 7(b) and 8(b) of this SOP. Paragraph 10 requires the income on a refinanced or restructured loan to be recognized prospectively rather than currently as a gain, as would have been Investor A's accounting absent these provisions.

4. See footnote 15 of this SOP.

Variable Rate Loans

B.48. In response to the comment letters, AcSEC addressed variable rate loans in this SOP. AcSEC considered three approaches for variable rate loans whose contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate. In the first approach, the contractually required payments receivable and cash flows expected to be collected should be calculated based on the factor as it changes over the life of the loan. The second approach required contractually required payments receivable and cash flows expected to be collected to be fixed at the rate in effect at the date the loan was acquired. The third approach allowed the investor to select and apply consistently either of those methods.

B.49. Paragraph 18(c) of FASB Statement No. 91 allows preparers the alternative of recalculating a new effective rate each time the index on a loan changes. Further, paragraph 57 of FASB Statement No. 91 notes that the effect on the amortization as a result of subsequent changes in interest rates generally would not be significant. However, in FASB Statement No. 91, a variable rate change affects only the amortization of the premium or discount, a component of income, whereas, for this SOP, variable rate changes affect all cash flows. AcSEC determined that, for purposes of this SOP, the effects of the interest rate changes could be significant. Therefore, the guidance in paragraphs 7 and 8 for increases and decreases should be followed without having to meet the significance threshold contained in those paragraphs. AcSEC decided that the only meaningful approach is to require both the loan's contractually required payments receivable and cash flows expected to be collected to be calculated based on the factor as it changes over the life of the loan.

Multiple Loans Accounted for as a Single Asset

B.50. *Aggregation of loans not accounted for as debt securities.* Aggregation may enhance an investor's confidence in the cash flow projections needed to apply the guidance in this SOP. Aggregation, if desired by the investor and if certain criteria are met, provides for a practical approach by permitting the evaluation of pools of loans and the use of statistics of pool behaviors. Paragraph 12 of FASB Statement No. 114 allows a creditor to aggregate loans that have "risk characteristics in common with other impaired loans" and to use, in part, "a composite effective interest rate" as a means of measuring impairment of those loans. AcSEC applied that concept in concluding that, for purposes of applying the recognition, measurement, and disclosure provisions of this SOP, investors should be allowed to aggregate loans that are not accounted for as debt securities and to use a composite interest rate and cash flow expectation for the pool. AcSEC does not intend for this aggregation to be analogized to for purposes other than this SOP. Further, AcSEC decided not to allow aggregation for loans accounted for as debt securities because FASB Statement No. 115 does not permit aggregation.

B.51. *Aggregation criteria.* Other authoritative accounting literature permits aggregation based on common characteristics for a practical approach. For example, paragraph 63(g)(1) of FASB Statement No. 140 identifies risk characteristics such as financial asset type, interest rate, date of origination, term, and geographic location. The exposure draft of this SOP would have required aggregated loans to have common risk characteristics including financial asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Several respondents to the exposure draft indicated that the proposed aggregation criteria were too restrictive. AcSEC agreed and the criteria for aggregation in the final SOP were made less restrictive.

B.52. After each loan is determined individually to meet the scope criteria of paragraph 3 of this SOP and if certain criteria are met, the investor may aggregate into pools loans that are not accounted for as debt securities. The aggregation should be based on common risk characteristics that include similar credit risk or risk ratings, and one or more predominant risk characteristics. Aggregated loans must have been acquired in the same fiscal quarter.

B.53. *Unit of account.* AcSEC concluded that once a pool is assembled, the pool should be accounted for as a single asset. Therefore, the pool is deemed to be the unit of accounting and should be considered one loan for purposes of applying this SOP. A loan should be removed from a pool of loans only if the investor sells, forecloses, or otherwise receives assets in satisfaction of the loan, or the loan is written off, and it should be removed at its carrying amount.

B.54. *Example*. The following illustrates a scenario in which loans are accounted for individually and a scenario in which some of the loans are accounted for in assembled pools. In both scenarios, each loan is evaluated individually, whether the loan was acquired individually or in a group.

Scenario A: Loans acquired in a group; accounted for individually
An investor acquires 1,000 loans from Seller A in a single transaction and one loan from Seller B in another transaction the same day. The investor individually evaluates each loan, making individual determinations of probability of collecting all contractual cash flows. The loans for which there is evidence of deterioration of credit quality since origination and it is probable that a more than insignificant shortfall will occur are considered to be within the scope of this SOP and the investor accounts for each loan individually. The other loans (that is, those loans not meeting the paragraph 3 scope criteria) are accounted for as acquired loans under FASB Statement No. 91.

Scenario B: Loans acquired in a group; accounted for as a pool
Alternatively, to facilitate recordkeeping and reporting, the investor decides to aggregate certain loans that individually are within the scope of this SOP and that are not accounted for as debt securities into pools that have common credit risk characteristics such as past-due status, FICO score (an automated rating process for credit reports), or risk rating and a predominant risk characteristic, such as type of loan. All loans not determined individually to be within the scope defined in paragraph 3 of this SOP are accounted for as acquired loans under FASB Statement No. 91.

How This SOP Differs From Practice Bulletin 6

B.55. The exposure draft of this SOP posed a question to respondents regarding the application of the then-proposed SOP to loans acquired prior to the SOP's adoption date. As described in paragraph B.65, respondents believed such a "fresh start" approach would be troublesome. AcSEC agreed and decided that this SOP should apply prospectively to loans acquired in a transfer. Other than the guidance in Practice Bulletin 6 for decreases in cash flows expected to be collected, all provisions of Practice Bulletin 6 remain in place for loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6. AcSEC included the following paragraphs, which AcSEC considers to be consistent with the impairment guidance in FASB Statements No. 114 and No. 115, for users of Practice Bulletin 6 to better understand how this SOP differs from Practice Bulletin 6. The following discussion as it relates to this SOP is not applicable to loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6.

B.56. *Certain collateralized loans*. Paragraph 15 of Practice Bulletin 6 provides that if, after acquisition of a loan that is not accounted for as a debt security, it was later determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance in Practice Bulletin 1. This guidance to record the collateral instead of the loan has been eliminated for the reasons discussed in paragraphs B.20 through B.22 in this appendix. Income recognition for such loans is discussed in paragraph B.35.

B.57. *Mandated use of cost-recovery method*. Paragraph 15 of Practice Bulletin 6 provides that if, after acquisition, it is not possible for the investor to estimate the amount and timing of cash collections, accretion should cease and the cost-recovery method should be used. Paragraphs 16 and 17 of Practice Bulletin 6 further address applying the cost-recovery method to certain loans. However, paragraph 35 in FASB Statement No. 114 states:

> Application of judgment to determine expected future cash flows may be complex, but that complexity is the unavoidable result of the need for information about the effect of impaired loans on a creditor's financial position and results of operations.

AcSEC similarly believes it should be possible in most situations for an investor to estimate cash flows expected to be collected and, accordingly, did not carry forward the guidance in paragraphs 15 through 17 of Practice Bulletin 6 to this SOP.

B.58. *Collectibility.* Paragraph 18 of Practice Bulletin 6 identifies factors to consider in assessing the collectibility of loans within its scope. This SOP does not specify how an investor should determine that it is probable it will be unable to collect all cash flows expected at acquisition. AcSEC notes that the FASB found such requirements unnecessary when addressing the application of paragraph 23 of FASB Statement No. 5 to (*a*) loans accounted for as debt securities[5] and (*b*) loans not accounted for as debt securities.[6]

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5. Paragraph 16 of FASB Statement No. 115 states:

Impairment of Securities

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. [*Footnote omitted.*] If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair values. Subsequent increases in the fair value of available-for-sale securities shall be included in other comprehensive income pursuant to paragraph 13 [*of FASB Statement No. 115*]; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in other comprehensive income.

6. Paragraph 8 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states:

Recognition of Impairment

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in [FASB Statement No. 114 and FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*,] *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. For a loan that has been restructured in a troubled debt restructuring, *the contractual terms of the loan agreement* refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. [FASB Statement No. 114] does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of [FASB Statement No. 114]. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.

B.59. *Income recognition*. Paragraph 13 of Practice Bulletin 6 gives guidance on when and when not to accrete discounts on acquired loans. This SOP eliminates such guidance for acquired loans because FASB Statement No. 118 eliminated such guidance for originated loans from FASB Statement No. 114. Specifically, paragraph 20(b) of FASB Statement No. 114 simply requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. This SOP does not prohibit, however, subsequently suspending accrual of interest income (that is, placing loans on "nonaccrual status"), including use of the cost recovery method or cash basis method of income recognition.

Disclosures

B.60. Several respondents to the exposure draft indicated some of the proposed disclosures were not meaningful and would impose a significant cost burden on investors to obtain the necessary information. AcSEC reassessed the disclosures, eliminated those related to the nonaccretable difference, and modified other disclosures to amounts that would be more readily obtainable and yet would convey information regarding the credit quality of acquired loans that are within the scope of this SOP. AcSEC agreed that the outstanding balance (that is, unpaid principal, unpaid interest, penalties, and other) and the related carrying amount (including any related allowance for uncollectible amounts) should be disclosed at each balance sheet date because these disclosures provide an indication of credit quality, comparability between entities, and how the credit quality has changed from balance sheet to balance sheet. Similarly, AcSEC revised the disclosures to require certain information for loans within the scope of the SOP for which the income recognition model of the SOP is not being applied. Some identify such loans as loans on nonaccrual status. These disclosures are in addition to the disclosures of nonaccrual loans required by SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*. AcSEC does not prohibit disclosure of additional information that describes the difference between the contract balance and the carrying amount.

B.61. *Accounting policies*. Although AcSEC does not provide guidance in this SOP on whether and how to consider prepayments, AcSEC believes they should be treated consistently for projected contractually required cash flows and cash flows expected to be collected, as well as actual and expected prepayments, such that the nonaccretable difference is not affected. Accordingly, the accounting policy should describe how prepayments were considered.

B.62. *FASB Statement No. 114 disclosures*. As addressed in paragraph 15 of this SOP, AcSEC concluded that information about loans within the scope of this SOP should not be included in certain disclosures about impaired loans if the loan performs at least as well as expected at acquisition. AcSEC believes this approach is warranted given the focus of this SOP's recognition and measurement provisions on the investor's obtaining its originally expected yield on the loan. This approach is consistent with similar provisions in footnote 3 of FASB Statement No. 114, paragraphs 20 and 23 of FASB Statement No. 118, and the consensus in EITF Issue No. 96-22, *Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*.

B.63. *Financial statement disclosures*. AcSEC believes that the accounting for acquired loans within the scope of this SOP is sufficiently different from the accounting for originated loans, particularly with respect to provisions for impairment and the potential for upside revisions in yield, such that the amount of loans accounted for in accordance with this SOP should be disclosed separately in the notes to financial statements. AcSEC believes that the disclosure for loans acquired during the period of the amounts of contractually required payments receivable, cash flows expected to be collected, and fair value for loans meeting the scope criteria of paragraph 3 of this SOP, as well as the carrying amount of those loans at acquisition date that are within the scope of this SOP for which the income recognition model in this SOP is not applied in accordance with paragraph 6, provides users of the financial statements with useful information about the credit quality of loans at acquisition, and a basis for comparison between companies that acquire such loans. AcSEC also believes that disclosure of changes in cash flows expected to be collected via the disclosure of reclassifications between nonaccretable difference and accretable yield provides the reader with valuable information about the performance of the acquired loan portfolio, including whether management has obtained or currently expects to obtain more or less than the cash flows originally expected to be collected. Further, AcSEC believes that disclosure of the balance sheet carrying amount of all loans within the scope of this SOP for which the income recognition model in this SOP is not applied provides users of financial information with a better indication of the quality of loans acquired.

Effective Date and Transition

B.64. Respondents indicated that transition requirements applying to loans acquired before the adoption date would be burdensome. Accordingly, AcSEC concluded that initial application of this SOP should be at the beginning of a fiscal year with restatement of previously issued financial statements prohibited. Because cash flows expected to be collected are based on estimates that are likely to change, AcSEC concluded that restatement would not be meaningful.

B.65. The exposure draft of this SOP proposed application to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would have required transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would have been based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Several comment letters suggested the difficulty of distinguishing, as of the adoption date, loans that were originated from those that were acquired because the loans may not have been tracked separately in the accounting system. The difference in scope between this SOP and Practice Bulletin 6 also posed challenges with requiring a "fresh start" approach as proposed in the exposure draft. For these reasons, AcSEC concluded that this SOP should be applied prospectively to loans acquired by completion of a transfer after the initial application of this SOP.

B.66. Loans within the scope of Practice Bulletin 6 will continue to be accounted for in accordance with that guidance as amended. The issuance of FASB Statements No. 114 and No. 115 amended accounting for loan impairment, and accordingly, Practice Bulletin 6 was in conflict with that guidance as the Bulletin provided for recognition of decreases in cash flows prospectively over the remaining life of the loan. This SOP, in paragraphs 7(a) and 8(a), provides guidance for subsequent decreases in cash flows expected to be collected. To remove the conflict, AcSEC amended paragraph 15 of Practice Bulletin 6 as described in Appendix C, "Amended Paragraphs of Practice Bulletin 6 to Show Changes Made by This Statement of Position."

APPENDIX C

Amended Paragraphs of Practice Bulletin 6 to Show Changes Made by This Statement of Position

C.1. Some accounting issues involving differences attributable to credit quality were addressed in Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans.* However, as outlined in paragraph B.3 of this Statement of Position (SOP), the accounting for loss contingencies attributable to credit quality has subsequently changed. This SOP should be applied to loans acquired in fiscal years beginning after December 15, 2004. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6, this SOP amends the application of Practice Bulletin 6 for decreases in cash flows expected to be collected.

C.2. *Amended paragraph 2 of Practice Bulletin 6.* Conforming changes are specifically noted by bold italicized or strike-through text.

> This practice bulletin addresses the accounting and reporting by purchasers of loans ***in fiscal years beginning on or before December 15, 2004*** (1) that are acquired in a purchase business combination, bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest.

C.3. *Amended paragraph 15 of Practice Bulletin 6.* For loans within the scope of Practice Bulletin 6, investors should follow the guidance in paragraphs 7 and 8 of this SOP in accounting for decreases in cash flows expected to be collected. Conforming changes are specifically noted by bold italicized or strike-through text.

> Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon ***subsequent*** evaluation—
>
> - The estimate of the total probable collections is increased ~~or decreased but is still greater than the sum of the acquisition amount less collections plus the discount amortized to date and it is probable that collection will occur~~, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.
> - ***For a loan not accounted for as a debt security,*** the estimate of amounts probable of collection is reduced and ~~it is less than the acquisition amount less collections plus the discount amortized to date, amortization should cease, and either~~ the loan should be ~~written down or an allowance for uncollectibility relating to that loan should be recognized~~ ***considered impaired for purposes of applying the measurement and other provisions of FASB Statement No. 5,*** **Accounting for Contingencies,** ***or, if applicable, FASB Statement of Accounting Standards No. 114,*** **Accounting by Creditors for Impairment of a Loan.**
> - ***For a loan accounted for as a debt security, the fair value of the debt security has declined below its amortized cost basis, the acquirer should determine whether the decline is other than temporary. An acquirer should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115,*** **Accounting for Certain Investments in Debt and Equity Securities.**
> - It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph .17 below.
> - It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility re-

lated to that loan should be recognized, and the cost-recovery method should be used as described in paragraph .17 below.

- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1.

C.4. *New paragraphs for transition and effective date of Practice Bulletin 6*. Additions are specifically noted by bold italicized. The following paragraphs follow paragraph 18 of Practice Bulletin 6.

Transition and Effective Date

This Practice Bulletin is amended by SOP 03-3, **Accounting for Certain Loans or Debt Securities Acquired in a Transfer,** ***for decreases in estimated cash flows. The amendments should be applied prospectively for fiscal years beginning after December 15, 2004.***

This Practice Bulletin is effective for loans purchased in fiscal years beginning on or before December 15, 2004. Loans acquired in fiscal years beginning after December 15, 2004, should be accounted for in accordance with SOP 03-3. For loans purchased in fiscal years beginning on or before December 15, 2004, all guidance in this practice bulletin is applicable, as amended, for fiscal years beginning after December 15, 2004.

GLOSSARY

This glossary defines terms and phrases used in this Statement of Position (SOP).

Accretable yield. The excess of a loan's cash flows expected to be collected over the investor's initial investment in the loan.

Amortized cost. The sum of (1) the initial investment *less* (2) cash collected *less* (3) write-downs *plus* (4) yield accreted to date.

Cash flows expected at acquisition. The investor's estimate, at acquisition, of the amount and timing of undiscounted principal, interest, and other cash flows expected to be collected.[1] This would be the investor's best estimate of cash flows, including the effect of prepayments if considered, that is used in determining the acquisition price, and, in a business combination, the investor's estimate of fair value for purposes of acquisition price allocation.

Common risk characteristics. For purposes of applying this SOP, loans with similar credit risk (for example, evidenced by similar Fair Isaac Company [FICO] scores, an automated rating process for credit reports) or risk ratings, and one or more predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location, should be considered to have common risk characteristics.

Completion of a transfer. Completion of a transfer (1) that satisfies the conditions in paragraph 9 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to be accounted for as a sale; (2) in a purchase business combination; or (3) to a newly created subsidiary if the transferee has written the loan down to its fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company; or (4) that is a contribution receivable or a transfer that satisfies a prior promise to give.

Contractually required payments receivable. The total undiscounted amount of all uncollected contractual principal and contractual interest payments both past due and scheduled for the future, adjusted for the timing of prepayments, if considered, less any reduction[2] by the in-

1. One acceptable method of making this estimate is described in paragraphs 42 through 54 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which discusses the use of an expected cash flow approach.

2. This Statement of Position does not address when an investor should record a direct write-down of an impaired loan.

vestor. For an acquired asset-backed security (ABS) with required contractual payments of principal and interest, the "contractually required payments receivable" is represented by the contractual terms of the security. However, when contractual payments of principal and interest are not specified by the security, the investor should look to the contractual terms of the underlying loans or assets.

Fair value. Refer to paragraphs 68 through 70 of FASB Statement No. 140.

Initial investment. The amount paid to the seller plus any fees paid or less any fees received.[3] In a business combination accounted for as a purchase, the allocation of fair value to loans or groups of loans should be in accordance with FASB Statement No. 141, *Business Combinations*.

Loan. As defined in paragraph 4 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*:

> [A] contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.

This definition encompasses loans accounted for as *debt securities* (as defined in paragraph 137 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*).

Nonaccretable difference. A loan's contractually required payments receivable in excess of the amount of its cash flows expected to be collected.

Outstanding balance. For loans that have a net carrying amount, the undiscounted sum of all amounts, including amounts deemed principal, interest, fees, penalties, and other under the loan, owed to the investor at the reporting date, whether or not currently due and whether or not

3. Only certain fees paid are included in the initial investment in a purchased loan. Paragraph 36 of FASB Statement on Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, explains that "designation of a fee or cost as an origination fee or cost for a loan that is purchased is inappropriate because a purchased loan has already been originated by another party." Also, the answer to question 39 in the FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*, explains that:

> fees paid to an independent third party, or incurred internally, for portfolio management or investment consultation...are considered "other costs incurred in connection with acquiring purchased loans or committing to purchase loans" because they constitute investment advisory costs, not loan origination costs. Therefore, such costs should be charged to expense in accordance with paragraph 15 [of FASB Statement No. 91] whether the costs are paid to independent third parties or incurred internally.

any such amounts have been written or charged off by the investor. Amounts forgiven in a debt restructuring but contingently payable to the investor should be included in the forgiven contract balance, but amounts irrevocably forgiven in a debt restructuring should not be included. Amounts payable to the investor in cash, in kind, and by any other means should be included. Amounts legally discharged should not be included. The outstanding balance does not include amounts that would be accrued under the contract as interest, fees, penalties, and other after the reporting date.

Probable. As defined in paragraph 10 of FASB Statement No. 114 (*emphasis in original*):

> The term *probable* is used in this Statement consistent with its use in [FASB Statement No. 5, *Accounting for Contingencies*], which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:
>
> > *Probable.* The future event or events are likely to occur.
> >
> > *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
> >
> > *Remote.* The chance of the future event or events occurring is slight.

The term *probable* is further described in paragraph 84 [of FASB Statement No. 5], which states:

> The conditions for accrual in paragraph 8 [of FASB Statement No. 5] are not inconsistent with the accounting concept of conservatism. *These conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued.* [*Emphasis added.*] They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. [*Emphasis in original.*]

Revolving privileges. A feature in a loan that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same loan.

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