Accounting News...

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Implications of New Guidance on Accounting for Purchased Impaired Loans

Introduction

In response to recent accounting guidance from the American Institute of Certified Public Accountants (AICPA), beginning in 2005 banks and examiners must take a new approach to the accounting for, and evaluation of loss allowances on, purchased impaired loans. AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* was issued in December 2003. When it takes effect next year, it will supersede AICPA Practice Bulletin (PB) 6, *Amortization of Discounts on Certain Acquired Loans,* which was issued in 1989. Four years later, the Financial Accounting Standards Board (FASB) released Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), which treats impairment differently than PB 6. SOP 03-3 will eliminate this inconsistency by providing updated guidance on the accounting for purchased loans that show evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the purchaser will be unable to collect all "contractually required payments receivable." Loans meeting these two criteria can be acquired individually, in a group of loans, or in a purchase business combination. However, SOP 03-3 does not apply to purchased loans that are held for trading or to purchased mortgage loans that are designated as held for sale. It also does not cover loans that a bank has originated.

Key Provisions of the New Guidance

A key principle of SOP 03-3 is a prohibition on the "carrying over" or creation of an allowance for loan losses when initially accounting for the purchase of an impaired loan.[1] The price that the purchaser is willing to pay for an impaired loan reflects the purchaser's estimate of the credit losses over the life of the loan. In the AICPA's view, using a loan loss allowance to address the collectibility of the cash flows that the purchaser does not expect to receive and, therefore, was not willing to pay for would not properly reflect the substance of the loan purchase. Thus, the AICPA concluded that loan loss allowances recorded by the purchaser of impaired loans should reflect only those losses incurred by the purchaser after acquisition and not losses incurred by the seller of the loan prior to the sale.

The SOP will change banks' current practices in accounting for purchased impaired loans. In purchase business combinations, the acquiring bank normally "carries over" the acquired institution's allowance for loan losses when it records the acquired loan portfolio at fair value. In other words, the acquiring bank typically combines the acquired institution's loan loss allowance with its own allowance as of the date of the business combination. This practice was sanctioned by the Securities and Exchange Commission in *Staff Accounting Bulletin No. 61* and has been accepted by the banking agencies for Call Report purposes. This carryover practice has also been extended, by analogy, to purchases of pools of loans where

[1]The SOP uses the terms "allowance for loan losses" and "allowance" rather than "allowance for loan and lease losses" and "ALLL."

a specifically identifiable portion of the selling institution's loan loss allowance has been allocated to the loan pool. Once SOP 03-3 takes effect, the portion of the acquired or selling institution's allowance attributable to the purchased impaired loans should no longer be carried over and added to the acquiring bank's allowance.[2]

SOP Introduces New Terminology to the Accounting Literature

Under SOP 03-3, a purchased impaired loan is initially recorded at its fair value, which normally is the purchase price (see Example 1). In a purchase business combination, such a loan would be recorded at its allocated fair value (i.e., the present value of amounts to be received determined at an appropriate current interest rate). The SOP limits the yield that may be accreted on the loan, "the accretable yield," to the excess of the bank's estimate of the undiscounted principal, interest, and other cash flows expected at acquisition to be collected on the loan over the bank's initial investment in the loan. The excess of "contractually required payments receivable" over the cash flows expected to be collected on the loan, referred to as the "nonaccretable difference," must not be recognized as an adjustment of yield, a loss accrual, or a loan loss allowance. The "contractually required payments receivable" is the total undiscounted amount of all uncollected contractual principal and interest payments, and includes payments that are past due as well as those that are scheduled for the future. Neither the "accretable yield" nor the "nonaccretable difference" may be shown on the balance sheet.

Example 1: Purchased Impaired Loan at Acquisition Date under SOP 03-3

On December 31, 20x0, Bank A purchases a loan with a principal balance of $100,000 for $63,000. The contractual interest rate on the loan is 10 percent, and annual payments of $26,380 are required each December 31. Because the December 31, 20x0, payment has not been made, accrued interest of $10,000 is delinquent. Bank A purchases this loan at a discount because of concerns about the borrower's credit quality that have arisen since the origination of the loan. Bank A determines that it is probable that it will be unable to collect all of the contractually required payments on the loan. Instead, based on its analysis of the borrower's financial condition, Bank A expects to collect $18,000 at the end of each of the next five years, which would produce an effective interest rate of 13.2 percent on the loan. Bank A would report its initial investment in the loan on its balance sheet at $63,000 on December 31, 20x0, and it would not be permitted to establish an allowance for loan losses for this loan as of that date. Other information presented in the following table, such as the outstanding balance, contractually required payments receivable, and accretable yield, would be incorporated into the disclosures in the footnotes to Bank A's financial statements.

Principal balance	$100,000
Accrued delinquent interest	10,000
Outstanding balance	110,000
Contractual interest not yet earned	21,899
Contractually required payments receivable	131,899
Nonaccretable difference	(41,899)
Cash flows expected to be collected	90,000
Accretable yield	(27,000)
Initial investment (Initial carrying amount of loan receivable)	63,000
Allowance for loan losses	0
Net loan receivable	$ 63,000

However, because these loans are impaired when they are acquired, the purchasing bank must determine whether it is appropriate to recognize the "accretable yield" as income over the life of the loan. According to the SOP, in order to apply the interest method of income recognition for a purchased impaired loan, the bank must have sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected (see Example 2). When that is not the case, the bank

[2]The FASB is developing additional guidance on procedures to follow in applying the purchase method of accounting for business combinations. As one of its tentative decisions, the FASB would prohibit the carrying over of loan loss allowances for all loans acquired in such transactions, not just purchased impaired loans. The FASB expects to issue its "purchase method procedures" proposal in the third quarter of 2004.

should place the loan on nonaccrual status at acquisition and then apply the cost recovery method or cash basis income recognition to the loan. Under the cost recovery method, any payments received are first applied to reduce the carrying amount of the loan. Once the carrying amount has been reduced to zero, any additional amounts received are recognized as income.

Cash Flow Estimates Take on Added Importance

After the purchase of an impaired loan, the purchaser will need to regularly estimate the cash flows expected to be collected over the life of the loan based on current information and events (see Example 3). In general, a probable decrease in the cash flows that the purchaser reasonably expected to collect when the loan was acquired should be recognized as an impairment through the recording of an allowance for loan losses. Consistent with the general rule in FAS 114, this post-acquisition impairment would be measured based on the present value of expected future cash flows discounted at the purchased loan's effective interest rate.[3] On the other hand, if there is a probable significant increase in the cash flows compared with those that previously were reasonably expected to be collected, or if actual

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[3]However, as is customary for accounting standards addressing loan impairment, the SOP does not address when a loan, or a portion of a loan, should be charged off.

Example 2: Actual Cash Flows Equal Expected Cash Flows on a Purchased Impaired Loan

Bank A has determined that it has sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected on the purchased impaired loan. Thus, if Bank A were to receive the $18,000 per year that it expects to receive at the end of each of the five years of the life of the loan, this expected repayment activity would be reflected as shown in the following table. Unless one of Bank A's periodic evaluations over the life of the purchased impaired loan indicates that, based on current information and events, it is probable that the bank will be unable to collect all cash flows expected at the acquisition of the loan (see Example 3), no loan loss allowance should be established for this loan under SOP 03-3. If the actual cash flows on the loan equal the expected cash flows, Bank A's accounting for the loan over its five-year life will be consistent with the amounts in the table.

	A	B	C	D	E	F	G	H	I	J
	Contractually Required Payments Receivable	Cash Expected to Be Collected	Nonaccretable Difference (A–B)	Accretable Yield	Gross Carrying Amount of Loan Receivable (B–D)	Loan Loss Allowance	Net Loan Receivable (E–F)	Provision for Loan Losses	Cash	Interest Income
Dec. 31, 20x0	$131,899	$ 90,000	$ 41,899	$ 27,000	$ 63,000		$ 63,000		$ (63,000)	
20x1 Collections	(18,000)	(18,000)		(8,316)	(9,684)		(9,684)		18,000	$ 8,316
Balance, Dec. 31, 20x1	113,899	72,000	41,899	18,684	53,316		53,316			
20x2 Collections	(18,000)	(18,000)		(7,039)	(10,961)		(10,961)		18,000	7,039
Balance, Dec. 31, 20x2	95,899	54,000	41,899	11,645	42,355		42,355			
20x3 Collections	(18,000)	(18,000)		(5,592)	(12,408)		(12,408)		18,000	5,592
Balance, Dec. 31, 20x3	77,899	36,000	41,899	6,053	29,947		29,947			
20x4 Collections	(18,000)	(18,000)		(3,954)	(14,046)		(14,046)		18,000	3,954
Balance, Dec. 31, 20x4	59,899	18,000	41,899	2,099	15,901		15,901			
20x5 Collections	(18,000)	(18,000)		(2,099)	(15,901)		(15,901)		18,000	2,099
Balance, Dec. 31, 20x5	41,899	$ 0	41,899	$ 0	$ 0		$ 0			
Close-out	(41,899)		(41,899)							
Total	**$ 0**		**$ 0**						**$ 27,000**	**$ 27,000**

Example 3: Decrease in Cash Flows Expected After Two Years

Bank A receives the expected $18,000 at the end of each of the first two years. However, based on current information and events affecting the borrower and the loan, Bank A determines on December 31, 20x2, that the cash flows it expects to collect in each of the next three years will be reduced by $6,000 annually to $12,000 per year. Using the loan's effective interest rate of 13.2 percent, the present value of the remaining cash flows expected to be collected on December 31, 20x2, is $28,238.[4] From Example 2, the carrying amount of the loan receivable on that date before considering the reduced estimate of the cash flows expected to be collected was $42,355. Thus, the measurement of impairment on this loan on December 31, 20x2, is as follows:

Carrying amount of loan receivable	$ 42,355
Less: Present value of cash flows expected to be collected	(28,238)
Measure of impairment on December 31, 20x2	$ 14,117

Under the SOP, this impairment would be recognized through the establishment of a loan loss allowance for the loan. However, SOP 03-3 does not address when a charge-off should be taken. This example shows the allowance for this loan being maintained until the end of the loan's expected term, at which time Bank A charged off the uncollectible balance of the loan receivable (i.e., $14,117). Alternatively, Bank A could have charged off this uncollectible amount on December 31, 20x2, after establishing the allowance for the loan.

After the recognition of the impairment on the loan, the accretable yield on the loan must be recalculated to determine the amount of the adjustment to be made to this account for the future accretable yield no longer expected to be earned. The amount of the adjustment is calculated, and can be verified, as follows:

Remaining cash flows expected to be collected, December 31, 20x2		$ 36,000
Less the sum of:		
Initial investment in the loan	$ 63,000	
Less: Cash collected to date	(36,000)	
Less: Allowance and/or charge-offs	(14,117)	
Plus: Yield accreted to date	15,355	
		28,238
Remaining accretable yield as recalculated		7,762
Less: Balance of accretable yield before adjustment, December 31, 20x2		(11,645)
Adjustment needed to accretable yield		$ (3,883)

Proof of calculation:	
Total decrease in cash flows expected to be collected	$ 18,000
Present value of total decrease in cash flows (measure of impairment)	(14,117)
Adjustment needed to accretable yield (future accretable yield no longer expected to be earned)	$ 3,883

The effect of the impairment and the adjustment to reduce the accretable yield on the purchased impaired loan on December 31, 20x2, are reflected in the following table. The reduction in the accretable yield arising from the impairment will result in a decrease in the amount of interest income recognized on the loan in Bank A's earnings over the life of the loan (i.e., $23,117 in interest income in Example 3 compared to $27,000 in Example 2).

If the actual cash flows on the loan over the remaining three years of the life of the loan equal the expected cash flows and Bank A's evaluations over this period indicate no further impairment is probable, Bank A's accounting for the loan over its five-year life will be consistent with the amounts in the table.

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[4] The present value of the expected cash flows of $12,000 for each of the next three years discounted at 13.2 percent equals $28,238.

Example 3: Decrease in Cash Flows Expected After Two Years
(continued)

	A	B	C	D	E	F	G	H	I	J
	Contractually Required Payments Receivable	Cash Expected to Be Collected	Nonacc-retable Difference (A–B)	Accretable Yield	Gross Carrying Amount of Loan Receivable	Loan Loss Allowance	Net Loan Receivable (E–F)	Provision for Loan Losses	Cash	Interest Income
Dec . 31, 20x0	$ 131,899	$ 90,000	$ 41,899	$ 27,000	$ 63,000		$ 63,000		$ (63,000)	
20x1 Collections	(18,000)	(18,000)	—	(8,316)	(9,684)		(9,684)		18,000	$ 8,316
Balance, Dec. 31, 20x1	113,899	72,000	41,899	18,684	53,316		53,316			
20x2 Collections	(18,000)	(18,000)	—	(7,039)	(10,961)		(10,961)		18,000	7,039
Impairment		(18,000)	18,000	(3,883)		$ (14,117)	(14,117)	$ 14,117		
Balance, Dec. 31, 20x2	95,899	36,000	59,899	7,762	42,355	(14,117)	28,238			
20x3 Collections	(12,000)	(12,000)	—	(3,727)	(8,273)		(8,273)		12,000	3,727
Balance, Dec. 31, 20x3	83,899	24,000	59,899	4,035	34,082	(14,117)	19,965			
20x4 Collections	(12,000)	(12,000)	—	(2,635)	(9,365)		(9,365)		12,000	2,635
Balance, Dec. 31, 20x4	71,899	12,000	59,899	1,400	24,717	(14,117)	10,600			
20x5 Collections	(12,000)	(12,000)	—	(1,400)	(10,600)		(10,600)		12,000	1,400
Balance, Dec. 31, 20x5	59,899	$ 0	59,899	$ 0	14,117	(14,117)	$ 0	$ 14,117	$ 9,000	$ 23,117
Close-out	(59,899)		(59,899)		(14,117)	14,117				
	$ 0		$ 0		$ 0	$ 0				

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cash flows are significantly greater than those previously reasonably expected, the purchaser should reduce any post-acquisition loan loss allowance and adjust the amount of the "accretable yield," which should be recognized prospectively as an adjustment of the loan's yield over its remaining life.

Although the determination as to whether a loan that a bank acquires is a purchased impaired loan is to be made on an individual loan basis, the SOP permits the aggregation of individual impaired loans acquired in the same fiscal quarter that have common risk characteristics. The bank would then be able to use a composite effective interest rate and a combined set of cash flows expected to be collected for the pooled loans to simplify the ongoing accounting. The integrity of the pool should be maintained once it has been established. The bank should remove an individual loan from a pool only in the event of a foreclosure on, or a sale or charge-off of, that individual loan.

SOP 03-3 will take effect for loans purchased in fiscal years beginning after December 15, 2004. At that time, the SOP's provisions relating to the treatment of decreases in cash flows expected to be collected are to be applied prospectively to previously purchased loans that were subject to PB 6.

A Bank's Policies and Procedures Must Adequately Address the Provisions of the SOP

The banking agencies' 2001 *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations* states that the board of directors is responsible for ensuring that its institution has controls in place to consistently determine the allowance for loan and lease losses in accordance with the institution's stated policies and procedures, generally accepted accounting principles, and applicable supervisory guidance. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio. The policy statement further notes that an institution's written policies and procedures in this area should address the institution's accounting policies for loans and loan losses and should describe its systematic allowance methodology, which should be consistent with its accounting policies for determining the allowance.

Accordingly, a bank that acquires impaired loans, including a bank that does so in purchase business combinations, should establish policies and procedures appropriate to the volume of its loan purchases and the complexity of the credits involved to ensure compliance with this new SOP. The bank's procedures should include documentation standards for the contractually required payments receivable, the cash flows expected to be collected, and the fair value (initial investment) at the acquisition date for each impaired loan because these amounts drive the accounting under SOP 03-3. The bank also should have adequate support for its assessment of whether the amount and timing of the cash flows expected to be collected are reasonably estimable. For allowance calculation purposes, the bank will need to segregate the purchased impaired loans. In addition, to satisfy the disclosure requirements of the SOP, the bank must maintain other information about its purchased impaired loans, including their outstanding balance and the related carrying amount, accretable yield, and associated post-acquisition loan loss allowance.

New Accounting Guidance Affects the Focus of Examinations

From an examination standpoint, when a bank is a purchaser of impaired loans, its policies and procedures for implementing SOP 03-3 and the related documentation should be reviewed for reasonableness and sufficiency.[5] Furthermore, when evaluating the risk and possible adverse classification of a purchased impaired loan, the examiner should focus on the recoverability of the carrying amount of the loan rather than the outstanding balance of the loan itself. If a portion of the loan's carrying amount is classified Loss, the examiner should recommend that it be charged off.

In the assessment of the bank's loan loss allowance, the purchased impaired loans should be considered separately from the bank's other loans. The examiner should review the bank's cash flow estimation process and ensure that current information and events affecting the borrower and the loan are being satisfactorily factored into the impairment analysis called for by SOP 03-3. This analysis considers whether it is probable that the bank will be unable to collect all cash flows expected at acquisition plus additional expected cash flows arising from changes in this estimate after acquisition. Significant differences between the bank's and the examiner's determination of the amount of any cash flow shortfalls on purchased impaired loans should lead to recommendations for appropriate adjustments to the loss allowances for these loans, measured in accordance with the SOP, and the charge-off of any amounts deemed uncollectible.

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[5] Until the effective date of the SOP, an examiner should verify that a bank that is a purchaser of impaired loans is or will be developing appropriate policies and procedures to implement the SOP.