



Board Meeting Handout

Accounting for Financial Instruments: Impairment

October 10, 2012

PURPOSE OF THIS MEETING

1. The Board will discuss the following three issues related to the Current Expected Credit Loss (CECL) model:
 - (a) *Issue 1:* Modifications
 - (b) *Issue 2:* Reexposure of the Revised Credit Impairment Model
 - (c) *Issue 3:* Transition Guidance for the CECL Model.

ISSUE 1: MODIFICATIONS

2. Under existing U.S. generally accepted accounting principles (GAAP), modifications are accounted for differently depending on whether the modification qualifies as a troubled debt restructuring.

Trouble Debt Restructuring Modifications

3. A modification must first be evaluated to determine if it qualifies as a troubled debt restructuring. Two conditions must exist for a modification to be considered a troubled debt restructuring:¹
 - (a) The creditor grants a concession to the borrower.
 - (b) The borrower is experiencing financial difficulty.
4. If the modification is considered a troubled debt restructuring, there is generally no “new basis” of accounting. Rather, any assets received in partial satisfaction are recognized as a reduction of the basis in the asset, the effective interest rate applied

¹ Paragraph 310-40-15-5 of the *FASB Accounting Standards Codification*[®]

to the basis for interest income recognition is the original effective interest rate of the loan, and the allowance for credit losses must be calculated under Section 310-10-30, Receivables—Overall—Initial Measurement, which utilizes a discounted cash flow approach discounted at the original effective interest rate. As a result, the allowance for credit losses captures both of the following:

- (a) The difference between the original contractual terms and the modified contractual terms
- (b) The difference between the modified contractual terms and the current expected cash flows.

Non-Troubled Debt Restructuring Modifications

5. Modifications that are not troubled debt restructurings are accounted for in accordance with Section 310-20-35, Receivables—Nonrefundable Fees and Other Costs—Subsequent Measurement. Non-troubled debt restructuring modifications result in derecognition of the original loan and the recognition of a new loan at fair value (that is, a new basis of accounting) if the following two conditions are met:
 - (a) The modifications are more than minor, that is, the present value of the cash flows under the new terms is at least 10 percent different from the present value of the remaining cash flows under the original loan.²
 - (b) The terms of the new loan are at least as favorable to the lender as terms for comparable loans that are not refinanced or restructured (that is, they are not “below market terms”).
6. If both of the conditions above are not met, then the basis of the modified loan consists of the remaining net investment in the original loan, any additional loan proceeds, and any fees or direct origination costs. In practice, the effective interest rate is then recalculated (based on the updated basis and the new contractual cash

² Paragraph 310-20-35-11 (originally issued as EITF Issue No. 01-07, “Creditor’s Accounting for a Modification or Exchange of Debt Instruments”) directs the creditor to guidance in Topic 470, Debt, pertaining to application of the 10 percent test for debtors. Additionally, paragraph 470-50-40-12 (originally issued as EITF Issue No.96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments”) provides very detailed guidance on how to apply the 10 percent test.

flows) and applied prospectively. As a result, under this approach the allowance for credit losses may include only the difference between the modified contractual terms and the current expected cash flows because the difference between the original contractual terms and the modified contractual terms is captured prospectively through the use of an updated effective interest rate.

Question 1 for the Board

- 1) Does the Board wish the staff to broadly reconsider the accounting for modifications to debt instruments, including the accounting for troubled debt restructurings? If so, how would the Board like the staff to proceed with such a project?

7. If the Board decides to move forward with the CECL model without a broad reconsideration of the accounting for modifications (as discussed in Issue 1), Issue 2 considers how the CECL model can best accommodate the current guidance for modifications.
8. There are two primary alternative approaches for the Board's consideration. The staff notes that it believes that the net result of both of these approaches is the same.
 - (a) *Alternative 1:* Allow the CECL model to apply to all modified instruments wherein expected credit losses are based on the expected shortfall in contractual cash flows (that is, the current contractual cash flows to which the entity is legally entitled) and, to the extent that the entity chooses to use a discounted cash flow model, discounted using the current effective interest rate (that is, post modification). To accomplish this, the guidance in Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors, would be amended to require that when an entity executes a troubled debt restructuring, the cost basis of the asset should be adjusted so that the effective interest rate post-modification is the same as the original effective interest rate, given the new series of contractual cash flows. Specifically, the basis adjustment would be calculated as the amortized cost basis before modification less the present

value of the modified contractual cash flows (discounted at the original effective interest rate).

- (b) *Alternative 2*: Unlike the rest of the CECL model, this alternative would require that expected credit losses for financial assets restructured in a troubled debt restructuring be measured using a discounted cash flow model that discounts the expected cash flows (post-modification) using the original effective interest rate as the discounting factor. For financial assets modified in non-troubled debt restructuring situations, the CECL model would simply apply to the modified instrument, considering expected shortfalls in the then-current contractual cash flows (post-modification) and (to the extent the entity chooses to use a discounted cash flow model) using the effective interest rate (post modification).

Question 2 for the Board

- 2) Which alternative does the Board prefer?

ISSUE 2: REEXPOSURE OF THE REVISED CREDIT IMPAIRMENT MODEL

9. The *FASB Reference Manual* contains procedures for the issuance of a revised Exposure Draft. These procedures suggest that the Board should consider whether its redeliberations have resulted in substantive change to the previously exposed guidance, whether the Board could benefit from additional input on that change, and how much time has passed since issuance of the Exposure Draft.
10. On May 26, 2010, the Board issued a proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. Since issuing the May 2010 proposed Update, the Board has considered three different credit impairment models: the model jointly proposed in the Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative*

Instruments and Hedging Activities—Impairment, in 2011, the three-bucket model jointly developed with the IASB, and the CECL model.

11. The CECL model differs from previously proposed or developed models. For example, unlike the May 2010 proposed Update, the CECL model has a measurement objective of expected credit losses and would require an entity to consider reasonable and supportable forecasts in addition to information relating to past events and current conditions.

Question 3 for the Board

- 3) Does the Board wish to issue a revised Exposure Draft for impairment?

12. If the Board decides to issue a revised Exposure Draft for impairment, the Board would have to consider how it would issue the Exposure Draft. The proposals on impairment and classification and measurement have been redeliberated separately but have been coordinated to understand how the decisions in one project could affect the other. Therefore, a separate Exposure Draft on impairment or a combined Exposure Draft on impairment and classification and measurement could be issued.

Question 4 for the Board

- 4) Does the Board wish to issue a separate Exposure Draft on impairment or a combined Exposure Draft on impairment and classification and measurement?

ISSUE 3: TRANSITION GUIDANCE FOR THE CECL MODEL

Transition Approach

13. There are four alternatives relating to a possible transition approach, described below:
- (a) *Alternative 1: Full retrospective application.* Topic 250, Accounting Changes and Error Corrections, requires full retrospective application unless a standard provides specific transitional provisions. However, Topic 250 also states that it is deemed impracticable to apply the effects of a change in accounting principle retrospectively if this application would require assumptions about management's intent in a prior period that cannot be independently substantiated or significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates.
 - (b) *Alternative 2: Modified retrospective application.* This application would require an entity to apply retrospectively the proposed standard to all outstanding financial instruments within the scope of the project as of the effective date. The impracticability conditions included in Topic 250 also would apply to this method.
 - (c) *Alternative 3: Cumulative effect application.* This application would require an entity to apply the proposed standard to all outstanding instruments as of the effective date with no adjustment to prior periods presented. The cumulative effect of the change on prior periods would be reflected in the carrying amounts of assets and liabilities as of the effective date, and an offsetting adjustment would be made to the opening balance of retained earnings as of the effective date.

- (d) *Alternative 4*: Prospective application. Using prospective application, only financial instruments entered into on or after the effective date would be accounted for under the proposed standard.

Question 5 for the Board

- 5) Which transition approach does the Board prefer for the proposed Update?

Transition Disclosures

14. Topic 250 requires certain disclosures for a change in accounting principle. These disclosures were modified to be suited for the cumulative effect transition that was proposed by the Board in the May 2010 proposed Update. These disclosures include the following:

- (a) The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.
- (b) The method of applying the adoption.
- (c) The effect of the adoption on any line item in the statement of financial position for the reporting period that immediately precedes the effective date. Presentation of the effect on financial statement subtotals is not required.
- (d) The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the reporting period that immediately precedes the effective date.

Question 6 for the Board

- 6) Does the Board believe that an entity should apply the disclosures in paragraph 14(a) through (d) when adopting the new guidance on the recognition of expected credit losses?

Early Adoption

15. Early adoption would allow an entity to apply a new standard before the effective date. This would expedite application of a new standard but could compromise comparability across reporting entities if only some entities early adopt.

Question 7 for the Board

- 7) Does the Board wish to allow early adoption of the new guidance on the recognition of expected credit losses?

Effective Date

16. The final issue related to transition for the Board to consider is effective date, particularly whether there should be a different effective date for nonpublic entities than for public entities.

Questions 8 and 9 for the Board

- 8) Does the Board believe that the effective date of the proposed Update should be different for nonpublic entities? If so, what difference would the Board prefer?
- 9) If not, does the Board believe that the effective date should be no earlier than a certain date for both public and nonpublic entities and, if so, what date does the Board prefer?