HORNE BANKERS' FORUM 2010

Accounting Hot Topics
A Focus on Loans

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Agenda

- **Loans in the Cross Hairs**
  - Credit Quality Disclosures
  - Accounting for Financial Instruments
  - Allowance for loan losses
  - Acquisition Considerations
- **Other Accounting Considerations**
  - Derivative Instruments and Hedging Activities
  - Lease accounting

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Credit Quality Disclosures

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Credit Quality Disclosures

- **Overview**
  - In July 2010, FASB issued ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses
  - The guidance was issued to provide greater transparency about credit risk exposures and the adequacy of the allowance for credit losses.

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Credit Quality Disclosures (continued)

- **Objective is to provide disclosures that facilitate user's evaluation of the following:**
  - The nature of the credit risk inherent in the entity's portfolio of financing receivables
  - How that risk is analyzed and assessed in arriving at the allowance for credit losses
  - The changes and reasons for those changes in the allowance for credit losses
- **The new guidance requires disaggregation of existing disclosures and requires new disclosures related to credit quality information, credit risk exposure, and accounting policies**

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Credit Quality Disclosures (continued)

- **Applies to all entities, both public and nonpublic, that have financing receivables including:**
  - Loans and notes receivable
  - Trade receivables that exceed one year
  - Credit card receivables
  - Lessor's receivables for direct finance and sales-type
  - Lessor's receivables for leveraged leases (except for disclosures on the allowance for credit losses)
- **Scope excludes:**
  - Short-term trade receivables arising from sale of goods or services
  - Receivables or loans measured at fair value or LOCOM
  - Debt securities and beneficial interests in securitizations
  - Unconditional promises to give

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Credit Quality Disclosures (continued)

Definitions

Term	Definition
Class of Financing Receivable	A group of financing receivables determined on the basis of all of the following: a. Initial measurement attribute (for example, amortized cost or purchased credit impaired) b. Risk characteristics of the financing receivable c. An entity's method for monitoring and assessing credit risk
Portfolio Segment	The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses

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Credit Quality Disclosures (continued)

Categories of New Disclosures

Category	Portfolio Segment	Class
Nonaccrual and Past Due Loans		✓
Allowance for Credit Losses	✓	
Impaired Loans (Individually Evaluated)		✓
Credit Quality Information		✓
Modifications	✓	

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Credit Quality Disclosures (continued)

Determining Portfolio Segments

- The determination of portfolio segments should be **based on the level at which the allowance for credit losses is calculated and monitored** (i.e. management's method for determining the allowance for credit losses)
- The guidance shows portfolio segments as consisting of the following:
  - Commercial
  - Commercial real estate
  - Consumer
  - Residential
  - Finance Leases
  - Unallocated

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Credit Quality Disclosures (continued)

Determining Classes

- **The guidance provides the following process to determine the classes of financing receivables**
  - First, segregate financing receivables on the basis of the model under which they were initially recorded (i.e., amortized cost and acquired credit-impaired loans)
  - Secondarily (and using the portfolio segment as the starting point) determine classes based on the level that the entity uses when **assessing and monitoring the risk and performance of the portfolio** for various types of financing receivables, considering the risk characteristics of the financing receivables*****

*** This determination would be expected to be consistent with the information provided to the entity's key management personnel**

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Credit Quality Disclosures (continued)

Determining Classes (continued)

- The guidance further indicates that in determining the appropriate level of its internal reporting to use as a basis for disclosure, an entity should **consider the level of detail needed by a user to understand the risks inherent in the entity's financing receivables**
- It goes on to provide factors to consider in determining the disaggregation of portfolio segments into classes (see next slide)

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Credit Quality Disclosures (continued)

Determining Classes (continued)

Factor	Considerations
Categorization of borrower	• Commercial loan borrowers • Consumer loan borrowers • Related party borrowers
Type of financing receivable	• Mortgage loans • Credit card loans • Interest-only loans • Finance leases
Industry sector	• Real estate • Mining
Type of collateral	• Residential property • Commercial property • Government-guaranteed collateral • Uncollateralized (unsecured)
Geographic distribution	• Domestic • International

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Credit Quality Disclosures (continued)

Nonaccrual and Past Due Loans – By Class

Old Requirement	New Requirement
Accounting policies for financing receivables: • Placing receivables on nonaccrual • Recording payments received on nonaccrual receivables • Resuming accrual of interest • Charging off uncollectible receivables • Determining past due or delinquency status	Same disclosures required **by class** except that the disclosure of the accounting policy for charging off uncollectible receivables is required **by portfolio segment**

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Credit Quality Disclosures (continued)

Nonaccrual and Past Due Loans – By Class (continued)

Old Requirement	New Requirement
Recorded investment in receivables on nonaccrual status	Now required **by class**
Recorded investment in receivables past due by 90 days or more and still accruing	Now required **by class**
N/A	An entity shall provide, **by class**, an analysis of the age of the recorded investment in loans at the end of each reporting period that are past due, as determined by the entity's policy

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Credit Quality Disclosures (continued)

Example – Nonaccrual Status by Class

Commercial non-real estate	$XX,XXX
Commercial real estate	
Construction	XX,XXX
Other	XX,XXX
Consumer	
Credit Card	XX,XXX
Auto	XX,XXX
Other	XX,XXX
Residential	
Prime	XX,XXX
Subprime	XX,XXX
Finance Leases	XX,XXX
Total	$XX,XXX

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Credit Quality Disclosures (continued)

Example – Aging by Class

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Recoded Investment > 90 Days Accruing
Commercial non-real estate	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate							
Construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer							
Credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential							
Prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

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Credit Quality Disclosures (continued)

Allowance for losses – By Portfolio Segment

Old Requirement	New Requirement
N/A	Accounting policies regarding the credit loss allowance methodology **by portfolio segment**: • Description of factors that influenced management's judgment including historical losses and existing economic conditions • Discussion of risk characteristics relevant to each portfolio segment • Identification of any changes from prior periods and rationale

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Credit Quality Disclosures (continued)

Allowance for Losses – By Portfolio Segment (continued)

Old Requirement	New Requirement
Rollforward of total allowance for credit losses	Rollforward is required **by portfolio segment**: • Quantitative effect of changes in allowance methodology on current period provision • Amount of significant purchases of loans • Amount of significant loan sales and/or reclassifications to held for sale • Balance in ALLL disaggregated on basis of impairment method

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Credit Quality Disclosures (continued)

Allowance for Losses – By Portfolio Segment (continued)

Old Requirement	New Requirement
Recorded investment in financing receivables	Recorded investment in financing receivables **by portfolio segment** and disaggregated on the basis of impairment method
Disclosure requirements when no accrual is made for a loss contingency because either the loss is not probable or not reasonably estimable	Clarifies that the disclosure requirements do not apply to loss contingencies arising from an entity's estimation of its allowance for credit losses

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Credit Quality Disclosures (continued)

Example – Rollforward by Portfolio Segment

	Commercial Non-Real Estate	Commercial Real Estate	Consumer	Residential	Finance Leases	Unallocated	Total
Allowance for credit losses:							
Beginning balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Charge-offs	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Recoveries	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Provision	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Ending balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending balance:							
Individually evaluated for impairment	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Collectively evaluated for impairment	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Loans acquired with deteriorated credit quality	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Financing receivables:							
Ending Balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending Balance:							
Individually evaluated for impairment	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Collectively evaluated for impairment	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Loans acquired with deteriorated credit quality	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX

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Credit Quality Disclosures (continued)

Impaired Loans – By Class

Old Requirement	New Requirement
For individually-evaluated impaired loans: • The recorded investment in impaired loans • The amount of the recorded investment for which there is an allowance and the amount of the allowance • The amount of the recorded investment for which there is not an allowance	Same disclosure required **by class** Additionally, the following disclosures are also required **by class**: • The accounting for impaired loans • The amount of impaired loans • The total unpaid principal balance of impaired loans

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Credit Quality Disclosures (continued)

Impaired Loans – By Class (continued)

Old Requirement	New Requirement
For individually-evaluated impaired loans: • Accounting policy for recognizing interest income, including how cash receipts are recorded • The average recorded investment • The related interest income recognized when the loans were impaired • The amount of interest income recognized on the cash basis	Same disclosure required **by class** Additionally, the following disclosures are also required **by class**: • The entity's policy for determining which loans it assesses for impairment on an individual basis • The factors considered in determining that the loan is impaired

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Credit Quality Disclosures (continued)

Example – Impaired Loans by Class

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Consumer					
Credit Card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
With an allowance recorded:					
Commercial real estate					
Construction	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential					
Prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total:					
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Consumer	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Residential	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

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Credit Quality Disclosures (continued)

Credit Quality Information – By Class

- The following end of reporting period disclosure of quantitative and qualitative credit quality information is required by class
  - **A description of the credit quality indicator**
  - **The recorded investment in loans by credit quality indicator**
  - **The date or range of dates in which the credit quality indicator was updated**
  - **How internal risk ratings relate to likelihood of loss**
- The disclosures do not apply to loans measured at fair value or LOCOM or debt securities, but do apply to loans collectively evaluated for impairment, leases (including leveraged leases), credit card receivables, and acquired credit-impaired loans

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Credit Quality Disclosures (continued)

Credit Quality Information – By Class (continued)

- The guidance provides the following examples of disaggregation by credit quality indicator:
  - Consumer credit risk scores
  - Credit-rating-agency ratios
  - Internal credit risk grades
  - Loan-to-value ratios
  - Collateral
  - Collection experience
  - Other internal metrics
- Judgment should be used to determine credit quality indicator for each class of loans, **considering how the entity monitors loans and uses information in determining the allowance for credit loans**

Credit Quality Disclosures (continued)

Example – Credit Quality by Class

Corporate Credit Exposure – By Credit Rating

	Commercial Non Real Estate	Commercial Real Estate Construction	Commercial Real Estate Other
AAA - AA	$XX,XXX	$XX,XXX	$XX,XXX
A	XX,XXX	XX,XXX	XX,XXX
BBB - BB	XX,XXX	XX,XXX	XX,XXX
B	XX,XXX	XX,XXX	XX,XXX
CCC - C	XX,XXX	XX,XXX	XX,XXX
D	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX

Consumer Credit Exposure – By Internally Assigned Grade

	Residential – Prime	Residential – Subprime
Grade:		
Pass	$XX,XXX	$XX,XXX
Special Mention	XX,XXX	XX,XXX
Substandard	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX

Consumer Credit Exposure – By Payment Activity

	Credit Card	Auto	Other	Finance Leases
Performing	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Nonperforming	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Credit Quality Disclosures (continued)

Modifications of Loans and Troubled Debt Restructurings (TDRs)

Requirement	By Class	By Portfolio Segment
For each income statement presented, disclosures about troubled debt restructurings of loans that occurred during the period	Qualitative and quantitative information about the nature of modifications and the impact the modifications had on the allowance for credit losses	Qualitative information about how such modifications are factored into the determination of the allowance for credit losses
For each income statement presented, disclosures about loans modified as troubled debt restructurings within the previous 12 months for which there was a payment default during the current period	Qualitative and quantitative information about the type of loans that defaulted during the current period and the amount of loans that defaulted during the current period	Qualitative information about how such defaults are factored into the determination of the allowance for credit losses

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Credit Quality Disclosures (continued)

Example – Modification by Class Disclosure

Troubled Debt Restructurings	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential – prime	XXX	$XX,XXX	$XX,XXX
Residential – subprime	XXX	XX,XXX	XX,XXX
Consumer – other	XXX	XX,XXX	XX,XXX
Finance Leases	XXX	XX,XXX	XX,XXX

Troubled Debt Restructurings that Subsequently Defaulted	Number of Contracts	Recorded Investment
Residential – prime	XXX	$XX,XXX
Residential – subprime	XXX	XX,XXX
Consumer – other	XXX	XX,XXX
Finance Leases	XXX	XX,XXX

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Credit Quality Disclosures (continued)

- **Effective Date and Transition**
  - **Public Companies**
    - Disclosures required as of the **end** of the reporting period are effective for interim and annual reporting periods **ending** on or after December 15, 2010 (current year for calendar year companies)
    - Disclosures required about **activity** that occurs **during** a reporting period are effective for interim and annual reporting periods **beginning** on or after December 15, 2010 (next year for calendar year companies)
  - **Nonpublic Companies**
    - All of the amendments are effective for first annual reporting period ending on or after December 15, 2011
  - **Transition**
    - Encourages but does not require comparative disclosures for earlier reporting periods in the initial period of adoption

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Accounting for Financial Instruments

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Accounting for Financial Instruments

- **Overview of Proposal**
  - **Would require**
    - Fair value for most financial instruments (including loans and deposits)
      - Exceptions (amortized cost): short-term trade receivables and payables; debt, unless the entity has significant financial assets
    - Change in fair value goes to net income unless qualifies for OCI
      - Must be held long-term for collection of cash flows
      - Must not have embedded derivatives
    - **Fair value = exit price, even for loans (not PV)**

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Accounting for Financial Instruments (Continued)

- **Who would be affected by the proposal?**
  - All entities that have financial instruments
  - It will have a **greater impact on traditional banking-type institutions** due to the large number of financial assets that are measured at amortized cost.
  - The proposal does provide for nonpublic entities with less than $1 billion in total assets with an additional 4 years to implement the new requirements relating to loans, loan commitments, and core deposit liabilities that meet certain criteria.

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Accounting for Financial Instruments (Continued)

Valuation (continued)

- **Core Deposit Liabilities** (Core Deposit Liabilities Remeasurement Approach)
  - Measure at the present value of the average amount during the period discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits
- **Other Deposit Liabilities**
  - Measured at its fair value

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Accounting for Financial Instruments (Continued)

Definitions

- **All-in-Cost-to-Service Rate**
  - A rate that includes the net direct costs to service core deposit liabilities, including all of the following:
    - Interest paid on the deposits
    - The expense of maintaining a branch network
    - ***Less*** fee income earned on the deposit accounts
- **Alternative Funds Rate**
  - A rate associated with the next available source of funds if core deposit liabilities are not an available source of funds. **The alternative funds source must be cost effective and sufficient in volume and duration to replace the core deposit liabilities as a source of funds.** A blended rate may be used if one source is not sufficient in volume.

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Accounting for Financial Instruments (Continued)

Presentation

- Financial Instruments for which all changes in fair value are recognized in net income
  - **Face of the statement of financial position**
    - Fair value
    - Amortized cost
  - **Face of the statement of comprehensive income**
    - Aggregate amount for realized and unrealized gains or losses

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Accounting for Financial Instruments (Continued)

Presentation (continued)

- Financial Instruments for which qualifying changes in fair value are recognized in other comprehensive income
  - **Face of the statement of financial position**
    - Amortized cost
    - Allowance for credit losses
    - Accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value
    - Fair value
  - **Face of the statement of comprehensive income**
    - Current-period interest income and expense, including amortization (accretion) of premium (discount) recognized upon acquisition
    - Credit impairment for the current period on financial assets
    - Realized gains or losses

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Accounting for Financial Instruments (Continued)

Presentation (continued)

- **Core Deposit Liabilities**
  - Face of the statement of financial position
    - Amortized cost of the deposits (amount due on demand)
    - Amount needed to adjust amortized cost to the amount calculated under the remeasurement approach
    - Amount of the deposits determined using the core deposit liabilities remeasurement approach
- **Accumulated Other Comprehensive Income**
  - Face of the statement of financial position
    - Amounts related to the qualifying changes in fair value or qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income

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Accounting for Financial Instruments (Continued)

When would the Proposed Amendment be Effective?

- **Unknown**
  - They have received over 450 comment letters so far
  - Overwhelmingly against the proposal
  - Received negative feedback from investor group
    - Interested in fair value, but not on the face of the statement of financial position
  - Expected to reach out to more companies and investors in understanding the complexities and unintended consequences of adopting this proposal

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Allowance for Loan Losses

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Allowance for Loan Losses

FASB's Proposed Impairment Model

- **Single model for all financial assets (FV-OCI)**
- **Replace multiple models in current GAAP**
  - Incurred loss model for loans
  - OTTI model for securities
  - Other models (acquired loans)
- **Expected loss model – estimate of cash flows that will not be collected**
- **No "probability threshold" – earlier loss recognition**
- **Time horizon covers the life of the financial asset**

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Allowance for Loan Losses (continued)

FASB's Proposed Impairment Model (continued)

- **Estimate considers past events and existing conditions**
  - Assumption that existing conditions will not change
  - Future economic conditions are not forecasted
  - Interrelationships between existing and future conditions
  - Fair values using market participant assumptions
- **Impairments recognized in an allowance account**
  - Potential for impairment reversals
  - Implications for debt securities
- **Definition of a write-off**
  - No reasonable expectation of recovery

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Allowance for Loan Losses (continued)

FASB's Proposed Impairment Model (continued)

- **Estimate of cash flows that will not be collected**
  - For originated assets – all contractual cash flows
  - For purchased assets – all cash flows expected at acquisition
  - Effect of changes in prepayments, currency exchange rates, and variable interest rates
- **Impairment evaluations**
  - Individual asset basis
  - Collective (pool) basis
- **No specific requirement for when to use either basis**

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Allowance for Loan Losses (continued)

FASB's Proposed Impairment Model (continued)

- **Assets evaluated on an individual basis**
  - If impaired, recognize loss equal to amortized cost less present value of expected cash flows
  - If not impaired based on present value of cash flows, evaluate for impairment with assets having similar risk characteristics (pool basis)
  - If collateral-dependent, practical expedient available to measure impairment based on fair value of the collateral
  - No further evaluation of collateral-dependent assets if not impaired based on fair value of the collateral
  - New definition of collateral-dependent – repayment primarily or substantially through operation or sale of the collateral

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Allowance for Loan Losses (continued)

FASB's Proposed Impairment Model (continued)

- **Assets evaluated on a collective (pool) basis**
  - Loss exists in a group of assets with similar risk characteristics even though impairment not associated with specific assets
  - Apply historical loss rate (adjusted for current economic factors and conditions) to the pool balance
  - Loss rates result in allowances that reflect cash flows not expected to be collected over the life of the assets in the pool
  - Recognition of life-of-asset impairments in the period the asset is originated or acquired (added to the pool)

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Allowance for Loan Losses (continued)

FASB's Proposed Impairment Model (continued)

- **Interest Income Recognition**
  - **Basic model would change current practice**
    - Apply effective interest rate to amortized cost less allowance for credit losses
    - Excess of contractual interest due over interest income is credited to the allowance for credit losses
    - Adjust the allowance by a credit to the impairment provision
  - **Inappropriate to recognize interest income on the principal balance not expected to be collected**
  - **Interaction (comingling) of models for credit impairment and interest income**
  - **Non-accrual status limited to expectation of negative yield (undiscounted cash flows less than principal balance)**

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Allowance for Loan Losses (continued)

Expert Advisory Panel

- **Formed last December by the IASB and FASB**
- **Main objective to advise on how operational challenges might be resolved**
- **Diverse group of participants**
  - IASB and FASB board and staff
  - Credit risk management
  - External audit
  - Regulatory agency observers
- **Participants served as individuals (not as representatives of their organizations)**

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Allowance for Loan Losses (continued)

Expert Advisory Panel (continued)

- **Operational Challenges**
  - **Implementing redundant impairment assessments between pool and individual methods**
    - Double jeopardy – if not individually impaired put back into pool and reassess
  - **Implementing different estimation methods for pool and individual assessments**
    - PV of expected cash flows vs. historical loss rate adjusted for current (and frozen) economic conditions

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Allowance for Loan Losses (continued)

Expert Advisory Panel (continued)

- **Too Little Too Late**
  - Immediate recognition of 100% of lifetime expected losses appears to go too far – "Too much too soon"
  - Yet the restriction to "expected losses, freezing current conditions" means the approach fails to address "too little too late" precisely when it is most important – at the top of the credit cycle
- **Pro-cyclicality**
  - Extremely pro-cyclical – magnifies the actual credit cycle by requiring full-life loss estimates at each point in the cycle to be based on straight-line extrapolation of current conditions

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Allowance for Loan Losses (continued)

- **Conceptual Issues – FASB Impairment Model**
  - Does not reflect economic results of the business
  - Front-loads loss recognition
  - Limiting useable information creates a disconnect with credit markets
  - Impairment assessment inconsistent with fair value measures
  - Treatment of "excess cash" (interest collected but not recognized as income) does not reflect economic return
  - Limiting non-accrual status to "negative yield" scenarios reduces the decision-usefulness of reported information
  - No economic basis for different measure of lifetime loss for pool vs. individual assessment

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Acquisition Considerations

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Acquisition Considerations

Recognition and Initial Measurements

- Initially recognize loans at fair value
- No allowance for loan losses recorded at the acquisition date
- Establish for each loan:
  - Accretable yield – excess of cash flows expected to be collected over fair value of the loan (i.e. carrying value)
  - Nonaccretable difference – excess of contractually required payments receivable over cash flows expected to be collected
  - Neither element recognized on the balance sheet
- Cash flows expected to be collected and contractually required payments receivable include both principal and interest

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Acquisition Considerations (continued)

Pooling of Loans – Requirements

- Allowed to pool loans with common risk characteristics
  - Loans acquired within the quarter
  - Pools are "closed"
- A pool of loans has a single composite interest rate and expectation of cash flows
- A portion of the total acquisition cost must be assigned to each "individual asset acquired" on the basis of its relative fair value at the acquisition date
  - Is the asset the loan or the pool?
- A loan should be removed from a pool at its carrying amount only if
  - Sold
  - Foreclosed upon
  - Otherwise liquidated
  - Written off

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Acquisition Considerations (continued)

Pooling of Loans – Operational Considerations

- Number of pools
  - Larger number
    - Operationally more difficult
    - More granularity in estimating cash flows and analyzing changes
  - Smaller number
    - Operationally simpler
    - Risk of pooling loans that do not have similar risk characteristics
- More difficult to pool nonhomogeneous (e.g. commercial) loans based on common risk characteristics

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Acquisition Considerations (continued)

Subsequent Measurement – Requirements

- Continue to estimate expected cash flows over the life of the loan
- If it is probable that all expected cash flows will not be collected, impairment must be recognized
- If it is probable that there has been a significant increase in expected cash flows, this is recognized by
  - Reversing any recognized allowance
  - Increasing the accretable yield (i.e. "reclassifying" a portion of the nonaccretable difference)

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Acquisition Considerations (continued)

Subsequent Measurement – Operational Considerations

- Requires highly complex and subjective cash flow models
- Difficult to attribute changes in timing and amounts of expected cash flows to specific drivers
  - Credit losses
  - Prepayments
  - Changes in variable interest rates
- Most institutions have a deeply ingrained “principal credit loss” mindset
- Manual accounting processes

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Acquisition Considerations (continued)

Income Recognition – Requirements

- Depends upon having a reasonable expectation about the timing and amount of cash flows expected to be collected
- If recognized, initially based on the effective interest rate that equates cash flows expected to be collected with the fair value of the loan (i.e. the accretable yield)
- Loans placed on nonaccrual status only if the timing and amounts of expected cash flows were not estimable
  - Pools of loans might never be placed on nonaccrual status
- Changes in variable interest rates not assumed in estimating future cash flows
  - Impairment reversal before increase in accretable yield

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Acquisition Considerations (continued)

Income Recognition – Operational Considerations

- Changes in timing but not amount of future cash flows – impairment or yield adjustment?
- Yield analysis – a key control
- Judgment required in:
  - Attributing drivers of cash flow changes
  - Determining whether changes in cash flows (or changes in the net present value of the loan) should be recognized as impairment or a yield adjustment

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Derivative Instruments and Hedging Activities

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Derivative Instruments and Hedging Activities

Overview

- No changes to types of items, transactions, and risks eligible or hedge accounting
- Only qualitative assessments required at inception of the hedge; reassess only if circumstances suggest a change
- Effectiveness threshold modified from highly effective to reasonably effective for all hedges
- Elimination of shortcut method and the critical terms matching method

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Derivative Instruments and Hedging Activities (continued)

Hedge Effectiveness

- **The basis for concluding that a hedge is reasonably effective shall include identifying both of the following:**
  - The sources of volatility associated with the fair value of the hedged item or the cash flows of the forecasted transaction
  - The factors supporting a conclusion that the hedging instrument is reasonably effective in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows over the life of the hedging relationship

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Derivative Instruments and Hedging Activities (continued)

Dedesignation of a Hedging Relationship

- **A hedge can only be dedesignated if one of the following conditions is met:**
  - The qualifying criteria for designating a hedging relationship are no longer met
  - The hedging instrument expired, sold, terminated or exercised
- **Dedesignation will no longer be elective**

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Lease Accounting

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Lease Accounting

- **FASB noted the following problems with current lease accounting**
  - Off-balance sheet presentation of leased assets and related financing
  - Bright-line rules lead to structuring opportunities
  - Rules are very detailed
- **Proposal is applicable to all companies**

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Lease Accounting (continued)

- **Proposed model accounts for the value of the rights and obligations conveyed through the lease contract**
  - Instead of "all or nothing," it is a "to the extent of" model
- **Present value of cash flows**
  - Estimate lease term, considering likelihood of renewal (must be more likely than not)
  - Discount those lease payments and estimate contingent rentals, if any, using probability-weighted cash flows
  - **Exception for short-term leases (just accrue remaining lease payments at reporting period; no discounting or amortization)**

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Lease Accounting (continued)

Lessee

Balance Sheet	Income Statement
Debit Right of Use Asset	Amortize over lease term (or life if shorter)
Credit Lease Obligation	Recognize interest expense

- **Change in income statement recognition for long-term leases**
  - Interest expense and amortization, instead of rent expense

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Lease Accounting (continued)

Lessor

- **Accounting depends on whether significant risk of leased asset is retained**

Balance Sheet	Income Statement
If Yes:	
Debit Lease Receivable	Interest income
Credit Performance Obligation	Rental income over life of lease
If No:	
Debit Lease Receivable	Interest income
Credit Underlying leased asset	Gain or loss at inception of lease Residual impairment

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Lease Accounting (continued)

Status of Proposal

- Exposure draft was issued on August 17, 2010
- Comments are due by December 15, 2010
- FASB has received very few comment letters so far
- FASB plans to finalize the amendment in 2011

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Accounting Hot Topics
A Focus on Loans

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