

TPA# 21.30.09 Scope Part I: Application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer to Debt Securities*

Inquiry: Does the scope of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* include debt securities?

Reply: Yes. This SOP applies to loans, as defined in the Glossary, including those that are accounted for as debt securities. The SOP defines the terms “loan” and “debt security” by reference to FAS 114, *Accounting by Creditors for Impairment of a Loan*, and FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. The definition of loan in SOP 03-3’s glossary refers to FAS 114 for the definition of a loan and goes on to say that the definition of loan encompasses loans accounted for as debt securities as defined in par. 137 of FAS 115: (see below)

“Debt Securities: Any security representing a creditor relationship with an enterprise. It also includes (a) preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor and (b) a collateralized mortgage obligation (CMO) (or other instrument) that is issued in equity form but is required to be accounted for as a non-equity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position. However, it excludes option contracts, financial futures contracts, forward contracts, and lease contracts.”

Therefore, the scope of the SOP includes acquired loans that are accounted for as debt securities.

TPA# 2130.10 Scope Part II: Instruments Accounted For As Debt Securities under SOP 03-3

Inquiry: Some types of instruments are measured like debt securities. In accordance with the guidance of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, and considering expected cash flows for instruments measured like debt securities, when does the investor follow the guidance of par. 7 of the SOP (loans accounted for as debt securities) or par. 8 of the SOP (loans not accounted for as debt securities)?

Reply: Paragraph 14 of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides an example of instruments that are measured like debt securities:

“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 Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362)".

For these types of instruments measured like debt securities, investors should follow the impairment guidance in par. 7 (loans accounted for as debt securities) of the SOP, unless the asset is otherwise excluded according to par. 3 of the SOP.

TPA# 2130.11 Determining Evidence of Significant Delays and Shortfalls Relative to SOP-03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: Footnote 3 of the SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, states that "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." How might that assessment be determined?

Reply: That assessment will likely be based on individual facts and circumstances and should be guided by an accounting policy adopted and applied consistently by the investor. For instance a percentage could be established to indicate an "insignificant" shortfall and for those items that meet the percentage shortfall, the dollar shortfall itself would be evaluated as to whether it is insignificant in the aggregate.

TPA# 2130.12 Determining Evidence of Deterioration of Credit Quality and Probability of Contractual Payment Deficiency in accordance with SOP-03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: In accordance with SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, how can an investor identify loans that have evidence of deterioration of credit quality and for which it is probable that the investor will be unable to collect all contractually required payments receivable so that they can identify whether the loans are in the scope of SOP 03-3?

Reply: There are several things to consider when determining whether certain loans are within the scope of SOP 03-3. An investor may set policies, including thresholds based on the type of loan product. Commercial loans are generally classified or graded into risk categories as part of an ongoing credit review process. An investor may identify commercial loans with evidence of deterioration using the previous owner's record of changes in classification and accrual status. Such records may also provide evidence concerning whether it is probable that the investor will be unable to collect all contractually required payments receivable. In contrast, consumer loans are generally not individually reviewed or graded and non-accrual and charge-off policies vary by product. For instance, some types of consumer loans are immediately charged-off when the loan is a certain number of days past due and may never be classified as non-accrual.

As a result, indicators of credit quality deterioration for consumer products may vary depending on the product and may include non-accrual classification, past due status, or FICO score and changes therein. For debt securities, investors may establish other criteria to determine when securities should be considered for review for application under this SOP, for example, downgrades in credit grade categories.

TPA# 2130.13 Non-Accrual Loans Part I: Acquired Non-accrual Loans under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: Does an acquired loan (purchased individually or as part of a business combination) that was classified by the seller as non-accrual fall within the scope of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: Non-accrual status may be an indicator that a loan that meets the criteria of the SOP. However, the investor should analyze whether the loan meets all the scope criteria in par.3 of the SOP, including evidence of credit deterioration. Classification of a loan as non-accrual by the seller and/or investor does not provide an exemption from the SOP. SOP 03-3 does not prohibit carrying acquired loans on non-accrual status, when appropriate. However, certain disclosures are required for such loans in accordance with par. 16a (a4) of the SOP

TPA# 2130.14 Non-Accrual Loans Part II: Consumer Loans on Non-Accrual Status under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: Should SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, be applied to non-accrual (for example, 90 days past due) consumer loans that are reported as non-performing loans when such loans may be charged off completely in relatively short order (that is, after 120 days)?

Reply: Yes. The SOP is applicable to all loans within its scope, including non-accrual loans. The accrual accounting specified in the SOP should be applied if the investor is able to estimate expected cash flows, including cash flows resulting from foreclosure and other collection efforts. However, when the investor does not have the ability to reasonably estimate cash flows, the SOP does not prohibit carrying loans on non-accrual. Also, investors should note there are additional disclosure requirements for these circumstances.

TPA# 2130.15 Loans Held for Sale in Accordance with SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Inquiry: Why are only mortgage loans held for sale and not all loans held for sale excluded from the scope of SOP 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: Only mortgage loans held for sale that are accounted for under FAS 65, *Accounting for Mortgage Banking Activities*, are excluded from the scope because FAS 65 is higher level GAAP and the SOP, under the GAAP hierarchy, had to provide an exception. (See Appendix B (paragraph B-13) of the SOP for a further discussion.

TPA# 2130.16 Treatment of Commercial Revolving Loans under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: Par. 3f of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, excludes revolving credit agreements from its scope specifically noting as examples two types of consumer revolving agreements, credit cards and home equity loans. Revolving privilege is defined in the glossary as "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 then to reborrow under the same loan." Are commercial revolving loans also excluded from the scope of SOP 03-3?

Reply: Commercial revolving loans should be treated the same as consumer revolving loans. Thus, commercial revolving loans are excluded as well, if the borrower has revolving privileges at the acquisition date.

TPA# 2130.17 Application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer to Retained Interests*

Inquiry: The scope of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, excludes loans that are retained (transferor's beneficial) interests. How does the SOP scope relate to the scope of EITF Issue 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*?

Reply: Accounting for retained interests should follow EITF 99-20 and for purchased interests should follow SOP 03-3 if they meet the scope criteria in par. 3. EITF 99-20 par. 10 states, "The Task Force observes that when the proposed SOP on accounting for certain purchased loans is issued and becomes effective, beneficial interests subject to that SOP would be excluded from the scope of this Issue."

TPA# 2130.18 Loans Reacquired Under Recourse under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Inquiry: If a loan that was transferred with recourse and qualified for accounting as a sale under a FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is subsequently repurchased under the recourse provision, is it within the scope of the SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: Yes, if it meets the criteria in par. 3 of the SOP related to credit quality. Except for

purchases triggered by initial representations and warranty deficiencies, it is likely that the repurchased loan would meet the criteria to be included in the scope of the SOP. The SOP includes guidance on the evidence of credit deterioration. (See TPA# 2130.11, *Determining Evidence of Significant Delays and Shortfalls Relative to SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer*)

TPA# 2130.19 Acquired Loans Where Purchase Price is Greater than Fair Value under SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer.

Inquiry: If the fair value of a purchased loan is less than the purchase price because a loan is repurchased under a recourse provision, does SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, permit recording the loan at the purchase price?

Reply: If a loan meets the criteria of par. 3, such that it is in the scope of the SOP and the seller re-purchases the asset at a price that is more than fair value, the seller should record the asset at its fair value and record a loss for the difference between the price paid and the fair value, if not already recognized. An allowance for loan losses to offset recording the loan at the purchase price should not be recorded. In most cases, if the loan had previously been transferred with recourse, the seller should already have recognized an associated liability for the recourse obligation in accordance with FAS 5, *Accounting for Contingencies* and FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as well as FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

TPA# 2130.20 Acquired Loans Where Purchase Price is Less than Fair Value under SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer

Inquiry: In accordance with SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, if the fair value of a purchased loan is more than the purchase price because a loan is acquired, for example, as part of a clean up call, should the seller record a gain?

Reply: No. There may be instances where the seller is required or has an option to re-purchase an asset at a price that is less than fair value. In that situation and if the loan is within the scope of the SOP, the investor should record the asset at the purchase price and the excess of expected cash flows over the initial investment should be recognized as the yield under the SOP.

TPA# 2130.21 Accounting for Loans with Cash Flow Shortfalls That Are Insignificant Under SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer.

Inquiry: Related to footnote 3 of SOP 03-3, *Accounting for Certain Loans or Debt Securities*

Acquired in a Transfer, an investor might establish a policy that a shortfall in contractually required payments below a certain amount or percentage is insignificant and thus, certain acquired loans would not be in the scope of the SOP. For loans with shortfalls in payments of less than the established threshold, how should those discounts be accreted into income as a yield adjustment?

Reply: If a loan is not in the scope of SOP 03-3, then FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* applies, and par. 15 of FAS 91 requires that the entire discount be accreted to income over the life of the loan.

TPA# 2130.22 Carrying Over the Allowance for Loan and Lease Losses (ALLL) Under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. (Part I)

Inquiry: Can some or all of an Allowance for Loan and Lease Losses (ALLL) be carried over in a business combination under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, does not address the appropriateness of carrying over the ALLL for loans not in its scope.¹

TPA# 2130.23 Carrying Over the Allowance for Loan and Lease Losses (ALLL) under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (Part II)

Inquiry: Are there any recommendations on calculating allowance ratios relating to loans in the scope of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: Although the nonaccretable difference is akin to an ALLL because it represents amounts that are not expected to be collected, it should not be included in the ALLL or ALLL ratios. The only time there is any ALLL for the loans within the scope of the SOP is when the expected cash flows have decreased after acquisition and a loss is recognized by the investor. In other words, at the purchase date, for loans within the scope of the SOP, the allowance-to-loans ratio is always zero. The investor may wish to disclose in the notes to the financials the amount of the nonaccretable difference so that the readers understand by how much the loans have already been "written down".

TPA# 2130.24 Carrying Over the Allowance for Loan and Lease Losses (ALLL) under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (Part III)

On June 30, 2005, the FASB issued an ED of a Proposed Statement of Accounting Standards, *Business Combinations – a replacement of FASB Statement No. 141*. The comment period ended. The FASB tentatively took the position that no ALLL should be carried over.

Inquiry: For loans evaluated collectively by the previous owner that have related FAS 5, *Accounting for Contingencies*, components, should the investor in a business combination carry over the ALLL?

Reply: If the investor has acquired loans within the scope of the SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, in a business combination for which a portion of the predecessor's allowance had been specifically allocated to those loans, that portion of the ALLL would not be carried over. Even when loans are acquired within the scope of the SOP for which there had been no specific allocation, it is expected that some portion of the predecessor's ALLL related to such loans and should not be carried over. However, it may be difficult to determine the amount of the ALLL allocable to those loans where the ALLL had been estimated by a pool methodology and when there were "unallocated" components of the allowance. In considering how to attribute the appropriate amount of the predecessor's ALLL to loans in the scope of SOP 03-3, investors should carefully consider that loans within the scope of the SOP likely have additional risk characteristics that may warrant a heavier weighting of the ALLL to those loans, considering other factors such as prior charge-offs. The AICPA staff understands that the portion of the predecessor's ALLL that is not carried over because it relates directly to or has been allocated to loans within the scope of the SOP should be disclosed for public companies. Another consideration related to determining the amount of the ALLL that should not be carried over is the seller's calculated nonaccretable difference. After a loan by loan analysis to determine whether an individual loan is in the scope of SOP 03-3, SAB 61, (*Adjustments to Allowances for Loan Losses in Connection with Business Combinations*) will continue to apply to public companies to the remainder of the loans and the ALLL that are not within the scope of the SOP.

TPA# 2130.25 Income Recognition for Non-accrual Loans Acquired Under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part I)*

Inquiry: What is the accounting for a purchased loan that was classified by the previous owner as non-accrual and for which cash flows cannot be reasonably estimated under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Response: The SOP does not prohibit placing (or keeping) loans on non-accrual. At inception or thereafter the investor may place a loan on non-accrual, if the conditions in Par. 6 of the SOP are met. Par. 16a (4) of the SOP requires certain disclosures for purchases of non-accrual loans.

TPA# 2130.26 Income Recognition for Non-accrual Loans Acquired Under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part II)*

Inquiry: A loan is classified as non-accrual by a seller because the debtor is not meeting its obligations under the loan's contractual terms. That loan is sold to an investor who determines that the loan meets the requirements of SOP 03-3, *Accounting for Certain Loans*

or Debt Securities Acquired in a Transfer? If the investor can reasonably estimate cash flows, should the investor classify the loan as an accruing loan?

Reply: Yes, if the investor can reasonably estimate cash flows, it should recognize an accretable yield and the loan is an accruing loan as discussed in paragraph 6 of the SOP.

TPA# 2130.27 Income Recognition for Non-Accrual Loans Acquired Under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part III)*

Inquiry: Assuming the investor followed the cost recovery method on a loan, and assuming the loan was brought current for a period of time, could the investor return the loan to accrual status and account for the loan as a new loan?

Reply: If the loan was within the scope of the SOP when it was purchased, it is not accounted for as a new loan but is always under the requirements of the SOP, even if the loan's performance improves. However, as discussed in TPA# 2130.26, the loan should be accruing income whenever the investor is able to reasonably estimate cash flows. Also, if the currently expected cash flows exceed the originally expected cash flows, the guidance in Par. 7 or 8 of the SOP should be applied, which may result in recognizing income at a higher yield than originally expected.



TPA# 2130. 28 Estimating Cash Flows under SOP-03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: In accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, how often should an investor reassess the cash flows expected to be collected?

Reply: Investors should reassess expected cash flows at the end of each reporting period. Thus, for entities that prepare quarterly GAAP-basis financial statements, it is expected that cash flows will be re-assessed at least quarterly.

TPA# 2130.29 EITF 01-7 Implications with a Restructured or Refinanced Loan under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part I)*

Inquiry: Can a loan that meets the requirements of EITF Issue 01-7, *Creditor's Accounting for a Modification or an Exchange of Debt Instruments*, be removed from the scope of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*? If a loan is within the scope of SOP 03-3 and there are modifications to that loan, should the guidance in EITF 01-7 apply?

Reply: No. EITF 01-7 only applies to loans that are not within the scope of SOP 03-3. The point of par. 10 in the SOP is that a loan stays in the scope of the SOP, regardless of restructuring or refinancing, except for a troubled debt restructuring.

TPA# 2130.30 EITF 01-7 Implications with a Restructured or Refinanced Loan under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part II)*

Inquiry: Can a loan that has been extinguished in accordance with EITF Issue 01-7, *Creditor's Accounting for a Modification or an Exchange of Debt Instruments*, and given a new loan number, with new terms, but which has not been paid off, be accounted for as a new loan under the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*? What steps could the investor and borrower take to permit the loan to be accounted for as a new loan?

Reply: A loan within the scope of the SOP can never be accounted for as a new loan, except through a troubled debt restructuring in accordance with FAS 15, *Accounting by Debtors and Creditors for a Troubled Debt Restructuring*.

TPA# 2130.31 Variable Rate Loans and Changes in Cash Flows and SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: In accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* should an investor in variable rate loans determine the cause of a decrease in expected cash flows?

Reply: Yes. To the extent that the investor can directly attribute a decrease in expected cash flows to a decrease in the contractual interest rate, the investor should reduce the yield recognized in income on a prospective basis. However, if the investor is not able to directly attribute the decrease in expected cash flows to a decrease in the contractual interest rate (for example, because the change in the index or rate has no direct effect on the cash flows available to the borrower to service the loan or because the change in the index or rate had no direct effect on expected cash flows that relate to the value of the collateral) the investor should immediately recognize any decrease in expected cash flows as an impairment, not over time as reduced yield.

TPA# 2130.32 Pool Accounting under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part I)*

Inquiry: In accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, if a loan is removed from a pool, how is the specific carrying amount of a loan determined?

Response: As discussed in paragraph 13 of the SOP, once a pool has been assembled the integrity of the pool should be maintained. If the loan is removed under the specific criteria in paragraph 13, it should be removed at its carrying amount. In some cases the cash flows of the pool will have been estimated for the pool as a whole such that there is no specific information on the carrying amount and cash flows related to any particular loan. In that case, an allocation of carrying amount to the loan on a pro rata basis is an appropriate way to achieve the goal of not impacting the accounting for the remaining pool. In other cases, the cash flows of the pool may have been built up as the sum of cash flows of individual loans and there is specific information related to the loan being removed. In that case, the carrying amount is allocated on the basis of the specific information for the loan removed. In either case, the goal remains the same -- that is, to not have a removal event result in either impairment or an increase in yield for the remaining pool.

TPA# 2130.33 Pool Accounting under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer (Part II)*

Inquiry: Alternatively, and related to TPA# 2130.32 should the loan be removed at its initial fair value in accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*?

Reply: Generally, no. Removing a loan at its initial fair value, unless done very shortly after acquisition of the loan and creation of the pool, would likely result in a change in the effective yield of the remaining pool and the stated intent of the SOP is that removing a loan from a pool should not result in such a change.

TPA# 2130.34 Application to Fees Expected to be Collected under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: In accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* should fees be included in "expected cash flows?" We note the glossary definition for "cash flows expected at acquisition" includes "principal, interest and other cash flows expected to be collected." Does the SOP address late fees and other fees?

Reply: "Other cash flows expected to be collected" includes all fees. If late fees are expected to be collected and are contractual, the investor should include them in total contractual cash flows and expected cash flows for purposes of calculating yield and making disclosures. If late fees are contractual but not expected to be collected, the investor should exclude late fees from contractual cash flows and disclose that accounting policy (if it is considered material).

TPA# 2130.35 Application to Cash Flows from Collateral and Other Sources under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*

Inquiry: In accordance with the guidance in SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, should cash expected to be received from the ownership and sale of assets taken in settlement of loans be included in “other cash flows expected to be collected”?

Reply: Cash flows expected at acquisition includes all cash flows directly related to the acquired loan, including those expected from collateral. Although yield is measured on this basis under SOP 03-3 for the loan prior to foreclosure, an asset received by the investor in full or partial settlement of a loan should be accounted for in accordance with par. 28 of FAS 15, *Accounting by Debtors and Creditors for a Troubled Debt Restructuring*.