Ernst & Young LLP
One Manhattan West
New York, NY 10001-8604

Tel: +1 212 773 3000
ey.com

Ms. Hillary H. Salo
Technical Director
File Reference No. 2023-ED400
Financial Accounting Standards Board
801 Main Avenue
P.O. Box 5116
Norwalk, CT 06856-5116

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Proposed Accounting Standards Update, Financial Instruments — *Credit losses (Topic 326): Purchased Financial Assets*

Dear Ms. Salo:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Financial Instruments — Credit Losses (Topic 326): Purchased Financial Assets*, issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's efforts to address concerns stakeholders raised during the post-implementation review of Accounting Standards Codification (ASC or Codification) 326, *Financial Instruments — Credit Losses*, related to the complexity of applying the current guidance and the lack of comparability in the accounting for purchased assets with credit deterioration (PCD) and non-PCD assets.

While we support the Board's objective to provide a uniform accounting approach for purchased financial assets, we recommend that certain aspects of the proposal be revised to address the many operational issues that could arise during implementation and lead to accounting and auditing challenges.

We believe the inclusion of credit cards and other revolving credit arrangements in the scope of the guidance would result in operational complexities beyond those that the FASB sought to address with ASU 2016-13. If the FASB includes these arrangements in the scope of the final guidance, it should provide practical expedients to address the unit of account, the seasoning criteria and the "substantially all" criteria. In addition, we believe the guidance should clarify whether the criteria for determining whether a loan is considered to be originated should be analogized to ASC 310-20.

We also recommend that the FASB explicitly state in the final ASU which assets would fall under the definition of a purchased financial asset. It is not clear from the proposal whether the definition would apply to contract assets and sales-type and direct financing lease receivables. While we agree that the guidance should not apply to available-for-sale (AFS) debt securities, we believe their exclusion from the scope would result in a lack of clear guidance on how to account for the interest accretion for an AFS security where full contractual collection was not expected at the time of acquisition, since ASC 326-30 superseded ASC 310-30.

We recommend requiring entities to apply the guidance prospectively, which would minimize the costs of adoption, with an option to apply it on a modified retrospective basis. That is because the information available before an acquisition that an entity needs to apply the seasoning criteria and the "substantially all" criteria, and the information available before system conversion and possible third-party servicing periods may not be still retained for purposes of applying the modified retrospective approach, as proposed.

Our responses to certain questions in the proposal are included in the Appendix to this letter.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

Appendix — Responses to *Questions for Respondents* included in the FASB's proposal

Question 1 — The amendments in this proposed Update would expand the population of acquired financial assets accounted for under the gross-up approach, which currently applies only to PCD assets. Should certain classes of financial assets or specific transactions be included (for example, AFS debt securities) or excluded (for example, credit cards or similar revolving credit arrangements)? Please explain why or why not.

Credit cards and other revolving arrangements

While we support the Board's objective to align the accounting for acquired financial assets, the inclusion of credit cards and similar revolving credit arrangements in the scope of the guidance would pose various operational challenges for both entities and auditors. The accounting to be performed at the individual account level for the allocation of the acquisition-date credit component, the treatment of charge-offs and the estimation of recoveries may require entities to develop new systems and design and implement internal controls over financial reporting, which would result in additional time, judgment and costs in auditing.

Given the complexities in applying the proposed guidance to credit cards and similar revolving credit arrangements, we believe these arrangements should be excluded from the scope. We discuss the proposal's operability and related auditing challenges and provide suggestions for practical expedients for credit card revolvers and similar revolving credit arrangements in our response to Question 3.

AFS debt securities

While we agree that the guidance should not apply to AFS debt securities as the Board noted in the Introduction and Background and Basis for Conclusions sections, the proposed ASU does not explicitly exclude them from the scope. An explicit exclusion would result in a lack of guidance on calculating interest income for an AFS debt security that has experienced significant credit deterioration upon acquisition.

Before adoption of ASU 2016-13, entities recognized interest income for AFS debt securities where full contractual collection was not expected in accordance with ASC 310-30. After adoption, ASC 326-30 superseded ASC 310-30. Given that the proposed ASU would supersede the pertinent sections of ASC 326-30 and would not apply to AFS debt securities, there would no longer be guidance on the accounting for interest income for these types of securities. We believe the language in the Codification should be updated accordingly.

Definition of purchased financial assets

We also believe there is inconsistency in the proposed definition of purchased financial assets between the Master Glossary and the Basis for Conclusions. The proposal's Master Glossary contemplates only financial assets acquired and does not explicitly include certain other assets (e.g., contract assets and sales-type and direct financing lease receivables accounted for under ASC 606 and ASC 842, respectively) that are implied to be included as referenced in BC19.

If the Board affirms its position suggested in BC19 that the gross-up approach would apply to contract assets, we believe it should clarify the guidance accordingly.

Because the definition of a financial asset is used in guidance outside of ASC 326 (e.g., ASC 805), it is important for the Board to be explicit about the scope of the definition.

Contract assets acquired in a business combination

The Board suggested in BC19 that contract assets arising from revenue contracts that are acquired in a business combination should be accounted for under the gross-up approach. We question whether the gross-up model is operable for these assets and recommend excluding them from the scope. If the Board decides to do so, we propose an approach for the Board to consider in our response to Question 3.

If the Board affirms its position suggested in BC19, we recommend that it state explicitly in the Codification that acquired contract assets are, in fact, subject to the gross-up approach at the acquisition date.

ASC 805 includes several exceptions to the fair value measurement principle that generally apply to assets acquired in a business combination. One of those exceptions requires an acquirer to measure acquired contract assets using the measurement principles in ASC 606 instead of fair value. That measurement exception clearly defines the population of acquired assets subject to that guidance by referencing the Master Glossary definition of contract assets.[1]

In contrast, while the proposal would add another exception to fair value measurement to ASC 805 for purchased financial assets, it is unclear based on the proposed amended definition of that Master Glossary term that an acquirer also would be required to apply the proposed measurement exception (i.e., apply the gross-up approach) to contract assets.

The definitions of purchased financial assets and financial assets[2] do not consider contract assets or otherwise reference that Master Glossary term. In addition, while language in BC19 suggests that a contract asset is an example of a financial asset, the Codification does not specify that contract assets also are financial assets. In practice, stakeholders generally conclude that a contract asset does *not* meet the definition of a financial asset because an entity's right to consideration is conditional in nature. Without explicit guidance, we are concerned that entities may not consistently apply the proposed measurement guidance in ASC 805 to contract assets.

In addition, we suggest that the Board limit its use of the term "exception" throughout the Basis for Conclusions to refer only to existing and proposed accounting guidance (e.g., exceptions to fair value measurement in ASC 805). Currently, Board and stakeholder views about the applicability of the

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[1] A *contract asset* is defined as "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)."

[2] A *financial asset* is defined as "cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following: (a) Receive cash or another financial instrument from a second entity or (b) Exchange other financial instruments on potentially favorable terms with the second entity."

gross-up approach to various acquired assets are described in the context of a "scope exception." We believe that discussion is confusing and could be misinterpreted to mean that the gross-up approach does not apply to contract assets. Alternatively, if the Board decides to amend the Codification to explicitly include contract assets acquired in a business combination in the scope of the gross-up approach, this concern may be diminished.

Question 2 — Would the proposed amendments enhance comparability and improve the decision usefulness of financial information? Are there specific disclosures related to these proposed amendments that would be useful to investors? Please explain why or why not.

In our view, the question about whether the proposal would improve the decision usefulness of financial information would be best addressed by investors.

Question 3 — Do you foresee operability or auditing concerns in applying the gross-up approach to certain classes of financial assets (for example, credit cards or other revolving arrangements), certain types of transactions (for example, business combinations, asset acquisitions, or the consolidation of a VIE that is not a business), or certain classes of financial assets in specific transactions (for example, credit cards or other revolving arrangements in an asset acquisition)? Please describe the nature of those concerns and the magnitude of associated costs, differentiating between one-time costs and recurring costs. Are there practical expedients or implementation guidance that would mitigate your concerns? Are there practical expedients or implementation guidance that would enhance comparability? For any proposed practical expedients suggested, please explain your reasoning.

The first aspect of complexity for credit card revolvers and other revolving credit arrangements would be the unit of account. ASC 326-20-30-13 states "at the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium."

The inclusion of credit cards and other revolving credit arrangements in the scope of the proposed guidance would result in entities having to track two units of account for the same arrangement with a borrower (i.e., existing credit cards would be treated as purchased and new draws would be treated as originated). Accordingly, an entity's accounting systems and current expected credit losses (CECL) models would need to be redesigned and programmed to track this level of information, thus adding a layer of complexity and making implementation and related auditability more challenging and costly.

In addition, an entity may not have information available before the acquisition date that would be needed to evaluate and apply the seasoning criteria on the balances purchased and conclude on the "substantially all" criteria to apply the modified retrospective transition or prospective approach. The entity also may not have the information available post-acquisition through pre-conversion of systems to apply the modified retrospective transition approach. This would make the audit more challenging and contribute further to inconsistencies in comparability due to the inconsistent application of a systematic and rational audit approach. This also would require significant upfront effort to reprogram existing CECL models to track this level of information.

If the Board decides to proceed with the proposed guidance as written for credit cards and other revolving credit arrangements, we suggest that it provide practical expedients, such as:

- The option to apply the guidance at the pool level for credit cards and other revolving credit arrangements
- The option to amortize the credit component over the same expected life used in the CECL model
- The option to use the contract origination dates of credit cards and other revolving credit arrangements for seasoning criteria and the substantially all evaluation for revolving balances acquired

We also foresee significant operability and auditing concerns with the adoption of the proposed ASU using a modified retrospective approach. Refer to Questions 1 and 6 for further detail, including additional practical expedients.

Contract assets acquired in a business combination

We believe that applying a gross-up approach to acquired contract assets introduces additional accounting complexity. The costs of applying such an approach may not justify the expected benefits because most contract assets acquired in a business combination are short-lived. Thus, the financial reporting outcome of applying the gross-up approach to these assets generally may not be material or meaningful to investors.

We recommend the Board exclude contract assets acquired in a business combination from the scope of the gross-up approach and clarify in ASC 805 that recognizing acquired contract assets using ASC 606 measurement principles requires separate recognition of an allowance for expected credit losses on the acquisition date in accordance with ASC 326-20. That guidance could be codified as follows:

> For contract assets recognized in a business combination in accordance with paragraph 805-20-25-28C, the acquirer shall also recognize a separate valuation allowance for the expected credit losses in accordance with paragraph 606-10-45-3 at the acquisition date.

We observe that ASC 805-20-30-4 states that a separate valuation allowance as of the acquisition date is not recognized for assets that are measured at their acquisition date fair values. However, since contract assets are not measured at fair value under ASC 805, we believe this approach aligns with the recognition of a valuation allowance for other assets that are not required to be measured at fair value (e.g., indemnification assets, deferred income taxes).

We believe this approach would not compromise the usefulness of information disclosed to investors because it would result in the acquirer initially recognizing contract assets acquired in a business combination at the amounts expected to be collected based on entity-specific assumptions, as if the acquirer had originated the related revenue contract at its inception date. We also believe this approach would be more consistent with how the acquiree would have measured the contract assets in its financial statements immediately prior to the business combination.

Alternatively, if the Board affirms its position suggested in BC19 to include contract assets in the scope of the gross-up approach, we believe that more authoritative guidance is needed to explain how that model should be applied to contract assets acquired in a business combination that are measured using ASC 606 measurement principles. Without additional guidance, we question whether the proposed guidance would be operable for these assets.

ASC 805 refers to examples in ASC 326-20 that illustrate the gross-up approach when an entity acquires an individual financial asset and a group of financial assets (e.g., a loan or portfolio of loans). Those examples illustrate that the amortized cost of an acquired PCD asset is initially measured by determining an estimate of expected credit losses in accordance with that subtopic and adding that amount to the asset's purchase price. An entity recognizes the amortized cost of the asset, a valuation allowance for expected credit losses, and a noncredit discount (or premium),3 if any, as separate units of account upon initial recognition. The sum of those three units of account is equal to the PCD asset's purchase price.

However, neither ASC 326 nor ASC 805 defines purchase price or explains how an entity should determine a financial asset's purchase price for purposes of applying the gross-up approach when that asset is included in an acquired set of assets that constitute a business.

In practice, the purchase price of a financial asset acquired in a business combination is generally its acquisition-date fair value under ASC 805. Because contract assets would be subject to the gross-up model for the first time[4] under the proposal and are not measured at fair value in a business combination, it is unclear how the purchase price should be determined for purposes of establishing an acquired contract asset's initial amortized cost.

We recommend that the Board provide an example illustrating how to apply the gross-up approach to contract assets acquired in a business combination. We also believe additional guidance may be necessary to address the subsequent accounting for the grossed-up contract asset since that will be measured on a basis that is different from an ASC 606 measurement basis. A similar example would also be helpful for other assets that the Board believes should be subject to gross-up accounting that are not measured at acquisition-date fair value (e.g., lease receivables arising from acquired sales-type and direct financing leases in which the acquiree is a lessor).

Question 4 — There are no proposed amendments to the gross-up approach as it is currently applied to PCD assets; rather, there are proposed amendments that would expand the population of financial assets that apply the gross-up approach at acquisition. Do you agree that no amendments are needed to the existing gross-up approach? Please explain why or why not.

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[3] The noncredit discount (premium) represents the difference between the contractual amount that is due (i.e., the face or stated principal amount) and the asset's amortized cost at the acquisition date.

[4] As mentioned in our response to Question 1, because stakeholders typically conclude that contract assets do not meet the definition of a financial asset, contract assets generally are not subject to the gross-up approach when they are initially recognized in business combination accounting.

In our view, except for as it relates to contract assets in a business combination, the gross-up approach does not require any amendments. As it is currently applied, the gross-up approach is practical, and a comprehensive audit approach has already been implemented and developed.
However, the proposed guidance would significantly expand the scale of the approach's application, requiring entities to develop systems to handle the higher volume of loans accounted for under the approach, redevelop CECL models, implement and modify the entities' internal controls over financial reporting, which would result in additional time, judgment and costs in auditing.

Question 5 – Do you agree with the proposed seasoning criteria in paragraph 326-20-30-15 and 30-16? If not, please explain why or why not and describe any potential alternatives for the Board's consideration.

Although we agree with intent of the defined seasoning criteria in ASC 326-20-30-15 and 30-16, we have concerns about applying the criteria in practice, since they could result in certain acquisitions being considered loan originations depending on the method an entity used as its basis for evaluation creating inconsistencies in presentation across entities for similar transactions (i.e., as BC26 suggests an entity could use different methods based on the transaction-specific facts and circumstances).

Determining whether an entity (e.g., a FinTech company partnering with a bank as an in-substance lender) is a loan originator under ASC 310 may involve significant judgment. The proposed criteria may suggest that if you are an originator under ASC 326, you may also be considered an originator under ASC 310, and therefore, the fees and costs associated with the origination (which could include incentives) would be accounted for in accordance with ASC 310-20, instead of other accounting literature (e.g., ASC 606). We suggest that the Board clarify whether the criteria proposed in paragraphs 326-20-30-15 and 30-16 should be analogized for the application of ASC 310-20.

Question 6 – Do you agree with the modified retrospective transition guidance in this proposed Update? Should early adoption be permitted? Please explain why or why not.

We recognize that the proposed modified retrospective transition approach is intended to provide users of financial statements with a uniform accounting approach for all purchased financial assets presented in the financial statements. However, we believe this transition approach would result in significant challenges and unintended consequences, making it infeasible for many entities and their auditors.

That is because requiring entities to apply a modified retrospective approach would require recasting management estimates for quarterly and annual allowance considerations subsequent to the date of acquisition.

With respect to the qualitative components of the allowance, management would need to apply a systematic and rational approach to recast certain judgments without incorporating hindsight, and auditors would need to evaluate and assess the appropriateness of those judgments when auditing these retrospective estimates. For example, loans accounted for as non-PCD will retrospectively have an increase in cost basis. Some of these loans would have been fully or partially charged off before the time the proposed ASU is adopted. This would impact historical charge-off disclosures and charge-off rates. To the extent that charge-off rates are materially impacted, it is not clear whether the updated

charge-off rate should be applied to other loans otherwise not impacted by the proposed ASU (e.g., originated loans).

In addition, certain entities may not possess the level of historical data necessary (as discussed in Questions 1 and 3) to adopt the guidance on a modified retrospective basis.

For all affected entities, adoption would involve significant upfront implementation costs and, in many cases, efforts that duplicate those made during the original adoption of the credit losses standard. In addition, there would be ongoing costs to maintain and redevelop systems and audit the increased volume of assets accounted for under the gross-up approach.

Therefore, we recommend that the Board consider requiring a prospective transition approach, with an option to apply the guidance on a modified retrospective basis. However, if the Board decides to proceed with requiring a modified retrospective approach, we believe it should provide practical expedients, such as the following:

- For historical charge-offs on non-PCD assets, the option not to update charge-off rates, given the presumed negligible impact

Refer to our response to Question 3 for additional practical expedients.

Question 7 — How much time would be needed to implement the proposed amendments? Is additional time needed for entities other than public business entities? Please explain your response.

The timing of implementation would depend on the potential revisions to the proposal based on stakeholder feedback. If the FASB finalizes the proposal as written, we believe entities would need more than two years to implement the guidance due to the significant amount of effort involved. Because the proposed guidance, as written, would not prescribe an example of a systematic and rational approach for retrospective adoption, the transition approach may not be consistent across affected entities.

In addition, entities would need sufficient time to develop or redevelop systems and models used, and subsequently, allow sufficient time for reaudits. As described in our responses to Questions 1, 3 and 4, we foresee significant operability challenges leading to auditing hurdles related to adoption on a modified retrospective basis.

However, if the Board revises the proposed transition approach as we suggest, we believe the complexity of implementation and auditability would be reduced.