Credit Acceptance
We change lives!

February 8, 2018

Mr. Russell Golden, Chairman
Ms. Susan Cosper, Technical Director
Financial Accounting Standards Board
401 Merritt 7 P.O. Box 5116
Norwalk, CT 06856-5116

Re: Agenda Request – Scope of Initial Measurement Guidance for Purchased Financial Assets with Credit Deterioration

Ladies and Gentlemen:

Credit Acceptance Corporation (the "Company", "Credit Acceptance", "we", "our", or "us") is submitting this letter to request that the Financial Accounting Standards Board (either on its own, or with the assistance of the Emerging Issues Task Force or the Transition Resource Group for Credit Losses), consider amending the scope of the measurement guidance for purchased financial assets with credit deterioration added to the Accounting Standards Codification (ASC) by ASU 2016-13, *Measurement of Credit Losses on Financial Instruments.*

ASC Topic 310-10, *Receivables - Overall* and ASC Topic 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Costs* provide guidance related to that initial measurement and recognition of interest income for certain financial assets that is different from the guidance that applies to other financial assets. The alternative guidance (which is found in ASC 310-10-35-53A through 35-53C and ASC 326-20-30-13 through 30-15) applies to 1) financial assets that, as of the date of acquisition by the entity, have experienced a more-than-insignificant deterioration in credit quality since origination (see glossary definition of "purchased financial assets with credit deterioration", and 2) beneficial interests classified as held-to-maturity if there is a significant difference between contractual cash flows and expected cash flows at the date of recognition, even if there has been no deterioration in credit quality since origination (see ASC 325-40-30-1A). We believe that GAAP would be improved by requiring (or at least permitting) the application of this alternative guidance (the "PCD Method") to any financial instrument (not just a beneficial interest) where there is a significant difference between contractual cash flows and expected cash flows at the date of recognition due to credit quality.

The guidance added to the Codification by ASU 2016-13, *Measurement of Credit Losses on Financial Instruments,* must be adopted by public companies for fiscal years beginning after December 15, 2019. We believe that the application of ASC 310-10 and 326-20, as revised by ASU 2016-13, will result in changes to our accounting that are inconsistent with the economics of our business. We believe that the FASB can, before the mandatory adoption date, make minor changes to the scope of the PCD Method that will result in significantly improved accounting for us and for other companies with similar businesses (subprime lending).

This letter describes our business and our understanding of the requirements of ASC 310-10 and 326 as they apply to our business. We have previously discussed this matter with the staff of the Securities and Exchange Commission (the "SEC Staff"), who have informed us that they believe, as the ASC is currently written, we would not be permitted to apply the PCD Method. An SEC Staff Member publicly spoke about this issue on December 4, 2017, at the AICPA Conference on Current SEC and PCAOB Developments (https://www.sec.gov/news/speech/sledge-aicpa-2017-conference-sec-pcaob-developments).

BACKGROUND

Since 1972, we have offered financing programs that enable automobile dealers to sell vehicles to consumers, regardless of their credit history. Our financing programs are offered through a nationwide network of automobile dealers ("Dealers") who benefit from sales of vehicles to consumers who otherwise could not obtain financing; from repeat and referral sales generated by these same customers; and from sales to customers responding to advertisements for our financing programs, but who actually end up qualifying for traditional financing.

Without our financing programs, consumers are often unable to purchase vehicles or they purchase unreliable ones. Further, as we report to the three national credit reporting agencies, an important ancillary benefit of our programs is that we provide consumers with an opportunity to improve their lives by improving their credit score and move on to more traditional sources of financing.

Upon enrollment in our financing programs, the Dealer enters into a Dealer servicing agreement with us that defines the legal relationship between Credit Acceptance and the Dealer. The Dealer servicing agreement assigns the responsibilities for administering, servicing, and collecting the amounts due on retail installment contracts (referred to as "Consumer Loans") from the Dealers to us. We are an indirect lender from a legal perspective, meaning the Consumer Loan is originated by the Dealer and assigned to us.

Substantially all of the Consumer Loans assigned to us are made to consumers with impaired or limited credit histories. We have two programs: the Portfolio Program and the Purchase Program. Under the Portfolio Program, we advance money to Dealers (referred to as a "Dealer Loan") in exchange for the right to service the underlying Consumer Loans. Under the Portfolio Program, we are entitled to certain cash flows from the underlying Consumer Loan, as well as a servicing fee, with excess cash flows going to the Dealer. Under the Purchase Program, we buy the Consumer Loans from the Dealers (referred to as a "Purchased Loan") and keep all amounts collected from the consumer. Dealer Loans and Purchased Loans are collectively referred to as "Loans".

Typically the combination of the payment we make to the Dealer and the consumer's down payment provides the Dealer with a cash profit at the time of sale. We cannot demand repayment of advances or purchase payments except in the event the Dealer is in default of the Dealer servicing agreement.

For accounting purposes, the transactions described under the Portfolio Program are not considered to be loans from the Company to consumers. Instead, our accounting reflects that of a lender to the Dealer. The classification as a Dealer Loan for accounting purposes is primarily a result of (1) the Dealer's financial interest in the Consumer Loan and (2) certain elements of our legal relationship with the Dealer. For accounting purposes, the transactions described under the Purchase Program are considered to be originated by the Dealer and then purchased by us.

CURRENT LOAN ACCOUNTING

We do not believe the current authoritative guidance addresses the credit characteristics of our Loans, which are loans with a significant difference between contractual cash flows and expected cash flows at the time of origination due to credit quality. Our current loan accounting policies were developed and agreed upon among us, our independent registered public accounting firm and SEC Staff (Office of the Chief Accountant) in 2005. These policies are largely, although not completely, analogous to the concepts within ASC 310-30, *Loans Acquired with Deteriorated Credit Quality*, as it relates to revenue recognition, aggregation and measuring credit losses.

ACCOUNTING UPON THE ADOPTION OF ASU 2016-13

Upon adoption of the guidance in ASC 2016-13, ASC 310-10 and ASC 326-20 are the authoritative guidance for recognizing interest income and measuring expected credit losses, respectively, on loans measured at amortized cost and provide two methods of accounting.

PCD Method – This method applies to a specific scope of financial assets at amortized cost

- Summary of Method:
  - The effective interest rate is based on expected cash flows, adjusted for any noncredit premium or discount existing at time of purchase.
  - Any discount that is attributable to an acquirer's assessment of credit losses at the time of purchase is excluded from the determination of the effective interest rate.
  - The initial amortized cost of the loan includes an allowance for credit losses, which is recorded at the time of purchase for expected credit losses and is added to the purchase price. Only subsequent adjustments to the allowance for credit losses for changes in estimates are recognized in net income.
- At the time of assignment, we would:
  - Calculate the effective interest rate as the rate that equates the present value of expected future cash flows to the advance paid under the Portfolio Program or the purchase price paid under the Purchase Program.

  - Record an allowance for credit losses equal to the present value of expected credit losses (contractual cash flows less expected cash flows) discounted at the effective interest rate.
  - Record the amortized cost of the loan receivable as the sum of the allowance for credit losses calculated as described above and the advance paid under the Portfolio Program or the purchase price paid under the Purchase Program.
- For each reporting period, we would:
  - Recognize finance charge revenue (interest income) by applying the effective interest rate to the net carrying amount of the loan (amortized cost of the loan receivable less the related allowance for credit losses).
  - Adjust the allowance for credit losses so that the net carrying amount of the loan (amortized cost of the loan receivable less the related allowance for credit losses) equals the present value of the current estimate of expected future cash flows discounted at the effective interest rate. The adjustment necessary for the reporting period would be recognized as provision for credit losses expense or a reversal of provision for credit losses expense.

<u>Originated Method</u> – This method applies to all other financial assets at amortized cost

- Summary of Method:
  - The effective interest rate is based on <u>contractual</u> cash flows, adjusted for any premium or discount existing at the time of origination or purchase.
  - Any discount that is attributable to an acquirer's assessment of credit losses at the time of origination or purchase is <u>included</u> in the determination of the effective interest rate.
  - The initial amortized cost of the loan does not include an allowance for credit losses for expected credit losses at the time of origination or purchase. Both the establishment of an allowance for credit losses for expected credit losses and subsequent adjustments to the allowance for credit losses for changes in estimates are recognized in net income.
- At the time of assignment, we would:
  - Calculate the effective interest rate as the rate that equates the present value of contractual future cash flows to the advance paid under the Portfolio Program or the purchase price paid under the Purchase Program.
  - Record the amortized cost of the loan receivable as the advance paid under the Portfolio Program or the purchase price paid under the Purchase Program.
  - Record an allowance for credit losses equal to the difference between the amortized cost of the loan receivable and the present value of the initial estimate of expected future cash flows discounted at the effective interest rate. The initial allowance for credit losses would be recognized as provision for credit losses expense.
- For each reporting period, we would:
  - Recognize finance charge revenue (interest income) by applying the effective interest rate to the amortized cost of the loan receivable.
  - Adjust the allowance for credit losses so that the net carrying amount of the loan (amortized cost of the loan receivable less the related allowance for credit losses) equals the present value of the current estimate of expected future cash flows discounted at the effective interest rate. The adjustment necessary for the reporting period would be recognized as provision for credit losses expense or a reversal of provision for credit losses expense.

The PCD Method applies only to assets that meet the definition of "purchased financial assets with credit deterioration", and to certain beneficial interests in securitized financial assets. Our Loans are not beneficial interests as they do not embody rights to receive cash flows received by a trust or other entity.

ASC 326-20 defines purchased financial assets with credit deterioration as "*Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.*" ASC 326-20-30-15 also states that purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination should be accounted for in a manner consistent with originated financial assets.

Our Loans do not meet the definition of purchased financial assets with credit deterioration due to the following:

- The assignment of the Consumer Loan by the Dealer to us under our financing programs occurs a moment after the Consumer Loan is originated by the Dealer, so "a more-than-insignificant deterioration in credit quality since origination" has not occurred.
- Consumer Loans assigned under the Portfolio Program are considered to be advances under Dealer Loans originated by us rather than Consumer Loans purchased by us.

However, at the time of assignment, the cash flows we expect to collect are significantly lower than the contractual cash flows owed to us, due to credit quality. Our average expected collection rate at the time of assignment has ranged from 64% to 74% of contractual payments for the past ten years of Consumer Loan assignments. In addition, the advance paid under the Portfolio Program or the purchase price paid under the Purchase Program includes a significant discount due to credit quality. Our average advance rate under the Portfolio Program has ranged from 42% to 47% of contractual payments for the past ten years of Consumer Loan assignments. Our average purchase price under the Purchase Program has ranged from 45% to 51% of contractual payments for the past ten years of Consumer Loan assignments.

AGENDA REQUEST

While our Loans do not fall with the scope of the PCD Method under the guidance issued in ASU 2016-13, we believe that method provides far more relevant accounting:

- The advance amount paid under the Portfolio Program and the purchase price paid under the Purchase Program include significant discounts due to credit quality. The effective interest rate determined under the PCD Method is consistent with the economics of the loan as it reflects the yield used by us to determine the advance amount paid under the Portfolio Program or the purchase price paid under the Purchase Program. The effective interest rate determined under the Originated Method is inconsistent with the economics of the loan as it significantly inflates the yield for contractual amounts that were not expected to be collected at the time of assignment.
- Under the PCD Method, only changes in expected cash flow estimates after the time of assignment would be recognized as provision for credit losses expense or reversal of provision for credit losses expense. Under the Originated Method, all expected credit losses, including significant credit losses that were expected at both the time of origination and the time of assignment, would be recognized as provision for credit losses expense, despite the fact that the original estimate of credit losses does not in fact represent a loss to the Company.

BC85 of ASU 2016-13 states that the Board created a separate accounting method for purchased financial assets with credit deterioration because "*...recognizing interest revenue on the basis of contractual cash flows for all purchased assets could result in situations in which an entity accretes to an amount that it does not expect to collect, which would result in artificially inflated yields*" and "*...the discount embedded in the purchase price that is attributable to credit losses at the date of acquisition of a purchased financial asset with credit deterioration should not be recognized as interest income*". These statements are as true for our Loans as they are for those assets that were scoped into the PCD Method.

BC88 of ASU 2016-13 states that "*the Board decided not to extend the gross-up approach to all purchased assets because (a) the credit risk may be difficult to reliably isolate from other discounts reflected in the purchase price when it is insignificant, (b) the benefits would not justify the incremental costs associated with a requirement to separate the credit and noncredit discounts when the amounts are insignificant, and (c) the accretion of the discount into income due to credit would be insignificant*". In our business, the discount attributable to credit losses at the time of assignment is significant and not difficult to isolate. Indeed, estimating credit losses and calculating an appropriate discount based on those losses is inherent in our business model and our industry.

Although our Loans do not meet the definition of "purchased financial assets with credit deterioration", they have the characteristics that caused the Board to create the PCD Method, and do not have the characteristics that caused the Board to limit the scope of the PCD Method. We request that the Board amend the scope of the PCD Method so that it can be applied to all financial assets with a significant discount due to credit quality, even if that discount is not due to deterioration after origination.

The Board already has provided for the application of the PCD Method to certain financial assets that have not experienced credit deterioration. ASC 325-40-30-1A states that beneficial interests in securitized financial assets should be initially measured using the PCD Method when "*there is a significant difference between contractual cash flows and expected cash flows at the date of recognition*" and BC94 of ASU 2016-13 adds that these beneficial interests "*...should qualify for the gross-up approach, although there may not be deterioration since origination*". BC95 of ASU 2016-13 states that "*...purchased assets with credit deterioration and beneficial interests pose the same core issue, that is, whether it is inappropriate to recognize interest income on the basis of contractual cash flows if there is a significant difference between the contractual cash flows and what is expected at initial recognition of the asset. As a result, the Board decided that the model for purchased assets with credit deterioration should be applied to beneficial interests for which a significant difference exists between contractual and expected cash flows and the discount attributable to credit losses at the date of acquisition should not be accreted into interest income.*" While our financial assets are loans rather than beneficial interests in securitized financial assets, the same factors as those that caused the Board to reach its conclusions with respect to beneficial interests in securitized financial assets exist with our Loans. We request that the Board extend the scope of the PCD Method to cover subprime loans like ours for the same reasons that Board extended the scope to beneficial interests that have a significant discount due to credit quality at origination.

Thank you for your consideration of this matter. We would be happy to discuss this matter with you, as would our auditor and our financial reporting consultants. Contact information is provided below.

Sincerely,

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Credit Acceptance Corporation

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