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# A guide to accounting for investments, loans and other receivables

December 2023



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# 1. Overview

## 1.1 Overview

This guide addresses the accounting for certain investments in equity and debt securities, loans and other receivables after the adoption of ASU 2016-13, including subsequently issued ASUs that amended and clarified that new guidance and is organized as follows:

Chapter 1	Overview
Chapter 2	Accounting for equity securities (including certain options and forward contracts to purchase equity securities)
Chapter 3	Accounting for debt securities (including certain options and forward contracts to purchase debt securities)
Chapter 4	Recognition of credit losses on AFS debt securities
Chapter 5	Accounting for loans and other receivables
Chapter 6	Recognition and measurement of credit losses on financial assets measured at amortized cost and off-balance-sheet credit exposures
Chapter 7	Fair value option
Chapter 8	Presentation and disclosure considerations
Appendix A	Definitions, acronyms and literature references
Appendix B	SAB Topic 6.M, Financial Reporting Release No. 28
Appendix C	Summary of significant changes since last edition



## 1.2 Accounting Standards Updates

In 2016, the FASB issued ASU 2016-13 to address the measurement of credit losses.

The table that follows provides a high-level overview of ASU 2016-13, along with subsequently issued ASUs that amended or clarified its provisions. The table also summarizes the effective dates for both PBEs and other entities and the early adoption and transition provisions of those ASUs.

ASU 2016-13 (as amended by ASU 2018-19 and ASU 2019-10)		
<b>Overview</b>	Created new guidance for the measurement of credit losses on available-for-sale (AFS) debt securities (ASC 326-30) and financial assets that are measured at amortized cost (ASC 326-20). Most entities will be affected by this ASU, albeit to varying degrees. For lending institutions, this is arguably the most significant fundamental accounting change they have ever faced. However, the scope of this new guidance extends to assets that are routinely held by nonlending institutions, including trade accounts receivable, contract assets and debt securities. Substantially all assets within the scope of ASC 326-20 will have an allowance for credit losses. Refer to Chapters 4 and 6 for an in-depth analysis of the provisions of ASU 2016-13, including comparisons of its provisions to the guidance it replaced.	
	<b>PBEs</b>	<b>Other entities</b>
<b>Effective date</b>	<i>PBEs that are SEC filers, except for entities that are eligible to be smaller reporting companies (as defined by the SEC):<sup>1</sup></i> Fiscal years beginning after December 15, 2019, including interim periods within those years.	<i>All other entities:</i> Fiscal years beginning after December 15, 2022, including interim periods within those years.
<b>Early adoption provisions</b>	Permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.	
<b>Transition provisions</b>	Transition is through a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted, except for the following: <ul style="list-style-type: none"> <li>• Transition is prospective for debt securities for which an other-than-temporary impairment had been recognized before adoption. Amounts previously recognized in accumulated other comprehensive income as of the date of adoption that relate to significant improvements in cash flows should continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. Post-adoption recoveries of amounts previously written off should be recorded in income in the period received.</li> </ul>	

<sup>1</sup> An SEC filer's status as a smaller reporting company should be based on its most recent past smaller-reporting-company determination as of November 15, 2019 (which would be June 28, 2019 for an SEC filer with a calendar-year end [the last business day of its most recent second quarter]).

	<ul style="list-style-type: none"> <li>The provisions relevant to purchased financial assets with credit deterioration should be applied to assets that, prior to adoption, were accounted for under ASC 310-30. An entity should not reassess whether these financial assets meet the criteria of a purchased with credit deterioration (PCD) asset at the time of adoption. The allowance for expected credit losses at the date of adoption on these assets, as well as beneficial interests that have a significant difference between contractual and expected cash flows, should be recognized through an adjustment to the amortized cost basis of the assets rather than beginning retained earnings. An entity may elect to maintain pools of loans accounted for under ASC 310-30 at adoption of ASU 2016-13, without reassessing whether modifications to individual assets within those pools are TDRs. Lastly, the noncredit discount or premium is accreted to interest income using the interest method based on the effective interest rate determined after the adjustment for credit losses at the adoption date.</li> </ul> <p>As it relates to the disclosures of credit quality information by year of origination that is required for PBEs, smaller reporting companies that are not required to adopt until fiscal years beginning after December 15, 2022, are only required to show the most recent three years of origination information in the year of adoption, followed by four years of origination information in the year subsequent to adoption, and the full five years of origination information thereafter. Refer also to the discussions of ASU 2019-05 and ASU 2019-11 that follow for additional transition relief relevant to a fair value option election and TDRs.</p>
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**ASU 2019-04 (as it relates to modifications to ASU 2016-13)**

<b>Overview</b>	<p>Amends the guidance brought forth by ASU 2016-13 to:</p> <ul style="list-style-type: none"> <li>Allow various policy elections related to accrued interest, including a policy to not measure an allowance for credit losses for accrued interest if uncollectible accrued interest is written off in a timely manner.</li> <li>Address the accounting ramifications to the allowance for credit losses when transferring loans and securities between classifications (e.g., not held for sale and held for sale).</li> <li>Indicate that expected recoveries should be included in the allowance estimate, but should not exceed the aggregate of amounts previously written off and expected to be written off.</li> <li>Clarify the equity method losses allocation guidance to cross reference to ASC 326-20 and ASC 326-30 for the subsequent measurement of loans and debt securities.</li> <li>Clarify that all reinsurance recoverables within the scope of ASC 944 are within the scope of ASC 326-20.</li> <li>Permit projections of future interest rate environments when using a Discounted cash flows (DCF) method to measure expected credit losses on variable-rate financial assets, with the same assumptions used to determine a prepayment adjusted discount rate.</li> <li>Address the consideration that should be given to estimated costs to sell when foreclosure on a financial asset is probable.</li> </ul>
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	<ul style="list-style-type: none"> <li>• Address the presentation of line-of-credit arrangements that are converted to term loans in the vintage disclosures.</li> <li>• Clarify that when determining the contractual term of a financial asset, extension or renewal options that are not unconditionally cancellable by the creditor should be considered.</li> </ul>
<b>Effective date</b>	The effective date is the same as ASU 2016-13 for entities that have not yet adopted it. For entities that have adopted ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
<b>Early adoption provisions</b>	Permitted in any interim period after issuance of this ASU as long as the entity has adopted ASU 2016-13.
<b>Transition provisions</b>	The transition requirements are the same as ASU 2016-13 for entities that have not yet adopted it. For those that have adopted it, transition is a modified-retrospective basis by means of a cumulative-effect adjustment to the opening retained earnings balance as of the adoption date of ASU 2016-13.
<b>ASU 2019-05</b>	
<b>Overview</b>	Provides the ability to irrevocably elect the fair value option on an instrument-by-instrument basis upon the adoption of ASU 2016-13. Financial assets that are eligible for this fair value election are those that qualify under ASC 825-10 (refer to Chapter 7) and are within the scope of ASC 326-20 (refer to Chapter 6). However, the fair value option election does not apply to Held-to-maturity (HTM) securities.
<b>Effective date</b>	The effective date is the same as ASU 2016-13 for entities that have not yet adopted it. For those entities that have adopted ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
<b>Early adoption provisions</b>	Early adoption is permitted in any interim period after issuance as long as ASU 2016-13 is early adopted.
<b>Transition provisions</b>	Transition is on a modified-retrospective basis through a cumulative-effect adjustment to the opening balance of retained earnings as of the date of adoption of ASU 2016-13.
<b>ASU 2019-11</b>	
<b>Overview</b>	<p>Amends the guidance brought forth by ASU 2016-13 to, among other provisions:</p> <ul style="list-style-type: none"> <li>• Indicate that expected recoveries on PCD assets: (a) should be included in the allowance estimate, but should not exceed the aggregate of the amortized cost basis previously written off and expected to be written off by the entity, and (b) should not include any amounts that result in an acceleration of the noncredit discount when a method other than a DCF method is used to estimate expected credit losses.</li> <li>• Provide transition relief by permitting an accounting policy election to adjust the effective interest rate on existing TDRs using</li> </ul>

	<p>prepayment assumptions on the date of adoption, rather than the prepayment assumptions in effect immediately before the restructuring.</p> <ul style="list-style-type: none"> <li>Clarify that when applying the practical expedient for financial assets secured by collateral maintenance provisions to measure expected credit losses, the entity should assess whether it reasonably expects the borrower will be able to continually replenish the collateral securing the financial asset.</li> </ul> <p>ASU 2019-11 also amends ASC 320-10-50 to permit an entity to exclude accrued interest from the amortized cost basis disclosures of AFS and HTM debt securities (with disclosure of the total amount of excluded accrued interest) if the entity excludes accrued interest from the amortized cost basis, and for AFS debt securities, from the fair value, for the purposes of recognizing impairment.</p>	
<b>Effective date</b>	The effective date is the same as ASU 2016-13 for entities that have not yet adopted it. For those entities that have adopted ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.	
<b>Early adoption provisions</b>	Early adoption is permitted in any interim period after issuance as long as ASU 2016-13 is early adopted.	
<b>Transition provisions</b>	Transition is on a modified-retrospective basis through a cumulative-effect adjustment to the opening balance of retained earnings as of the date of adoption of ASU 2016-13.	
<b>ASU 2020-02 (as it relates to modifications to ASU 2016-13)</b>		
<b>Overview</b>	Among other provisions, the ASU amends ASC 326-20 to include the guidance in SAB Topic 6.M, <i>Financial Reporting Release No. 28 - Accounting for Loan Losses by Registrants Engaged in Lending Activities Subject to FASB ASC Topic 326</i> , in ASC 326-20-S99-1.	
	<b>PBEs</b>	<b>Other entities</b>
<b>Effective date</b>	The staff guidance is applicable upon a registrant's adoption of ASC 326. See ASC 326-10-65-1 to 65-3.	Not applicable.
<b>Early adoption provisions</b>	Same as those for ASU 2016-13 as amended by other ASUs.	Not applicable.
<b>Transition provisions</b>	Same as ASU 2016-13 as amended by other ASUs.	Not applicable.
<b>ASU 2020-03</b>		
<b>Overview</b>	Among other provisions, amends the following accounting guidance for financial instruments: <ul style="list-style-type: none"> <li>1. Clarifies that the disclosure requirements in ASC 320 apply to the disclosure requirements in ASC 942 for depository and lending institutions.</li> </ul>	

	2. Clarifies that the contractual term of a net investment in a lease determined in accordance with ASC 842 should be the contractual term used to measure expected credit losses under ASC 326.	
<b>Effective date</b>	The amendment related to issue 1 above is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.	
	<b>PBEs</b>	<b>Other entities</b>
	<p><i>PBEs that are SEC filers, except for entities that are eligible to be smaller reporting companies (as defined by the SEC):</i></p> <p>The amendment related to issue 2 above is effective for fiscal years beginning after December 15, 2019, including interim periods within those years.</p>	<p>Except for entities that have early adopted the guidance in ASU 2016-13, the amendment related to issue 2 above is effective for fiscal years beginning after December 15, 2022, including interim periods within those years.</p>
<b>Early adoption provisions</b>	The amendment related to issue 2 above may be early adopted provided the entity has adopted ASU 2016-13 (see ASC 326-10-65-4).	
<b>Transition provisions</b>	<p>For entities that have not yet adopted the guidance in ASU 2016-13, the effective dates and the transition requirements for the amendment related to issue 2 above are the same as the effective date and transition requirements in ASU 2016-13.</p> <p>Entities that have already adopted the guidance in ASU 2016-13 must record the effects of adopting the requirements related to issue 2 by means of a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in which ASU 2016-13 was first adopted.</p>	
<b>ASU 2022-02</b>		
<b>Overview</b>	<p>Among other provisions, the ASU:</p> <ol style="list-style-type: none"> <li>1. Eliminates the recognition and measurement guidance for TDR for creditors and requires specific disclosures when borrowers are experiencing financial difficulty during a loan modification.</li> <li>2. Updates vintage disclosures for PBEs, requiring current-period gross write-offs by year of origination for financing receivables and net investments in leases subject to ASC 326-20.</li> </ol>	
<b>Effective date</b>	For entities that have not yet adopted the guidance in ASU 2016-13, the effective date is the date ASU 2016-13 is adopted. For entities that have already adopted the guidance in ASU 2016-13, the effective date is for fiscal, and interim periods within those fiscal years, beginning after December 15, 2022.	

<b>Early adoption provisions</b>	Permitted for entities that have adopted ASU 2016-13. Entities may elect to early adopt the amendments related to issue 1 above separately from issue 2.
<b>Transition provisions</b>	<p>For issue 1 above, entities can adopt either:</p> <ul style="list-style-type: none"> <li>a. Prospectively, with application to loan modifications occurring after the date of adoption of ASU 2022-02; or</li> <li>b. On a modified retrospective basis through a cumulative-effect adjustment to the opening retained earnings balance as of the beginning of the fiscal year of adoption for any change in the allowance for credit losses that had been recorded for loans modified or reasonably expected to be modified in a TDR.</li> </ul> <p>For issue 2 above, all entities should apply the amendments on a prospective basis as of the beginning of the period of adoption.</p>

### 1.3 Important information about the scope of this guide

The guidance in the chapters that follow is based on the FASB ASC, as modified by the ASUs summarized in the preceding section. The following is the list of topics in the FASB ASC that were considered in the development of this guide, along with an indication of any portions or subtopics that were not considered.

ASC topics within the scope of this guide	Subtopics or portions excluded, if any
ASC 230 on the cash flow statement	All content other than ASC 230-10-45-7 to 45-21A
ASC 310 on receivables	ASC 310-10-S99-4, which provides SEC staff guidance on accounting for loan losses by registrants engaged in lending activities, but has not been updated for the issuance of ASU 2016-13
ASC 320 on investments in debt securities	ASC 320-10-S99, which provides SEC staff guidance on adjustments in assets and liabilities for holding gains and losses related to the implementation of ASC 320-10
ASC 321 on equity investments	None
ASC 325 on other investments	ASC 325-30 on investments in insurance contracts
ASC 326 on credit losses on financial instruments	None
ASC 815 on derivatives	All content other than the subsections entitled Certain Contracts on Debt and Equity Securities
ASC 825 on financial instruments	The general provisions of ASC 825-10 and ASC 825-20

In addition to the guidance in ASC 323, which was excluded from this guide in its entirety, the following incremental industry guidance relevant to the topics that are the focus of this guide was also excluded and should be considered when relevant:

ASC subtopics	Focus of guidance
ASC 905-310	Receivables for entities in the agricultural industry and for patrons of agricultural cooperatives
ASC 905-325	Other investments for entities in the agricultural industry, including an agricultural cooperative's investment in another cooperative
ASC 910-310	Presentation and disclosure issues relating to construction contract receivables
ASC 912-310	Recognition, presentation and disclosure of receivables resulting from federal government contacts
ASC 940-320	Clearance and settlement activities and accounting for proprietary transactions of brokers and dealers in securities
ASC 940-325	Financial-restructuring transactions by brokers and dealers in securities
ASC 942-310	Debt-equity swap programs, loans to financially troubled countries and customers' liabilities on acceptances
ASC 944-310	Accounting and financial reporting by insurance entities for receivables, including mortgage loans, reinsurance recoverables and the unearned premium revenue and receivables for financial guarantee insurance contracts
ASC 946-310	Investment company presentation and disclosure of receivables
ASC 946-320 and ASC 946-325	Investment company accounting for investments
ASC 954-310	Guidance on receivables for health care entities
ASC 954-325	Nonfinancial instrument investments of health care entities
ASC 958-310	Promises to give (i.e., contributions) receivable
ASC 958-320	Accounting and reporting for debt securities and disclosure requirements for most investments held by NFPs
ASC 958-321	Investments in equity securities held by NFPs
ASC 958-325	Other investments held by NFPs (e.g., investments in real estate, mortgage notes that are not debt securities)

ASC subtopics	Focus of guidance
Plan accounting guidance in ASC 960-310, ASC 962-310 and ASC 965-310	Plan receivables
Plan accounting guidance in ASC 960-325, ASC 962-325 and ASC 965-325	Investments and insurance contracts of plans
ASC 965-320	Debt and equity securities investments of health and welfare benefit plans
ASC 976-310	Receivables from retail land sales
ASC 978-310	Time-sharing receivables

#### 1.4 Ongoing standard setting

While this guide incorporates relevant ASUs issued through September 2023, the standard setting continues, and interpretations and application of the guidance are likely to continue to evolve. The [FASB website](#) is a useful resource to remain up to date on recent developments as it includes an overview of open projects (accessible through their [technical agenda](#) page), as well as information on [exposure documents](#) and [minutes from board meetings](#).

#### 1.5 Comparison of U.S. GAAP to IFRS

The accounting under U.S. GAAP for certain investments in equity and debt securities, loans and other receivables is not fully converged with IFRS. Some of the more notable differences relate to the following guidance in IFRS 9:

- An entity can elect to account for certain equity investments at fair value through OCI rather than account for them at fair value through net income.
- Classification of other financial assets is based on the contractual cash flow characteristics of the instrument and, in certain cases, the business model under which the assets are managed. Depending on the facts and circumstances, the accounting outcome could be fair value through net income, fair value through OCI or amortized cost for both loans and debt securities.
- The impairment provisions generally require lifetime expected credit loss recognition only for those instruments within the scope of IFRS 9 for which there have been significant increases in credit risk since initial recognition, and 12-month expected credit loss recognition for other instruments.
- Financial assets are not subject to derivative bifurcation requirements.
- The fair value option is more restrictive than U.S. GAAP.



The following chart provides a high-level comparison of U.S. GAAP prior and subsequent to the adoption of the ASUs summarized in this chapter and IFRS 9.

Financial instruments	U.S. GAAP	IFRS 9
Equity securities with readily determinable fair values (excluding those accounted for under the equity method)	Accounted for at fair value through net income.	Accounted for at fair value through net income, unless election is made to account for securities not held for trading at fair value through OCI.
Equity securities that do not have readily determinable fair values (excluding those accounted for under the equity method)	Accounted for at fair value through net income, except for those securities that qualify for the measurement alternative, which if elected are originally accounted for at cost and adjusted to fair value through net income when there are observable price changes in orderly transactions or indicators of impairment.	Accounted for at fair value through net income, unless election is made to account for securities not held for trading at fair value through OCI.
Equity investments that give the investor the ability to exercise significant influence	Accounted for under the equity method as described in ASC 323, which is beyond the scope of this guide.	Accounted for under the equity method as described in IAS 28.
Debt security	<p>Classified as trading, AFS or HTM and accounted for at:</p> <ul style="list-style-type: none"> <li>Fair value through net income (if trading)</li> <li>Fair value through OCI (if AFS)</li> <li>Amortized cost (if HTM)</li> </ul> <p>Expected credit losses on AFS debt securities are recognized through an allowance (limited to the amount by which the amortized cost of an individual security exceeds its fair value) that will be reversed as cash flow expectations improve. Full impairment on AFS debt securities is recognized in earnings if the entity intends to sell the security or would more likely than not be required to sell the security before recovery.</p> <p>Expected credit losses on HTM debt securities are recognized through an</p>	<p>Accounted for at either amortized cost, fair value through OCI or fair value through net income, depending on the business model for managing the assets and the contractual cash flow characteristics of the instrument.</p> <p>Impairment is recognized under the IASB impairment provisions summarized earlier.</p>

Financial instruments	U.S. GAAP	IFRS 9
	allowance regardless of whether fair value is below amortized cost.	
Loans and other receivables	<p>Accounted for at either amortized cost or, if held for sale, the lower of cost or fair value.</p> <p>Credit losses that are expected to occur over the life of an asset carried at amortized cost are recognized through an allowance.</p>	<p>Accounted for at either amortized cost, fair value through OCI or fair value through net income, depending on the business model for managing the assets and the contractual cash flow characteristics of the instrument.</p> <p>Impairment is recognized under the IASB impairment provisions summarized earlier.</p>
Fair value option	Can elect for recognized financial assets, other than those explicitly excluded in ASC 825-10.	Can elect for financial assets if doing so eliminates or significantly reduces an accounting mismatch.

## 2. Accounting for equity securities (including certain options and forward contracts to purchase equity securities)

### 2.1 Applicability of this guidance

This chapter primarily summarizes the guidance in ASC 321 and, unless otherwise noted, is applicable to all entities except those in industries that account for substantially all investments at fair value through earnings or the change in net assets, such as broker-dealers, investment companies, health and welfare plans and postretirement plans.

Equity securities are defined in ASC 321-10-20 to include preferred, common and other ownership interests in entities, including partnerships, joint ventures and limited liability companies. Investments in mutual funds or ownership interests in companies or partnerships are considered to be equity securities even if the assets of the investee consist solely of debt securities given that, as indicated in ASC 321-10-55-6, it is not appropriate to look through the form of the investment.

The ASC 321 definition of equity securities also includes rights to acquire or dispose of ownership interests in entities at fixed or determinable prices (e.g., warrants, forward contracts, call and put options), if those rights are not derivatives subject to ASC 815. Furthermore, ASC 815-10-25-18 requires forward contracts and purchased options on equity securities within the scope of the *Certain Contracts on Debt and Equity Securities* subsections of ASC 815-10 to be recognized in a manner consistent with ASC 321. As noted in ASC 815-10-15-141, forward contracts and purchased options within the scope of these subsections are those that possess all of the following characteristics:

- Are not required to be accounted for as a derivative (refer to Section 2.1.1 for additional guidance)
- Require physical settlement by delivery of equity securities within the scope of ASC 321
- If a purchased option, the option does not have intrinsic value at the time the option is acquired

When determining if equity securities to be delivered upon settlement of a contract are within the scope of ASC 321, consideration should not be given to whether individually or with existing investments, the underlying securities would be accounted for under the equity method in ASC 323 or the fair value option in ASC 825.

The definition of equity securities excludes written equity options (because they represent obligations of the writer, not investments), cash-settled options and options on equity-based indexes (because they do not represent ownership interests in an entity), as well as convertible debt and preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the investor's option. Additionally, the following equity securities are excluded from the scope of ASC 321-10:

- Derivative instruments subject to ASC 815 (refer to Section 2.1.1 for additional guidance)
- Investments accounted for under the equity method of accounting in ASC 323
- Investments in consolidated subsidiaries
- Broker-dealer ownership interests in exchanges as described in ASC 940-340
- Investments in Federal Home Loan Bank and Federal Reserve Bank stock that are accounted for in accordance with ASC 942-325-35<sup>2</sup>

### 2.1.1 Consideration of derivative instruments, including hybrid instruments

Freestanding instruments such as forward contracts and options to buy or sell shares or other equity instruments may by definition be a derivative and require derivative accounting (measured at fair value, with changes in fair value recognized through earnings) under ASC 815 unless the contract or option qualifies for a derivative scope exception. The definition of a derivative is provided in ASC 815-10-15-83. While ASC 815 is beyond the scope of this guide, generally when determining if contracts to buy or sell equity interests meet the definition of a derivative, it often comes down to whether net settlement exists. Common ways in which net settlement may exist include a contractual provision for the contract to be settled net in cash or net in shares (e.g., cashless exercise) or through the underlying securities being actively traded such that they can be readily converted to cash. The derivative scope exceptions are summarized in ASC 815-10-15-13. The regular-way security trades scope exception that is discussed beginning in ASC 815-10-15-15 is an example of a scope exception that may apply to a contract to buy or sell shares if all requirements are met.

It is not uncommon for equity investments that are not themselves derivatives to contain potential embedded derivatives such as an option for the holder to convert its preferred shares into common shares, or a call option that gives the issuer the ability to buy back preferred shares. A contract that embodies both an embedded derivative and a host contract (i.e., an equity or debt instrument) is referred to as a hybrid instrument. Entities are required to analyze hybrid instruments to determine whether any embedded features should be separately recognized as a derivative under ASC 815-15-25-1. This analysis involves determining the nature of the host contract and evaluating whether the economic characteristics and risks of the potential embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If not, the embedded feature would require separate recognition as a derivative if it meets the definition of a derivative on a freestanding basis and is within the scope of ASC 815-10-15. However, in accordance with ASC 815-15-25-1(b), this analysis is not required for hybrid instruments that are measured at fair value with changes in fair value reported in earnings as they occur. Accordingly, when the hybrid instrument is an equity security within the scope of

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<sup>2</sup> Financial institutions commonly buy stock in the Federal Home Loan Bank and Federal Reserve Bank as a prerequisite to being a member of these entities and take advantage of the benefits that membership entails. The stock of these entities does not have a readily determinable fair value given that membership is restricted, and there is no market for the stock. It can only be sold back or transferred to another member at par. As such, ASC 942-325 requires that it be classified as a restricted investment security at cost and evaluated for impairment to determine if the par value is recoverable. Suggested criteria in determining if a decline in value affects the recoverability are outlined in ASC 942-325-35-3.

ASC 321, this analysis is only performed if the equity security is measured using the measurement alternative.

Derivative instruments that are subject to the requirements of ASC 815, including any embedded derivative that is bifurcated from a hybrid instrument, are outside the scope of ASC 321. However, when a hybrid instrument would otherwise be in the scope of ASC 321, the equity host contract that remains after an embedded derivative is bifurcated is subject to ASC 321 pursuant to ASC 321-10-15-5. Additionally, as noted in ASC 815-15-25-54, the host contract that remains after separating an embedded derivative is accounted for under the guidance that is applicable to instruments of the same type that do not contain embedded derivatives.

Refer to RSM's [A Guide to Accounting for Derivatives](#) for further guidance on accounting for derivatives, including embedded derivatives.

## 2.1.2 Questions regarding the applicability of ASC 321

### 2Q.1.2.1: *Do the accounting and disclosure requirements in ASC 321 apply to investments in money market funds classified as cash equivalents?*

Yes. Even if classified as a cash equivalent on the balance sheet, investments in money market funds are subject to all of the accounting and disclosure requirements in ASC 321-10. The carrying value of investments in money market funds that are eligible to be classified as cash equivalents are expected to approximate their fair value.



#### **Spotlight: SEC amends certain rules governing money market funds**

On July 12, 2023, the SEC adopted amendments to certain rules governing money market funds in order to improve funds' resilience and transparency, given certain funds' vulnerability to runs in times of stress. The [amendments](#), as summarized by the SEC, effectively:

- Increase minimum liquidity requirements to provide a more substantial buffer in the event of rapid redemptions
- Remove provisions from the current rule that permit a money market fund to temporarily suspend redemptions and remove the regulatory tie between the imposition of liquidity fees and a fund's liquidity level
- Require certain money market funds to implement a liquidity fee framework that will better allocate the costs of providing liquidity to redeeming investors
- Enhance certain reporting requirements to improve the SEC's ability to monitor and assess money market fund data

The SEC amended a liquidity fee framework to protect remaining shareholders from dilution when certain money market funds experience daily net redemptions that exceed 5% of net assets. The framework, which was amended in lieu of adopting a proposed swing pricing requirement, is also designed to allocate costs so that redeeming shareholders bear the costs of redeeming from the fund when liquidity in underlying short-term funding markets is costly.

The rule amendments, including changes to forms N-1A and N-CSR are effective October 2, 2023. The amendments to forms N-CR, N-MFP and PF are effective June 11, 2024.

#### *Financial reporting considerations for investors*

Cash equivalents are defined in the ASC Master Glossary as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so close to maturity that they present insignificant risk of changes in value because of changes in interest

rates. Despite representing an ownership interest in an investment company, certain investments in money market funds (e.g., money market funds regulated pursuant to Rule 2a-7 under the Investment Company Act of 1940) are eligible to be classified as cash equivalents because they maintain stable per-share net asset value (usually set at \$1 per share) and they allow investors to make withdrawals from the fund on short notice and without penalties.

The SEC's final rule addressed GAAP considerations in the context of commenters' discussion about the potential accounting implications of swing pricing, noting that under normal market conditions they generally would not expect the amount of a liquidity fee a fund charges to prevent a shareholder from continuing to classify the fund's shares as cash equivalent under GAAP. However, if events that give rise to credit or liquidity issues for funds occur, shareholders would need to reassess if their investments in that money market fund would continue to meet the definition of a cash equivalent. If events occur that cause shareholders that are corporate entities to determine that their money market fund shares are not cash equivalents, the shares would need to be classified as investments, and shareholders would have to account for them accordingly.

*2Q.1.2.2: Should an entity look through the form of its equity interest to the nature of the investments held by the investee to determine whether its equity interest is in the scope of ASC 321?*

No. Looking through the form of the equity interest held is not appropriate even if substantially all of the investee's assets represent debt securities. For example, assume a reporting entity holds an equity interest in an unconsolidated investment partnership that invests only in debt securities and that the equity interest in the investment partnership is not accounted for under the equity method. Assume further that the reporting entity is not in a specialized industry that is excluded from the scope of ASC 321 pursuant to ASC 321-10-15-3. It would not be appropriate for the reporting entity to look through the form of its equity interest to the nature of the securities held by the investee investment partnership to determine the applicable classification and measurement guidance for its equity interest. In this example, the reporting entity's interest represents an equity security subject to the guidance in ASC 321.

*2Q.1.2.3: Do short sales of securities (i.e., sales of borrowed securities) represent investments subject to the accounting and disclosure requirements in ASC 321?*

No. Short sales of securities represent obligations to deliver securities and are not investments. Such transactions are generally recorded at fair value, with changes in fair value recorded in earnings as they occur, under either industry-specific guidance (e.g., ASC 940-320) or ASC 815-10-55-57, if they meet the definition of a derivative.

*2Q.1.2.4: Does ASU 2016-01 affect the SEC staff guidance on the application of the equity method to investments in limited partnerships?*

No. The SEC staff guidance that is included in ASC 323-30-S99, which requires entities to account for investments of greater than 3% to 5% in limited partnerships under the equity method, is unaffected by the amendments in ASU 2016-01. However, investments in limited partnerships and similar entities that are not accounted for under the equity method are subject to the guidance in ASC 321.

*2Q.1.2.5: Should an investment in a corporate subsidiary that is a real estate venture be accounted for by the investor-parent using the principles applicable to investments in subsidiaries or those applicable to investments in corporate joint ventures?*

ASC 323 provides the standards for use of the equity method for corporate joint ventures and includes guidance for applying that method in the financial statements of the investor. Pursuant to ASC 970-323-25-10, ASC 323 applies to corporate joint ventures created to own or operate real estate projects. Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those

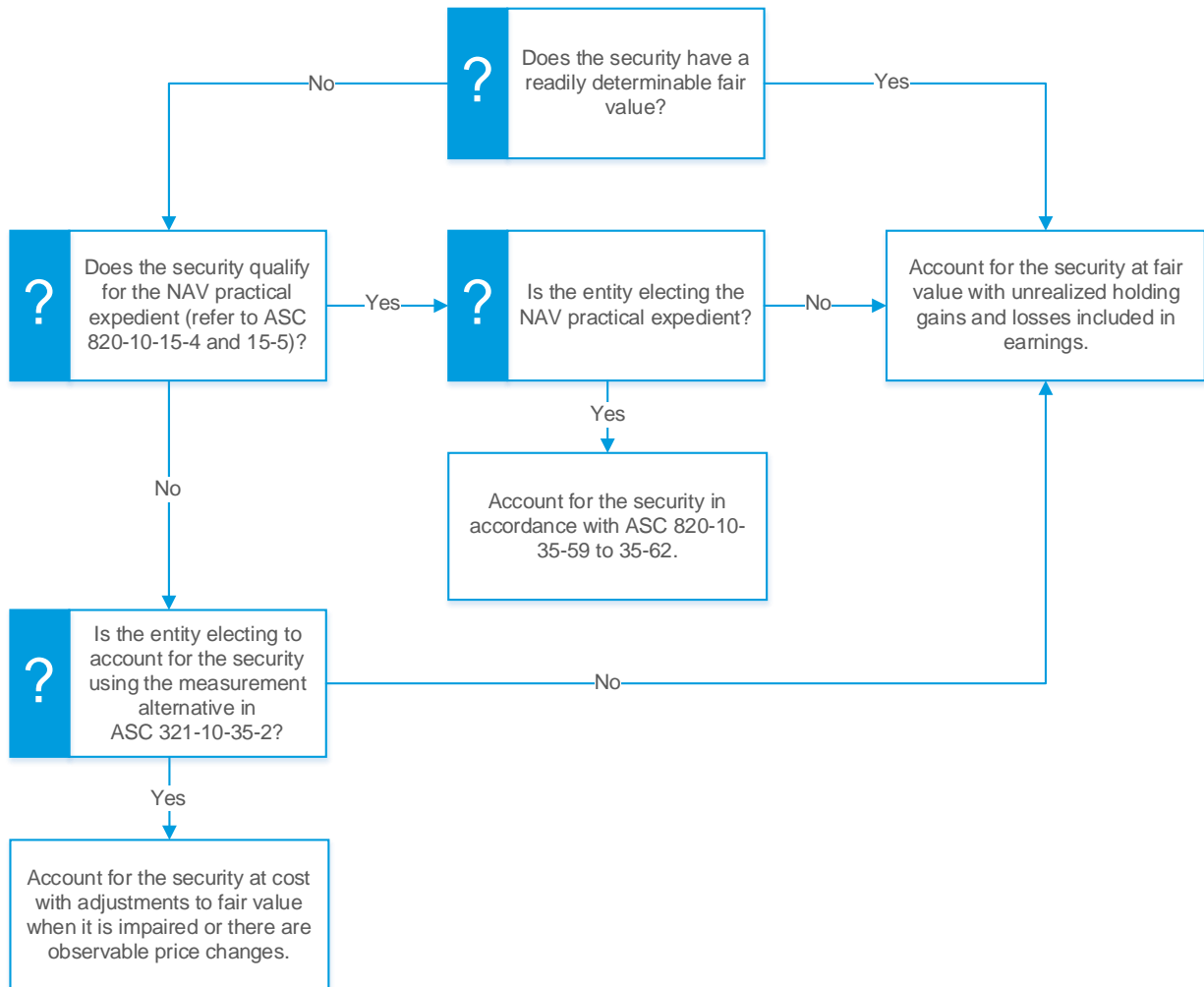
applicable to investments in corporate joint ventures. Noncontrolling shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in ASC 321 or ASC 323.

## **2.2 Initial recognition and subsequent measurement**

ASC 321 does not address when an entity should recognize the acquisition of an equity security. However, trade date accounting is required for brokers and dealers, investment companies and depository and lending institutions, as well as benefit plans. Entities not governed by industry guidance can make an accounting policy election to account for purchases and sales of securities on either the trade date or settlement date. Agreements to purchase or sell securities that are not accounted for on the trade date should be evaluated to determine whether they are derivatives under ASC 815, and if so whether the scope exception for regular-way security trades that is discussed beginning in ASC 815-10-15-15 is met. Agreements that require recognition as a derivative are recorded at fair value upon execution of the agreement. Refer to Section 2.1.1 for additional discussion of derivative considerations.

Generally, equity securities within the scope of ASC 321 are required to be accounted for initially and subsequently at fair value, with all unrealized holding gains and losses included in earnings. Dividend income from investments in equity securities are also included earnings.

It is important to note that two elections are available for certain securities that do not have readily determinable fair values that are illustrated and discussed in the flowchart and narrative that follow. These elections can be made on a security-by-security basis and once elected, should be consistently applied.



### 2.2.1 Readily determinable fair value

Based on the related definition in ASC 321-10-20, an equity security is considered to have a readily determinable fair value if any one of the following three conditions is met:

- Sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market (if publicly reported by the NASDAQ systems or by OTC Markets Group Inc.). Restricted stock meets this definition if the restriction terminates within one year.
- The security is traded in a foreign market of a breadth and scope comparable to one of the U.S. markets referred to in the previous bullet point.
- The security is an investment in a mutual fund or similar structure, and the fair value per share is determined and published and is the basis for current transactions.

### 2.2.2 NAV practical expedient

ASC 820-10-35-59 provides a practical expedient whereby an election can be made, on a security-by-security basis, to measure the fair value of certain investments (e.g., member units, an ownership interest



in partners' capital to which a proportionate share of net assets is attributed) using the NAV per share or its equivalent, if the NAV per share or equivalent is calculated in a manner consistent with ASC 946 as of the reporting entity's measurement date.

As discussed in ASC 820-10-15, this election can be made only for investments that do not have readily determinable fair values as of the measurement date and are either an investment in an investment company within the scope of ASC 946 or certain investments in real estate funds. As noted in ASC 820-10-15-5, this practical expedient cannot be elected for investments that would have a readily determinable fair value (as defined in the preceding section) were it not for a restriction expiring in more than one year.

For those investments that the election is made, if the NAV per share or equivalent is not as of the reporting entity's measurement date or is not calculated in a manner consistent with ASC 946, it may be necessary to adjust the most recent NAV per share so that it is reflective of an estimate that is calculated in a manner consistent with ASC 946 as of the reporting entity's measurement date.

Once made, assuming the fair value does not become readily determinable, the election must be consistently applied to the entire position in a particular investment, unless it is probable at the measurement date that a portion of an investment will be sold at an amount different from the NAV per share. In other words, the fair value of any portion that is probable of being sold at an amount different from the NAV per share should be determined in accordance with the general provisions of ASC 820. ASC 820-10-35-62 outlines the following criteria that all need to be met as of the reporting entity's measurement date for a sale to be considered probable:

- a. Management, having the authority to approve the action, commits to a plan to sell the investment.
- b. An active program to locate a buyer and other actions required to complete the plan to sell the investment have been initiated.
- c. The investment is available for immediate sale subject only to terms that are usual and customary for sales of such investments (for example, a requirement to obtain approval of the sale from the investee or a buyer's due diligence procedures).
- d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

### **2.2.3 Election to account for the security using the measurement alternative**

ASC 321-10-35-2 permits reporting entities to make an election on a security-by-security basis to account for equity securities that do not have readily determinable fair values at cost, with adjustments for impairment and certain observable price changes reflected in earnings (commonly referred to as the measurement alternative). In other words, such securities are adjusted to fair value when an observable price change occurs or impairment is identified. This election is not available for securities that qualify for the NAV practical expedient, nor can it be elected by entities that are excluded from the scope of ASC 321-10. Any security for which the election is made is required to be accounted for in this manner unless: (a) it no longer qualifies, which could be the case, for example, if its fair value becomes readily determinable, or if the security becomes eligible for the aforementioned NAV practical expedient, or (b) an irrevocable election is made to measure the security at its fair value on an ongoing basis. If made, the irrevocable election would apply not only to the security for which it is made, but also identical or similar investments of the same issuer, including future purchases.

#### **2.2.3.1 Impairment considerations**

Any security for which the election is made to determine its carrying amount using the measurement alternative in ASC 321-10-35-2 is required to be evaluated for impairment under a one-step impairment model. (Impairment considerations are not relevant to those securities that are subsequently measured at

fair value, including through the NAV practical expedient given that unrealized holding gains and losses are included in earnings.) Under the one-step impairment model outlined in ASC 321-10-35-3, if a qualitative analysis indicates impairment exists, the fair value of the security will need to be estimated, and any excess of its carrying value over its fair value is recognized in net income. No consideration is given to whether the impairment is permanent or temporary.

Impairment indicators in ASC 321-10-35-3 to consider include, but are not limited to, the following:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

As noted in ASC 815-10-35-6, the carrying amount of forward contracts and purchased options on equity securities without readily determinable fair values that are measured in accordance with the measurement alternative in ASC 321-10-35-2 are required to be remeasured in their entirety at fair value when there is a change in observable price or impairment of the underlying securities.

### 2.2.3.2 Adjusting the carrying amount for observable price changes

ASC 321-10-55-8 to 55-9 elaborate on the requirement to adjust the carrying amount of securities measured using the measurement alternative for observable price changes. This necessitates identifying orderly transactions for the identical or a similar investment of the same issuer that occurred on or before the balance-sheet date that are known or can reasonably be known. An entity is not expected to conduct an exhaustive search, but rather make a reasonable effort to identify observable transactions.



#### **RSM COMMENTARY: Ramifications of overlooking an observable price change**

The guidance does not elaborate on what may constitute a reasonable effort, and questions have been raised regarding whether it is an error if subsequent to the issuance of the financial statements, the entity becomes newly aware of an observable price change that occurred and was not considered in the prior-period financial statements. During the FASB meeting on September 5, 2018, the FASB staff expressed the view that if the entity put forth a reasonable effort in the prior period, this would generally not be viewed as an error. The observable price change (along with any subsequent observable price changes and indications of impairment) would be considered in the period it is discovered rather than restating the carrying amount of the security in the prior period.

The following are examples of what we believe may constitute an observable price change in an orderly transaction and warrant an adjustment to the carrying amount, if: (a) the transaction related to the identical security or a similar security of the same issuer, (b) the consideration was cash or other assets that have an observable value and (c) there is nothing to indicate that the transaction was not orderly:

- New issuances or sales
- Negotiated buybacks by the issuer

- Sales from one investor to another

Conversely, we believe the following are examples that would generally not constitute an observable price change in an orderly transaction:<sup>3</sup>

- Stock issued to employees or consultants for services
- Transactions for noncash consideration (e.g., debt) that does not have an observable value
- Transactions that involve multiple elements, unless the values of the other elements are observable (e.g., if the same or similar investment is sold in a transaction that includes other securities that do not have a readily determinable fair value, the transaction price would not constitute an observable price for an individual security)
- Offers to buy or sell the identical or similar security unless or until an actual transaction occurs

As indicated in ASC 815-10-35-6, when the measurement alternative is elected for a forward contract or purchased option, consideration should be given to the occurrence of observable price changes in either the forward contract or option itself or in its underlying securities.

When an adjustment to the carrying amount of a security accounted for under the measurement alternative is necessary due to observable price changes in orderly transactions, the carrying amount of the security should be adjusted to its fair value determined in accordance with ASC 820 as of the date of the observable transaction. In paragraph BC112 of ASU 2019-04, the belief is expressed that in most cases, the observable price change in an orderly transaction of the identical or similar investment of the same issuer would generally represent the fair value change in that investment. In circumstances whereby the instrument that is accounted for under the measurement alternative is a forward contract or purchased option and the observable price change is on the underlying securities, the entire fair value of the forward contract or option would need to be remeasured as indicated in ASC 815-10-35-6.

If the orderly transaction is associated with a similar security of the same issuer (rather than the identical security), ASC 321-10-55-9 requires giving consideration to whether the observable price needs to be adjusted for any differences between the similar and actual security in arriving at the adjustment to the carrying amount of the actual security. Upon remeasurement, a security would also be subject to the nonrecurring fair value disclosure requirements of ASC 820.

#### *2.2.3.2.1 Determining whether securities issued by the same issuer are similar*

In evaluating if a security issued by the same issuer is similar to an equity security held by the reporting entity, ASC 321 provides guidance that is limited to indicating that consideration should be given to the different rights and obligations of the securities, such as rights related to voting, distributions, liquidation preferences and conversion. In practice, we have observed that the following additional factors are commonly considered when evaluating whether securities are similar:

- The significance of the impact any differences in rights and obligations would have on the fair values of the securities, and
- The difficulty that would be encountered to derive the fair value of the security the reporting entity holds from an observable price associated with the potentially similar security. For example, adjustments to an observable price for differences in rights and obligations may require the use of

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<sup>3</sup> While not considered an observable price change in an orderly transaction, certain of these events may provide an indication that the security is impaired and should be evaluated consistent with the discussion in the preceding section.

significant unobservable inputs and complex valuation models to estimate the fair value of the security that the reporting entity holds.

Other factors may be considered in the analysis, and individual factors may not be determinative. For example, the adjustment to the observable price for an identified difference between securities may be significant, but if the adjustment is simple to calculate, this may indicate the securities are similar. Likewise, the adjustment to the observable price for the differences between the rights and obligations of the securities may require significant use of unobservable inputs, but if the adjustment would have an insignificant effect on the fair value of the security held, this may also indicate that the securities are similar.

As shown above, the determination of whether two securities are similar is highly judgmental and can be operationally challenging. Consequently, entities should establish a reasonable framework with key considerations for determining whether a security for which the measurement alternative is elected is similar to another security issued by the same issuer, and the framework should be consistently applied.



#### **RSM COMMENTARY: Indicator of impairment**

An observable price for a security of the same issuer that an entity concludes is not a similar security could be an indicator of impairment that requires a fair value measurement pursuant to ASC 321-10-35-3 if the observable price is below the carrying value of the security that is held by the reporting entity. Refer to Section 2.2.3.1 for additional information on impairment considerations.

### **2.2.3.3 Deciding whether to elect to account for the security using the measurement alternative**

Careful consideration should be given to the advantages and disadvantages of this election given the ramifications noted in Section 2.2.3 if the election is revoked.

One significant advantage is that, if elected, it will generally be unnecessary to estimate a fair value for the security unless impairment is identified. Another potential advantage is the possibility for this election to result in less earnings volatility as all changes in fair value are recognized in earnings if not elected for a particular security, while only impairment and observable price changes are recognized in earnings if elected.

Disadvantages include the fact that if impairment is recognized, it cannot be reversed unless an observable price change supports an upward adjustment to the carrying amount. Additionally, there are notable ongoing efforts necessary to apply the election. Consider, for example, the need to put in place processes to: (a) reassess individual securities to determine if they continue to qualify for the election, (b) put forth reasonable effort to identify observable price changes for the security or similar securities of the issuer (which entails an analysis to determine if other securities with observable transactions are similar, and if so, how the observable price should be adjusted for differences between the securities), (c) determine if the transactions resulting in observable prices were orderly and (d) assess the security for impairment and, if impaired, estimate the fair value.

## **2.2.4 Measurement considerations when there is a change in level of ownership or degree of influence in an investee**

### **2.2.4.1 Initial measurement considerations when an investment no longer qualifies for the equity method of accounting**

When an investment no longer qualifies for the equity method (e.g., due to a decrease in the level of ownership in an investee) and is then determined to be in the scope of ASC 321, the investment's initial ASC 321 basis should be the previous carrying amount of the investment immediately before it ceased to qualify to be accounted for under the equity method. ASC 323-10-35-36 makes it clear that previously

accrued equity method earnings or losses that relate to the investment retained by the investor should remain as a part of the initial ASC 321 basis of the investment (i.e., the carrying amount of the investment should not be adjusted retroactively).

Upon discontinuance of the equity method, an entity is required to remeasure its retained investment at fair value in accordance with ASC 321-10-35-1 or the measurement alternative in ASC 321-10-35-2, as applicable. Pursuant to ASC 321-10-30-1, an entity that applies the measurement alternative should consider all observable price changes in orderly transactions for the identical security (that no longer qualifies for the equity method) or a similar investment of the same issuer, including those transactions that require it to apply or discontinue the equity method. If a transaction occurs that results in discontinuing the equity method, the entity will need to determine whether the transaction is orderly and represents an observable price change as discussed in the preceding sentence such that the entity must remeasure the retained investment at fair value in accordance with ASC 820. Under the circumstances described above, this amendment aligns the initial accounting for investments measured under the measurement alternative with that for equity securities with readily determinable fair values, which are remeasured at fair value immediately before applying and upon discontinuing the equity method.

#### **2.2.4.2 Subsequent measurement considerations when an investment accounted for in accordance with ASC 321 becomes subject to the equity method of accounting**

An investment that is accounted for under ASC 321 may subsequently become subject to the equity method due to an increase in the level of ownership (e.g., through acquisition of additional voting stock by the investor). In accordance with ASC 323-10-35-33, on the date the investment becomes subject to the equity method of accounting, the investor is required to add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting. Importantly, the current basis of the investor's previously held interest in the investee must be remeasured in accordance with ASC 321-10-35-1 or the measurement alternative in ASC 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying ASC 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying ASC 323, the entity must remeasure its previously held interest at fair value immediately before applying ASC 323.

#### **2.2.5 Accounting considerations for foreign-currency-denominated equity securities**

Equity securities that are denominated in a currency other than the entity's functional currency and that are subsequently measured at fair value are required to be remeasured using current foreign-currency exchange rates as of the measurement date. The entire fair value change, including the amount attributable to changes in foreign currency exchange rates, is recognized in earnings.

For purposes of complying with the guidance in ASC 830-10-45-18, foreign-currency-denominated equity securities that are measured using the measurement alternative under ASC 321-10-35-2 are considered nonmonetary assets that are required to be remeasured using their historical exchange rates on the later of the date the investment was acquired or the most recent date on which its carrying value was adjusted to fair value, if applicable. For an equity security that is measured using the measurement alternative, a carrying value adjustment to current fair value is required either as a result of (1) an observable price in an orderly transaction for the same or similar security of the same issuer or (2) impairment. Therefore, if a foreign-currency-denominated equity security that is measured using the measurement alternative is subsequently adjusted to reflect its then-current fair value, the exchange rate on the date of that adjustment must be used, and the entire change in the carrying amount is recognized in earnings.

## 2.2.6 Accounting for short sales of equity securities

A short sale is the sale of a stock the seller does not own. It is generally a transaction in which an investor sells borrowed securities in anticipation of a price decline; the seller is then required to return an equal number of shares at some point in the future. In a “naked” short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard settlement period.

Short sale transactions are generally recorded at fair value, with changes in fair value recorded in earnings as they occur, under either industry-specific guidance (e.g., ASC 940-320) or, if they meet the definition of a derivative, under ASC 815-10-55-57.

## 2.2.7 Accounting for simple agreement for future equity (SAFE) investments

A simple agreement for future equity (SAFE) investment is a contract that allows an investor to receive shares of an entity in the future, generally contingent upon certain triggering events. These events may include equity financing rounds, a change of control (e.g., acquisition) or an initial public offering. A SAFE is typically not structured as an actual share of stock or a debt investment. Instead, it is a contractual agreement that lacks the features of typical equity instruments, such as dividends and voting rights, and the features of typical debt instruments, such as an interest rate and stated maturity.

To determine the accounting for an investment in a SAFE contract, the investor would first need to consider whether the SAFE in its entirety meets the definition of a derivative in ASC 815-10-15-83. If it does meet that definition, it would be accounted for at fair value, with changes in fair value reported in earnings pursuant to ASC 815. If the SAFE in its entirety does not meet the definition of a derivative, it generally would be considered a hybrid financial instrument. In that case, the investor may elect to measure the SAFE at fair value pursuant to the fair value option under ASC 825. If the investor does not elect to do so, it would be required to analyze the hybrid instrument to determine whether any embedded features should be separately recognized as a derivative under ASC 815-15-25-1. This analysis involves determining the nature of the host contract and evaluating whether the economic characteristics and risks of the potential embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If not, the embedded feature would require separate recognition as a derivative if it meets the definition of a derivative on a freestanding basis and is within the scope of ASC 815-10-15.

If the SAFE is not considered a derivative in its entirety, does not include an embedded derivative, and the fair value option is not elected, its classification and measurement depends on whether it qualifies as a debt security under ASC 320, an equity security under ASC 321 or a loan under ASC 310. If the SAFE is considered to be a hybrid instrument, the host contract would be accounted for as a debt investment or an equity investment as the case may be, and the embedded derivative would be accounted for at fair value with changes in fair value reported in earnings pursuant to ASC 815.

Refer to RSM's [A Guide to Accounting for Derivatives](#) for additional guidance on determining what constitutes a derivative, including embedded derivatives.

### 3. Accounting for debt securities (including certain options and forward contracts to purchase debt securities)

#### Summary of key changes

- With the issuance of ASU 2016-13, the impairment guidance formerly contained in ASC 320-10-35 was eliminated and ASC 326 was created.
  - Portions of ASC 320-10-35 pertaining to debt securities were carried over with modification to newly created ASC 326-30, which applies to AFS debt securities (see Chapter 4).
  - ASC 326-20 was created to address the recognition of credit losses on financial assets carried at amortized cost, including HTM securities (see Chapter 6).
- Refer to Chapter 1 for effective date and transition considerations.

#### 3.1 Applicability of this guidance

This chapter summarizes the guidance in ASC 320-10 and applies to all debt securities except those held by entities with specialized accounting practices that account for substantially all debt securities at fair value, with changes in fair value recognized in earnings or in the change in net assets. For example, this guidance does not apply to brokers and dealers, investment companies, health and welfare plans and post retirement plans that account for debt securities at fair value through earnings or change in net assets. NFP entities are also excluded from the scope of ASC 320-10 given that ASC 958-320 contains the relevant guidance for NFPs to follow.

This chapter also summarizes the guidance relevant to forward contracts and purchased options on debt securities that are within the scope of the *Certain Contracts on Debt and Equity Securities* subsection of ASC 815. As noted in ASC 815-10-15-141, forward contracts and purchased options within the scope of this guidance are those that possess all of the following characteristics:

- Are not required to be accounted for as a derivative,
- Require physical settlement by delivery of debt securities within the scope of ASC 320, and,
- If a purchased option, the option does not have intrinsic value at the time the option is acquired.

##### 3.1.1 Consideration of derivative instruments, including hybrid instruments

Freestanding instruments such as forward contracts and options to buy or sell debt securities may by definition be a derivative and require derivative accounting (measured at fair value, with changes in fair value recognized through earnings) under ASC 815 unless the contract or option qualifies for a derivative scope exception. The definition of a derivative is provided in ASC 815-10-15-83. While ASC 815 is beyond the scope of this guide, generally when determining if contracts to buy or sell securities meet the definition of a derivative, it often comes down to whether net settlement exists. Common ways in which net settlement may exist include a contractual provision for the contract to be settled net in cash or through the underlying securities being actively traded such that they can be readily converted to cash. The derivative scope exceptions are summarized in ASC 815-10-15-13. The regular-way security trades scope exception that is discussed beginning in ASC 815-10-15-15 is an example of a scope exception that may apply to a contract to buy or sell debt securities if all requirements are met.

It is not uncommon for debt securities that are not themselves derivatives to contain potential embedded derivatives such as an option for the holder to convert the debt security into a class of shares, early redemption features (such as put and call options that can accelerate payoff), additional payments if a contingent event such as a change in control occurs, and interest that is indexed to something other than

interest rates. The focus when determining if there are features within a debt security that may require separate recognition as a derivative should be on features that can alter the amount or timing of cash flows or the manner in which the contract can be settled (e.g., in shares rather than cash). A contract that embodies both an embedded derivative and a host contract (i.e., an equity or debt instrument) is referred to as a hybrid instrument.

Entities are required to analyze hybrid instruments to determine whether any embedded features should be separately recognized as a derivative under ASC 815-15-25-1. This analysis involves determining the nature of the host contract and evaluating whether the economic characteristics and risks of the potential embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If not, the embedded feature would require separate recognition as a derivative if it meets the definition of a derivative on a freestanding basis and is within the scope of ASC 815-10-15. However, in accordance with ASC 815-15-25-1(b), this analysis is not required for hybrid instruments that are measured at fair value with changes in fair value reported in earnings as they occur (e.g., investments classified as trading securities).

Derivative instruments that are subject to the requirements of ASC 815, including any embedded derivative that is bifurcated from a hybrid instrument, are outside the scope of this chapter. However, as noted in ASC 815-15-25-54, the host contract that remains after separating an embedded derivative is accounted for under the guidance that is applicable to instruments of the same type that do not contain embedded derivatives. Hence, an investment with a debt host contract would be within the scope of this chapter.

Refer to chapter 3 of RSM's [A Guide to Accounting for Derivatives](#) for further guidance on derivatives, including embedded derivatives.

### 3.2 What is and is not a debt security

Debt security is defined in ASC 320-10-20 as “any security representing a creditor relationship with an entity.” Inherent in this definition and determining if an instrument is within the scope of this guidance is the need to consider if the instrument is in the form of a security. A security, as defined in ASC 320-10-20, has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

As noted in ASC 310-10-35-45 and ASC 860-20-35-2, financial assets such as beneficial interests, loans or other receivables that meet the following two criteria should be subsequently measured like investments in debt securities classified as AFS or trading: (1) they can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all (interpreted in practice to be 90% or more) of its recorded investment, and (2) they are not required to be accounted for as derivatives under ASC 815-10. If the instrument does meet the definition of a debt security, it would be subject to all relevant provisions of ASC 320-10, including the disclosure requirements.

It is important to note that when considering if a security is a debt security, it is not appropriate to look through the form of the investment to the nature of the underlying securities. As illustrated by the examples in ASC 320-10-55-9 and discussed in Section 2.1.2, an investment in a limited partnership that



meets the definition of an equity security and an investment in a mutual fund would be considered equity securities even if all the assets of the limited partnership and the mutual fund are debt securities.

Specific examples of debt securities include:

- Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
- A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument (e.g., it meets the definition of a debt security)
- U.S. Treasury and government agency securities
- Municipal securities
- Corporate bonds
- Convertible debt
- Commercial paper
- All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
- Interest-only and principal-only strips

ASC 320-10-55-2 contains the following list of debt instruments that are within the scope of ASC 320-10 if they meet the definition of a debt security:

- Loans restructured as securities
- Beneficial interests in securitized financial assets that are in equity form but meet the definition of debt security
- Certificates of deposits (e.g., negotiable jumbo certificates of deposit)
- Guaranteed investment contracts
- Redeemable convertible preferred stock

Specific examples of what is *not* considered a debt security include:

- Options, financial futures and forward contracts<sup>4</sup>
- Lease contracts
- Receivables that do not meet the definition of a security. For example:
  - Trade accounts receivable
  - Loans receivable arising from consumer, commercial and real estate lending activities of financial institutions

As noted in ASC 320-10-55-3, even loans, such as mortgage loans that can be readily converted into a security, are not considered to be debt securities until the securitization occurs (i.e., the loans are transformed into securities).

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<sup>4</sup> As noted in Section 3.1, this chapter includes an overview of the accounting for certain contracts to purchase debt securities that are within the scope of the subsections entitled *Certain Contracts on Debt and Equity Securities* within ASC 815-10.

### 3.3 Classification and measurement of debt securities (including certain options and forward contracts to purchase debt securities)

ASC 320 does not address when an entity should recognize the acquisition of a debt security. However, trade date accounting is required for brokers and dealers, investment companies and depository and lending institutions, as well as benefit plans. Entities not governed by industry guidance can make an accounting policy election to account for purchases and sales of securities on either the trade date or settlement date. Agreements to purchase or sell a security that is not accounted for on the trade date should be evaluated to determine whether they are derivatives under ASC 815, and if so, whether the scope exception for regular-way security trades that is discussed beginning in ASC 815-10-15-15 is met. Agreements that require recognition as a derivative are recorded at fair value upon execution of the agreement. Refer to Section 3.1 for additional discussion of derivative considerations.

Debt securities, including forward contracts and purchased options on debt securities that are within the scope of ASC 815-10-15-141,<sup>5</sup> are required to be classified in one of three categories at the time of acquisition. The classification should be documented by the investor at acquisition. This initial classification is important as it determines how the securities are subsequently accounted for, including the timing and amount of credit loss recognition. The classification may also limit the circumstances under which securities can subsequently be disposed of without causing negative accounting consequences. The classification categories, descriptions and subsequent measurement for each category of debt securities are addressed in ASC 320-10-35-1 and are summarized as follows:

Classification	Description	Subsequent measurement
Trading	Required classification for securities acquired with the intent to sell within hours or days. However, an entity is not precluded from using this classification for securities it plans to hold for a longer period.	Fair value, with unrealized holding gains and losses included in earnings.
HTM	Classification for debt securities management has the positive intent and ability to hold until maturity.	Amortized cost, net of an allowance for credit losses.
AFS	Debt securities that are not classified as trading or as HTM.	Fair value, net of an allowance for credit losses, with subsequent changes in fair generally reflected in OCI, net of deferred taxes.

The recognition of credit losses is not relevant to trading securities given that all changes in fair value are reflected in earnings. With the issuance of ASU 2016-13, expected credit losses on HTM and AFS debt securities are recognized through an allowance; however, there are significant differences in the timing and amount of credit loss recognition given that HTM securities are subject to ASC 326-20 and AFS securities are subject to ASC 326-30, which are discussed in Chapters 6 and 4, respectively. Notable differences are summarized as follows:<sup>6</sup>

<sup>5</sup> Refer to ASC 815-10-25-17.

<sup>6</sup> Incremental guidance relevant to certain forward contracts and purchased options to acquire debt securities is discussed later in this section.

ASC 326-20 (HTM securities)	ASC 326-30 (AFS securities)
HTM securities are required to be evaluated on a pooled basis with assets that have similar risk characteristics when estimating expected credit losses.	AFS securities are required to be evaluated individually for impairment. (A security is deemed to be impaired if its fair value is less than its amortized cost.)
Expected credit losses need to be recognized through an allowance for credit losses regardless of the relationship of the fair value of a security to its amortized cost basis. An intent or potential requirement to sell the security is not relevant to the analysis.	An impairment analysis is not necessary unless the fair value of a security is less than its amortized cost. If management intends to sell an impaired security, or it is more likely than not that the security will be required to be sold before its amortized cost basis is recovered, the security is written down to its fair value. If neither of these conditions are met, expected credit losses, when present, are recognized on impaired securities through an allowance for credit losses. The allowance for credit losses is limited to the amount by which the amortized cost of a security exceeds its fair value.
The estimate of expected credit losses should include a measure for the expected risk of loss even if that risk is remote. Because of this, the expectation is that circumstances in which an HTM security does not have an allowance for expected credit losses would be rare (e.g., securities of the U.S. government and its agencies).	Expected losses should be based on management's best estimate. In certain circumstances, a conclusion may be reached qualitatively that no allowance is necessary (i.e., an analysis of relevant qualitative factors support the expectation that all contractual cash flows will be received).
A DCF approach may be used for estimating expected credit losses, but is not required.	A DCF approach is required to be used in estimating expected credit losses.

### 3.3.1 Foreign currency-denominated securities

The accounting and financial statement presentation considerations for investments in debt securities denominated in a currency other than the entity's functional currency can be summarized as follows:

Investment category	Foreign currency considerations
Trading	Trading securities that are denominated in a currency other than the functional currency of the reporting entity are required to be adjusted to reflect the current exchange rate at each reporting date. The measurement of unrealized holding gains and losses pursuant to ASC 320-10-35-1 include changes resulting from movements in both foreign exchange rates and other market factors (e.g., changes in interest rates, credit, liquidity, etc.). The entire change in fair value of a foreign-currency-denominated trading security may be reported in a single line item in the income statement, without separately reporting any foreign exchange component of the overall change in the fair value of the security.
AFS	AFS debt securities that are denominated in a currency other than the functional currency of the reporting entity are required to be adjusted to reflect the current exchange rate at each reporting date. The measurement

Investment category	Foreign currency considerations
	of unrealized holding gains and losses pursuant to ASC 320-10-35-1 include changes resulting from both movements in foreign exchange rates and movements in other market factors (e.g., changes in interest rates, credit, liquidity, etc.). In accordance with ASC 320-10-35-36, the entire change in the fair value of foreign-currency-denominated AFS debt securities, excluding the amount recorded in the allowance for credit losses, is reported in OCI, net of deferred taxes.
HTM	Foreign-currency-denominated debt securities classified as HTM are considered monetary assets under ASC 830 because their settlement amounts are fixed and do not depend on future prices. Any change in exchange rates between the functional currency of the holder of the debt security and the currency in which the debt security is denominated will cause an increase or decrease in expected functional currency cash flows. Under ASC 830-20-35-1, this represents a foreign currency transaction gain or loss that is included in net income for the period in which the exchange rate changes.

### 3.3.2 Forward contracts and purchased options on debt securities

Forward contracts and purchased options on debt securities that are within the scope of ASC 815-10-15-141 are subject to the subsequent measurement guidance, by classification category, discussed earlier in this section. Additional guidance relative to the recognition of credit losses and measurement of purchased debt securities upon settlement or exercise of the contract is provided in ASC 815-10-35-5 and summarized as follows:

Classification	Recognition of credit losses	Measurement of purchased debt securities upon settlement or exercise
Trading	Not applicable given the contracts are accounted for at fair value with changes in fair value recognized through earnings.	Fair value
HTM	Credit losses on the underlying debt securities are recognized through an allowance for credit losses determined in accordance with ASC 326-20 (refer to Chapter 6 for additional guidance), with the allowance on purchased options limited to the option premium.	Contract price for forward contracts and option strike price plus the remaining carrying amount of the option premium for option contracts.  If an option expires worthless and the same debt security is purchased in the market, the security is recorded at its market price plus the remaining carrying amount of the expired option's premium. (Note that if an entity does not take delivery under the forward contract or purchase the same security in the market if the option expires worthless, the entity's

Classification	Recognition of credit losses	Measurement of purchased debt securities upon settlement or exercise
		intent to hold other debt securities to maturity will be called into question).
AFS	Credit losses on the underlying securities are recognized through an allowance for credit losses determined in accordance with ASC 326-30 (refer to Chapter 4 for additional guidance), with the allowance on purchased options limited to the option premium.	Settlement date fair value for forward contracts and the option strike price plus the fair value of the option at the exercise date for option contracts.  If an option expires worthless and the same debt security is purchased in the market, the security is recorded at its market price plus any remaining carrying amount for the option premium.

### 3.3.3 Classification as HTM

In deciding upon the classification of a debt security, it is important to note that there are restrictions on when debt securities can be classified as HTM. Transfers from the HTM category should be rare, except for transfers due to the changes in circumstances identified in ASC 320-10-25-6(a) through (f) (see Section 3.3.3.3). It is not sufficient that an entity has the current intent to hold the security or the intent to hold it for only an indefinite period. When evaluating intent for a particular security, it is helpful to give consideration to circumstances that have in the past led, or may in the future lead, to a decision to sell securities as most actual or potential sales are inconsistent with a stated intention to hold a security to maturity.

#### 3.3.3.1 Scenarios in which a debt security should not be classified as HTM



##### ASC 320-10-25-4

An entity shall not classify a debt security as held-to-maturity if the entity has the intent to hold the security for only an indefinite period. Consequently, a debt security shall not, for example, be classified as held-to-maturity if the entity anticipates that the security would be available to be sold in response to any of the following circumstances:

- a. Changes in market interest rates and related changes in the security's prepayment risk
- b. Needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims)
- c. Changes in the availability of and the yield on alternative investments
- d. Changes in funding sources and terms
- e. Changes in foreign currency risk.

ASC 320-10-25-5 (included below) lists specific scenarios in which a debt security should *not* be classified as HTM. The sale or transfer of an HTM security under these scenarios calls into question an entity's stated intent to hold other debt securities to maturity in the future. These scenarios are:

- Securities that can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment (e.g., certain callable debt securities purchased at a premium<sup>7</sup> and mortgage-backed interest-only certificates)
- Securities that are available to be sold (or may be sold) in response to changes in market interest rates, changes in prepayment risk, liquidity needs, changes in foreign exchange risk or other similar factors
- Securities that are available to be sold as part of an entity's asset-liability management activities or a dynamic hedging program
- Securities that may need to be sold to implement tax-planning strategies (e.g., generating taxable gains to offset existing taxable losses)
- Sales in advance of any deterioration in the creditworthiness of the issuer (e.g., a sale based solely on industry statistics)
- Sales to meet regulatory capital requirements
- The exercise of a put option and certain puttable debt securities pursuant to ASC 860-20-35-2
- Convertible debt securities
- Securities held by regulated entities for which the entity indicated to regulators that the securities could be sold to meet liquidity needs in a defined interest rate scenario that is reasonably possible of occurring



#### ASC 320-10-25-5

Specific scenarios in which a debt security shall not be classified as held-to-maturity (or where sale or transfer of a held-to-maturity security will call into question an investor's stated intent to hold other debt securities to maturity in the future) are as follows:

- a. A security shall not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. The justification for using historical-cost-based measurement for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. However, that justification does not extend to receivables purchased at a substantial premium over the amount at which they can be prepaid, and it does not apply to instruments whose payments derive from prepayable receivables but have no principal balance. Therefore, a callable debt security purchased at a significant premium might be precluded from held-to-maturity classification under paragraph 860-20-35-2 if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. In addition, a mortgage-backed interest-only certificate shall not be classified as held-to-maturity. Paragraphs 860-20-35-3 through 35-6 provide further guidance on application of this paragraph. Note that a debt security that is purchased late enough in its life such that, even if it was prepaid, the holder would recover substantially all of its recorded investment, could be initially classified as held-to-maturity if the conditions of this paragraph and paragraph 320-10-25-1 are met. (A debt security that can contractually be prepaid or otherwise settled in such a

<sup>7</sup> Consideration should be given to ASC 815 as this prepayment feature may need to be given separate recognition as a derivative.

way that the holder of the security would not recover substantially all of its recorded investment may contain an embedded derivative. Therefore, such a security should be evaluated in accordance with Subtopic 815-15 to determine whether it contains an embedded derivative that needs to be accounted for separately.)

- b. A debt security that is available to be sold in response to changes in market interest rates, changes in the security's prepayment risk, the entity's need for liquidity, changes in foreign exchange risk, or other similar factors shall not be included in the held-to-maturity category because the possibility of a sale is indicative that the entity does not have a positive intent and ability to hold the security to maturity. A debt security that is considered available to be sold as part of an entity's asset-liability management activities shall not be classified as held-to-maturity. Similarly, an entity that maintains a dynamic hedging program in which changes in external factors require that certain securities be sold to maintain an effective hedge would not have the intent and ability to hold those securities to maturity.
- c. Securities that may need to be sold to implement tax-planning strategies (for example, to generate taxable gains to offset existing taxable losses—or vice versa—or in response to changes in the entity's anticipated future profitability—for example, if taxable losses were expected for the next several years) should be classified as available-for-sale, not held-to-maturity.
- d. The sale of a held-to-maturity security in advance of any deterioration in the creditworthiness of the issuer, perhaps based solely on industry statistics, will call into question an investor's stated intent to hold other debt securities to maturity in the future. The sale of a held-to-maturity security must be in response to an actual deterioration, not mere speculation. That deterioration shall be supported by evidence about the issuer's creditworthiness; however, the entity need not await an actual downgrading in the issuer's published credit rating or inclusion on a credit watch list.
- e. The sale of held-to-maturity securities to meet regulatory capital requirements will call into question an investor's stated intent to hold other debt securities to maturity in the future. An entity's ability and intent to hold securities to maturity would be called into question by the sale of held-to-maturity securities to realize gains to replenish regulatory capital that had been reduced by a provision for loan losses. Gains trading with held-to-maturity securities to meet an entity's capital requirements is inconsistent with the held-to-maturity notion.
- f. The exercise of a put option on a security classified as held-to-maturity will call into question an investor's stated intent to hold other debt securities to maturity in the future. Furthermore, a puttable debt security might be precluded from held-to-maturity classification pursuant to paragraph 860-20-35-2.
- g. Convertible debt securities shall not be classified as held-to-maturity. Classifying a security as held-to-maturity means that the entity is indifferent to future opportunities to profit from changes in the security's fair value and intends to accept the debt security's stipulated contractual cash flows, including the repayment of principal at maturity. Convertible debt securities generally bear a lower interest rate because the investor hopes to benefit from appreciation in value of the option embedded in the debt security. Given the unique opportunities for profit embedded in a convertible security, it generally would be contradictory to assert the positive intent and ability to hold a convertible debt security to maturity and forego the opportunity to exercise the conversion feature. The exercise of a conversion feature on a security classified as held-to-maturity will call into question an investor's stated intent to hold other debt securities to maturity in the future. (See Section 815-15-25 for additional guidance. If convertible debt is bifurcated into an equity option and a host debt instrument under the requirements of Subtopic 815-15, it generally still would be contradictory to assert the positive intent and ability to hold the debt host contract to maturity and forego the opportunity to exercise the conversion feature.)
- h. A documented policy to initially classify all debt securities as held-to-maturity but then automatically transfer every security to available-for-sale when it reaches a predetermined point before maturity (for example, every held-to-maturity security will be transferred to

available-for-sale 24 months prior to its stated maturity) so that an entity has the flexibility to sell securities is not consistent with the held-to-maturity classification. Under the policy described, the entity does not intend to hold any security to maturity.

- i. An insurance entity or other regulated entity shall not classify securities as held-to-maturity and also indicate to regulators that those securities could be sold to meet liquidity needs in a defined interest rate scenario whose likelihood of occurrence is reasonably possible but not probable.

Policies to initially classify all debt securities as HTM and subsequently transfer them to AFS at a predetermined point before maturity would preclude HTM classification for all securities. As pointed out in the industry guidance for depository and lending entities in ASC 942-320-55, while financial institution regulators generally have the authority to require divestiture of assets that pose an undue safety and soundness risk, this does not mean that an institution does not have the ability to hold any security to maturity. However, specific facts and circumstances, such as a high-risk security posing safety and soundness concerns for a specific institution, could indicate that the institution does not have the ability to hold the security until maturity.

### 3.3.3.2 Accounting consequences of sales or transfers that taint the entity's HTM intent

When a sale or transfer of an HTM security represents a material contradiction of an entity's stated intent to hold those securities to maturity or when a pattern of such sales has occurred, any remaining HTM securities are required to be reclassified to AFS. An entity would be precluded from classifying investments as HTM until it can demonstrate that circumstances have changed such that management can assert with a greater degree of credibility that it has the intent and ability to hold debt securities to maturity. The SEC staff have indicated this could be up to a two-year period of time.

### 3.3.3.3 Circumstances involving sales or transfers of HTM securities that do not call into question an entity's intent to hold other securities to maturity



#### ASC 320-10-25-6

The sale or transfer of a held-to-maturity security due to one of the following changes in circumstances shall not be considered inconsistent with its original classification:

- a. Evidence of a significant deterioration in the issuer's creditworthiness (for example, a downgrading of an issuer's published credit rating)
- b. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- c. A major business combination or major disposition (such as sale of component of an entity) that necessitates the sale or transfer of held-to-maturity securities to maintain the entity's existing interest rate risk position or credit risk policy
- d. A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security
- e. A significant increase by the regulator in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities
- f. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes



**ASC 320-10-25-7**

It is not appropriate to analogize to the exceptions specified in (a) through (f) in the preceding paragraph.

**ASC 320-10-25-8**

If a regulator directs a particular institution (rather than all institutions supervised by that regulator) to sell or transfer held-to-maturity securities (for example, to increase liquid assets), those sales or transfers are not consistent with paragraph 320-10-25-6(d), which describes a change in regulations applicable to all entities affected by the legislation or regulator enacting the change. (The same is true of paragraph 320-10-25-6(e) through (f).) However, it is possible that the circumstances causing a regulator to direct an institution to sell securities could be considered an event that is isolated, nonrecurring, and unusual that could not have been reasonably anticipated as described in the following paragraph and paragraph 320-10-25-6.

**ASC 320-10-25-9**

In addition to the changes in circumstances listed in paragraph 320-10-25-6(a) through (f), certain other events may cause the entity to sell or transfer a held-to-maturity security without necessarily calling into question (tainting) its intent to hold other debt securities to maturity. Such events must meet all of the following four conditions to avoid tainting its intent to hold other debt securities to maturity in the future:

- a. The event is isolated.
- b. The event is nonrecurring.
- c. The event is unusual for the reporting entity.
- d. The event could not have been reasonably anticipated.

**ASC 320-10-25-10**

Other than extremely remote disaster scenarios (such as a run on a bank or an insurance entity), very few events would meet all four of those conditions.

**ASC 320-10-25-11**

Extremely remote disaster scenarios shall not be anticipated by an entity in deciding whether it has the positive intent and ability to hold a debt security to maturity.

**ASC 320-10-25-14**

Sales of debt securities that meet either of the following conditions may be considered as maturities for purposes of the classification of securities and the disclosure requirements under this Subtopic:

- a. The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable) that interest rate risk is substantially eliminated as a pricing factor. That is, the date of sale is so near the maturity or call date (for example, within three months) that changes in market interest rates would not have a significant effect on the security's fair value.
- b. The sale of a security occurs after the entity has already collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due either to prepayments on the debt security or to scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. For variable-rate securities, the scheduled payments need not be equal.

**ASC 320-10-25-15**

Selling a debt security after a substantial portion of the principal has been collected shall be considered equivalent to holding the security to maturity. The collection of 85 percent of the principal outstanding at acquisition (not the principal outstanding at issuance for securities purchased in the

secondary market) constitutes a reasonable threshold of what represents a substantial portion of the principal.

#### **ASC 320-10-25-16**

The limited practical exception in the preceding paragraph applies to both of the following:

- a. Debt securities that are payable in equal installments that comprise both principal and interest, such as certain level-payment mortgage-backed securities. For example, many banks routinely sell their investments in mortgage-backed securities after a substantial portion of the principal has been recovered through prepayments. The tail portion of a mortgage-backed security is sold because it no longer represents an efficient investment to the entity mainly due to the economic costs of accounting for remnants of the original issue.
- b. Variable-rate debt securities when the scheduled payments would be payable in equal installments absent a change in interest rates.

#### **ASC 320-10-25-17**

It is not appropriate to apply the limited practical exception in paragraph 320-10-25-15 by analogy to a debt security that has a contractual payment schedule of level principal payments plus interest that accrues based on the declining outstanding principal balance; the payments on that type of security do not represent equal installments that are made up of both principal and interest.

#### **ASC 320-10-25-18**

Specific scenarios in which a debt security may be classified as held to maturity (or where sale or transfer of a held-to-maturity security will not call into question an investor's stated intent to hold other debt securities to maturity in the future) are as follows:

- a. Although its asset-liability management may encompass consideration of the maturity and repricing characteristics of all investments in debt securities, an entity may decide that it can accomplish the necessary adjustments under its asset-liability management without having all of its debt securities available for disposition. In that case, the entity may choose to designate certain debt securities as unavailable to be sold to accomplish those ongoing adjustments deemed necessary under its asset-liability management, thereby enabling those debt securities to be accounted for at amortized cost on the basis of a positive intent and ability to hold them to maturity.
- b. The sale of one or more held-to-maturity securities if an entity chooses to downsize to comply with a significant increase in the industry's capital requirements would not call into question the classification of other held-to-maturity securities.
- c. In some circumstances it may not be possible to hold a security to its original stated maturity, such as when the security is called by the issuer before maturity. The issuer's exercise of the call option effectively accelerates the security's maturity and shall not be viewed as inconsistent with classification in the held-to-maturity category.
- d. A puttable debt security shall be classified as held-to-maturity only if the entity has the positive intent and ability to hold it to maturity.
- e. If a transfer of a held-to-maturity debt security is accounted for as a sale under Subtopic 860-20 and it is transferred for a reason other than those specified in paragraphs 320-10-25-6, 320-10-25-9, and 320-10-25-14, then the transfer would taint the held-to-maturity portfolio. However, if the transfer is accounted for as a secured borrowing, then the transfer would not taint the held-to-maturity portfolio. Transactions involving held-to-maturity securities that are not accounted for as sales under Subtopic 860-20 would not contradict an entity's stated intent to hold a security to maturity and, therefore, do not call into question the entity's intent to hold other debt securities to maturity. Examples of such transactions are as follows:

1. Held-to-maturity securities pledged as collateral, provided that the transaction is not accounted for as a sale under Subtopic 860-20 and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral
2. Held-to-maturity securities subject to a repurchase agreement or a securities lending agreement, provided that the transaction is accounted for as a secured borrowing under Subtopic 860-20 and the entity intends and expects to be able to repay the borrowing

Beneficial interests classified as held-to-maturity that are desecuritized in a transaction that is not accounted for as a sale if the financial assets received in or that continue to be held after the desecuritization are held to maturity. Unless the debt instrument received or retained as a result of the transaction is held to maturity, the transaction would call into question the entity's intent to hold other debt securities to maturity. Desecuritizations are not specifically included within the scope of this paragraph. Nevertheless, that guidance is also appropriate for desecuritizations that are not accounted for as sales.

There are certain limited circumstances under which an entity can sell or transfer an HTM security and not call into question its intent to hold other securities to maturity in the future.

These circumstances<sup>8</sup> are discussed more fully in ASC 320-10-25-6 to 25-18 and summarized as follows:

- Significant deterioration in the issuer's creditworthiness as evidenced, for example, by a credit rating downgrade. See Section 3.3.3.3.1 for further discussion.
- Change in tax law that eliminates or reduces the tax-exempt status of interest on the security. See Section 3.3.3.3.2 for further discussion.
- Major business combination or major disposition that necessitates the sale or transfer of HTM securities to maintain the entity's existing interest rate risk position or credit risk policy. See Section 3.3.3.3.3 for further discussion.
- Changes in regulatory requirements that apply to the industry (as opposed to regulatory orders directed to a particular institution) that significantly modify either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, significantly increase regulatory capital requirements causing the entity to downsize, or increase the regulatory risk weights of the securities. See Section 3.3.3.3.4 for further discussion.
- Sales due to events that are isolated, nonrecurring, unusual for the reporting entity and could not have been reasonably anticipated. The expectation is that, absent an extremely remote disaster scenario (such as a run on a bank or an insurance entity, which should not be anticipated when deciding if the intent and ability to hold a security to maturity exists), very few events would meet all four of these conditions.
- Accelerated maturity due to the issuer's exercise of a call option.
- Transfers of securities that are accounted for as secured borrowings rather than sales under ASC 860.
- The following circumstances that can be considered maturities rather than sales:
  - Sales so near the maturity or call date (e.g., within three months) that changes in market interest rates would not have a significant effect on the security's fair value.
  - Sales that occur after the entity has already collected a substantial portion (at least 85%) of the principal outstanding at acquisition due either to prepayments on the debt security or to

<sup>8</sup> Pursuant to ASC 320-10-25-7, it is not appropriate to analogize to the exceptions specified in (a) through (f) of ASC 320-10-25-6.

scheduled payments on a debt security payable in equal installments (both principal and interest) over its term.<sup>9</sup> (For variable-rate securities, the exception also applies when the scheduled payments would be payable in equal installments absent a change in interest rates.)



#### **Spotlight: Certain limited elections to sell or transfer HTM securities**

ASC 848-10-35-1 (which was created with the issuance of ASU 2020-04 on Reference Rate Reform), permits entities to make a one-time election to sell certain HTM securities or transfer them to AFS or trading. Specifically, at the time of applying the one-time election, it permits the entity to sell, transfer, or both sell and transfer debt securities that were classified as HTM before January 1, 2020, and reference LIBOR or a reference rate that is expected to be discontinued as a result of reference rate reform.

A sale or transfer made in accordance with these provisions will not in, and of itself, call into question an entity's prior assertions of its intent and ability to hold remaining HTM debt securities. ASC 848-10-35-2 emphasizes this and addresses the accounting for the transfer (see Section 3.4.1 and Section 3.4.2 for related guidance). This one-time election may be made no later than December 31, 2024.

Pursuant to ASC 848-10-50-1, an entity that applies this one-time election must also apply the disclosure requirements in ASC 320-10-50-10 for the sale or transfer of debt securities classified as HTM.

ASU 2022-01 permits an entity that applies portfolio layer method hedging to one or more closed portfolios that include HTM debt securities to transfer those securities to AFS at the date of its adoption. The decision of which securities to reclassify must be made within 30 days after the date of adoption, and the securities must be included in one or more closed portfolios that are designated in a portfolio layer method hedge within that 30-day period.

The guidance in ASC 848 is temporary and pursuant to [ASU 2022-06, Reference Rate Reform \(Topic 848\): Deferal of the Sunset Date of Topic 848](#), is set to expire on December 31, 2024 with limited exceptions.

#### **3.3.3.3.1 Sale or transfer due to a significant deterioration in the issuer's creditworthiness**

Entities may want to sell an HTM security in response to a deterioration in the creditworthiness of the security's issuer. To help ensure that an entity's intent to hold other debt securities until maturity is not called into question, the sale of an HTM security must be in response to an actual credit deterioration (rather than mere speculation); however, the entity need not wait until an actual downgrading in the issuer's published credit rating or inclusion on a credit watch list (see ASC 320-10-25-5(d)). Importantly, for the sale or transfer of an HTM security not to be considered inconsistent with its original classification there must be evidence of a significant deterioration in the issuer's creditworthiness (see ASC 320-10-25-6(a)).

ASC 320 does not define the term "significant deterioration." Consequently, an entity should develop and consistently apply an accounting policy as to the meaning of a significant deterioration in creditworthiness of a security's issuer. In addition, we believe the determination of a significant deterioration in creditworthiness should be based on changes in a security's credit quality since the date of its acquisition rather than the security's original issuance date.

<sup>9</sup> Pursuant to ASC 320-10-25-17, it is not appropriate to apply this limited practical exception to a debt security that has a contractual payment schedule of level principal payments plus interest that accrues based on the declining outstanding principal balance; the payments on that type of security do not represent equal installments that are made up of both principal and interest.

The sale of an HTM security in advance of a significant deterioration in the issuer's creditworthiness will call into question an entity's stated intent to hold other debt securities to their maturity in the future. This is the case even if the sale is based on industry statistics.

#### *3.3.3.3.2 Sale or transfer due to a change in tax law*

In accordance with ASC 320-10-25-6(b), the sale or transfer of an HTM security due to a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security is not inconsistent with HTM classification. However, a change in tax law that revises the marginal tax rates applicable to interest income would not qualify for this exception. In addition, a change in tax status of an entity (e.g., change from C Corporation to S Corporation) would not qualify for this exception.

If a tax law is enacted that eliminates or reduces the tax-exempt status of interest on state or municipal bonds, the entire holdings of debt securities may be sold or transferred without bringing into question their HTM classification.

#### *3.3.3.3.3 Sale or transfer due to a major business combination or major disposition*

The sale or transfer of an HTM security due to a major business combination or major disposition (e.g., a component of an entity) that necessitates the sale or transfer of HTM securities to maintain the entity's existing interest rate risk position or credit risk policy is an example of a circumstance described in ASC 320-10-25-6(c) that would not be considered inconsistent with its original classification. That is, sales or transfers under such circumstances would not call into question the entity's intent to hold other debt securities to maturity in the future. However, those necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition.

##### *3Q3.3.3.3.1 What constitutes a "major" business combination or a "major" disposition under ASC 320-10-25-6(c)?*

ASC 320 does not specify a quantitative threshold for a major business combination or disposition; however, ASC 320-10-25-6(c) refers to a sale of a component of an entity as an example of a major disposition. The ASC Master Glossary defines a component of an entity as something that "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group."

ASC 320-10-25-13 provides the following examples of transactions that would not qualify for the exception of ASC 320-10-25-6(c):

- a. A purchase or sale of a large pool of financial assets (for example, conforming mortgages) or liabilities (for example, deposit liabilities) (which would not be considered a major business combination or disposition)
- b. Sales of held-to-maturity securities to fund an acquisition (or a disposition, for example, if deposit liabilities are being assumed by the other party)
- c. Sales of held-to-maturity securities in anticipation of or otherwise before a major business combination or disposition
- d. A sale of held-to-maturity securities in response to an unsolicited tender offer from the issuer (which also is not an event that is isolated, nonrecurring, and unusual that could not have been reasonably anticipated).

##### *3Q3.3.3.3.2 Is it consistent with ASC 320-10-25-6(c) to reassess the classification of HTM securities concurrent with or shortly after a major business combination accounted for as a purchase?*

Yes. Following a business combination, the continuing management may need to sell or transfer some HTM securities to maintain the entity's existing credit risk policy, foreign exchange risk exposure or interest rate risk position under its asset-liability management policy. Similarly, following a major purchase

acquisition, some of the acquiring entity's HTM securities may need to be transferred or sold because of the nature of the liabilities assumed.

**3Q3.3.3.3.3** *May securities classified as HTM be sold under the exception provided in ASC 320-10-25(c) in anticipation of or otherwise prior to a major business combination or disposition without calling into question the entity's intent to hold other debt securities to maturity in the future?*

No. Necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition.

**3Q3.3.3.3.4** *ASC 320-10-25-12(a) states that "... necessary transfers or sales should occur concurrent with or shortly after the business combination or disposition." How long is "shortly"?*

ASC 320 does not define "shortly." As time passes, however, it is increasingly difficult to demonstrate that the business combination, and not other events or circumstances, necessitated the transfer or sale of HTM securities.

**3.3.3.3.4** *Sale or transfer due to change in statutory or regulatory requirements*

According to ASC 320-10-25-5(e), an entity's ability and intent to hold securities to maturity would be called into question by the sale of HTM securities to realize gains to replenish regulatory capital that had been reduced by a provision for loan losses. Gains trading with HTM securities to meet an entity's capital requirements is also inconsistent with the held-to-maturity notion. In contrast, the following changes in circumstances would not be considered inconsistent with a security's original HTM classification:

- A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security [ASC 320-10-25-6(d)]
- A significant increase by the regulator in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities [ASC 320-10-25-6(e)]
- A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes [ASC 320-10-25-6(f)]

According to ASC 320-10-25-8, if a regulator directs a particular institution (rather than all institutions it supervises) to sell or transfer HTM securities (e.g., to increase liquid assets), those sales or transfers do not qualify for the exception described in ASC 320-10-25-6(d) above, which describes a change in regulations applicable to all entities affected by the legislation or regulator enacting the change. The same is true of ASC 320-10-25-6(e) to 25-6(f). However, it is possible that the circumstances causing a regulator to direct an institution to sell securities could be considered an event that is isolated, nonrecurring, unusual, and unable to have been reasonably anticipated.

**3.3.4 Accounting for other investments in an equity method investee**

An investor in the common stock of an equity method investee may also invest in the debt securities or preferred stock issued by the investee or extend a loan to that same investee. In some cases, applying the equity method of accounting (which is beyond the scope of this guide) may result in reducing the carrying amount of the equity method investee to zero. In such instances, questions arise as to whether and how the investor should adjust the basis of its other investments in the equity method investee, the sequence for recognizing losses across the entity's various investments in the investee, and whether and how to recognize future income from the investee. ASC 323-10-35-23 to 35-26 provides guidance addressing these issues and on the steps that an investor should perform to determine the amount of equity method loss to report.



### **ASC 323-10-35-23**

The guidance in the following paragraph applies to situations in which both of the following conditions exist:

- a. An investor is not required to advance additional funds to an investee.
- b. Previous losses have reduced the common stock investment account to zero.

### **ASC 323-10-35-24**

In the circumstances described in paragraph 323-10-35-23, the investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30 to the other investments, as applicable.

### **ASC 323-10-35-25**

The cost basis of the other investments is the original cost of those investments adjusted for the effects of write-downs, unrealized holding gains and losses on debt securities classified as trading in accordance with Subtopic 320-10 or equity securities accounted for in accordance with Subtopic 321-10 and amortization of any discount or premium on debt securities or financing receivables. The adjusted basis is the cost basis adjusted for the allowance for credit losses account recorded in accordance with Topic 326 on measurement of credit losses for an investee financing receivable and debt security and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded shall be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior investments first).

### **ASC 323-10-35-26**

If the investor has other investments in the investee (including, but not limited to, preferred stock, debt securities, and loans to the investee) that are within the scope of Subtopic 310-10, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

- a. Apply ASC 320-10-35-3 to determine the maximum amount of equity method losses.
- b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
  1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.
  2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method

losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30).

- c. After applying this Subtopic, apply Subtopics 310-10, 320-10, and 321-10 to the adjusted basis of the other investments in the investee, as applicable.
- d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scope of Subtopics 310-10, 320-10, or 321-10.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

The following example illustrates the application of the guidance in ASC 323-10-25-26.



**Example 3-1: Investee losses if the investor has other investments in investee (from Example 4 in ASC 323-10-55-30 to 55-47)**

This example illustrates the application of paragraph 323-10-35-24 to an investment involving all of the following circumstances:

- a. Investor owns 40 percent of the outstanding common stock of Investee.
- b. The common stock investment has been reduced to zero at the beginning of 20X1 because of previous losses.
- c. Investor also has done both of the following:
  - 1. Invested \$100 in redeemable preferred stock (that meets the definition of debt security and is classified as an available-for-sale debt security) of investee (40 percent of the outstanding preferred stock of Investee)
  - 2. Extended \$100 in loans to investee (which represent 40 percent of all loans extended to Investee).
- d. The investor is not obligated to provide any additional funding to Investee.

In accordance with paragraphs 323-10-35-7 and 323-10-35-16, Investee's operating income and losses in the following table have been adjusted for intra-entity interest on the loan and dividends received or receivable on the preferred stock. As of the beginning of year 20X1, the carrying value of Investor's total combined investment in Investee is \$200, as follows:

	Carrying Balance
Common stock	\$0
Loan	\$100
Preferred stock	\$100



Assume the following facts for the years 20X1 through 20X7:

Year	Investee Operating Income/(Loss)	Carrying Value of the Loan Under Subtopic 310-10	Fair Value of the Preferred Stock Under Subtopic 320-10
20X1	\$(200)	\$ 95	\$ 90
20X2	(400)	95	90
20X3	0	60	50
20X4	400	95	90
20X5	0	45	55
20X6	0	95	90
20X7	1,000	100	(a)

(a) Preferred stock was sold for \$90 on January 2, 20X7

Following are the steps investor would follow in applying the equity method of accounting to its investment in investee during the years 20X1 through 20X7.

**Investor would make all of the following entries in 20X1:**

- a. In accordance with this Subtopic, record the equity method loss ( $40\% \times \$200 = \$80$ ) to the cost basis of the preferred stock (the next level of capital) at the time that the common stock investment becomes zero.

<b>Equity method loss</b>	<b>\$80</b>	
<b>Preferred stock investment</b>		<b>\$80</b>

- b. In accordance with Subtopic 326-20 on financial instruments measured at amortized cost, record an allowance for credit losses on the loan.

<b>Credit loss expense</b>	<b>\$5</b>	
<b>Allowance for credit losses</b>		<b>\$5</b>

- c. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of \$90 less the carrying amount after entry [a] of \$20, equals \$70 unrealized gain).

<b>Preferred stock investment</b>	<b>\$70</b>	
<b>Loan loss valuation allowance</b>		<b>\$70</b>

In 20X1, the total profit-and-loss charge is \$85 (\$80 for the equity method loss and \$5 for the loan). Other comprehensive income is credited \$70 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to \$185 (\$0 for the common stock investment, \$95 for the loan, and \$90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$70. The adjusted basis of the total combined investment in Investee is reduced to \$115 (\$0 for the common stock investment, \$95 for the loan, and \$20 for the preferred stock investment).

**Investor would make both of the following entries in 20X2:**

- a. In accordance with this Subtopic, record the equity method loss ( $40\% \times \$400 = \$160$ ) to the adjusted basis of the preferred stock of \$20 and, because the adjusted basis of the preferred stock will then be reduced to zero, record the remaining equity method loss to the adjusted basis of the loan (the next level of capital). The total equity method loss recorded would be limited, however, to the adjusted basis of the total combined investment in Investee of \$115; therefore, \$45 of equity method losses are unreported.

<b>Equity method loss</b>	<b>\$115</b>	
<b>Preferred stock investment</b>		<b>\$20</b>
<b>Loan</b>		<b>\$95</b>

- b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of \$90 less the carrying amount after the above entry of \$70, equals \$20 unrealized gain).

<b>Preferred stock investment</b>	<b>\$20</b>	
<b>Unrealized gain – other comprehensive income</b>		<b>\$20</b>

In 20X2, the total profit-and-loss charge is \$115 (equity method loss). Other comprehensive income is credited \$20 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to \$90 (\$0 for the common stock investment, \$0 for the loan, and \$90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$90. The adjusted basis of the total combined investment in Investee is reduced to \$0 (\$0 for the common stock investment, \$0 for the loan, and \$0 for the preferred stock investment).

**In 20X3, there is no equity method income or loss ( $40\% \times \$0 = \$0$ ). Investor would make both of the following entries in 20X3:**

- a. Because the adjusted basis of the loan was reduced to zero in 20X2 as a result of applying equity method losses to the loan, no entry is needed to reflect the Subtopic 326-20 reduction in carrying amount from \$95 to \$60.
- b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (fair value of \$50 less the carrying amount of \$90 equals \$40 unrealized loss).

<b>Unrealized gain – other comprehensive income</b>	<b>\$40</b>	
<b>Preferred stock investment</b>		<b>\$40</b>

In 20X3, other comprehensive income is debited \$40 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to \$50 (\$0 for the common stock investment, \$0 for the loan, and \$50 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$50. The adjusted basis of the total combined investment in Investee remains \$0.

**Investor would make both of the following entries in 20X4:**

- a. In accordance with this Subtopic, record the equity method income ( $40\% \times \$400 = \$160$ ). However, in accordance with this Subtopic, Investor resumes applying the equity method only after its share of that income equals the unreported equity method losses of \$45. Therefore, the equity method income to be reported for the period is \$115 ( $\$160 - \$45$ ). The adjusted bases of the other investments are restored in the reverse order of the application of the equity method losses (loan first, then preferred stock).

<b>Loan</b>	<b>\$95</b>	
<b>Preferred stock investment</b>	<b>\$20</b>	
	<b>Equity method income</b>	<b>\$115</b>

- b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of \$90 less the carrying amount of \$70 equals \$20 unrealized gain).

<b>Preferred stock investment</b>	<b>\$20</b>	
	<b>Unrealized gain – other comprehensive income</b>	<b>\$20</b>

In 20X4, the total profit-and-loss credit is \$115 (the equity method income after Investor's share of unreported equity method losses of \$45 in 20X2). Other comprehensive income is credited \$20 for the preferred stock investment. The carrying amount of the total combined investment in Investee is increased to \$185 (\$0 for the common stock investment, \$95 for the loan, and \$90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$70. The adjusted basis of the total combined investment in Investee is increased to \$115 (\$0 for the common stock investment, \$95 for the loan, and \$20 for the preferred stock investment).

**In 20X5, there is no equity method income or loss ( $40\% \times \$0 = \$0$ ). Investor would make both of the following entries in 20X5:**

- a. In accordance with Subtopic 326-20, record an allowance for credit loss for the loan.

<b>Credit loss expense</b>	<b>\$50</b>	
	<b>Allowance for credit losses</b>	<b>\$50</b>

- b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of \$55 less the carrying amount of \$90 equals \$35 unrealized loss).

	<b>Unrealized loss – other comprehensive income</b>	<b>\$35</b>
	<b>Preferred stock investment</b>	<b>\$35</b>

In 20X5, the total profit-and-loss charge is \$50 (from the loan). Other comprehensive income is debited \$35 for the preferred stock investment. The carrying amount for the total combined investment in Investee is reduced to \$100 (\$0 for the common stock investment, \$45 for the loan, and \$55 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$35. The adjusted basis of the total combined investment in Investee is reduced to \$65 (\$0 for the common stock investment, \$45 for the loan, and \$20 for the preferred stock investment).

In 20X6, there is no equity method income or loss ( $40\% \times \$0 = \$0$ ). Investor would make both of the following entries in 20X6:

- a. In accordance with Subtopic 326-20, adjust the allowance for credit losses on the loan.

<b>Allowance for credit losses</b>	<b>\$50</b>	
		<b>\$50</b>
<b>Credit loss expense</b>		<b>\$50</b>

- b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of \$90 less the carrying amount of \$55 equals \$35 unrealized gain).

<b>Preferred stock investment</b>	<b>\$35</b>	
		<b>\$35</b>
<b>Unrealized gain – other comprehensive income</b>		<b>\$35</b>

In 20X6, the total profit-and-loss credit is \$50 (from the loan). Other comprehensive income is credited \$35 for the preferred stock investment. The carrying amount of the total combined investment in Investee is increased to \$185 (\$0 for the common stock investment, \$95 for the loan, and \$90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of \$70. The adjusted basis of the total combined investment in Investee is increased to \$115 (\$0 for the common stock investment, \$95 for the loan, and \$20 for the preferred stock investment).

Investor would make all of the following entries in 20X7:

- a. Record the sale of the preferred stock.

<b>Cash</b>	<b>\$90</b>	
		<b>\$90</b>
<b>Other comprehensive income</b>	<b>\$70</b>	
		<b>\$70</b>
<b>Preferred stock investment</b>		<b>\$90</b>
<b>Gain on sale of security</b>		<b>\$70</b>

- b. In accordance with this subtopic, record the equity method income ( $40\% \times \$1,000 = \$400$ ). Although Investor has recorded losses for all prior Investee losses, \$80 of such recorded losses (representing the difference between the cost basis of the preferred stock investment of \$100 and its adjusted basis of \$20) have effectively been reversed by the above entry by recording a \$70 gain on the sale of the preferred stock when an actual loss of \$10 (representing the difference between the cost basis of the preferred stock investment of \$100 and the proceeds of \$90) was incurred. Accordingly, only \$320 of equity method income should be recorded ( $\$400 - \$80$ ).

<b>Investment in investee (common)</b>	<b>\$320</b>	
		<b>\$320</b>
<b>Equity method income</b>		<b>\$320</b>

- c. In accordance with Subtopic 326-20, adjust the allowance for credit losses on the loan.

<b>Allowance for credit losses</b>	<b>\$5</b>	
		<b>\$5</b>
<b>Credit loss expense</b>		<b>\$5</b>

In 20X7, the total profit-and-loss credit is \$395 (\$70 gain from the sale of the preferred stock, \$320 for the equity method income, and \$5 from the loan). The carrying value of the total combined investment in Investee is increased to \$420 (\$320 for the common stock investment and \$100 for the loan), and the balance in accumulated other comprehensive income is \$0. The adjusted basis of the total combined investment in Investee is increased to \$420 (\$320 for the common stock investment, \$100 for the loan, and \$0 for the preferred stock investment).

### 3.4 Reassessment of classification and accounting for transfers

The appropriateness of the classification of securities should be reassessed at each reporting date in accordance with the guidance beginning in ASC 320-10-35-5. For example, securities should no longer be classified as HTM if the entity no longer has the ability to hold them to maturity. Transfers of securities between categories of investments are accounted for at fair value as of the transfer date, but the accounting treatment of the unrealized holding gains or losses and the related income tax effects on any temporary differences are dependent on the category into which the security is transferred.

#### 3.4.1 Transfers from or into trading category

ASC 320-10-35-10 outlines the accounting for transfers of debt securities from or into the trading category, noting that the transfers should occur at fair value. If a security is transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and should not be reversed. If a security is transferred into the trading category, any unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings is recognized.



#### ASC 320-10-45-7

This Subtopic does not specify the income statement classification of gains and losses for transfers involving trading securities. However, gains and losses that have accumulated before the transfer shall be classified consistently with realized gains and losses for the category from which the security is being transferred, not the category into which the security is being transferred.

Given the nature of trading securities, transfers into or from the trading category should be rare. SEC staff member John M. James provided his viewpoints on this matter in a speech he gave at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. The SEC staff does not view transferring securities due to changes in investment strategies, achieving accounting results more closely matching economic hedging activities or repositioning the portfolio due to anticipated changes in the economic outlook as consistent with the notion of *rare* as they represent factors that are frequently present. While *rare* does not mean *never*, it is viewed as a very high threshold. Examples of potential circumstances in which it may be acceptable to transfer securities between the trading and AFS categories include transfers due to a change in statutory or regulatory requirements and a significant business combination or other event that greatly alters the entity's liquidity position or investing strategy. Other facts and circumstances might also exist that would make such transfers acceptable, but those facts and circumstances would need to clearly indicate that the event is unusual and highly unlikely to recur in the near term.

**3Q.4.1.1: *If an entity decides to sell a security that has been classified as available-for-sale, should it be transferred to trading?***

No. According to ASC 320-10-35-13, available-for-sale securities should not be automatically transferred to the trading category due to the passage of time that has caused the maturity date to be within one year or because management intends to sell the security within one year.

#### 3.4.2 Transfers from HTM to AFS

If an entity no longer has the ability to hold securities to maturity, their continued classification as HTM would not be appropriate. However, the expectation is that management's intent should not change, and it would be inappropriate to automatically transfer securities to the trading or AFS category because of a change in intent to sell. ASC 320-10-35-8 makes clear that a sale or transfer of a security classified as HTM that occurs for a reason other than those specified in ASC 320-10-25-6, 320-10-25-9, or 320-10-25-14, calls into question (taints) the entity's intent about all securities that remain in the HTM category.

Section 3.3.3.3 lists those circumstances involving sales or transfers of HTM securities that do not call into question an entity's intent to hold other securities to maturity. Pursuant to ASC 320-10-35-9, when a sale or transfer of HTM securities represents a material contradiction of an entity's stated intent to hold those securities to maturity, or when a pattern of such sales has occurred, any remaining HTM securities are required to be reclassified to AFS, and the entity is precluded from classifying investments as HTM until it can demonstrate that circumstances have changed such that management can assert with a greater degree of credibility that it has the intent and ability to hold debt securities to maturity. The SEC staff have indicated this could be up to a two-year period.

### 3.4.2.1 Accounting for transfers between categories

ASC 320-10-35-10A requires the following accounting for transfers of debt securities from the HTM category to the AFS category on the date the security is reclassified:

- Reverse through earnings any allowance for credit losses previously recorded on the HTM security,
- Carry over the security's amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses) to the AFS category,
- Determine if an allowance for credit losses is necessary in accordance with ASC 326-30,
- Report in OCI any unrealized gain or loss on the AFS security, excluding the amount recorded in the allowance for credit losses recognized in accordance with ASC 326-30, and
- Consider whether the transfer of the security from the HTM category to the AFS category calls into question the entity's intent and ability to hold securities that remain in the HTM category to maturity in accordance with ASC 320-10-35-8 through 35-9.

ASC 320-10-45-8B requires any allowance amounts reversed or established upon the transfer to be presented gross in the income statement or in the notes to the financial statements.

The security's amortized cost basis that carries over to the AFS category is used for all of the following purposes:

- The subsequent amortization of the historical premium or discount,
- The comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses under ASC 320-10-35-1(b), and
- The required disclosures of amortized cost.

Chapter 4 addresses the accounting guidance for determining allowances for credit losses in accordance with ASC 326-30. The following example illustrates the accounting for transfers of securities from HTM to AFS.



#### Example 3-2: Transfer of security from HTM to AFS

On January 1, 20X0, Bank Corp acquires a newly issued municipal revenue bond with a face value of \$80,000 at par and classifies the investment as HTM. In accordance with ASC 326-20, Bank Corp records an allowance for credit losses of \$2,000.

In 20X2, a significant increase in regulatory risk weights for municipal revenue bonds cause Bank Corp management to change its intent to hold its investment in a municipal revenue bond debt security until the bond's maturity.<sup>1</sup> Therefore, the decision is made to transfer the security to AFS. On June 30, 20X2 (the date of the transfer), the fair value of the security is \$75,000 and the amortized cost basis is unchanged at \$80,000. In accordance with ASC 326-30, Bank Corp determines that only \$1,500 of the total unrealized loss of \$5,000 is due to credit.<sup>2</sup> For simplicity, accrued interest and income taxes are ignored in this

example. In accordance with ASC 320-10-35-10A, Bank Corp records the following journal entries related to the transfer:

<b>Dr. AFS security</b>	<b>\$80,000</b>	
	<b>Cr. HTM security</b>	<b>\$80,000</b>

**Note:** To carry over the amortized cost basis of the security to the AFS category.

<b>Dr. Allowance for credit losses</b>	<b>\$2,000</b>	
	<b>Cr. Credit loss expense</b>	<b>\$2,000</b>

**Note:** To reverse through earnings the allowance for credit losses previously recognized on the HTM security in accordance with ASC 326-20.

<b>Dr. Credit loss expense</b>	<b>\$1,500</b>	
	<b>Cr. Allowance for credit losses</b>	<b>\$1,500</b>

**Note:** To record the allowance for credit losses determined in accordance with ASC 326-30.

<b>Dr. OCI – AFS security unrealized loss</b>	<b>\$3,500</b>	
	<b>Cr. AFS security – unrealized loss adjustment</b>	<b>\$3,500</b>

**Note:** To report in OCI the unrealized loss on the AFS security attributed to non-credit related factors, excluding the amount recorded in the allowance for credit losses recognized in accordance with ASC 326-30.

**Footnotes:**

<sup>1</sup> Bank Corp's change in intent to hold the security to maturity does not call into question its intent to hold other debt securities to maturity in the future. That's because ASC 320-10-25-6(f) makes clear that sales or transfers of HTM securities following a significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes is not considered inconsistent with its original classification.

<sup>2</sup> For simplicity, this example assumes that Bank Corp (a) has not decided to sell the security and (b) more likely than not, would not be required to sell the security before recovery of its amortized cost basis.

### 3.4.3 Transfers from AFS to HTM

ASC 320-10-35-10B addresses the transfer of debt securities from the AFS category to the HTM category and requires the following accounting on the date the security is transferred:

- Reverse in earnings any allowance for credit losses previously recorded on the AFS security,
- Transfer the security to the HTM category at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowances for credit losses) plus or minus the amount of any remaining unrealized holding gain or loss (i.e., the fair value adjustment),
- Evaluate the security for an allowance for credit losses by following the guidance in ASC 326-20, and
- Continue to report the unrealized holding gain or loss at the time of the transfer in a separate component of accumulated other comprehensive income, but amortize that balance over the remaining life of the security as a yield adjustment in a manner consistent with the amortization of any premium or discount in accordance with ASC 310-20. The amortization of this unrealized holding gain or loss reported in accumulated other comprehensive income will offset the effect on interest income of the amortization of the premium or discount included in the amortized cost basis for that HTM

security attributable to the fair value adjustment that was created upon the transfer described in the second bullet above.

Refer to Section 5.4 for additional discussion of the amortization of premiums and discounts. Chapter 6 addresses the accounting guidance for determining allowances for credit losses in accordance with ASC 326-20.



**Example 3-3: Transfer of security from AFS to HTM (Example 4 from ASC 320-10-55-24 and 55-25)**

The following example (Example 4 from ASC 320-10-55-24 and 55-25) illustrates the accounting for the transfer of a debt security from the AFS category to HTM. For simplicity the example ignores any allowances for credit losses (which could be the case if the security represents sovereign debt (e.g., U.S. Treasury securities) whereby the potential default is greater than zero, but the expected nonpayment upon default is zero). At the date of transfer (1/1/X2), the amortized cost basis of the security in the HTM category is \$120 determined as follows:

Security's par value	\$100
Unamortized purchase premium	5
Unrealized holding gain	<u>15</u>
Beginning amortized cost basis of HTM security	<u>\$120</u>

The \$20 premium between the security's par value (\$100) and the new amortized cost basis at the date of transfer (\$120), as well as the amount of unrealized holding gain remaining in OCI (\$15), should be amortized over the remaining five years to the security's maturity date in accordance with ASC 310-20. However, for simplicity the amortization in the example is computed on a straight-line basis.



	Amortized Cost			Fair Value	Unrealized Holding Gain in Other Comprehensive Income (Amortization)	Deferred Tax Adjustment in Other Comprehensive Income @ 30% <sup>(a)</sup> Credit (Debit)	Unrealized Holding Gain, Net of Tax, in Other Comprehensive Income Credit (Debit)	Cumulative Effect on Interest Income Credit (Debit)
	Par	Premium (Amortization)	Total					
	1/1/X1	100	6					
19X1		(1)	(1)	(1)				(1)
12/31/X1	100	5	105	120	15	(4.5)	10.5	(1)
1/1/X2	100	20	120	120	15	(4.5)	10.5	
19X2		(4)	(4)		(3)	0.9	(2.1)	(1)
12/31/X2	100	16	116	119	12	(3.6)	8.4	(2)
19X3		(4)	(4)		(3)	0.9	(2.1)	(1)
12/31/X3	100	12	112	114	9	(2.7)	6.3	(3)
19X4		(4)	(4)		(3)	0.9	(2.1)	(1)
12/31/X4	100	8	108	107	6	(1.8)	4.2	(4)
19X5		(4)	(4)		(3)	0.9	(2.1)	(1)
12/31/X5	100	4	104	102	3	(0.9)	2.1	(5)
19X6		(4)	(4)		(3)	0.9	(2)	(1)
12/31/X6	(100)		(100)	100				
12/31/X6	-	-	-		-	-	-	(6)

(a) The offsetting accounting entry would be to record or adjust a deferred tax liability.

For illustrative purposes, amortization of the premium and the unrealized holding gain was computed on a straight-line basis. Premiums and discounts on debt securities should be amortized pursuant to Subtopic 310-20. Paragraph 320-10-35-10B requires that the unrealized holding gain or loss at the date of transfer be amortized in a manner consistent with any premium or discount. The Cumulative Effect on Interest Income column represents the difference between the amortization of the premium and the unrealized holding gain over the life of the security and does not reflect any coupon interest received.

### 3.5 Income statement considerations

#### 3.5.1 Treatment of commissions and other fees

Fees incurred to purchase a debt security are generally considered part of the cost basis for AFS and HTM securities. Fees on trading securities affect the income statement as the security is adjusted to fair value. In other words, some entities expense the commissions and other fees as incurred and report such costs in an income statement line item separate from unrealized gains and losses attributed to changes in the fair value of the securities. Others include such costs as part of the investments' cost basis (i.e., they capitalize the costs) upon initial recognition before adjusting the value of the trading securities to fair value (i.e., before applying fair value accounting). As a result, even if there has been no price movement since the acquisition of the investment classified as trading, the entity would immediately recognize an

unrealized loss on day one equal to the value of the capitalized commissions and other fees. Regardless of the approach applied by the entity, the timing for recognizing the income statement impact is the same, but the presentation is different. If significant, the entities policy should be disclosed and consistently applied.

### 3.5.2 Interest income recognition

Interest income on debt securities, including the amortization and accretion of any premiums or discounts on securities classified as AFS or HTM, is addressed in ASC 310-20 and requires the use of the interest method, which entails determining the effective yield of the investment and applying that yield to the net investment balance at each period to determine the interest (inclusive of discounts and premiums) to be recognized for the period. (Refer to Section 5.4 for additional information on the application of the interest method.)

Purchase discounts are amortized to the debt security's maturity, even if the security can be called (repaid) by the issuer at an earlier date. ASC 310-20-35-33 provides guidance for amortizing premiums<sup>10</sup> on debt securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates at prices less than the amortized cost basis of the security.



#### ASC 310-20-35-33

For each reporting period, to the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the next call date, the excess (that is, the premium) shall be amortized to the next call date, unless the guidance in paragraph 310-20-35-26 is applied to consider estimated prepayments. For purposes of this guidance, the next call date is the first date when a call option at a specified price becomes exercisable. Once that date has passed, the next call date is when the next call option at a specified price becomes exercisable, if applicable. If there is no remaining premium or if there are no further call dates, the entity shall reset the effective yield using the payment terms of the debt security. Securities within the scope of this paragraph are those that have explicit, noncontingent call options that are callable at fixed prices and on preset dates at prices less than the amortized cost basis of the security. Whether a security is subject to this paragraph may change depending on the amortized cost basis of the security and the terms of the next call option.



#### Spotlight: Application of ASC 310-20-35-33

ASU 2020-08 clarified that an entity should reevaluate whether a callable debt security is within the scope of ASC 310-20-35-33 each reporting period. In other words, the conclusion about whether a callable debt security is subject to this guidance can change from one period to the next. The ASU also clarifies that the next call date is the first date when a call option at a specified price becomes exercisable. When that date has passed, the next call date is when the next call option at a specified price becomes exercisable, if applicable.

<sup>10</sup> ASC 310-20-35-33 defines a premium as the amount by which the amortized cost basis of the security exceeds the amount repayable at the earliest (next) call date.

**Example 3-4: An illustration of the application of ASC 310-20-35-33**

On January 1, 2021, an entity purchases callable bonds with a par value of \$5,000 for \$5,030. The bonds have a stated maturity date of December 31, 2030, and are callable at \$5,016 on or after December 31, 2023, and at \$5,010 on or after December 31, 2025.

To calculate the effective yield of the bonds, the entity determines it must consider the guidance in ASC 310-20-35-33 because the bonds have explicit, noncontingent call features that are callable at fixed prices (\$5,016 and \$5,010) and on preset dates (on or after December 31, 2023 and 2025, respectively). In accordance with that guidance, at each reporting date the entity must determine whether the amortized cost basis of the bonds exceeds the amount repayable by the issuer at the next call date and if so, amortize that excess amount (i.e., the premium) to the next call date because the guidance in ASC 310-20-35-26 was not applied to estimate prepayments.

In this example, the first call date is December 31, 2023, because it's the first date the issuer can call the bonds at the specified price of \$5,016, and because the initial cost basis of the securities (\$5,030) exceeds the call price on that date, the excess amount (\$14) will need to be amortized over the three-year period beginning from the acquisition date (January 1, 2021) to that call date. If the issuer does not exercise the first call option, the effective yield is reset prospectively, and the entity will need to reevaluate whether the bonds remain within the scope of ASC 310-20-35-33. In this example, the bonds continue to be subject to this guidance because the next call date (December 31, 2025) allows the issuer to repay the bonds at a price of \$5,010, which is less than the remaining \$5,016 amortized cost basis of the securities on the reassessment date of January 1, 2024. As a result, the excess amount (\$6) will need to be amortized over the next two years ending December 31, 2025. If the bonds are not called on the second call date, the effective yield will again be reset prospectively, and the entity will amortize the \$10 of remaining cost basis in excess of the bonds' par value over the remaining five years to the bonds' maturity.

Premium and discount recognition is not relevant for trading securities given that they are accounted for at fair value with changes in fair value reported through earnings. The guidance beginning in ASC 310-20-35-18 and discussed in Chapter 5 addresses application of the interest method in special circumstances, including when an instrument's stated interest rate increases or decreases during its term or is variable.

For debt securities that are considered to be PCD assets as explained at Section 4.1.7 for AFS securities and at Section 6.12 for HTM securities, ASC 310-10-35-53 indicates that income recognition is dependent on having a reasonable expectation about the amount expected to be collected. In certain circumstances, it is appropriate to place debt securities on nonaccrual status and use the cost recovery or cash basis method of income recognition.

### 3.5.2.1 Beneficial interest in securitized financial assets

ASC 325-40 provides income recognition guidance for beneficial interests in securitized financial assets that are: (a) either debt securities or are required to be accounted for like debt securities in accordance with ASC 860-20-35-2 and (b) have contractual cash flows (e.g., loans, receivables, debt securities and guaranteed lease residuals, among other items). As defined in the Master Glossary of the ASC, beneficial interests are:

Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

- a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
- b. Premiums due to guarantors
- c. Commercial paper obligations
- d. Residual interests, whether in the form of debt or equity.

Common examples of beneficial interests include mortgage and other asset-backed securities. This guidance does not apply to securitized financial assets, such as equity securities, that do not involve contractual cash flows. Additionally, it does not apply to instruments that are both high credit quality and cannot contractually be prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment. (High credit quality for this purpose is generally interpreted as securities with credit ratings of AA or better, based in part on views expressed by the SEC staff.)

For those beneficial interests within the scope of ASC 325-40, in determining the amount of income to be recognized, it is first necessary to determine the accretable yield. For beneficial interests that are not PCD assets as described in Section 4.1.7 for AFS securities and in Section 6.12 for HTM securities, the initial accretable yield is measured as the excess of all cash flows attributable to the beneficial interest that are expected to be collected over the initial investment. For those beneficial interests that are determined to be PCD assets, the initial accretable yield is measured as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition date over the amortized cost basis, which is the purchase price plus the initial allowance for credit losses.

The accretable yield is recognized as interest income over the life of the beneficial interest using the effective yield method. The estimate of expected cash flows should continue to be updated over the life of the beneficial interest. The present value of the remaining cash flows expected to be collected at the initial recognition date (or at the last date it was previously revised) should be compared to the present value of the cash flows expected to be collected at the current financial reporting date to determine the change in expected cash flows. Cash flows for this purpose should be discounted at the current rate used to accrete the beneficial interest. Once the change in expected cash flows is determined, consideration should first be given to the guidance in Chapter 6 for HTM securities and Chapter 4 for AFS securities to determine the impact attributable to credit losses.

To the extent the change in expected cash flows is not reflected as an increase or decrease in the allowance for credit losses, the accretable yield should be recalculated as the excess of cash flows expected to be collected over the beneficial interest's reference amount. (The reference amount is defined as the initial investment, including the initial allowance for a PCD asset, less both cash received to date and writeoffs of amortized cost basis, plus the yield accreted to date.) The cost recovery method should be used when beneficial interests are placed on nonaccrual status or when cash flows cannot be reliably estimated.

### 3.5.2.2 Income recognition for certain structured notes

ASC 320-10-35 requires the use of the retrospective interest method for income recognition on certain structured notes. A structured note is defined as a debt instrument with cash flows that are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates or other market variables. The notes typically contain embedded forward or option components, such as caps, calls and floors, and contractual cash flows that vary based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes. Various types of structured notes are described in ASC 320-10-55-10. Use of the retrospective interest method is required for structured notes classified as either AFS or HTM that meet any of the following conditions:

- Either the contractual principal amount of the note or its original investment is at risk for other than failure of the borrower to pay the contractual amounts due. For example, this may be the case if the amount that is required to be repaid is based on an equity or other index or the occurrence of certain events or circumstances.
- The note's return on investment is subject to variability (other than due to credit rating changes of the borrower) because of either of the following:
  - There is no stated coupon rate or the stated coupon rate is not fixed or specified, and the variation in the return on investment or coupon rate is not a constant percentage of, or in the same direction as, changes in market-based interest rates or an interest rate index (e.g., LIBOR).
  - The variable or fixed coupon rate is below market rates of interest for traditional notes of comparable maturity, and a portion of the potential yield (including upside potential for principal) is based on the occurrence of future events or circumstances. (Examples of instruments that meet this condition include inverse floating-rate notes, dual-index floating notes and equity-linked bear notes.)
- The contractual maturity of the bond is based on a specific index or on the occurrence of specific events or circumstances outside the control of the parties to the transaction (excluding the passage of time or events that result in normal covenant violations). Examples of instruments that meet this condition include index-amortizing notes and notes that base contractual maturity on the price of oil.

According to ASC 320-10-35-38, the use of the retrospective method does not apply to the following instruments:

- Mortgage loans or other similar debt instruments that do not meet the definition of a security
- Traditional convertible bonds that are convertible into the stock of the issuer
- Multicurrency debt securities
- Debt securities classified as trading
- Debt securities participating directly in the results of an issuer's operations (e.g., participating mortgages or similar instruments)
- Reverse mortgages
- Structured note securities that, by their terms, suggest that it is reasonably possible that the entity could lose all or substantially all of its original investment amount (for other than failure of the borrower to pay the contractual amounts due). Such securities are required to be subsequently measured at fair value with all changes in fair value reported in earnings.

In applying the retrospective interest method, the income recognized for a reporting period is measured as the difference between the amortized cost of the security at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period. The amortized cost is

calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimated future cash flow streams to the initial investment. When estimating future cash flows to determine the effective yield, quoted forward market rates or prices in active markets should be used when available. When not available, future cash flows should be estimated using current spot rates or prices. If the effective yield is negative (i.e., the sum of the newly estimated undiscounted cash flows is less than the security's amortized cost), the amortized cost would be calculated using a 0% effective yield.



**Example 3-5: Calculation of Income Recognized under the Retrospective Interest Method (from Example 1 in ASC 320-10-55-16 to 55-19)**

This Example illustrates the guidance in paragraphs 320-10-35-38 through 35-43. This Example has the following assumptions:

- a. The investor purchases a 3-year, \$100 par value structured note at par.
- b. The principal to be repaid at maturity is based on the performance of the Standard & Poor's S&P 500 Index, which, based on current Standard & Poor's S&P Futures indexes, is expected to provide the investor with principal of \$106 at the end of Year 3, and the coupon interest on the note is fixed at 6 percent per year.
- c. On the acquisition date of the note, the investor expects the following cash flows and income to be recognized over the life of the note.

Period	Cash Flows	Income Recognized	Noncash Income	Ending Amortized Cost
Acquisition	\$(100)			
Year 1	6	\$7.85	\$1.85	\$101.85
Year 2	6	8.00	2.00	103.85
Year 3	112	8.15	2.15	-

These cash flows produce an effective yield of 7.85 percent.

At the end of Year 1, assume the investor expects to receive only \$80 in principal at the end of Year 3, which results in a negative effective yield of 0.71 percent over the life of the note (assume that the investor concludes that a credit loss has not occurred). Accordingly, the amortized cost amount must be reduced to the present value of the estimated future cash flows using a zero percent effective yield, or \$92, at the end of Year 1. The income recognized in Year 1 is negative \$2 (the amortized cost amount at the end of Year 1 in the table below of \$92 less the amortized cost amount at the beginning of the year of \$100 plus cash received during the year of \$6). The cash flow and income recognition table as of the end of Year 1 is as follows.

Period	Cash Flows	Income Recognized	Noncash Income	Negative Yield Adjustment Recognized	Ending Amortized Cost
Acquisition	\$(100)				
Year 1	6	\$7.85	\$1.85	\$(9.85)	\$92
Year 2	6	-	(6)	-	86
Year 3	86	-	(6)	-	-

These cash flows produce an effective yield of negative 0.71 percent.

At the end of Year 2, assume the S&P 500 Index market reverses and the investor now expects to receive the same cash flows that it expected upon acquisition of the note. Using the first table above, the investor would increase the amortized cost amount of the note to \$103.85 at the end of Year 2, which would result in recognizing income of \$17.85 in Year 2 (amortized cost from the first table at the end of Year 2 of \$103.85 less the amortized cost from the second table at the end of Year 1 of \$92 plus cash received in Year 2 of \$6).

The guidance in ASC 320-10-55-10 to 55-21 lists various types of structured notes, illustrates the application of the retrospective interest method and contains other guidance relevant to entities that invest in structured notes. In addition to considering the guidance in ASC 320-10 for income recognition, consideration should be given to ASC 815 as in many cases, embedded features within structured notes require separate recognition as a derivative. An entity that does not elect to measure its investment in a structured note that contains an embedded derivative at fair value with changes in fair value reported in earnings, would first need to bifurcate the embedded derivative before determining the interest income to be recognized in subsequent periods in accordance with the guidance beginning in ASC 320-10-35-40.

Refer to ASC 320-10-25-19 and 25-20 for accounting considerations related to structured transactions.

### 3.5.3 Accounting for sales of securities

Entities can generally make an accounting policy election to account for sales (and purchases) of securities on either the trade date or settlement date. Trade date accounting is required for brokers and dealers, investment companies and depository and lending institutions, as well as certain benefit plans.

Given that trading securities are accounted for at fair value with changes in fair value reported in earnings, the sale of a trading security does not necessarily give rise to a gain or loss. Generally, a debit to cash (or trade date receivable) is recorded for the sales proceeds, and a credit is recorded to remove the security at its fair value (or sales price). If the entity is not taxed on the changes in fair value, the deferred tax accounts would be adjusted. Some adjustment to this procedure will be necessary for entities that have not yet recorded the security's change in fair value up to the point of sale (e.g., because fair value changes are recorded at the end of each day).

Although entities have different bookkeeping methods for AFS securities, generally, a sale of an AFS security is recorded by a debit to cash (or trade date receivable) for the sales proceeds, and a credit to remove the security at its fair value (or sales price). The amount recorded in OCI, representing the unrealized gain or loss at the date of sale, is reversed into earnings, and the deferred tax accounts are adjusted. Some adjustment to this procedure will be necessary for entities that have not yet recorded the security's change in fair value up to the point of sale (e.g., because fair value changes are recorded at the end of each interim period) or when write-downs have been recognized. ASC 860-10-40 provides relevant guidance for determining if a transfer of securities should be accounted for as a sale or a secured borrowing.

#### 3.5.3.1 Short sale of debt securities

Sales of debt securities that the seller does not own at the time of sale are obligations to deliver securities, not investments (Refer to ASC 320-10-55-6). ASC 815-10-55-57 provides guidance for evaluating whether a short sale transaction involves a derivative instrument that should be recorded at fair value with changes in value reported through earnings as they occur. Short sale obligations are specifically addressed in the guidance for certain industries, such as ASC 940-320-35-1 with respect to broker-dealers and ASC 942-405-25-1 with respect to depository institutions.

### 3.5.4 Hedge accounting

ASC 815 prohibits hedge accounting if the hedged item is remeasured (or will be remeasured subsequent to acquisition) to fair value with changes in fair value attributed to the hedged risk reported in earnings. Accordingly, entities cannot use fair value and cash flow hedge accounting for securities classified as trading, and they are not permitted to use cash flow hedge accounting for forecasted acquisitions of securities that will be classified as trading upon acquisition. As discussed further in ASC 320-10-35-1, if an AFS security is designated as a hedged item in a fair value hedge, the changes in fair value of the security attributable to the hedged risk are reflected in net income, rather than OCI, while hedge accounting is applied. The changes in fair value of the AFS security attributable to other risks not being hedged continue to be reflected in OCI. By contrast, the entire change in fair value of an AFS security that is designated as a hedged item in a cash flow hedge is reflected in OCI, similar to AFS securities that are not designated in a hedge as the application of cash flow hedge accounting does not impact the carrying amount of the hedged item.

ASC 815 prohibits hedges of interest rate risk for HTM securities. However, a HTM security can be hedged for credit risk or foreign currency risk in a fair value hedge. In these cases, the carrying value of the HTM security is adjusted through earnings for changes in its fair value attributable solely to the eligible risk being designated as hedged.



## 4. Recognition of credit losses on AFS debt securities

### Summary of key changes

The debt securities impairment guidance contained within ASC 320-10-35 was superseded with the issuance of ASU 2016-13. ASC 326-30 was created to address the measurement of credit losses on AFS debt securities, which is the focus of this chapter and should be applied upon the adoption of ASU 2016-13.

The following chart highlights the most significant differences between legacy guidance and ASC 326-30.

ASC 320-10-35 (legacy guidance)	ASC 326-30
<p>Debt securities were required to be evaluated individually to determine if impairment should be recognized. If the fair value of an individual security was less than amortized cost basis as of the reporting date, it was considered impaired. Impairment was recognized through a direct write-down to the amortized cost basis of the security if the impairment was deemed to be other than temporary. If the entity did not intend to sell the security, and it was more likely than not that it would not be required to sell the security before recovering its amortized cost basis, only the impairment associated with credit loss was recognized in earnings, with the amount related to all other factors recognized in OCI.</p>	<p>AFS debt securities continue to be evaluated individually, with credit impairment recognized through an allowance rather than a direct write-down to the amortized cost basis of the security, unless the intent or more-likely-than-not requirement to sell exists. The allowance is limited to the excess of the security's amortized cost basis over its fair value at the reporting date. In determining if a credit loss exists, consideration should no longer be given to the length of time the security has been impaired or to recoveries or additional declines in the fair value after the balance-sheet date (Refer to paragraph BC82 of ASU 2016-13). The concept of <i>other than temporary</i> is no longer relevant, and the expectation is that the recognition of losses will be accelerated.</p>
<p>Changes in interest rates on variable-rate securities could not be projected when estimating expected cash flows, or when determining the effective interest rate to use in discounting those cash flows, to quantify expected credit losses.</p> <p>The effective rate to use in discounting expected cash flows could not be adjusted for expected prepayments.</p>	<p>Changes in interest rates on variable-rate securities are permitted (but not required) to be projected when estimating expected cash flows, and determining the effective interest rate to use in discounting those cash flows, to quantify expected credit losses. If changes in interest rates are projected when estimating future cash flows, the effective rate should also be adjusted to consider the impact of expected prepayments on cash flows.</p> <p>The effective rate used in discounting expected cash flows to quantify expected credit losses may be adjusted to consider the impact of expected prepayments through an accounting policy election.</p>
<p>For debt securities for which other-than-temporary impairment was recognized, subsequent increases in expected cash flows were recognized on a prospective basis as interest income.</p>	<p>Both subsequent increases and decreases in expected cash flows are reflected in net income immediately through a reduction or increase in credit loss expense.</p>

No impairment or allowance was recognized upon purchasing a security. For debt securities acquired with deteriorated credit quality, contractual cash flows not expected to be collected were accounted for as a nonaccretable difference (rather than an allowance). While impairment that occurred subsequent to the acquisition was recognized as incurred if other than temporary, increases in expected cash flows were accreted into interest income over the security's remaining life.

If at the time of purchase, a security has experienced a more-than-insignificant deterioration in credit quality since its origination, an allowance for expected credit losses is recognized through an increase to the security's initial carrying amount. Both subsequent increases and decreases in expected cash flows are reflected in net income immediately through a reduction or increase in credit loss expense.

**4Q.1: Why does ASC 326-30 contain a credit loss model for AFS debt securities that is different than the credit loss model in ASC 326-20 for financing receivables, HTM securities and certain other instruments?**

The Current Expected Credit Losses (CECL) model in ASC 326-20 is designed to measure expected credit losses over the contractual life of financial assets that are intended to be held to maturity, such as loans not held for sale or HTM debt securities, which is not appropriate for AFS debt securities that are not held solely for the collection of contractual cash flows. Although the CECL model in ASC 326-30 also requires lifetime losses to be reflected in earnings, the FASB ultimately decided to create a different CECL model for AFS debt securities for the following reasons:

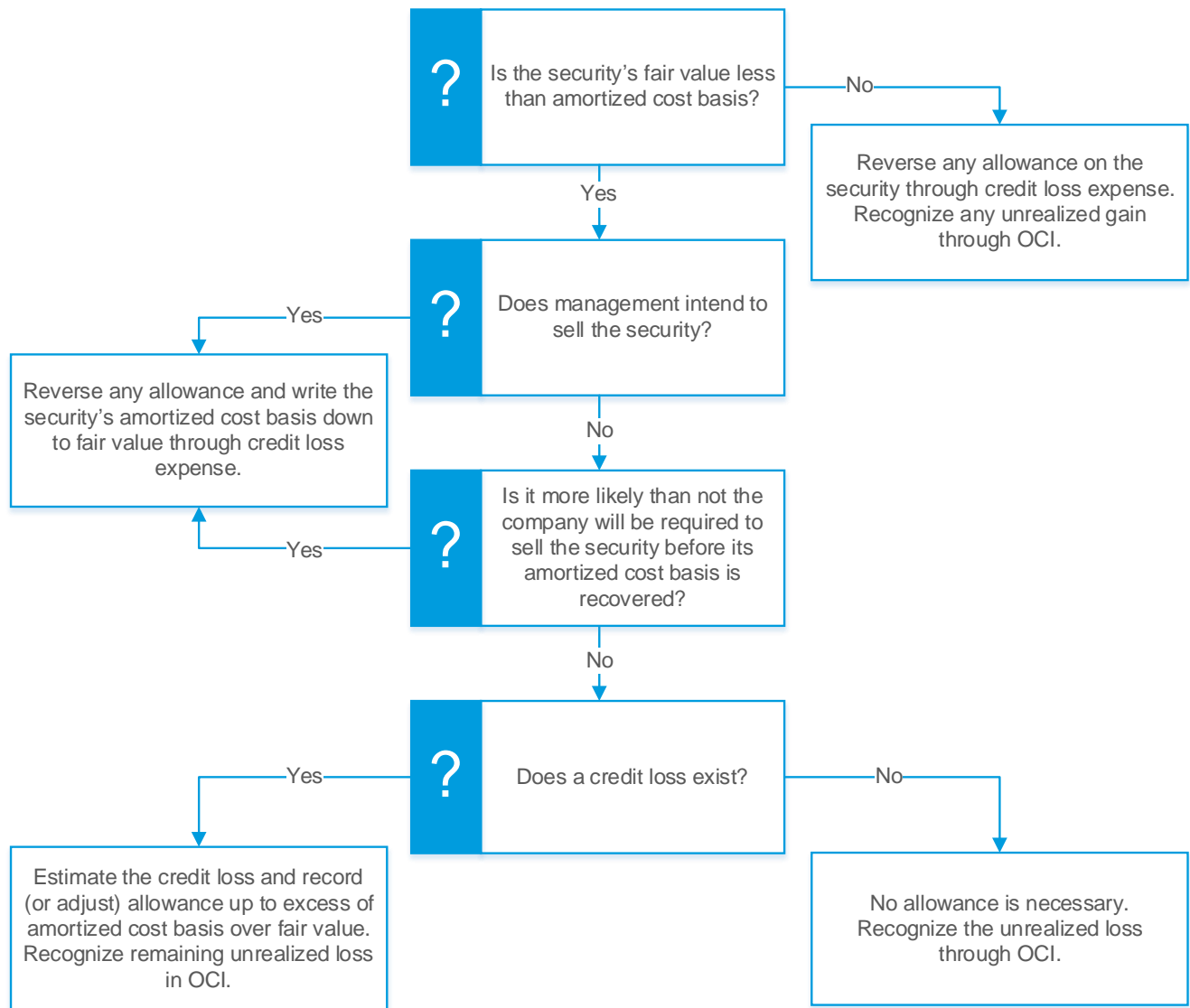
- The measurement attribute for AFS debt securities is different, which necessitates a separate credit loss model because an entity may realize the total value of the securities either through collection of contractual cash flows or through sales of the securities.
- The unit of account for AFS debt securities is defined as an individual security, which means the collective evaluation prescribed in ASC 326-20 is not an acceptable approach for determining credit losses for these assets.
- The amount of credit losses that will be realized for AFS debt securities is limited to the amount that fair value is less than amortized cost because an entity can sell its investment at fair value to avoid realization of credit losses.

#### 4.1 Overview and process for identifying, recognizing and measuring impairment

This chapter applies solely to AFS debt securities (including other financial assets (e.g., loans) measured like investments in debt securities classified as AFS pursuant to ASC 860-20-35-2 that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment) and to all entities that hold such securities.

ASC 326-30-35 and the implementation guidance in ASC 326-30-55 contain the relevant accounting guidance to be followed in identifying, recognizing and measuring impairment on AFS debt securities. A security is deemed to be impaired at a given reporting date if the fair value of the security is less than its amortized cost basis. Any impairment attributable to factors other than credit is recorded through OCI, net of applicable taxes. Any credit-related impairment is recorded through an allowance for credit losses on the balance sheet and a corresponding credit loss expense on the income statement. Impairment is also recognized in the income statement (rather than through OCI) if (1) management intends to sell the security or (2) it is more likely than not that the security will be required to be sold before its amortized cost basis is recovered.

The accounting analysis under ASC 326-30 is rather involved and the flowchart that follows outlines one approach that may be followed when navigating through that guidance. Supplemental discussion follows the flowchart.



#### 4.1.1 Is the security's fair value less than its amortized cost basis?

ASC 326-30-35-4 requires that AFS debt securities be assessed for impairment at the individual security level. Debt securities with the same Committee on Uniform Security Identification Procedures number can be aggregated on an average cost basis if that is the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses. Providing a general allowance for an unidentified impairment in a portfolio of AFS debt securities is not appropriate.

A security is deemed to be impaired at a given reporting date if the fair value of the security is less than its amortized cost (i.e., the security is in an unrealized loss position). Among other things, ASC 326-30-35-5 prohibits an entity from considering the offsetting or mitigating effects of freestanding contracts that

provide credit enhancements or market value guarantees when determining whether a security is impaired. Further analysis is necessary to determine if and to what extent impairment should be recognized in the income statement rather than through OCI. With the issuance of ASU 2022-01, any basis adjustments to securities that arose from an existing portfolio layer method hedge (as described in ASU 815-20-25-12A) should not be considered in the impairment assessment. Given that ASC 326-30-35-3 limits the allowance for credit losses on securities to the amount by which fair value is less than amortized cost, any allowance on a security that is not in an unrealized loss position at the balance-sheet date must be reversed through credit loss expense. The security's carrying amount would then be adjusted to fair value (i.e., to reflect the unrealized holding gain) with a corresponding adjustment recorded in OCI.

#### 4.1.2 Does management intend to sell the security?

In determining whether management intends to sell the security, keep in mind that intent to sell a security should not be equated with the possibility that an entity may sell a security. In ASC 326-30-35-10, intent to sell is equated with a decision to sell a security. In other words, generally an intent to sell would not be present until specific securities have been identified to sell. Given that recognition of impairment losses in the income statement hinges partially on management's intent to sell, which is not observable, it is important for management to contemporaneously document when and why decisions are made to sell specific securities. If, as of the balance-sheet date, management intends to sell an impaired security, the security's amortized cost basis should be written down to fair value, after writing off any allowance for credit losses on that security. Any incremental impairment is recognized in earnings.



#### Example 4-1: Recognition of impairment through earnings when an entity has decided to sell its investment

On December 31, 20X0, management of XYZ Corp decides it will sell its entire position in a corporate bond classified as AFS for \$700,000 (the fair value at that date) to raise the funds necessary to make capital improvements to its factory. The security's par amount is \$1,000,000. At September 30, 20X0, fair value of the security was \$800,000, the related allowance for credit losses was \$150,000 and the unrealized loss recorded in OCI totaled \$50,000.

Assuming XYZ Corp sells the security on January 2, 20X1 (the next business day following the entity's decision to sell), the following journal entries would be recorded at December 31, 20X0, assuming that the incremental impairment in the security's value since September 30, 20X0 was not related to credit:

<b>Dr. Allowance for credit losses</b>	<b>\$150,000</b>	
<b>Dr. AFS security – unrealized loss<sup>(1)</sup></b>	<b>150,000</b>	
<b>Dr. Loss on investment</b>	<b>150,000</b>	
		<b>Cr. AFS security – amortized cost basis</b>
		<b>\$300,000</b>
		<b>Cr. OCI – AFS security unrealized loss<sup>(1)</sup></b>
		<b>150,000</b>

**Note:** Journal entries to write-down the security's cost basis to its fair value and eliminate the related allowance for credit losses and unrealized loss in OCI in accordance with ASC 326-30-35-10. The loss on investment represents the impairment recognized in earnings during the current period that was not credit related.

- (1) ASC 326-30 does not specify whether a reporting entity is required to adjust the carrying value of the security to its fair value before recording the adjustments required under ASC 326-30-35-10. In this example, it is assumed that XYZ Corp adjusted the carrying value of its investment to reflect the fair value of the security at December 31, 20X0 (i.e., \$700,000, which represents an additional \$100,000 increase in unrealized holding losses) before recording the entries to reflect management's decision to sell the impaired security. If that was not the case, the

debit and credit to AFS security – unrealized loss and OCI – AFS security unrealized loss would be decreased by \$100,000, respectively, but the end results would still be the same.

#### 4.1.3 Is it more likely than not the entity will be required to sell the security before its amortized cost basis is recovered?

For those impaired securities that management does not intend to sell, an assessment needs to be performed in accordance with ASC 326-30-35-10 to determine if it is more likely than not that the security will be required to be sold before the recovery of its amortized cost basis. This assessment should be based on both positive and negative available evidence and consider factors such as cash or working capital requirements, contractual and regulatory obligations and the factors listed in ASC 326-30-55-1 to 55-2. Consideration should be given to conditions or events that could result in the need to sell the security and the likelihood of the conditions or events occurring. If, as of the balance-sheet date, it is more likely than not that the security will be required to be sold before recovery of its amortized cost basis, the security should be written down to fair value, after writing off any allowance for credit losses on that security. Any incremental impairment is recognized in earnings.

##### 4.1.3.1 Commonly asked questions related to an intent or likely requirement to sell

###### 4Q.1.3.1.1: *If an entity sells an impaired security shortly after a reporting period end, should an impairment loss be recognized in the reporting period prior to the sale?*

To answer this question, it is necessary to consider whether, as of the period end prior to the sale, any circumstances existed that would warrant recognition of an impairment loss in that period end. As such, in addition to considering if a credit loss existed at the period end (as elaborated on in Section 4.1.4), consideration needs to be given to when management made the decision to sell the security, and if the security was required to be sold, when the circumstances resulting in the need to sell arose. For this reason, it is important for management to contemporaneously document the timing of any decisions to sell securities and perform a documented assessment at each reporting period end of the circumstances that could likely require a sale and the probability of those circumstances occurring before the securities' forecasted recovery of their amortized cost bases.

Specific examples include the following:

- On March 31, 20X3, management does not intend to sell an impaired security. On April 5, 20X3, a dealer that expresses an interest in purchasing the security approaches management. The terms are attractive to management and the sale is conducted at the end of April. Assuming no likely requirement to sell existed on March 31 and no credit loss was evident, no impairment should be recognized in March.
- Management sells an impaired security in April 20X3 due to its liquidity needs. Management had not previously identified a credit loss attributable to the security nor did they have the intent to sell prior to April. Under these circumstances, consideration should be given to whether as of March 31, 20X3, or an earlier date, it was more likely than not the entity would be required to sell the security prior to recovering the amortized cost basis. The reason for the sale and close proximity to the balance-sheet date would suggest a likely requirement to sell existed at the balance-sheet date.

*4Q.1.3.1.2: If management sells an impaired security after documenting that they had no intent to sell impaired securities, does this call into question the validity of management's intent for the specific security sold or other securities?*

Generally, no. Unlike the guidance that was in place for debt securities prior to 2009, the expression of intent now relevant to AFS debt securities is not to hold an investment until it recovers or to maturity, but is rather just that as of the reporting period end, management does not have the intent to sell. We generally expect that the period of time from when the intent to sell arises (i.e., a decision to sell a specific security has been made) until the sale occurs will be relatively brief (i.e., within days) for securities that are actively traded. In contrast, for securities that are not actively traded, weeks or months may transpire between management's decision to sell and an actual sale. The longer time period in these instances is often necessary to organize a private sale of the securities.

#### **4.1.4 Does a credit loss exist?**

ASC 326-30-55-1 provides the following list of factors (which is not intended to be an all-inclusive list) that should be considered in determining whether a credit loss exists on AFS debt securities:

- The extent to which the fair value is less than the amortized cost basis
- Adverse conditions specifically related to the security (including the issuer's or underlying obligor's financial condition, collateral, etc.), an industry or geographic area
- The payment structure of the security and the likelihood of the issuer being able to make payments that increase in the future
- Failure of the issuer of the security to make scheduled interest or principal payments
- Any changes to the rating of the security by a rating agency

With the issuance of ASU 2016-13, as noted in paragraph BC82, it is no longer appropriate to consider the length of time the fair value of a security has been in an unrealized loss position or recoveries in fair value that occurred after the balance-sheet date to conclude that a credit loss does not exist.

ASC 326-30-35-2 also refers to the guidance in ASC 326-30-35-6 and ASC 326-30-55-2 to 55-4 for the determination of whether a credit loss exists, which is discussed in the section that follows. In some cases, after considering the preceding list of factors, as well as other relevant positive and negative evidence related to potential credit losses associated with the individual security, it may be possible to conclude qualitatively that there are no expected credit losses. However, if the evidence suggests a credit loss may be present in the security, the next step would be to estimate and record the credit loss.

#### **4.1.5 Estimate and record the credit loss**

As described in ASC 326-30-35-6, the amount of credit loss is quantified by comparing the present value of expected cash flows for a security to its amortized cost basis. Many entities engage a specialist with deep knowledge of the particular type of impaired security to estimate and discount its expected cash flows. An allowance for credit losses is recorded, or adjusted (as necessary) for the shortfall, but only to the extent that the amortized cost basis of the security exceeds its fair value. For example, assume an AFS debt security has an amortized cost basis of 100 and a fair value is 97. If the security has a credit loss of five, an allowance for credit losses of three would be recorded. That is, the allowance for credit losses is limited to the extent the current fair value of the security exceeds its amortized cost basis (in this instance, 100-97).

For the purpose of determining expected credit losses, components of the amortized cost basis can be considered on a combined basis or by separately measuring the applicable accrued interest component from the other components of the amortized cost basis. If expected credit losses on accrued interest are determined separately, accrued interest would be excluded from both the amortized cost basis and the

fair value of the security when evaluating expected losses on the principal portion of the security. Additionally, if excluded, ASC 326-30-30-1B permits an accounting policy election, at the major security-type level, to not recognize an allowance for credit losses for accrued interest if the entity writes off uncollectible accrued interest in a timely manner.

When estimating expected cash flows to quantify expected credit losses, keep in mind the following, which are outlined in ASC 326-30-35-7 to 35-9 and ASC 326-30-55-2 to 55-4:

- The estimate should represent management's best estimate. If a range is used for either the amount or timing of cash flows, the likelihood of possible outcomes should be considered in deriving the estimate.
- All available information that is relevant to the collectibility of the security should be considered (including the following) and weighted commensurate with the extent to which the information can be objectively verified:
  - Information about past events (e.g., historical loss rates on similar securities), current conditions and reasonable and supportable forecasts, including:
    - The security's remaining payment terms and how the security will perform if payments are required to increase in the future
    - Prepayment speeds
    - The financial condition of the issuer
    - Expected defaults
    - Credit enhancements that are not separate contracts (including the ability and willingness of a guarantor to pay), subordinated interests capable of absorbing losses and the value of underlying collateral
    - Industry analyst reports and forecasts, credit ratings and other relevant market data
    - Relevant industry, geographical, economic and political factors
- Expected cash flows are generally discounted at the effective interest rate implicit in the security at the time of acquisition to derive the present value. An accounting policy election can be made by major security type to adjust the effective interest rate to consider the timing (and changes in the timing) of prepayments on expected cash flows so that credit risk can be more appropriately isolated when computing expected losses.
- As it relates to securities that have interest rates that vary based on an index or rate:
  - An election can be made to determine the effective rate based on: (a) the factor as it changes over the life of the security, (b) the factor as it is projected to change or (c) the rate in effect at the date that the determination is made that a credit loss exists. The option selected should be applied consistently to all such instruments.
  - Changes in the factor may also be projected when estimating expected future cash flows; however, those same projections should be used to determine the effective rate used to discount those cash flows, and that effective rate should be adjusted to consider the timing (and changes in the timing) of prepayments on expected cash flows.
  - An election can be made to present the change in present value attributable to the passage of time as interest income rather than as credit loss expense (or reversal thereof).

An example follows to illustrate how an entity may want to estimate expected cash flows and determine the allowance amount that should be recorded.



#### Example 4-2: Determining the allowance on a corporate bond designated as AFS

Oil Company Bond was downgraded in the first quarter when oil prices continued to drop significantly. At the end of the first quarter, the fair value of the bond was \$70 in comparison to its amortized cost of \$100, resulting in an unrealized loss of \$30. In estimating expected cash flows, management started with contractual cash flows and adjusted them down for the amounts they did not expect to collect.

Management considered factors such as historical loss rates on similarly rated bonds in the industry, and adjusted these rates upward given that both current and forecasted conditions are worse for the industry than the historical period from which the loss rates were derived. Management discounted the resulting expected cash flows using the bond's original effective rate to arrive at a \$75 present value of expected cash flows. Given that the amortized cost basis exceeds this amount by \$25, management debits credit loss expense and credits the allowance for credit losses by this same amount because this amount does not exceed the \$30 amount by which the amortized cost basis exceeds the security's fair value.

At the end of the second quarter, the fair value of the bond improves to \$80 and the amortized cost basis remained \$100. Management updates its estimate of expected cash flows and determines that the shortfall between the net present value of these cash flows and the amortized cost basis of the security remained \$25. While this agrees to the recorded allowance balance, the allowance balance now exceeds the \$20 difference between the amortized cost basis and the security's fair value. As such, management debits the allowance for credit losses and credits credit loss expense for \$5.

#### 4.1.6 Subsequent measurement considerations

In accordance with ASC 326-30-35-3, at each reporting date, entities are required to record an allowance for credit losses for each impaired security that reflects the amount of impairment related to credit losses. The allowance for each security is limited by the amount that its fair value is less than its amortized cost basis. Both increases and decreases to the allowance for credit losses are recognized through earnings in the period of change as a credit loss expense or a reversal of credit loss expense; however, an entity should not reverse a previously recorded allowance for credit losses to an amount below zero.

##### 4.1.6.1 Writeoffs

ASC 326-20-35-8 requires that financial assets be written off in full or in part in the period in which they are deemed uncollectible. If accrued interest is excluded from both the amortized cost basis and the fair value of the security for the purpose of identifying and measuring credit losses, ASC 326-30-35-13A permits an accounting policy election at the major security-type level<sup>11</sup> to write off uncollectible accrued interest by reversing interest income, recognizing credit loss expense or using a combination of both.

##### 4.1.6.2 Accounting for securities written down due to intent or more likely than not requirement to sell

Once a security is written down to fair value because of an intent or more likely than not requirement to sell, as noted in ASC 326-30-35-14, this fair value amount becomes the security's new amortized cost basis. This amortized cost basis should not be adjusted for subsequent recoveries in fair value. ASC 326-30-35-15 provides that any difference between this new amortized cost basis and the cash flows that are expected to be collected on the security as of any period end should be accreted into interest income. If

<sup>11</sup> ASC 320-10-50-1B states that major security type shall be based on the nature and risks of the security. Examples include U.S. Treasuries, corporate debt securities and mortgage-backed securities. See Section 8.4.3 for additional guidance and examples.



there is a subsequent significant increase in expected cash flows or actual cash flows significantly exceed expectations, the yield should be adjusted prospectively. Any post write-down changes in fair value should be reflected in OCI unless additional credit loss recognition is necessary.

#### 4.1.7 Special considerations related to PCD securities and beneficial interests in securitized financial assets



##### Spotlight: FASB project

On June 27, 2023, the FASB issued a proposed ASU that would extend the population of financial assets subject to the gross-up approach in ASC 326 that is currently applied only to PCD assets. Under the proposed ASU, acquirers would no longer need to determine whether or not an acquired financial asset is considered PCD based on the degree of credit deterioration since its origination. Rather, the gross-up approach would be applied to all financial assets acquired as part of a business combination. In addition, for financial assets recognized by consolidating a non-business VIE or through an asset acquisition, the acquirer would account for purchased financial assets based on certain criteria intended to account for similar transactions in a similar manner. The criteria aim to determine whether the acquirer was involved with originating the asset. If the acquirer was not involved with the origination, it would use the gross-up approach to account for the acquired asset.

The proposed ASU would not change the measurement, presentation or disclosure requirements of the gross-up approach. A final ASU is expected to be issued during the first quarter of 2024.

Refer to [Financial Instruments—Credit Losses \(Topic 326\)—Acquired Financial Assets Tentative Board Decisions to Date](#) for the most up to date information related to this project.

At the time a security is purchased, consideration should be given to whether the security is PCD, which would be the case if, as of the date of acquisition, the security has experienced a more-than-insignificant deterioration in credit quality since its origination. To make this determination, ASC 326-30-30-2 refers to the indicators of a credit loss included at Section 4.1.4.

If an analysis of these factors indicate a credit loss exists at the acquisition date, the security would be considered PCD. The allowance for credit losses for PCD securities is measured in a manner consistent with the general provisions described earlier. However, an important factor to note is that the asset's initial amortized cost basis is the sum of its purchase price and its allowance for credit losses on the purchase date. (In other words, the acquisition-date allowance for a PCD security is recognized through an increase to the security's carrying amount rather than through credit loss expense.) While ASC 326-30-35-2 limits the allowance to the amount that the fair value is less than the amortized cost basis, as a consequence of including the allowance in the amortized cost basis, it would be inappropriate to conclude that the fair value and amortized cost basis are the same on the purchase date. The discount that is embedded in the purchase price that is attributable to expected credit losses should be recognized as the purchase date allowance rather than accreting it into interest income over the life of the security. When estimating expected credit losses on a PCD security, expected cash flows should be compared with contractual cash flows and the shortfall discounted using the rate that equates the present value of estimated future cash flows with the purchase price of the asset to arrive at expected credit losses and the purchase date allowance. While the purchase date allowance for a PCD security is recognized through an increase to the asset's initial carrying amount, subsequent changes in the allowance are recognized through credit loss expense or a reversal of credit loss expense, as appropriate.

As noted in ASC 325-40-30-1A, the treatment outlined in the preceding paragraph also applies to beneficial interests in securitized assets within the scope of ASC 325-40 that either meet the definition of

PCD, or as of the date of initial recognition, a significant difference exists between contractual cash flows and expected cash flows. As changes in expected cash flows occur on beneficial interests, the allowance for credit losses is remeasured and the accretable yield is recalculated (refer to Section 3.5.2.1). The recalculated accretable yield is used not only for interest income recognition, but also for discounting cash flows for the purpose of determining expected credit losses.



**RSM COMMENTARY:** The PCD asset guidance should only be applied to assets that meet the PCD threshold and are within the scope of ASC 326-20 or 326-30. The PCD asset guidance should be applied to financial assets that are acquired individually, as part of an acquisition of a pool of loans or in a business combination. However, when an entity acquires more than one financial asset, it may determine whether each individual asset should be considered PCD, or it may make that determination at the group level. Entities are allowed to perform the evaluation on a group basis because it may not be practical to individually assess each asset to determine if there was a more-than-insignificant deterioration in credit quality since origination. However, when an entity acquires a group of AFS debt securities, ASC 326-30 requires that the PCD determination be made on an individual security basis.

It is important to note that although the PCD assessment for assets within the scope of ASC 326-20 can be done on a collective basis, any amortized cost basis adjustment resulting from acquiring a pool of PCD assets, including the allowance for credit losses and any noncredit discount or premium resulting from the acquisition, should be allocated to the individual assets within the pool (see ASC 326-20-30-13).

## 5. Accounting for loans and other receivables

### Summary of key changes

- With the issuance of ASU 2016-13 and the creation of ASC 326-20 to address the recognition of credit losses on financial assets carried at amortized cost:
  - The guidance in ASC 310-10-35 related to loan impairment and credit losses was eliminated. As such, the concept of an impaired loan is no longer relevant and the measurement of credit losses is under a new model that is the subject of Chapter 6.
  - The designation of, and guidance in ASC 310-30 related to, loans and debt securities acquired with deteriorated credit quality was eliminated. Upon adoption, any loans designated as such are considered to be PCD assets and subject to the guidance in ASC 326 as discussed within Chapter 6.
- ASU 2022-02 eliminated the accounting guidance for TDRs by creditors in ASC 310-40 while enhancing the disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Specifically, rather than applying the recognition and measurement guidance for TDRs, an entity must now apply the loan refinancing and restructuring guidance in ASC 310-20-35-9 through 35-11 to determine whether a modification results in a new loan or a continuation of an existing loan (as discussed in Section 5.5.1)
- Refer to Chapter 1 for effective date and transition considerations.

### 5.1 Applicability

This chapter is primarily based on ASC 310-10, which addresses the accounting for loans and other receivables. Refer to Chapter 7 for loans accounted for under the fair value option.

#### 5.1.1 Embedded derivative considerations

It's not uncommon for loans to contain potential embedded derivatives such as an option for the holder to convert the loan into a class of shares,<sup>12</sup> early redemption features (such as put and call options that can accelerate payoff), additional payments if a contingent event such as a change in control occurs, and interest that is indexed to something other than interest rates. The focus when determining if there are features within a loan that may require separate recognition as a derivative should be on features that can alter the amount or timing of cash flows or the manner in which the contract can be settled (e.g., in shares rather than cash). A contract that embodies both an embedded derivative and a host contract (i.e., an equity or debt instrument) is referred to as a hybrid instrument.

Entities are required to analyze hybrid instruments to determine whether any embedded features should be separately recognized as a derivative under ASC 815-15-25-1. This analysis involves determining the nature of the host contract (generally debt for instruments within the scope of this chapter) and evaluating whether the economic characteristics and risks of the potential embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If not, the embedded feature would require separate recognition as a derivative if it meets the definition of a derivative on a freestanding basis and is within the scope of ASC 815-10-15. However, in accordance with ASC 815-15-25-1(b), this analysis is not required for hybrid instruments that are measured at fair value with changes in

<sup>12</sup> Consideration should be given to the scope of Chapter 3 for loans that have an embedded conversion option because if they meet the definition of a debt security they would be subject to the scope of that chapter rather than Chapter 5.

fair value reported in earnings as they occur (e.g., loans or other receivables that are accounted for under a fair value option).

Derivative instruments that are subject to the requirements of ASC 815, including any embedded derivative that is bifurcated from a hybrid instrument, are outside the scope of this chapter. However, as noted in ASC 815-15-25-54, the host contract that remains (e.g., a loan) after separating an embedded derivative is accounted for under the guidance that is applicable to instruments of the same type that do not contain embedded derivatives.

Refer to RSM's [A Guide to Accounting for Derivatives](#) Section 3 for further guidance on derivatives, including embedded derivatives.

## 5.2 Classification and measurement of loans and receivables

### 5.2.1 General provisions

Loans and receivables are generally measured at amortized cost; however, loans that are *held for sale* should be classified as such on the balance sheet and measured at the lower of amortized cost or fair value. The accounting for fees, costs, discounts, premiums and impairment is impacted by the classification as more fully discussed in the sections that follow.

### 5.2.2 Loans and receivables measured at amortized cost

Receivables and nonmortgage loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are carried on the balance sheet at amortized cost in accordance with ASC 310-10-35-47A. Mortgage loans that are classified as held-for-long-term-investment are also carried at amortized cost. ASC 948-310-25-1 indicates that a mortgage banking entity should not classify a loan as held-for-long-term-investment unless it has both the ability and intent to hold the loan for the foreseeable future or until maturity. Absent such an ability and intent, the loan would be classified as held for sale (see Section 5.2.3. for further discussion).

Chapter 6 addresses the recognition and measurement of credit losses and the related allowance on these instruments, and Section 5.4.3 addresses the accounting for fees and costs associated with lending activities, as well as purchase premiums and discounts on loans and other receivables. Any difference between the carrying amount of a loan measured at amortized cost and its outstanding principal balance should be recognized as an adjustment to the yield using the interest method (described at Section 5.4.2).

### 5.2.3 Loans held for sale

According to ASC 310-10-35-48, nonmortgage loans held for sale are measured at the lower of amortized cost or fair value through recognition of a loss and valuation allowance for the amount by which the amortized cost exceeds fair value as of the reporting date. ASC 948-310-35-3 provides specific guidance for how fair value should be measured for mortgage loans held for sale. Loan origination fees and direct loan origination costs (defined in Sections 5.4.3.3 and 5.4.3.4, respectively) associated with a loan held for sale should be deferred as a component of the loan's amortized cost basis until the loan is sold, at which time the deferred fees and costs will impact the gain or loss on sale. Additionally, as ASC 948-310-35-2 points out, purchase discounts on mortgage loans should not be amortized into interest income during the period the loans are held for sale.

The guidance in ASC 948-310-30-1 through 30-3 also addresses mortgage loan sales to an affiliated entity (defined in the Master Glossary of the ASC as "an entity that directly or indirectly controls, is controlled by, or is under common control with another entity; also, a party with which the entity may deal if one party has the ability to exercise significant influence over the other's operating and financial policies as discussed in Section 323-10-15"). The carrying amount of mortgage loans to be sold to an affiliated

entity should be adjusted through earnings to the lower of amortized cost or fair value as of the decision-to-sell date, as determined by, at a minimum, formal authorized approval of the purchaser, issuance of a commitment to purchase and seller acceptance of the commitment.

If all or a particular class of mortgage loans are originated exclusively for an affiliated entity, the originator is viewed as an agent of the affiliate, and the transfer should be accounted for at the originator's acquisition cost (which the Master Glossary of the ASC indicates is "equal to the principal amount of the loan adjusted for unamortized net fees and costs and any unearned discounts or premiums"). However, ASC 948-310-30-2 indicates that an agency relationship would not exist if the originator retains all the risks associated with ownership of the loans through a right of first refusal or similar agreement or commitment.

#### **5.2.4 Change in classification**

If a decision is made to sell a nonmortgage loan that is not currently classified as held for sale, the loan should be transferred into the held-for-sale classification when the decision to sell is made. Conversely, if the decision is made to hold a nonmortgage loan classified as held for sale for the foreseeable future rather than sell it, the loan would be transferred out of held for sale. Similarly, the classification of mortgage loans may change between held for sale and held for long term investment.

ASC 310 and ASC 948-310 address transfers of loans between classifications. Specifically, if a loan is transferred into the held-for-sale classification from a held-for-long-term-investment or not-held-for-sale classification, any previously recorded allowance for credit losses at the transfer date should be reversed into earnings, and the loan transferred into the held-for-sale classification at its amortized cost basis (exclusive of the allowance, but reduced by any previous writeoffs). A valuation allowance would be recognized in accordance with Section 5.2.3 if and to the extent this amortized cost basis exceeds the fair value of the loan.

Similarly, if a loan is transferred out of a held-for-sale classification into a held-for-long-term-investment or not-held-for-sale classification, any previously recorded valuation allowance at the time of transfer should be reversed into earnings, with the amortized cost basis of the loan exclusive of the valuation allowance, but reduced by any previous writeoffs, transferred over to the new classification. Consideration should then be given to ASC 326-20 (the subject of Chapter 6) to determine if an allowance for credit losses is necessary.

Amounts reversed or established for a valuation allowance and the allowance for credit losses related to the transfer of a loan between classifications should be presented on a gross basis, either in the income statement or in the notes to the financial statements.

#### **5.2.5 Loans or other receivables that can contractually be settled for less than substantially all of the holder's recorded investment**

ASC 860-20-35-2 to 35-5 indicate that a financial asset, such as a loan or other receivable, that can contractually be prepaid or otherwise settled in a manner that the holder would not recover substantially all (e.g., 90%) of its recorded investment should be classified and accounted for as either an available-for-sale or trading debt security in accordance with ASC 320. The disclosure requirements of ASC 320 are not relevant unless the asset also meets the definition of a security. The emphasis should be on the contractual provisions in determining if the asset can be settled in a manner that the holder would not recover substantially all of its investment, rather than on noncontractual events such as default. The guidance in ASC 860-20-35-2 to 35-5 does not apply to instruments that are within the scope of ASC 815 because such instruments are required to be accounted for at fair value through its provisions.

### 5.2.6 Commitments to originate, purchase or sell loans or receivables

Loan origination commitments that relate to mortgage loans that will be held for sale should be accounted for by the lender as a derivative at fair value in accordance with ASC 815-10-15-71. Pursuant to ASC 815-10-15-69, any other types of commitments to lend are excluded from ASC 815's derivative requirements. This exclusion does not extend to commitments to purchase or sell assets such as loans and other receivables at a future date. As such, consideration should be given to whether purchase and sale forward commitments or options meet the definition of a derivative and are within the scope of ASC 815. Forward commitments or options to purchase and sell assets, such as residential mortgages that can be readily converted to cash or otherwise meet the criteria in ASC 815-10 for net settlement, are generally required to be accounted for as derivatives unless they meet the exception in ASC 815-10-15-14 for regular-way security trades.

ASC 310-10-25-6 provides guidance for standby commitments to purchase loans that are within its scope (i.e., those standby commitments that are not derivatives subject to the scope of ASC 815). That guidance indicates that if (1) the settlement date for a standby commitment is within a reasonable period (e.g., a normal loan commitment period), and (2) the entity has the intent and ability to accept delivery without selling assets, the standby commitment would be viewed as part of the normal production of loans. In these instances, the loans purchased through the commitment would be recognized on the settlement date, net of the commitment fee received. If both of the conditions in ASC 310-10-25-6 are not met, the standby commitment should be accounted for as a written put option, with the commitment fee recognized as an option premium liability that represents the fair value of the commitment on the trade date. The carrying amount of this liability would be subsequently adjusted through earnings to the greater of the initial standby commitment fee or the fair value of the written put option. This is in contrast to commitments recognized as derivatives, which are required to be continuously adjusted to fair value.

### 5.2.7 Notes exchanged for cash

When a note is received or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged (see ASC 835-30-25-4). If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in ASC 835-30-25-6.

### 5.2.8 Notes exchanged for property, goods or services

The following accounting is based on the guidance in ASC 310-10-30-3 through 30-6.

A note exchanged for property, goods, or service represents two elements, which may or may not be stipulated in the note: (1) the principal amount, equivalent to the bargained exchange price of the property, goods, or service as established between the supplier and the purchaser and (2) an interest factor to compensate the supplier over the life of the note for the use of funds he would have received in a cash transaction at the time of the exchange. Notes so exchanged are accordingly valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction. The difference between the face amount and the present value upon issuance is shown as either discount or premium, which is amortized over the life of the note.

If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or service acquired or sold in consideration for a note may be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and market value of the notes provide the evidence of the present value. The above methods are preferable means of establishing the present value of the note.

When a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. That presumption, however, must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note. In the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note, the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest as described in ASC 835-30. This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

### **5.3 Sales or other transfers of receivables**

#### **5.3.1 General provisions**

ASC 860 addresses transfers of financial assets (such as loans and receivables), with ASC 860-10-40 containing the criteria that should be considered in determining whether a transfer should be accounted for as a sale in accordance with ASC 860-20, such that the transferred asset or assets are removed from the balance sheet of the transferor. Any transfers of financial assets that do not meet the sale criteria in ASC 860-10-40 should be accounted for as secured borrowings in accordance with ASC 860-30, which results in the transferred asset or assets remaining on the balance sheet of the transferor until the sale criteria are met.

#### **5.3.2 Loan participations and syndications**

A loan participation involves a lender originating an entire loan to a borrower and then selling, assigning or otherwise transferring various portions of the balance outstanding to other parties, referred to as participants. ASC 860 is relevant in determining if the transfer should be accounted for as a sale, such that portions transferred would be removed from the balance sheet of the originating lender. If the transfer does not meet the requirements in ASC 860-10-40 for sale treatment, including the definition of a participating interest, then the portions transferred would remain on the balance sheet of the originating lender where they would be accounted for as a secured borrowing.

Loan syndications differ from loan participations in that each lender within a loan syndication lends a specific amount of the total syndicated borrowing directly to the borrower (rather than one lender originating the loan and transferring portions to other lenders), and each lender has the right to repayment of its amount lent from the borrower. Each lender in the syndication recognizes the amounts it is owed by the borrower. If repayments by the borrower are made to a lead lender who then distributes the collections to the other lenders of the syndicate, the lead lender is simply servicing the loans and does not recognize the aggregate loan as an asset. ASC 860 does not apply to arrangements that are legally structured as a loan syndication, given that no transfer occurs because each lender is the originator for its portion of the syndicated loan.

### 5.3.3 Factoring arrangements

Transfers of receivables under factoring arrangements meeting the sale criteria of ASC 860-10-40-5 should be accounted for by the factor (i.e., the transferee) as purchases of receivables. Transfers not meeting the sale criteria in ASC 860-10-40-5 are accounted for as secured loans (i.e., loans provided by the factor (transferee) that are collateralized by the borrower's (i.e., the transferor's) customer accounts or receivables). ASC 860-30 provides additional guidance in those situations.

Purchase discounts on acquired receivables, such as factoring commissions, should be recognized over the period of the loan contract in accordance with ASC 310-20. That period begins when a finance company or an entity with financing activities including trade receivables funds a customer's credit and ends when the customer's account is settled.

## 5.4 Interest income recognition for loans, receivables and debt securities

### 5.4.1 Overview

Interest income on loans, debt securities and long-term receivables typically arises from contractually stated interest payments. However, in some cases, there may not be an explicit interest payment or the stated interest payment may be below the market rate, which typically results in the asset being issued or purchased at a discount to the payoff or face amount. Examples include zero coupon bonds and a noninterest bearing loan for \$100,000 that is required to be paid back for \$110,000 at the end of its one-year term. The difference between a receivable or debt security's face amount and its initial carrying amount is referred to as a discount if the face amount is higher or premium if the face amount is lower. Premiums typically result from a receivable or debt instrument that pays a higher than market rate of interest and discounts typically result from an instrument that pays a lower than market rate of interest. Discounts and premiums are reported as a direct deduction or addition to the instrument's face amount and amortized as interest income. Interest income recognition on loans is also impacted by certain deferred loan origination fees and costs, which are discussed in Section 5.4.3. Interest income is recognized through application of the interest method, which may differ significantly from recognition based on the contractual rate.

### 5.4.2 Application of the interest method

#### 5.4.2.1 Overview

The interest method entails recognizing interest income (inclusive of the amortization of premiums, discounts, and for loans, net origination fees or costs discussed in Section 5.4.3), over the life of the asset at a constant (i.e., effective) rate of interest when applied to the amount outstanding at the beginning of any period. If interest income that is received exceeds the interest recognized under the interest method, the excess is deferred. Conversely, if interest recognized under the interest method exceeds interest that is received, interest is accrued. As noted in ASC 835-30-35-4, other methods of amortization can be used if the results are not materially different from the interest method.

Generally, the calculation of the effective rate necessary to apply the interest method is determined based on the contractual payment terms (e.g., maturity) of the asset and prepayments of principal are not anticipated to shorten the term of the asset. However, there are certain exceptions to the general rule. As discussed more fully in Section 3.5.2, premiums on debt securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates are amortized to the security's next call date, while discounts are amortized to the debt security's maturity date. Also, as discussed more fully in Section 5.4.2.6, ASC 310-20-35-26 allows entities that hold a large number of similar loans, securities or receivables for which prepayments are probable and can be reasonably estimated to estimate prepayments when computing the effective rate for the group of similar assets.



The following example from the FASB Codification illustrates the application of the interest method. Note that this example considers loan origination fees and direct origination costs that are required to be deferred in accordance with the guidance discussed in Section 5.4.3.



**Example 5-1: Application of the interest method of amortization based on contractual payment terms (from Example 1 in ASC 310-20-55-20 to 55-22)**

This Example illustrates the guidance in paragraphs 310-20-35-17 through 35-24, displaying amortization under the interest method using the contractual payment terms and assuming no prepayments. This Example has the following assumptions.

On January 1, 19X7, Entity A originates a 10-year \$100,000 loan with a 10 percent stated interest rate. The contract specifies equal annual payments of \$16,275 through December 31, 19Y6. The carrying amount of the loan is computed as follows [with consideration given to loan origination fees and direct origination costs that are required to be deferred in accordance with the guidance discussed in Section 5.4.3]:

Loan principal	\$100,000
Origination fees	(3,000)
Direct loan origination costs	1,000
Carrying amount of loan	\$98,000

In calculating the effective rate to apply the interest method, the discount rate necessary to equate 10 annual payments of \$16,275 to the initial carrying amount of \$98,000 is approximately 10.4736 percent (i.e., it is necessary to solve for the effective rate, using the contractual payment terms and the initial carrying amount). The table that follows demonstrates how this effective rate is applied to the loan's outstanding carrying amount at the beginning of each year to arrive at the total interest income to be recognized each year (column 4).

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(98,000)				\$100,000	\$2,000	\$98,000
1	16,275	\$10,000	\$264	\$10,264	93,725	1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	16,275	8,682	257	8,939	79,230	1,217	78,013
4	16,275	7,923	248	8,171	70,878	969	69,909
5	16,275	7,088	234	7,322	61,691	735	60,956
6	16,275	6,169	215	6,384	51,585	520	51,065
7	16,275	5,159	189	5,348	40,469	331	40,138
8	16,275	4,047	157	4,204	28,241	174	28,067
9	16,275	2,824	116	2,940	14,790	58	14,732
10	16,275	1,485 <sup>(a)</sup>	58	1,543	-	-	-
Total amortization			\$2,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan’s stated interest rate (10%)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for prior year × the effective interest rate (10.4736%) <sup>(b)</sup>
Column (5)—Column (5) for prior year – (Column [1] – Column [2])
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

<sup>(a)</sup> \$6 rounding adjustment.

<sup>(b)</sup> The effective interest rate is the discount rate that equates the present value of the future cash inflows to the initial net cash outflow of \$98,000.

*5Q.4.2.1.1: Assume that a lender grants a loan that matures in 90 days and collects a nonrefundable fee that approximates market. Assume also that any future extension of credit would be evaluated at maturity of the original loan and would include an extension fee at that time. Based on experience, the lender anticipates that the credit will be extended an additional 90 days; however, the lender is not committed to provide an extension. How should the lender account for the fees received? Over what period should the fee collected on the original 90-day loan be amortized?*

Pursuant to ASC 310-20-55-17, the fee, net of qualifying origination costs, should be deferred and amortized over the original 90-day loan contract.

### 5.4.2.2 Increasing, decreasing and variable rate loans

There are certain nuances in applying the interest method when the stated interest rate is not constant over the period of the loan. For loans with predefined interest rates that increase during the term of the loan such that the interest recognized in the early periods under the interest method exceeds interest at the stated rate, interest income should not be recognized to the extent the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Importantly, prepayment penalties should be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. As such, ASC 310-20-35-18(a) imposes a limit on the amount of periodic amortization that can be recognized. However, that limitation does not apply to the capitalization of costs incurred (such as direct loan origination costs and purchase premiums) that cause the investment in the loan to be in excess of the amount at which the borrower could settle the obligation. That’s because the capitalization of costs incurred is different from increasing the net investment in a loan through accrual of interest income that is only contingently receivable.



#### **RSM COMMENTARY: Effect of increasing-interest terms on the deferral of net loan origination fees**

The stated interest rate of a loan may increase during its term until maturity. If so, at times over the life of the loan, the lender’s recorded net investment may exceed the amount for which the borrower can settle the open obligation. For these loans, ASC 310-20-30-3 permits the recorded net investment in the loan to exceed the amount by which the borrower could settle the obligation but only if the difference between the recorded net investment and the settlement amount results from either:

- A purchase premium (for loans that have been acquired) or

- Deferred net loan origination fees (for loans originated by the lender).

ASC 310-20-20 does not provide a specific definition of the term "recorded net investment"; however, the ASC Master glossary does define the terms "net investment in an original loan" and "recorded investment" that have a similar conceptual basis. This definitional guidance indicates that the term "recorded net investment" as used in ASC 310-20, includes the following:

Unpaid loan principal

Plus or minus: Net unamortized deferred fees or costs

Plus or minus: Net unamortized purchase premium or discount

Plus: Accrued interest receivable

Less: Amounts written-off, if any

Although a lender's recorded investment reflects write-offs, it does not include any valuation allowance. However, if a loan is a hedged item in a fair value hedge, the amount of that loan's recorded investment should include the unamortized amount of the cumulative fair value hedge adjustments.

If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, ASC 310-20-35-18(b) states that the excess should be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. In determining the effective yield to be used in recognizing deferred fees and costs on loans that have a stated interest rate that varies based on future changes in an independent factor, such as an index or rate (e.g., the prime rate, SOFR or the U.S. Treasury bill weekly average rate), ASC 310-20-35-18(c) indicates that an entity can choose to either calculate the effective yield based on

- a. the factor that is in effect at the inception of the loan, or
- b. the factor as it changes over the life of the loan by recomputing a new effective yield to be used from the time of the change (i.e., the constant effective yield is recalculated not from the inception of the loan but from the time of the change).

The method selected should be applied consistently over the life of the loan.

The following examples and estimates from the FASB Codification are illustrative only and are not intended to modify or limit in any way the provisions of ASC 310-20. All examples assume that principal and interest payments are made on the last day of the year.

The following example illustrates the guidance in ASC 310-20-35-18(a), displaying amortization under the interest method. The effective yield is used to recognize an amount in excess of net fees for a loan with an increasing stated rate. The excess recognized is permissible only to the extent that the loan agreement provides for a prepayment penalty that is effective through the loan term.



**Example 5-2: Application of the interest method of amortization when the loan's prepayment penalty is effective throughout the entire term (from Example 5 in ASC 310-20-55-34)**

Entity E grants a 10-year \$100,000 loan with an 8 percent stated interest rate in Year 1 and 10 percent in Years 2-10. Entity E receives net fees of \$1,000 related to this loan. The contract specifies that the borrower must pay a penalty equal to 1 percent of any principal prepaid. Application of the effective yield

to recognize an amount in excess of net fees is appropriate for a loan with an increasing stated interest rate only to the extent that the loan agreement provides for a prepayment penalty that is effective throughout the loan term. The loan would be accounted for as follows.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees <sup>(a)</sup>	(7) Carrying Amount	(8) Settlement Amount
	\$(99,000)				\$100,000		\$99,000	
1	14,903	\$8,000	\$1,710	\$9,710	93,097	\$(710)	93,807	\$94,028
2	16,165	9,310	(108)	9,202	86,242	(602)	86,844	87,104
3	16,165	8,624	(106)	8,518	78,701	(496)	79,197	79,488
4	16,165	7,870	(102)	7,768	70,406	(394)	70,800	71,110
5	16,165	7,041	(97)	6,944	61,282	(297)	61,579	61,895
6	16,165	6,128	(88)	6,040	51,245	(209)	51,454	51,757
7	16,165	5,124	(78)	5,046	40,204	(131)	40,335	40,606
8	16,165	4,021	(65)	3,956	28,060	(66)	28,126	28,340
9	16,165	2,806	(47)	2,759	14,701	(19)	14,720	14,848
10	16,165	1,464 <sup>(b)</sup>	(19)	1,445	-	-	-	-
Total amortization			\$1,000					
Computations:								
Column (1)—Contractual payments								
Column (2)—Column (5) for prior year × the loan’s stated interest rate (8% year 1, 10% in years 2-10)								
Column (3)—Column (4) – Column (2)								
Column (4)—Column (7) for the prior year x the effective interest rate (9.8085%)								
Column (5)—Column (5) for prior year – (Column [1] – Column [2])								
Column (6)—Initial net fees – amortization to date								
Column (7)—Column (5) – Column (6)								
Column (8)—Column (5) x 1.01 (to calculate the settlement amount including prepayment penalty)								

<sup>(a)</sup> Unamortized net fee and accrued interest.

<sup>(b)</sup> \$6 rounding adjustment.

The following example illustrates the guidance in ASC 310-20-35-18(a) for the application of the interest method of amortization with an increasing rate loan and with no penalty charged for prepayment of principal.



**Example 5-3: Application of the interest method of amortization with an increasing rate loan and with no penalty for prepayment of principal (from Example 6 in ASC 310-20-55-36 to 55-37)**

Entity F grants a 10-year \$100,000 loan. The contract provides for 8 percent interest in Year 1 and 10 percent interest in Years 2-10. Entity F receives net fees of \$1,000 related to this loan. The contract specifies that no penalty will be charged for prepayment of principal.

The discount factor that equates the present value of the cash inflows in Column 1 with the initial cash outflow of \$99,000 is 9.8085 percent. In Year 1, recognition of interest income on the investment of \$99,000 at a rate of 9.8085 percent would cause the investment to be \$93,807, or \$710 greater than the amount at which the borrower could settle the obligation. Because the condition set forth in paragraph 310-20-35-18(a) is not met, recognition of an amount greater than the net fee is not permitted. The loan would be accounted for as follows.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(99,000)				\$100,000		\$99,000
1	14,903	\$8,000	\$1,000	\$9,000	93,097	\$ -	93,097
2	16,165	9,310	-	9,310	86,242	-	86,242
3	16,165	8,624	-	8,624	78,701	-	78,701
4	16,165	7,870	-	7,870	70,406	-	70,406
5	16,165	7,041	-	7,041	61,282	-	61,282
6	16,165	6,128	-	6,128	51,245	-	51,245
7	16,165	5,124	-	5,124	40,204	-	40,204
8	16,165	4,021	-	4,021	28,060	-	28,060
9	16,165	2,806	-	2,806	14,701	-	14,701
10	16,165	1,464 <sup>(a)</sup>	-	1,464	-	-	-
Total amortization	\$1,000						
Computations:							
Column (1)—Contractual payments							
Column (2)—Column (5) for prior year × the loan’s stated interest rate (8% year 1, 10% in years 2-10)							
Column (3)—Column (4) – Column (2)							
Column (4)—Column (7) for prior year × the effective interest rate (9.8085%) as limited by paragraph 310-20-35-18(a)							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							
Column (7)—Column (5) – Column (6)							

<sup>(a)</sup> \$6 rounding adjustment.

The following example illustrates the guidance in ASC 310-20-35-18(b) for the application of the interest method for a loan with a decreasing interest rate.



**Example 5-4: Application of the interest method of amortization for a loan with decreasing interest rate (from Example 7 in ASC 310-20-55-39)**

Entity G grants a 10-year \$100,000 mortgage. Entity G receives net fees of \$1,000 related to this loan. The contract provides for an interest rate of 12 percent in Year 1, 11 percent in Year 2, and 10 percent thereafter. The loan would be accounted for as follows.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees (a)	(7) Carrying Amount
	\$(99,000)				\$100,000		\$99,000
1	17,698	\$12,000	\$(1,259)	\$10,741	94,302	\$2,259	92,043
2	17,031	10,373	(388)	9,985	87,644	2,647	84,997
3	16,428	8,764	458	9,222	79,980	2,189	77,791
4	16,428	7,998	441	8,439	71,550	1,748	69,802
5	16,428	7,155	418	7,573	62,277	1,330	60,947
6	16,428	6,228	385	6,613	52,077	945	51,132
7	16,428	5,208	339	5,547	40,857	606	40,251
8	16,428	4,086	281	4,367	28,515	325	28,190
9	16,428	2,852	206	3,058	14,939	119	14,820
10	16,428	1,489 <sup>(b)</sup>	119	1,608	-	-	-
Total amortization			\$1,000				
Computations:							
Column (1)—Contractual payments							
Column (2)—Column (5) for prior year × the loan's stated interest rate (12% in year 1, 11% for Year 2, and 10% in Years 3-10)							
Column (3)—Column (4) – Column (2)							
Column (4)—Column (7) for prior year × the effective interest rate (10.8491%)							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							
Column (7)—Column (5) – Column (6)							

<sup>(a)</sup> Unamortized net fee and deferred interest.

<sup>(b)</sup> \$6 rounding adjustment.

The following example illustrates the guidance in ASC 310-20-35-18(c) for the application of the interest method for a variable rate loan with the amortization based on the index at the date the loan is granted ignoring subsequent changes in the factor.



**Example 5-5: Application of the interest method for a variable rate loan with amortization based on factor established at inception (from Example 8 in ASC 310-20-55-41)**

Entity H grants a 10-year variable rate mortgage. The loan's interest rate and payment are adjusted annually based on the weekly Treasury bill index plus 1 percent. At the date the loan is granted, this index is 7 percent and does not change until the end of Year 3. The first year loan interest rate is 8 percent (equal to the Treasury bill index plus 1 percent). Entity H receives net fees of \$3,000. At the end of Year 3 the index changes to 9 percent and does not change again. Therefore, the loan's stated interest rate is 8 percent for Years 1-3 and 10 percent for Years 4-10. Entity H chooses to determine the amortization based on the index at the date the loan is granted and to ignore subsequent changes in the factor. The loan would be accounted for as follows.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(97,000)				\$100,000		\$97,000
1	14,903	\$8,000	\$420	\$8,420	93,097	\$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,973	7,759	375	8,134	69,412	1,400	68,012
5	15,973	6,941	347	7,288	60,416	1,053	59,363
6	15,973	6,042	314	6,356	50,521	739	49,782
7	15,973	5,052	272	5,324	39,636	467	39,169
8	15,973	3,964	221	4,185	27,663	246	27,417
9	15,973	2,766	160	2,926	14,492	86	14,406
10	15,973	1,445 <sup>(a)</sup>	86	1,531	-	-	-
Total amortization			\$3,000				
Computations:							
Column (1)—Contractual payments							
Column (2)—Column (5) for prior year x the loan's stated interest rate (8% in years 1-3, and 10% in years 4-10)							
Column (3)—Calculated as if the index did not change- that is, the amount that would have been recognized on an 8%, 10- year \$ 100,000 mortgage with no prepayments and a \$ 3,000 net fee							
Column (4)—Column (2) + Column (3)							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							
Column (7)—Column (5) – Column (6)							

<sup>(a)</sup> \$4 rounding adjustment.

The following example illustrates the guidance in ASC 310-20-35-18(c) for the application of the interest method to a variable rate loan with amortization recalculated for subsequent changes in the loan's index.



**Example 5-6: Application of the interest method for a variable rate loan with amortization recalculated for subsequent changes in factor (from Example 9 in ASC 310-20-55-43)**

Entity I grants a 10-year variable rate mortgage. The loan's interest rate and payment are adjusted annually based on the weekly Treasury bill index plus 1 percent. At the date the loan is granted, this index is 7 percent and does not change until the end of Year 3. The first year loan interest rate is 8 percent (equal to the Treasury bill index plus 1 percent). Entity I receives net fees of \$3,000. At the end of Year 3 the index changes to 9 percent and does not change again. Therefore, the loan's stated interest rate is 8 percent for Years 1-3 and 10 percent for Years 4-10. Entity I chooses to recalculate a new amortization schedule each time the loan's index changes. The loan would be accounted for as follows.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(97,000)				\$100,000		\$97,000
1	14,903	\$8,000	\$420	\$8,420	93,097	\$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,937	7,759	358	8,117	69,412	1,417	67,995
5	15,937	6,941	340	7,281	60,416	1,077	59,339
6	15,937	6,042	311	6,353	50,521	766	49,755
7	15,937	5,052	275	5,327	39,636	491	39,145
8	15,937	3,964	227	4,191	27,663	264	27,399
9	15,937	2,766	168	2,934	14,492	96	14,396
10	15,937	1,445 <sup>(a)</sup>	96	1,541	-	-	-
Total amortization			\$3,000				
Computations:							
Column (1)—Contractual payments							
Column (2)—Column (5) for prior year x the loan's stated interest rate (8% in years 1-3, and 10% in years 4-10)							
Column (3)—Column (4) – Column (2)							
Column (4)—Column (7) for prior year x the effective interest rate (8.6809%) for years 1-3 and Column (7) for the prior year x the effective interest rate (10.7068%) for Years 4-10							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							
Column (7)—Column (5) – Column (6)							

<sup>(a)</sup> \$4 rounding adjustment.



### 5.4.2.3 Recognition of interest income on financial assets with credit deterioration

ASC 310-10-35-53B and 35-53C provide guidance on interest income recognition for PCD assets (refer to Section 6.12 for financial assets measured at amortized cost and Section 4.1.7 for AFS debt securities). The discount that is embedded in the purchase price of a purchased financial asset with credit deterioration that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition is not accreted into interest income; however, any noncredit-related (e.g., interest-rate-related) discount or premium is accreted into interest income.

ASC 310-10 does not otherwise address how a creditor should recognize, measure or display interest income on a financial asset with credit deterioration. Rather than accruing interest using the interest method when collectibility concerns exist, accounting methods, such as cost-recovery, cash-basis or a combination of the two, are typically used such that the amortized cost basis of a financial asset (inclusive of accrued interest) does not exceed the amount that is expected to be collected.

### 5.4.2.4 Purchase of credit card portfolio

ASC 310-10-25-7 provides guidance addressing the purchase of a credit card portfolio, including the cardholder relationships. When the purchase price exceeds the sum of the amounts due under the credit card receivables, that excess or premium should be allocated between the acquired cardholder relationships and loans. The premium attributable to the cardholder relationships should be accounted for as an identifiable intangible asset in accordance with ASC 350. The premium allocated to the loans should be amortized over the life of the loans, including periods that extend beyond the card's expiration if the repayment period extends beyond expiration. (Any discount on purchase would be accounted for in accordance with Section 5.4.1.)

### 5.4.2.5 Purchase of a loan or group of loans

ASC 310-20-30-5 and ASC 310-20-25-22 through 25-24 provide additional guidance relevant to the purchase of loans and permit the purchase price (i.e., initial investment) to be allocated to the individual loans or accounted for in the aggregate. The initial investment in a purchased loan or group of loans includes fees and amounts paid to the seller less any fees received. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans (including a loan participation<sup>13</sup>) should be expensed as incurred given that the costs are not loan origination costs, which are addressed in Section 5.4.3. The difference between the initial investment and the related loan's principal amount is recognized as an adjustment of yield over the life of the loan.

ASC 310-20-35-16 explains that the cash flows provided by the underlying loan contracts should be used to apply the interest method, except as set forth in ASC 310-20-35-26 (see Section 5.4.2.6). If prepayments are not considered in calculating the constant effective yield when applying the interest method and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount should be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

The following example illustrates application of the interest method using the asset's contractual life to amortize net deferred fees and costs for a group of loans with full prepayment in a single year.

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<sup>13</sup> ASC 310-20-25-24 explains that for the originating lender, net fees and costs associated with a loan participation would become a component of the net loan investment balance to be used in calculating the gain or loss on a subsequent sale as described in ASC 310-20-35-16.



**Example 5-7: Application of the interest method of amortization based on contractual payment terms with full prepayment in Year 3 (from Example 2 in ASC 310-20-55-24 to 55-25)**

On January 1, 19X7, Entity B originates a 10-year \$100,000 loan with a 10 percent stated interest rate. The contract specifies equal annual payments of \$16,275 through December 31, 19Y6. The contract also specifies that no penalty will be charged for prepayments of the loan. Entity B charges a 3 percent (\$3,000) nonrefundable fee to the borrower and incurs \$1,000 in direct loan origination costs.

Entity B accounts for this loan using contractual payments to apply the interest method of amortization. The amortization if the borrower prepays the remaining principal at the end of Year 3 is shown in the following table.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(98,000)				\$100,000		\$98,000
1	16,275	\$10,000	\$264	\$10,264	93,725	\$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	95,505	8,682	1,474	10,156	-	-	-
Total amortization	\$2,000						
Computations:							
Column (1)—Contractual payments + prepayments							
Column (2)—Column (5) for prior year x the loan's stated interest rate (10%)							
Column (3)—Column (4) – Column (2)							
Column (4)—Column (7) for prior year x the effective interest rate (10.4736%) plus in year 3 an adjustment of \$1,217 representing the unamortized net fees recognized when the loan is paid in full.							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							
Column (7)—Column (5) – Column (6)							

The following example illustrates the options allowed under ASC 310-20-35-16 when amortizing net deferred fees using the asset's contract life if a partial prepayment is made by the borrower.



**Example 5-8: Amortization using the contract life with a partial prepayment in year three (from Example 10 in ASC 310-20-55-45 to 55-47)**

The following Cases illustrate the guidance in paragraph 310-20-35-16 for the application of the interest method of amortization using the contract life with a partial prepayment in Year 3.

Example 2 (paragraph 310-20-55-23) [Example 5-7 above] illustrates the application of the guidance in paragraphs 310-20-35-17 through 35-24 by a lender that is using contract life to amortize net deferred fees and costs for a group of loans with a full prepayment in Year 3. If the lender receives a partial prepayment in Year 3 rather than a full prepayment, the lender has two options to calculate the adjustment to unamortized net fees as required in paragraph 310-20-35-26, which states that a lender

using contract life to amortize net fees and costs must adjust the unamortized amount if, and when, loan prepayments occur. Such prepayments should not result in a change in the effective interest rate of the loan. The lender should calculate the adjustment to unamortized net fees under either of the following Cases depending on the terms of the loan contract:

- a. The lender will determine a new annual payment assuming the borrower will continue to make the payments through the original term of the loan contract (Case A).
- b. The borrower will continue to make the original annual payment, however, over a shorter period than the term specified in the loan contract (Case B).

**Case A: New annual payment, original term**

Year	Cash (Out) Inflow	Stated Interest	Amortization	Interest Income	Remaining Principal	Unamortized Net Fees	Carrying Amount
	\$(98,000)				\$100,000		\$98,000
1	16,275	\$10,000	\$264	\$10,264	93,725	\$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	26,275	8,682	407 <sup>(4)</sup>	9,089	69,230	1,067 <sup>(3)</sup>	68,163 <sup>(2)</sup>
4	14,220 <sup>(1)</sup>	6,923	216	7,139	61,933	851	61,082
5	14,220	6,193	204	6,397	53,906	647	53,259
6	14,220	5,391	187	5,578	45,077	460	44,617
7	14,220	4,508	165	4,673	35,365	295	35,070
8	14,200	3,537	136	3,673	24,682	159	24,523
9	14,200	2,469 <sup>(a)</sup>	99	2,568	12,931	60	12,871
10	14,220	1,485 <sup>(b)</sup>	60	1,349 <sup>(a)</sup>	-	-	-
			\$2,000				

Step	Calculation	
1. Determine new annual payment	Remaining periods = 7 Remaining principal = \$69,230 Stated rate = 10% Calculated payment = \$14,220	
2. Determine new carrying amount	Calculated payment (Step 1) = \$14,220 Remaining periods = 7 Original effective interest rate = 10.4736% Calculated carrying amount = \$68,163	
3. Determine the remaining balance of unamortized net fees	Remaining principal balance (Step 1) Less carrying amount (Step 2)	\$ 69,230 68,163 <u>\$ 1,067</u>
4. Determine the adjustment to unamortized net fees	Prior year balance of unamortized net fees Less calculated unamortized net fees (Step 3)	\$ 1,474 1,067 <u>\$ 407</u>

(a) \$1.00 rounding adjustment

(b) \$4.00 rounding adjustment

### Case B: Original Annual Payment, Shorter Term

The following tables illustrate how the lender should calculate the adjustment to unamortized net fees assuming the borrower will continue to make the original annual payment, however, over a shorter period than the term specified in the loan contract.

Year	Cash (Out) Inflow	Stated Interest	Amortization	Interest Income	Remaining Principal	Unamortized Net Fees	Carrying Amount
	\$(98,000)				\$100,000		\$98,000
1	16,275	\$10,000	\$264	\$10,264	93,725	\$1,736	91,989
2	16,275	\$9,373	262	9,635	86,823	1,474	85,349
3	26,275	\$8,682	546 <sup>(4)</sup>	9,228	69,230	928 <sup>(3)</sup>	68,302 <sup>(2)</sup>
4	16,275 <sup>(1)</sup>	\$6,923	231	7,154	59,878	697	59,181
5	16,275	\$5,988	210	6,198	49,591	487	49,104
6	16,275	\$4,959	184	5,143	38,275	303	37,972
7	16,275	\$3,828	149	3,977	25,828	154	25,674
8	16,275	\$2,583	106	2,689	12,136	48	12,088
9	13,349	\$1,214	48	1,262 <sup>(a)</sup>	-(b)	-	-
10	-	-	-	-	-	-	-
			\$2,000				

Step	Calculation	
1. Determine new payment period	Remaining principal = \$69,230 Stated rate = 10% Annual payment = \$16,275 Calculated payment period= 5.813	
2. Determine new carrying amount	Annual payment= \$16,275 Calculated payment period (Step 1) = 5.813 Original effective interest rate = 10.4736% Calculated carrying amount = \$68,302	
3. Determine the remaining balance of unamortized net fees	Remaining principal balance (Step 1) Less carrying amount (Step 2)	\$ 69,230 <u>68,302</u> \$ 928
4. Determine the adjustment to unamortized net fees	Prior year balance of unamortized net fees Less calculated unamortized net fees (Step 3) Adjustment	\$ 1,474 <u>928</u> \$ 546

- (a) \$4.00 rounding adjustment.  
 (b) \$1.00 rounding adjustment.

#### 5.4.2.6 Estimating principal prepayments



##### ASC 310-20-35-26

Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the entity anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the entity shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income.

##### ASC 310-20-35-27

Loans grouped together shall have sufficiently similar characteristics that prepayment experience of the loans can be expected to be similar in a variety of interest rate environments. Loans that are grouped together for purposes of applying the preceding paragraph shall have sufficiently similar levels of net fees or costs so that, in the event that an individual loan is sold, recalculation of that loan's carrying amount will be practicable.

ASC 310-20-35-26 requires contractual payment terms to be used in calculating the constant effective yield necessary to apply the interest method. The maturity date of each loan or debt security should otherwise be used in determining the effective yield, without considering expected prepayments except for a group of loans accounted for in accordance with the paragraph that follows. Unamortized net fees and costs should be adjusted as prepayments or sales occur (recognized in interest income) so that the effective interest rate on the remaining portion continues unchanged. Prepayments of principal should not be anticipated to shorten the term of the loan when calculating the constant effective yield necessary to apply the interest method except when certain conditions discussed in ASC 310-20-35-26 are met.

ASC 310-20-35-26 permits entities that hold a large number of similar loans for which prepayments are probable and for which the timing and amount of prepayments can be reasonably estimated to estimate prepayments when computing the effective yield to be used when applying the interest method. In these instances, historical prepayment data, as well as external information on existing and forecasted interest rates, economic conditions, published mortality and prepayment tables for similar loans and other relevant factors, should be considered in estimating future prepayments.

Loans that are grouped together must have similar characteristics (discussed further below) that prepayment experience can be expected to be similar in a variety of interest rate environments, and the grouped loans must have similar levels of net fees or costs so that, if one individual loan is sold, the recalculation of that loan's carrying amount is practicable. As differences arise between estimated and actual prepayments, the yield should be recalculated to reflect actual payments to date and anticipated future payments, with the net investment in the loans adjusted through interest income to the amount that would have been recorded had the new effective yield been applied since the acquisition of the loans. The investment in the loans should be adjusted to the new balance with a corresponding charge or credit to interest income. Net fees and costs are amortized over the contract life and adjustment are made based on the actual prepayments if loan-by-loan accounting is used.

There are many characteristics to be considered when determining whether a lender holds a large group of similar loans for purposes of estimating prepayments. ASC 310-20-35-30 provides the following examples:

- a. Loan type
- b. Loan size
- c. Nature and location of collateral
- d. Coupon interest rate
- e. Maturity
- f. Period of origination
- g. Prepayment history of the loans (if seasoned)
- h. Level of net fees or costs
- i. Prepayment penalties
- j. Interest rate type (fixed or variable)
- k. Expected prepayment performance in varying interest rate scenarios.

A lender may select the most appropriate method for a group of loans based on the characteristics of those loans. For example, homogeneous mortgage loans could be aggregated while construction loans are accounted for separately. Once the decision is made to account for a loan individually or within a group, the methodology chosen should be used throughout the life of the loan or group of loans.

ASC 310-20-35-32 notes that if loans that are aggregated for purposes of estimating prepayments are subsequently sold, in the absence of sufficiently detailed accounting records for the aggregated loans, a pro-rata calculation of net fees and costs based on the ratio of the outstanding principal balances of the loans sold could be used for the gain or loss calculation.

The example that follows illustrates the guidance in ASC 310-20-35-26, displaying amortization under the interest method using the anticipated prepayment patterns for a large number of loans.



**Example 5-9: Amortization based on estimated prepayment patterns (from Example 3 in ASC 310-20-55-26 to 55-28)**

On January 1, 19X7, Entity C originates 1,000 10-year \$10,000 loans with 10 percent stated interest rates. Each contract specifies equal annual payments through December 31, 19Y6. The contracts also specify that no penalty will be charged for prepayments. Entity C charges each borrower a 3 percent (\$300) fee and incurs \$100 in direct origination costs for each loan. The carrying amount of the loans is computed as follows.

Loan principal amounts	\$10,000,000
Origination fees	(300,000)
Direct loan origination costs	100,000
Carrying amount of loans	\$9,800,000

Entity C chooses to account for this large number of loans using anticipated prepayment patterns to apply the interest method of amortization. Entity C estimates a constant prepayment rate of 6 percent per year, which is consistent with Entity C's prior experience with similar loans and Entity C's expectation of ongoing experience. The amortization when prepayments occur as anticipated is shown in the following table.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(9,800,000)				\$10,000,000		\$9,800,000
1	2,227,454	\$1,000,000	\$35,141	\$1,035,141	8,772,546	\$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	1,880,619	760,018	28,724	788,742	6,479,577	104,189	6,375,388
4	1,719,716	647,958	25,453	673,411	5,407,819	78,736	5,329,083
5	1,566,144	540,782	22,111	562,893	4,382,457	56,625	4,325,832
6	1,419,028	438,246	18,677	456,923	3,401,675	37,948	3,363,727
7	1,277,230	340,168	15,131	355,299	2,464,613	22,817	2,441,796
8	1,138,934	246,461	11,458	257,919	1,572,140	11,359	1,560,781
9	1,000,180	157,214	7,646	164,860	729,174	3,713	725,461
10	802,091	72,917	3,713	76,630	-	-	-
Total amortization			\$200,000				
Computations:							
Column (1)—Contractual payments+ 6% of Column (5) for the prior year (except in year 10)							
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)							
Column (3)—Column (4) – Column (2)							
Column (4)—Column (7) for prior year × the effective interest rate (10.4736%)							
Column (5)—Column (5) for prior year – (Column [1] – Column [2])							
Column (6)—Initial net fees – amortization to date							

Column (7)—Column (5) – Column (6)

The example that follows illustrates the guidance in ASC 310-20-35-26, displaying amortization under the interest method using the anticipated prepayment patterns with actual prepayment experience that *differs* from the anticipated amounts.



**Example 5-10: Amortization based on estimated patterns adjusted for change in estimate (from Example 4 in ASC 310-20-55-30 to 55-32)**

On January 1, 19X7, Entity D originates 1,000 10-year \$10,000 loans with 10 percent stated interest rates. Each contract specifies equal annual payments through December 31, 19Y6. The contracts also specify that no penalty will be charged for prepayments. Entity D charges each borrower a 3 percent (\$300) fee and incurs \$100 in direct origination costs for each loan.

Entity D chooses to account for this portfolio of loans using anticipated prepayment patterns to apply the interest method of amortization. Entity D estimates a constant prepayment rate of 6 percent per year, which is consistent with Entity D's prior experience with similar loans and Entity D's expectation of ongoing experience.

The following table illustrates the adjustment required by paragraph 310-20-35-26 of this Subtopic when an entity's actual prepayment experience differs from the amounts anticipated. The loans have actually prepaid at a rate of 6 percent in Years 1 and 2 and 20 percent in Year 3, and based on the new information at the end of Year 3, Entity D revises its estimate of prepayment experience to anticipate that 10 percent of the loans will prepay in Year 4 and 6 percent of the loans will prepay in remaining years. The carrying amount of the loans at the end of Year 3 is adjusted to the amount that would have existed had the new effective yield been applied since January 1, 19X7. Included in amortization in Year 3 is an adjustment for the difference in the prior effective yield and the new effective yield applied to amounts outstanding in Years 1 and 2. Amortization in Years 4-10 assumes the new estimates of prepayment experience occur as anticipated.

Year	(1) Cash (Out) Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	\$(9,800,000)				\$10,000,000		\$9,800,000
1	2,227,454	\$1,000,000	\$35,141	\$1,035,141	8,772,546	\$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	2,944,644	760,018	41,951	801,969	5,415,552	90,962	5,324,590
4	1,653,939	541,555	23,294	564,849	4,303,168	67,668	4,235,500
5	1,246,229	430,317	18,998	449,315	3,487,256	48,670	3,438,586
6	1,129,164	348,726	16,050	364,776	2,706,818	32,620	2,674,198
7	1,016,331	270,682	13,005	283,687	1,961,169	19,615	1,941,554
8	906,285	196,117	9,849	205,966	1,251,001	9,766	1,241,235
9	795,875	125,100	6,574	131,674	580,226	3,192	577,034
10	638,249	58,023	3,192	61,215	-	-	-



Total amortization	\$200,000	
Computations:		
Column (1)—Contractual payments + prepayments		
Column (2)—Column (5) for prior year × the loan’s stated interest rate (10%)		
Column (3)—Column (4) – Column (2)		
Column (4)—Column (7) for the prior year x the effective rate (10.5627% for years 1 and 2, and 10.6083% for years 3-10, + an adjustment of \$8,876 in year 3 representing the cumulative effect <sup>(a)</sup> applicable to years 1 and 2 of changing the estimated effective rate)		
Column (5)—Column (5) for prior year – (Column [1] – Column [2])		
Column (6)—Initial net fees – amortization to date		
Column (7)—Column (5) – Column (6)		

<sup>(a)</sup> An adjustment would also be required if the level of prepayments realized was less than anticipated.

### 5.4.3 Loan fees and direct origination costs

#### 5.4.3.1 Applicability

ASC 310-20 is the focus of this section and addresses the accounting for nonrefundable fees, origination costs and acquisition costs associated with lending activities and loan purchases. It is evident from the following table, included in ASC 310-20-15-4, that this guidance is also relevant to debt securities.

Types of assets	Basis of accounting	Applicability of this subtopic
Loans or debt securities held in an investment portfolio	Historical or amortized cost basis <sup>(b)</sup>	Yes
Loans held for sale	Lower of amortized cost basis or fair value <sup>(b)</sup>	Yes
Loans or debt securities held in trading accounts by certain financial institutions	Fair value, changes in value are included in earnings	No
AFS debt securities or loans accounted for as such <sup>(a)</sup>	Fair value, changes in value reported in OCI	Yes

<sup>(a)</sup> This includes financial assets subject to prepayment as defined in paragraph 310-10-35-45 and debt securities classified as AFS under Topic 320.

<sup>(b)</sup> Entities may choose, at specified election dates, to measure eligible items at fair value (the fair value option). See Section 825-10-15 for guidance on the scope of the Fair Value Option subsections of ASC 825.

#### 5.4.3.2 Major provisions of ASC 310-20

As discussed further in Section 5.2.3, origination fees that qualify as direct loan origination costs associated with loans held for sale are deferred as part of the asset’s amortized cost basis until the loan is sold and recognized as part of the gain or loss on sale. For loans held for investment, ASC 310-20-30-2 requires loan origination fees and direct loan origination costs to be offset and the net amount deferred and recognized over the life of the loan as an adjustment to the yield, using the interest method (refer to Section 5.4.2) to arrive at a constant effective yield on the net investment. As further discussed in Section 5.4.3.5, a straight-line method is used (rather than the interest method) for certain types of assets.

Deferred net fees or costs should not be amortized during periods in which interest income on the asset is not being recognized due to concerns about collectibility of principal or interest. Section 5.5.1 addresses the treatment of deferred net fees or costs related to modified loans.

The guidance in ASC 310-20 should generally be applied to individual loans or investments. It is not appropriate to aggregate similar assets when recognizing net fees or costs and purchase premiums or discounts unless the provisions of ASC 310-20-35-26 (discussed in Section 5.4.2.6) are met or the resulting recognition is not materially different from the amount that would have been recognized on an individual asset basis. ASC 310-20 requires contractual payment terms to be used in calculating the constant effective yield necessary to apply the interest method. As further discussed in Section 3.5.2, the premium on certain callable debt securities is amortized to the earliest call date. The maturity date of each loan or debt security should otherwise be used in determining the effective yield, without giving consideration to expected prepayments except for a group of loans accounted for in accordance with the guidance discussed in Section 5.4.2.6.

### 5.4.3.3 Loan origination fees

Loan origination fees are defined in ASC 310-20 to include all of the following:

- Fees that are being charged to the borrower as prepaid interest or to reduce the loan's nominal interest rate or to otherwise result in terms that absent the fee would not have been considered (e.g., points, implicit or explicit yield adjustments)
- Fees to reimburse the lender for origination activities
- Other fees charged to the borrower that relate directly to originating, refinancing or restructuring a loan, including but not limited to management, arrangement, placement, application, underwriting and syndication and participation fees (to the extent they are associated with the portion of the loan retained by the lender)

Refundable fees are excluded from the scope of ASC 310-20 until they are no longer refundable.

#### 5.4.3.3.1 Other lending fees

ASC 310-20-35-34 indicates that loan fees that are unrelated to the origination of loans should also generally be recognized over the remaining life of the loan as an adjustment of yield. Examples include fees paid to the lender to extend the maturity of a loan or modify its interest rate. As is noted in ASC 310-10-25-13, delinquency fees should be recognized in income when chargeable if collectibility is reasonably assured.

### 5.4.3.4 Definition of direct loan origination costs

Direct loan origination costs are defined as costs associated with originating a loan and include only the following:

- Incremental direct costs of loan origination incurred in transactions with independent third parties that are not billed directly to the borrower. (As noted in ASC 310-20-25-25, if an entity uses a third party for loan originations that is not independent, but also is not an employee of the entity, the costs should be deferred). According to ASC 310-20-55-9, independent third parties possess the following characteristics:
  - They are not employees of the lender.
  - They are not receiving employee benefits of the lender.
  - The party is not under the control of the lender.

- Generally, the party also would provide similar services to other entities unrelated to the lender and there would not be an agreement between the lender and the party that precludes the party from providing similar services to other entities.



**RSM COMMENTARY: Independence considerations when the lender holds an ownership or equity interest in an entity that provided loan origination-related services on behalf of the lender**

Generally, the existence of an ownership or equity interest in a service provider indicates a relationship that would not qualify as an independent third party. However, a nominal passive investment from the standpoint of both the lender and the provider of service probably would not affect the provider's independence. According to ASC 310-20-55-10, such ownership interest should be evaluated based on the level of ownership and influence that could be imposed.

- Certain costs directly related to specified activities performed by the lender for that loan. Those activities<sup>14</sup> include all of the following:
  - Evaluating the prospective borrower's financial condition.
  - Evaluating and recording guarantees, collateral and other security arrangements.
  - Negotiating loan terms.
  - Preparing and processing loan documents.
  - Closing the transaction.

As noted in ASC 310-20-25-6 and 25-7, costs that are deferred should only include the portion of employees' total compensation and payroll-related fringe benefits that are directly related to time spent performing these activities for a particular originated loan and other costs related to those activities that would not have been incurred but for that loan.

Examples of incremental employee compensation costs directly related to the lending activities described above include:

- Bonuses based on successful production of loans that are paid to employees involved in loan origination activities. Such costs are partially deferrable as direct loan origination costs (ASC 310-20-25-6)
- The portion of total compensation of executive employees that relates directly to time spent approving successful loans prior to funding. For example, the amount of compensation allocable to time spent by members of a loan approval committee (ASC 310-20-55-13)
- Payroll-related fringe benefits such as any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include payroll taxes; dental and medical insurance; group life insurance; retirement plans; 401(k) plans; stock compensation plans (e.g., stock options and stock appreciation rights); and overtime meal allowances (ASC 310-20-55-12)

<sup>14</sup> ASC 310-20-55-15 provides the following examples of specified activities contemplated as direct loan origination costs under the definition of that term: (a) loan counseling, such as discussing alternative borrowing arrangements with borrowers, and negotiating terms, (b) application processing, (c) appraisal, (d) initial credit analysis, (e) initial credit investigation, (f) quality control review performed during the underwriting period, (g) direct approval processing, (h) loan evaluation and approval committees (all activities involved in origination decisions), and (i) loan closing.

**ASC 310-20-25-7**

If compensation for an employee traditionally paid by salary or hourly wage is switched wholly or partially to commissions on successful loan production, such costs would be partially deferrable as direct loan origination costs under the definition of that term. As specified in the preceding paragraph, only the portion of the employee's total compensation directly related to time spent on activities contemplated in the definition of that term for completed loans would be deferred.

Commission-based compensation arrangements between a lender and its employees may be similar to arrangements a lender may have with independent third parties such as loan brokers. However, when origination activities are performed by the lender's employees, the lender must allocate compensation costs applicable to the activities contemplated in the definition of direct loan acquisition costs based on the portion of time spent by employees. An allocation of the employees' total compensation between origination and other activities is made so that only those costs associated with those lending activities contemplated in the definition of that term are deferred for completed loans, even if commissions are 100 percent of such compensation and are based solely on completed loan transactions.

Examples of other direct loan origination costs that may be deferred for loans that are granted include (a) reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities, (b) costs of itemized long-distance telephone calls related to loan underwriting, and (c) reimbursement for mileage and tolls to personnel involved in on-site reviews of collateral before the loan is granted. [ASC 310-20-55-11]

**RSM COMMENTARY: Important reminder**

Understanding the definition of direct loan origination costs is critical. Only costs that both (a) relate directly to originating the loan, and (b) are incremental to originating the loan, may be deferred by the lender. In other words, only those costs that would not otherwise be incurred if the loan were not originated may be capitalized.

As indicated in ASC 310-20-25-3 to 25-5, the following lending-related costs are not considered to be direct loan origination costs and should be charged to expense as incurred:

- Costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans and other ancillary activities related to establishing and monitoring credit policies, supervision and administration
- Employees' compensation and fringe benefits associated with the preceding activities, unsuccessful loan origination efforts and idle time
- Administrative costs, rent, depreciation and all other occupancy and equipment costs
- Costs for software dedicated to loan processing
- Fees paid to a service bureau for loan processing
- Loan origination advisory fees

ASC 310-20-25-26 and 25-27 address other costs that should be expensed as incurred, regardless of whether the costs are paid to independent third parties or incurred internally:

- Fees paid to independent third parties for advisory services regarding loan origination activities, even if those same activities are performed internally, are not considered to be incurred for the specified activities set forth in the definition of the direct loan acquisition costs term
- Fees paid to an independent third party, or incurred internally, for portfolio management or investment consultation are considered other costs incurred in connection with acquiring purchased loans or

committing to purchase loans because they constitute investment advisory costs, not loan origination costs.



**RSM COMMENTARY: Important reminder**

Entities need to remember that costs incurred in connection with acquiring loans or committing to purchase loans, including a participation in a loan, should be charged to expense in accordance with ASC 310-20-35-15 (see Section 5.4.2.5). Designating such costs as an origination fee or cost for a loan is inappropriate because a purchased loan has already been originated by another entity (ASC 310-20-25-23).

**5.4.3.4.1 Determining the amount of lending-related costs to defer**



**ASC 310-20-25-8**

This Subtopic does not specify how costs are to be determined but rather what costs must be deferred. In many instances, standard costing may be used to estimate the costs to be deferred in accordance with the provisions of this Subtopic. For certain loans, the cost of origination may be similar and standard costing may be appropriate for those loans, while other loans may be of such a nature that costs must be identified separately. Lenders may use any one or a combination of methods that will provide adequate information to report financial results in accordance with this Subtopic. Development of a standard costing system will require periodic analysis of variances and, if necessary, adjustment of standard costing estimates. Possible standard cost methods that may be used to measure costs applicable to transactions that have occurred include standard costs, actual costs, job process (for example, homogeneous loans), or job order (for example, specific loans).

**ASC 310-20-25-9**

The successful-efforts accounting notion utilized at an entity-wide level may result in a standard cost system that does not accurately reflect the amount of costs that may be deferred and amortized under the provisions of this Subtopic. Successful loan efforts can be determined as a percentage of each function (for example, application, verification, underwriting, appraisal, closing) and may be based on the percentage, adjusted for idle time and time spent on activities for which the related costs cannot be deferred, of successful and unsuccessful efforts determined for each function.

For new loans that have not yet closed, ASC 310-20-25-10 requires that a lender use judgment to estimate the number of loans in process that it will execute successfully. Origination costs associated with a loan in process may be deferred until either (a) the loan is closed, or (b) the loan origination process is determined to be unsuccessful. Any deferred lending-related costs related to loans in process that are deemed unsuccessful after the balance sheet date, but before the financial statements are issued should be charged to expense in the period ending with the balance sheet date.



**RSM COMMENTARY: Important reminder about accounting for fees and direct loan origination costs**

The accounting for fees and direct lending costs depends on the nature of the fee or cost. As a result, an entity should establish appropriate processes and controls to ensure such fees and costs are properly captured and categorized in the accounting records. If an entity does not correctly categorize its lending fees and costs, fees and costs may be recognized in earnings in the wrong period. For example, a fee could be deferred and amortized into earnings over time when it should have been immediately recognized in earnings.

Common recordkeeping mistakes and related control deficiencies over financial reporting include:

- Failure to track fees and costs on an individual loan basis
- Failure to separately monitor and properly categorize fees and costs (e.g., commitment fees, underwriting fees, prepayment fees)
- Failure to reassess and revise estimates based on a periodic comparison of actual versus estimated costs

### 5.4.3.5 Special considerations

#### 5.4.3.5.1 Loan syndication fees

The entity managing a loan syndication (i.e., the syndicator) should recognize loan syndication fees when the syndication is complete unless a portion of the syndicated loan is retained. If the syndicator retains a portion of the loan, and with consideration given to the fees passed through by the syndicator, the yield on that portion is less than the average yield to the other syndication participants, the syndicator is required by ASC 310-20-25-19 to defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

#### 5.4.3.5.2 Commitment fees

ASC 310-20-35-3 provides guidance specific to the recognition of commitment fees to purchase or originate loans and providing commercial letters of credit.<sup>15</sup> If the commitment is exercised, the fee is recognized over the life of the loan as an adjustment of yield. If the commitment expires unexercised, the fee is recognized in income when the commitment expires.

Special guidance is provided for commitments for which exercise is considered to be remote. Namely, if an entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee should be recognized on a straight-line basis as service fee income (rather than interest income) over the commitment period. If the commitment is subsequently exercised, any unamortized commitment fee should be recognized over the life of the loan as an adjustment of yield. ASC 310-20-25-13 indicates that if the origination costs for a commitment with a remote likelihood of being exercised exceed the commitment fees that were received, these net costs should be charged to expense immediately rather than deferred.

Commitment fees that are determined retrospectively as a percentage of the available but unused commitment amount should be recognized as service fee income (rather than interest income) as of the determination date if the percentage fee is nominal in relation to the stated interest rate on any related borrowing, and the borrowing will bear a market interest rate at the date the loan is made.



#### **RSM COMMENTARY: Application of the guidance in ASC 310-20-35-3 to net commitment fees**

ASC 310-20-25-12 requires that the guidance discussed in this section be applied to any direct loan origination costs incurred to make a commitment to originate a loan net of any related commitment fees.

<sup>15</sup> ASC 310-20-25-14 makes clear that commitment fees include fees received for providing commercial letters of credit.

#### 5.4.3.5.3 Lines of credit

Guidance specific to lines of credit is included in ASC 310-20-55-3 and ASC 310-20-35-23 to 35-25 and indicates that direct origination costs associated with lines of credit should be recognized on a straight-line basis over the commitment period, or for a revolving line of credit and similar arrangements, the maximum term. If the borrower pays all borrowings and cannot borrow again under the contract, any unamortized net fees or costs should be recognized in income at that time. The interest method (rather than the straight-line method) should be used to recognize net unamortized fees or costs when the loan agreement provides for scheduled repayments and no additional borrowings are available under the agreement. If the likelihood that a nonrevolving commitment will be exercised is remote, any net costs should be charged to expense immediately.

For those lines of credit that provide the borrower with the option to convert to a term loan, the costs should be recognized on a straight-line basis over the combined life of the line of credit and term loan. As illustrated in ASC 310-20-35-24, if the borrower elects to convert the line of credit to a term loan, the unamortized net fees or costs should then be recognized as an adjustment of yield using the interest method.

#### 5.4.3.5.4 Line of credit or credit facility with multiple unscheduled drawdowns

If drawdowns are anticipated on a credit facility that provides for multiple, unscheduled drawdowns (or loans) with varying maturities, and the facility does not have the characteristics of a revolving line of credit (i.e., repayments of amounts borrowed are not available for re-borrowing), ASC 310-20-55-49 explains that the related commitment fee should be deferred until the facility is exercised and a drawdown is made. Given that there are multiple, unscheduled drawdowns, a pro rata portion of the commitment fee (equal to the percentage of the loan drawn down to the total facility) should be recognized over the life of the applicable drawdown as an adjustment of its yield.

The following example from the FASB Codification illustrates the accounting described above.



#### **Example 5-11: Line of Credit or Credit Facility with Multiple Unscheduled Drawdowns (from Example 11 in ASC 310-20-55-49 to 55-50)**

Assume that a commitment fee net of deferrable costs of \$100,000 is received at the inception of a 2-year facility of \$10,000,000 that permits the borrower to make multiple, unscheduled drawdowns of varying maturities during the 2-year commitment period. Assume then that the borrower draws down a \$1,000,000 loan due in 3 years in the fourth month of the 2-year commitment period. Assume further that the borrower draws down another \$2,000,000 loan due in 5 years in the sixth month of the commitment period. The remainder of the facility expires unused. The commitment fee would be recognized as follows:

- a. At inception of the facility. Qualifying costs to establish the credit facility would be deferred, and no fee income would be recognized because the entire fee is deferred until a drawdown occurs.
- b. Months 1-3. No net fee income would be recognized because no drawdowns have occurred.
- c. Month 4. A pro rata portion of the net commitment fee equal to the ratio of the drawdown to the total facility would be recognized over the life of the drawdown as an adjustment of yield. In this example:  $\text{Current drawdown} / \text{Total facility} \times \text{Net commitment fee} = \text{Amount to be recognized over the life of the drawdown as a yield adjustment}$ . For example:  $\$1,000,000 / \$10,000,000 \times \$100,000 = \$10,000$
- d. Month 6. Similar to the month 4 illustration, a pro rata portion of the deferred net fee equal to the ratio of the current drawdown to the total facility would be recognized over the life of the

drawdown as an adjustment of yield. In this example:  $\$2,000,000/\$10,000,000 \times \$100,000 = \$20,000$

- e. Months 7-23. No additional net fee income other than amortization of net commitment fees recognized as yield adjustments would be recognized because no further drawdowns have occurred; thus, the remaining \$70,000 net commitment fee would continue to be deferred.
- f. Month 24. The remaining deferred net commitment fee of \$70,000 would be recognized in income upon expiration of the facility because additional drawdowns are not possible.

#### *5.4.3.5.5 Credit card fees and costs*

ASC 310-20-25-15 to 25-18 and ASC 310-20-35-4 to 35-8 provide guidance for the deferral of credit card fees and origination costs. Credit card fees, net of direct origination costs, should generally be recognized on a straight-line basis over the period that the fee entitles the cardholder to use the credit card (i.e., the privilege period). If there is no significant fee, a one-year period should be used, in accordance with ASC 310-20-25-17. (Significance for this purpose should be evaluated based on the amount of the fee relative to the related costs.) As ASC 310-20-55-5 points out, costs associated with promotional offers and other solicitation efforts cannot be deferred, even if successful in garnering new accounts given that the lender would have incurred all of the solicitation costs regardless of the number of credit cards issued.

#### *5.4.3.5.6 Loans payable on demand*

For demand and other loan agreements that do not have scheduled payment terms, ASC 310-20-35-22 indicates that the net fees or costs should be amortized on a straight-line basis over a period of time consistent with the understanding between the borrower and lender, or if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding, with any unamortized amount recognized when the loan is paid in full. The estimated period of time should be monitored and revised as appropriate.

#### *5.4.3.5.7 Construction loan with related permanent financing*

Fees and costs on a nonrevolving construction loan for which the lender has made a permanent financing commitment should be recognized as an adjustment of yield over the combined life of the construction and permanent loans if the lender believes the commitment has more than a remote probability of being exercised. The interest method would be applied based on estimated payments if the timing and amount of payments are not specified. If the commitment to provide permanent financing subsequently expires unused, any unamortized fees and costs should be recognized at that time in accordance with ASC 310-20-55-16.

#### *5.4.3.5.8 Multi-option facility*

Some lenders offer loan commitments known as "multi-option facilities" that gives the borrower several alternative financing options. Under the multi-option facility, the borrower can access a combination of different funding options, and each option may have different terms and fees. The lenders may receive a variety of fees in connection with these types of facilities. Some fees may be yield related (e.g., fees for providing back-up facilities or revolvers), while others may be labeled as compensation for services rendered (e.g., management fees or note placement fees).

In accordance with ASC 310-20-35-3, commitment fees are generally deferred. For amortization purposes, fees received for a multi-option facility must be allocated to each product in the facility because the amortization of certain fees must be reported as service fee income while the amortization of other fees must be reported as interest income. If a portion of the fee is for a line of credit product, the fee



allocated should be recognized in income on a straight-line basis over the period the revolving line of credit is active. If the likelihood that a commitment provided under a multi-option facility will be exercised is remote, ASC 310-20-35-3(a) requires that the fee be recognized over the commitment period on a straight-line basis as service fee income. [ASC 310-20-55-4]

#### 5.4.3.5.9 Loans with teaser rates

An entity may issue a loan with a below-market interest rate for an initial period of time, but then adjust to a market rate. The initial below-market interest rate is sometimes referred to as a teaser rate. Under ASC 310-20-55-6, the entity issuing a loan with a teaser rate would amortize the net loan fees and costs using the interest method over the life of the loan.



#### ASC 310-20-55-6

Loans may be offered for some initial period at an interest rate below the current market rate with the interest rate scheduled to adjust to a market rate after the initial discount period. Amortization of net loan fees and costs is based on the interest method over the life of the loan and limited by the provisions of paragraph 310-20-35-18(a) and 310-20-35-18(c) during the discount period. Thereafter, the provisions of paragraph 310-20-35-18(c) are applicable. See Examples 5 and 6 (paragraphs 310-20-55-33 through 55-37) for illustrations.

#### ASC 310-20-55-7

Assume that an institution originates adjustable rate mortgages that have a below-market interest rate in the first year that subsequently will be adjusted to a market rate in the second year. Also assume that the adjustable rate mortgages are sold to an independent third party at a discount reflecting the below-market interest rate in Year 1. Paragraph 310-20-35-15 provides that the initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. The buyer should recognize the discount as an adjustment of yield over the life of the loan in accordance with paragraph 310-20-35-18(a) and 310-20-35-18(c). The purchase discount should be amortized to create a constant effective yield; thus, the majority of the discount would be recognized as interest income in the first year.

## 5.5 Loan refinancing or restructuring



### Spotlight: Important note on key changes

Prior to the adoption of ASU 2022-02, U.S. GAAP provided an exception to the general recognition and measurement guidance for loan restructurings and refinancings that an entity determined to meet specific criteria to be considered a TDR. Loan modifications were considered TDRs, and thus were subject to different accounting guidance, if they were made to borrowers experiencing financial difficulty and if the creditor had granted a concession. If a modification was deemed to be a TDR, an incremental expected loss, if any, was recorded in the allowance for credit losses upon modification. Also, discounted cash flow models were required for measurement of some TDRs given the nature of certain concessions granted to borrowers that can only be captured through the use of such models. Additionally, specific disclosures were required for TDRs.

With the issuance of ASU 2016-13 and the creation of a new model for recognizing credit losses on financial assets carried at amortized cost, some financial statement users and stakeholders noted that the TDR recognition and measurement guidance no longer provided meaningful information as the designation of a loan as impaired (including TDRs) is already considered upon the adoption of ASU 2016-13 as the lifetime estimate of expected credit losses must be considered when the instrument is initially created. As such, ASU 2022-02

eliminated the TDR recognition and measurement guidance for creditors and instead, requires an entity to apply the guidance in ASC 310-20 to all loan modifications to determine if the loan should be accounted for as a new loan or a continuation of an existing loan. The amendments also enhance existing disclosure requirements and introduce new requirements related to certain modifications of receivables made to borrowers experiencing financial difficulty (which are discussed in Section 8.4.2.1).



### Spotlight: Reference rate reform and phase out of LIBOR

Regulators in various jurisdictions around the world have been working to replace LIBOR and other interbank offered rates with reference interest rates that are supported by transactions in liquid and observable markets. Given the prevalent use of LIBOR, and other interbank offered rates expected to be discontinued, the volume of contracts that will have to be modified to replace these reference rates with alternative rates, and therefore be subject to U.S. GAAP on contract modifications, may be overwhelming for many entities. In addition, changes in a reference rate could affect the application of hedge accounting, and certain hedging relationships may not qualify as highly effective during the period of the market-wide transition to a replacement rate.

To ease the expected burden on financial reporting related to reference rate reform, the FASB issued [ASU 2020-04, Reference Rate Reform \(Topic 848\): Facilitation of the Effects of Reference Rate Reform on Financial Reporting](#). The ASU provides temporary optional expedients and exceptions to U.S. GAAP on contract modifications, hedge accounting and other transactions. Our white paper, [Optional accounting expedients can make LIBOR transition easier](#), provides additional information about reference rate reform and discusses the temporary optional expedients and exceptions provided by the FASB, as well as the circumstances under which an entity may elect those expedients and exceptions. These optional expedients can be applied until December 31, 2024 with limited exceptions.

#### 5.5.1 Determining if a modification should be treated as a new loan or the continuation of an existing loan

ASC 310-20 provides guidance for determining if a refinanced or restructured loan is treated as a new loan or the continuation of an existing loan, including the accounting treatment for any unamortized net fees or costs and any prepayment penalties that remain from the original loan (which is discussed in Section 5.5.1.1). These fees and costs would be fully recognized in interest income when the new loan is granted if the refinancing is deemed to be a new loan rather than being carried forward as a part of the net investment in the new loan, along with any fees and direct loan origination costs associated with the refinancing or restructuring, if not deemed to be a new loan.

For a loan restructuring or refinancing to result in the recognition of a new loan, both of the following conditions (which are elaborated on immediately thereafter) must be met:

- The terms of the modified loan are as favorable or better to the lender as the terms for comparable loans to other customers with similar credit risk, and
- The modifications to the original loan are more than minor.

ASC 310-20-35-9 indicates that if the terms of a refinanced or restructured loan are as favorable or better to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan, the refinanced loan should be accounted for as a new loan. In other words, the refinanced loan would be considered to be a new loan if its effective yield (considering

the nominal interest rate, commitment and origination fees, direct loan origination costs and other relevant factors) is at least equal to the effective yield for the comparable loans. However, ASC 310-20-35-10 clarifies that only modifications to the original loan that are considered to be more than minor result in recognition of a “new loan.”

ASC 310-20-35-11 indicates that modifications are considered to be more than minor if the present value of the cash flows under the terms of the modified instrument are at least 10% different than the present value of the remaining cash flows under the terms of the original instrument. The cash flows computation should be performed in a manner consistent with ASC 470-50. Codification also indicates that in the absence of a 10% difference, consideration should be given to the specific facts and circumstances to determine if the modification is more than minor. To illustrate this two-step evaluation, consider the following example.



**Example 5-12: Application of the loan modification guidance in ASC 321-20-35-11 when the quantitative assessment is inconclusive**

Assume that after a severe economic recession, resulting in a significant decline in market interest rates, a lender agrees to renegotiate the terms of business loan with a borrower. Following the renegotiation, the lender computes the present value of the expected cash flows consistent with the guidance beginning in ASC 470-50-40-10 and determines that the modification results in a 9% reduction in cash flows compared to the present value of the remaining cash flows under the terms of the original loan, which is less than the minimum 10% difference required under GAAP for the modification to be considered more than minor. However, ASC 310-20-35-11 indicates that in the absence of a 10% difference, consideration should be given to the specific facts and circumstances to determine if the loan modification is more than minor. The terms of the modified loan also resulted in a change in the collateral requirements. Prior to the modification the borrower was required to pledge government securities to secure the loan’s repayment. However, following an increase in the borrower’s creditworthiness, the lender agrees to release the collateral requirements thereby converting the secured loan to a loan that is unsecured. Accordingly, after considering that change, along with the 9% reduction in expected cash flows, the lender concludes that the modification is more than minor and represents the issuance of a new loan.



**Example 5-13: Application of Loan Modification Guidance (from Example 13 in ASC 310-20-55-54 to 55-56)**

This Example illustrates the guidance in paragraph 310-20-35-9 to determine whether the terms of a modified loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender.

This Example has the following assumptions: On January 1, 20X1, Entity J originates a 10-year \$100,000 consumer loan to an individual with a FICO score of 710. The loan’s stated interest rate is 7 percent. On June 30, 20X3, Entity J modifies the loan to reduce the effective interest rate to 3 percent. At the time of the modification, the borrower’s credit score is 650. Between the loan’s origination date and modification date, interest rates have decreased and the at-market interest rate for a borrower with a credit score of 650 is 5 percent at the date of the modification.

On the date of the modification, Entity J compares the effective interest rate on the modified loan with the effective interest rate that it has negotiated for new loans with similar characteristics originated to borrowers with a credit score that approximates 650. Entity J concludes that the effective interest rate on the modified loan (3 percent) is lower than the effective interest rate on a similar new loan (5 percent), and, therefore, Entity J does not have to assess whether the modification is more than minor in

accordance with paragraph 310-20-35-11. Instead, the modification would be accounted for as a continuation of the existing loan.



**RSM COMMENTARY:** Two conditions must be met for a loan restructuring or refinancing to result in the recognition of a new loan under ASC 310-20-35-9. First, the terms of the modified loan must be as favorable or better to the lender as the terms for comparable loans to other customers with similar credit risk, and second, the modifications to the original loan must be more than minor.

The example above states that the effective interest rate on the modified loan is 3%, which is less than the 5% effective interest rate Entity J negotiated on a new loan with a different borrower with a similar credit rating. Because the effective interest rate on the modified loan is less favorable to Entity J than the rate for a comparable loan with another customer with a similar credit risk, the modification fails the first condition in ASC 310-20-35-9, and obviates the need for Entity J to assess whether the modified terms are more than minor. As a result, the modification is treated as a continuation of the original loan.

**5Q.5.1.1:** *Blended-rate loans involve lending new funds at market interest rates combined with existing loans at rates currently lower than market rates. (Those funds are not advanced under a line of credit.) The combined loan yields an interest rate between the existing loan rate and the market rate. The resulting loan is subject to the same underwriting standards as all other new loans. Is this arrangement considered a refinancing?*

Pursuant to ASC 310-20-35-35, this arrangement is considered a refinancing but it does not meet the yield criteria prescribed in ASC 310-20-35-9. As a result, the unamortized net fees and costs on the existing loan as well as the net fees and costs associated with the refinancing should carry over to the new loan because the blended rate is below the market rate of loans with similar collection risks made to the lender's other customers.

#### **5.5.1.1 Accounting for unamortized net fees or costs and any prepayment penalties after a loan modification**

The determination of whether a modified loan represents a new loan impacts the accounting for any unamortized net fees or costs and any prepayment penalties that remain from the original loan. In accordance with ASC 310-20-35-9, any unamortized net fees or costs and any prepayment penalties are required to be fully recognized in interest income when the new loan is granted, if the modification is deemed to be a new loan. If the modification is not deemed to be a new loan, the unamortized net fees or costs and any prepayment penalties would be carried forward as a part of the net investment in the modified loan, along with any fees and direct loan origination costs associated with the refinancing or restructuring. In this case, ASC 310-20-35-10 indicates that the investment in the modified loan would consist of the remaining net investment in the original loan, any additional funds advanced to the borrower, any fees received, and any direct loan origination costs associated with the refinancing or restructuring.



#### **ASC 310-20-35-13**

The borrower and lender may enter into an agreement whereby the borrower increases his mortgage payments for a specified period, at the conclusion of which the lender forgives a portion of the remaining principal on the loan. The borrower may terminate the arrangement at any time but receives no principal reduction if he makes less than 12 consecutive increased payments. The guidance in paragraph 310-20-35-11 shall first be used to determine whether the modification is considered more than minor under paragraph 310-20-35-10. If not, [meaning the modification is

considered a continuation of the original loan (see Section 5.5.1)] and assuming it is probable that the borrower will continue to make the increased payments for the specified period, the expense relating to the partial forgiveness shall be accrued over the period of increased payments.

#### **ASC 310-20-35-14**

Because of a decline in general interest rates, a lender may reduce the interest rate on an existing loan and collect a loan fee. Because the interest rate modification does not require another loan closing, the borrower is not charged many of the standard closing costs. The effective yield on the new loan shall be compared with the effective yield of comparable loans to the lender's other new customers to determine whether the yield on the new loan is at least as favorable as the effective yield for such loans. If so, the guidance in paragraph 310-20-35-11 shall be used to determine whether the modification is considered more than minor under paragraph 310-20-35-10. [See Section 5.5.1] If not, [meaning the modification is considered a continuation of the original loan (see Section 5.5.1)] the unamortized net fees and costs from the original loan and any prepayment penalties shall be carried forward as part of the net investment in the new loan. However, if the interest rate modification is provided for in the original loan contract, the change in the interest rate shall be accounted for in accordance with paragraph 310-20-35-18 and not considered a refinancing for purposes of paragraphs 310-20-35-9 through 35-10.

### **5.5.2 Determining whether a debtor is experiencing financial difficulties**

A lender (creditor) is required to evaluate if the borrower (debtor) is experiencing financial difficulties whenever a loan is restructured or refinanced. That's because U.S. GAAP requires additional disclosures for certain modifications of loans made to borrowers experiencing financial difficulty regardless of whether the modification is treated as a new loan or the continuation of an existing loan. The following indicators from ASC 310-10-50-45 should be considered by the creditor in evaluating whether the debtor is experiencing financial difficulties for the purpose of the disclosure requirements in ASC 310-10-50-42 through 50-44 (see also Section 8.4.2.1):

- a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.
- b. The debtor has declared or is in the process of declaring bankruptcy.
- c. There is substantial doubt as to whether the debtor will continue to be a going concern.
- d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
- f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

### 5.5.2.1 Evaluating whether a restructuring results in a delay in payment that is insignificant

When a creditor determines that a debtor is experiencing financial difficulty, if the restructuring results in only insignificant payment delays, the disclosures required in ASC 310-10-50-42 through 50-44 are not required (see Section 8.4.2.1). The following factors from ASC 310-10-50-46, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

- a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
- b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
  1. The frequency of payments due under the debt
  2. The debt's original contractual maturity
  3. The debt's original expected duration.

If the debt has been previously restructured, an entity shall consider the cumulative effect of past restructurings made within the 12-month period before the current restructuring when determining whether a delay in payment resulting from the current restructuring is insignificant. [ASC 310-10-50-47]

The following examples from the FASB Codification illustrate what is and is not considered an insignificant payment delay.



#### **Example 5-14: Commercial real estate debt with balloon payment (from Example 4 in ASC 310-10-55-12B to 55-12E)**

A restructuring that results in only a delay in payment that is insignificant is not required to be disclosed. This Example illustrates the guidance in paragraphs 310-10-50-36 and 310-10-50-42 through 50-44 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

A creditor originates a seven-year loan to a debtor. The debt:

- a. Has a fixed interest rate
- b. Is collateralized by commercial real estate
- c. Requires monthly interest payments
- d. Requires a balloon principal payment at maturity.

At origination, the debtor expects to repay the principal by refinancing the debt with the real estate held as collateral. That is, the collateral is the primary source of payment of the debt's principal balance, whether through a refinancing of the debt or a sale of the property. However, before maturity, the fair value of the collateral was less than the principal amount due at maturity, and as a result of market conditions, the debtor is unable to refinance the debt. The debtor plans to sell the property to repay the debt and requests an extension of the debt's maturity date to allow time to liquidate the property. In response to the debtor's financial difficulties, the creditor grants the debtor a three-month extension of the debt maturity date. At the time that this extension was granted, the debtor had not yet identified a buyer for the collateral.

The restructuring results in a delay in payment that is not insignificant. Although the delay in timing of payment is insignificant (relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration), the creditor expects a significant shortfall in cash

flows relative to the contractual amount due when the property is sold because the property is the sole source of repayment.



**Example 5-15: Residential mortgage debt—temporary payment deferral (from Example 5 in ASC 310-10-55-12F to 55-12H)**

A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-10-50-36 and 310-10-50-42 through 50-44 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

A debtor obtains a 30-year mortgage loan that requires monthly principal and interest payments. In year 4, the debtor experiences financial difficulties and misses two payments. On the basis of the debtor's financial hardship, the debtor and the creditor agree on a forbearance arrangement and repayment plan. Under the terms of the forbearance arrangement and repayment plan, the creditor agrees not to take any foreclosure action if the debtor increases its next four monthly payments such that each payment includes one fourth of the delinquent amount plus interest. The agreement does not result in the creditor charging the debtor interest on past due interest. At the end of the forbearance arrangement, the debtor will:

- a. Have repaid all past due amounts
- b. Be considered current in relation to the debt's original terms
- c. Have resumed making monthly payments set out under the debt's original terms.

The restructuring results in a delay in payment that is insignificant. At the time of the forbearance arrangement, the creditor expects to collect all amounts due for the periods of delay. Furthermore, the length of delay resulting from the forbearance arrangement is considered insignificant in relation to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.



**Example 5-16: Commercial line of credit—short-term extension before the finalization of renegotiated terms (from Example 6 in ASC 310-10-55-12I to 55-12K)**

A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-10-50-36 and 310-10-50-42 through 50-44 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

A commercial debtor has a revolving line of credit with a creditor with an original term of five years. The terms of the line of credit require interest payments every 90 days on the average daily balance of the line. As the line of credit nears maturity, the debtor and creditor begin renegotiating the terms of a new line of credit. Because of a temporary cash shortfall due to a delay in collections from two key customers, the debtor is unable to make the final interest payment before the two parties finish renegotiating the terms of the new line of credit. The terms of the renegotiated line of credit are expected to be similar to the current line of credit, which are comparable to terms available to debtors with similar risk characteristics. The creditor expects the debtor to recover quickly from this temporary cash flow shortage. Accordingly, the creditor extends a 3-month payment deferral by adding the missed interest payment to

the balance of the line and requiring the debtor to make its first interest payment 90 days after the new line of credit is finalized, or 180 days after the due date of the missed interest payment.

The restructuring results in a delay in payment that is insignificant. Although the debtor is unable to make the contractual payment at the time it is due, thereby resulting in the three-month deferral, the creditor still expects to collect all amounts due, including interest at the contractual rate. Furthermore, the delay in timing of payment represents only one payment cycle under the terms of the line, which is insignificant relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.

### 5.5.3 Cost basis of debt security received in a restructuring

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring.

The issues are (1) what the initial cost basis of a debt security of the original debtor received in the restructuring of a loan should be and (2) how the creditor should account for any difference between the creditor's basis in the loan and the fair value of the security at the date of the restructuring.

ASC 310-20-40-10 clarifies that the initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses.

In accordance with ASC 310-20-40-11, a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest.

Subsequent to a loan restructuring, the debt security received by the creditor should be accounted for in accordance with the provisions of ASC 320 (see Section 3.3).

### 5.5.4 Accounting for partial or full satisfaction of a receivable

Assets received in conjunction with the full or partial settlement of a receivable should generally be recognized at fair value less costs to sell, if relevant. As discussed in Section 5.5.4.1, assets received in partial (rather than full) settlement of the loan are applied as a reduction to the amortized cost basis of the receivable. As discussed in Section 5.5.4.2, assets received in full satisfaction of a receivable result in loss recognition for the amount by which the creditor's net investment in the loan exceeds the fair value of the assets received. The creditor accounts for the assets received in the satisfaction of the debt post-restructuring the same as if they had been acquired for cash.



#### **RSM COMMENTARY: Use of amortized cost basis versus carrying amount**

The amortized cost basis is used in ASC 310-20-35-12A; ASC 310-20-35-12C; ASC 310-20-40-2 through 40-9; and ASC 310-10-50-36 instead of carrying amount of the receivable because the latter is net of an allowance for estimated uncollectible amounts or other valuation account, if any, while the former is not, in accordance with ASC 310-20-40-3.

The ASC Master Glossary defines the amortized cost basis as “the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.”



For a receivable, the ASC Master Glossary defines carrying amount as “the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs and also an allowance for uncollectible amounts and other valuation accounts.”

#### 5.5.4.1 Receipt of assets in partial satisfaction of a receivable

According to ASC 310-20-35-12C, a creditor should account for a loan refinancing or restructuring involving a partial satisfaction and modification of terms in accordance with the guidance in ASC 310-20-35-9 through 35-11 (see Section 5.5.1) to determine whether the modified loan should be treated as a new loan or the continuation of the original loan, except that, first,

- the assets received should be accounted for as prescribed in ASC 310-20-40-2 through 40-4 (see Section 5.5.4.2) and
- the amortized cost basis (as defined in the ASC Master Glossary) of the loan should be reduced by the fair value<sup>16</sup> less cost to sell of the assets received. If cash is received in a partial satisfaction of a receivable, the amortized cost basis should be reduced by the amount of cash received.

It's important to note that ASC 310-20-35-12C requires the accounting described above even if the stated terms of the remaining receivable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the receipt of assets (including an equity interest in the debtor). Also, as with any loan modification, the creditor should evaluate if the debtor is experiencing financial difficulties (see Section 5.5.2) to determine if the disclosures summarized in Section 8.4.2.1 apply.

#### 5.5.4.2 Receipt of assets in full satisfaction of a receivable

A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, should account for those assets (including an equity interest) at their fair value at the time of the restructuring. [ASC 310-20-40-2]

A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable should account for those assets at their fair value less cost to sell (as that term is used in ASC 360-10-35-43). The excess of (i) the recorded investment in the receivable (i.e., the amortized cost basis, as defined in the ASC Master Glossary) satisfied over (ii) the fair value of assets received (less cost to sell, if required above) is a loss to be recognized. Losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, should be included in measuring net income for the period (see ASC 310-20-40-3). According to ASC 310-20-40-4, creditors are not precluded from using the fair value of the receivable satisfied if more clearly evident than the fair value of the assets received in full satisfaction of a receivable.

<sup>16</sup> ASC 310-20-35-12B requires that the fair value of the assets received (less cost to sell) be used to determine the amount of the receivable satisfied to avoid the need to allocate the fair value of the receivable between the part satisfied and the part still outstanding.



**Example 5-17: Fair value less cost to sell less than the seller's net receivable (from Example 12 in ASC 310-20-55-51 to 55-53)**

This Example illustrates the guidance in Subtopic 310-20. The Example has the following assumptions:

- a. At December 31, 20X2, a lender's net real estate loan receivable was \$90,000. The net receivable was comprised of (a) \$100,000 principal balance and (b) \$10,000 allowance for credit losses due to the deterioration of the borrower's credit worthiness; the allowance was based on the underlying value of the real estate since the loan is collateral dependent.
- b. Between December 31, 20X2 and March 31, 20X3, the borrower did not make principal payments. On March 31, 20X3, the real estate's estimated fair value was \$75,000. The estimated costs to sell were \$4,000.
- c. On May 1, 20X3, the lender foreclosed on the real estate; the real estate's estimated fair value and costs to sell remained unchanged from March 31, 20X3. The real estate was classified as held for sale under Topic 360, subsequent to foreclosure.
- d. At September 30, 20X3, the fair value of the property was \$65,000. The estimated costs to sell were \$3,000.
- e. At March 31, 20X4, the fair value of the property was \$80,000. The estimated costs to sell were \$5,000.

On March 31, 20X3, the lender estimates expected credit losses using the fair value of the collateral in accordance with paragraphs 326-20-35-4 through 35-5. Accordingly, the lender should record an allowance for credit losses in the cumulative amount of \$29,000 (\$19,000 incremental amount plus \$10,000 recorded previously) measured as the difference between the amortized cost basis (\$100,000) and the fair value less cost to sell (\$71,000). Upon foreclosure on May 1, 20X3, the application of paragraph 310-20-40-5 results in the measurement of a new cost basis (also \$71,000) for long-lived assets received in full satisfaction of a receivable.

The fair value less cost to sell decrease to \$62,000 as of September 30, 20X3, requires the lender to recognize an impairment of \$9,000 (\$71,000 - \$62,000) under Topic 360. While the long-lived asset's fair value less cost to sell increased \$13,000 (\$75,000 - \$62,000) as of March 31, 20X4, the lender's gain recognition is limited to the cumulative losses recognized and measured under Topic 360, or \$9,000. The \$29,000 of credit losses recognized previously under Subtopic 326-20 on financial instruments measured at amortized cost are excluded from the measurement of cumulative losses under Topic 360.

#### 5.5.4.3 Sale of assets from a loan modification determined to be a new loan

A receivable from the sale of assets previously obtained from a loan refinancing or restructuring deemed to be a new loan (see Section 5.5.1) should be accounted for according to ASC 835-30, *Imputation of Interest*. Any difference between the amount of the new receivable and the carrying amount of the assets sold, is recognized as a gain or loss on the sale of the assets. [ASC 310-20-40-9]

#### 5.5.4.4 Use of zero-coupon bonds in a loan refinancing or restructuring

The guidance in ASC 310-20-55-18A through 55-18E illustrate the accounting for a loan modification involving the following circumstances:

In connection with a loan restructuring, a debtor, with the creditor's approval, sells the asset collateralizing the loan that has a fair value less than the creditor's net investment in the related loan. The debtor immediately invests the proceeds in a series of zero-coupon bonds that are transferred and held by the

creditor as collateral for the newly restructured loan. The bonds will mature at a value equal to each year's debt service requirement under the newly restructured terms.

*5Q.5.5.4.4. Does the sale of collateral, the purchase of the zero-coupon bonds, and their receipt by the creditor as collateral require the creditor to recognize a loss equal to the amount by which the net investment in the loan exceeds the fair value of the zero-coupon bonds?*

The creditor should recognize a loss equal to the amount by which its net investment (i.e., the amortized cost basis) in the satisfied loan exceeds the fair value of the assets received less cost to sell (as that term is used in ASC 360-10-35-43). To the extent such losses are not offset against allowances for uncollectible accounts or other valuation accounts, they should be included in measuring the creditor's net income for the period.

Additional transfer of financial assets considerations under ASC 860:

Creditor:

- To the extent the creditor has the right to sell or pledge the collateral received (i.e., the zero-coupon bonds), ASC 860-30-50-1A requires, in part, that the creditor disclose the fair value of that collateral and of the portion that it has sold or repledged.

Debtor:

- To the extent the creditor has the right to sell or pledge the collateral received (i.e., the zero-coupon bonds), ASC 860-30-45-1 requires that the debtor reclassify the collateral and report it in its balance sheet separately from other assets not so encumbered.
- If the creditor does not have the right to sell or pledge the collateral, ASC 860-30-50-1A requires that the debtor disclose information about that collateral.

## 5.5.5 Substitution or addition of debtors

A loan refinancing or restructuring involving substitution of or adding a debtor (i.e., another business entity, an individual or a government entity<sup>17</sup>) is accounted for according to its substance, which is based on the relationship between the new or additional debtor and the original debtor. According to ASC 310-20-35-12A:

- a. If the substitute or additional debtor is, in some manner, related to original debtor, the loan modification should be accounted for in accordance with the guidance in ASC 310-20-35-9 through 35-11 (see Section 5.5.1). Examples include arrangements where the substitute or additional debtor:
  - i. controls, is controlled by (as defined in ASC 810-10-15-8 through 15-8A) or is under common control with the original debtor, and
  - ii. are related after the restructuring by an agency, trust, or other relationship that in substance earmarks certain of the original debtor's funds or funds flows for the creditor although payments to the creditor may be made by the substitute or additional debtor
- b. If the substitute or additional debtor is not related to the original debtor, the modification should be accounted for in accordance with the guidance in ASC 310-20-40-2 through 40-5 (see Section 5.5.4.2)

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<sup>17</sup> Government entities include, but are not limited to, states, counties, townships, municipalities, school districts, authorities, and commissions.

### 5.5.6 Foreclosures

Pursuant to ASC 310-20-40-6, a loan restructuring that is in substance a repossession or foreclosure by the creditor (i.e., the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the loans or receivables) should be accounted for in accordance with the provisions of ASC 310-20-35-12C (see Section 5.5.4.1 for accounting for transactions resulting in the partial satisfaction of a receivable), ASC 310-20-40-2 through 40-4 (see Section 5.5.4.2 for accounting for receipt of assets in full satisfaction of a receivable) and ASC 310-20-40-9 (see Section 5.5.4 for accounting for sale of assets from a loan refinancing or restructuring).

ASC 310-20-55-18F states that a creditor is considered to have received physical possession of a residential real-estate property collateralizing a consumer mortgage loan as the result of an in-substance repossession or foreclosure if either of the following have occurred:

- a. The creditor obtains legal title to the residential real estate property upon completion of a foreclosure. A creditor may obtain legal title to the residential real estate property even if the borrower has redemption rights that provide the borrower with a legal right for a period of time after a foreclosure to reclaim the real estate property by paying certain amounts specified by law.
- b. The borrower conveys all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

As noted in ASC 310-20-40-12, after foreclosure, the cost basis of a long-lived asset received in full satisfaction of a receivable should be accounted for under ASC 360, which includes guidance that a valuation allowance should not be carried over as a separate element of the cost basis for purposes of accounting for the long-lived asset.

#### 5.5.6.1 Classification and measurement of certain government-guaranteed mortgage loans upon foreclosure

A guaranteed mortgage loan receivable should be derecognized by a creditor upon a foreclosure event that results in the creditor receiving physical possession of the real estate property collateralizing the mortgage loan in accordance with the guidance in ASC 310-20-40-6 (see Section 5.5.6), if the following conditions are met: [ASC 310-20-40-7]

- a. The loan has a government guarantee that is not separable from the loan before foreclosure.
- b. At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim. A creditor would be considered to have the ability to recover under the guarantee at the time of foreclosure if the creditor determines that it has maintained compliance with the conditions and procedures required by the guarantee program.
- c. At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

Moreover, upon a foreclosure event meeting the conditions described above, ASC 310-20-40-8 requires that the creditor recognize a separate other receivable based on the amount of the loan balance (both principal and interest) expected to be recovered by the guarantor.

### 5.5.7 Conversion of a loan into a debt security in a debt restructuring

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring. In these instances, the creditor must determine the initial cost basis of the debt security received in the

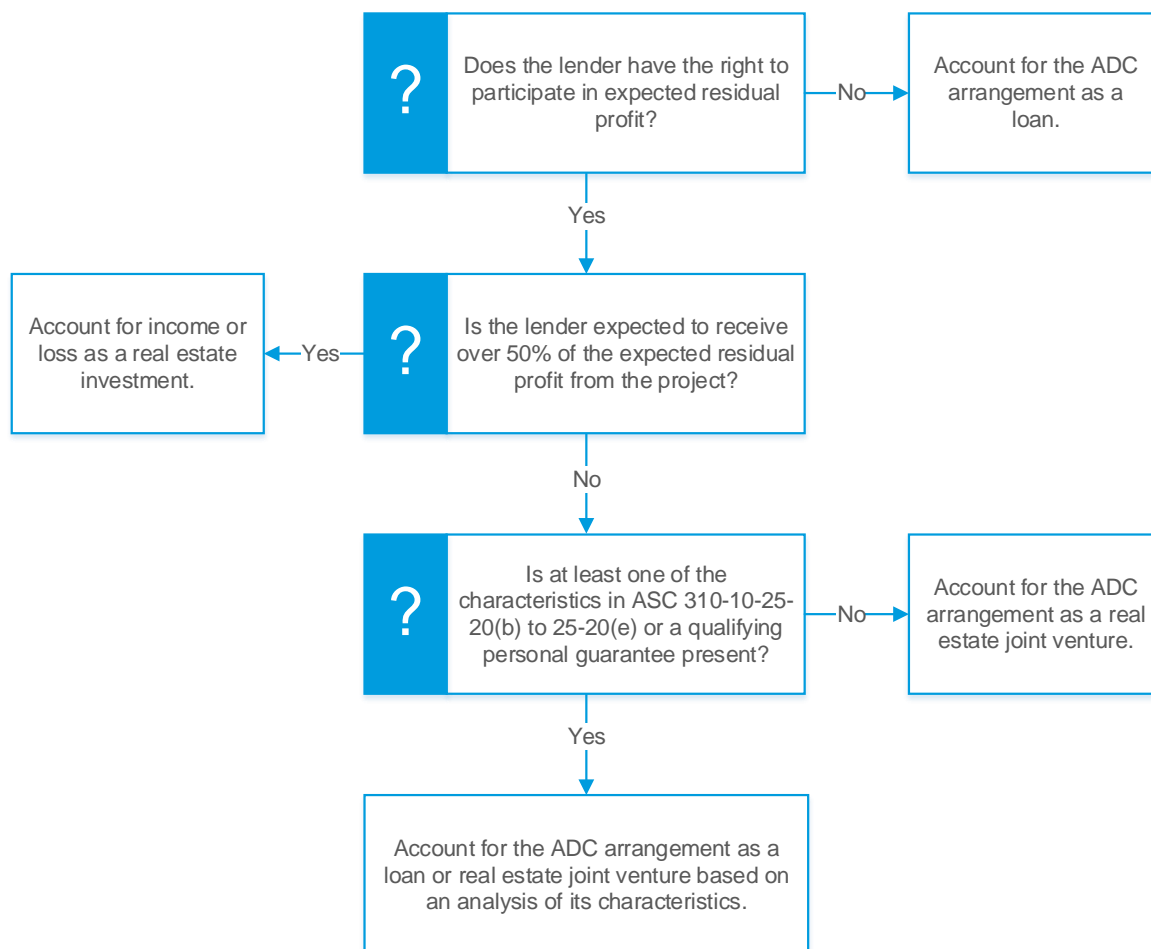
restructuring of the loan and how to account for any difference between the creditor's basis in the loan and the fair value of the security at the date of the restructuring.

In accordance with ASC 310-20-40-10, the initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the debt security received should be accounted for according to the provisions of ASC 320.

In accordance with ASC 310-20-40-11, a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to the provisions of ASC 320.

## 5.6 ADC arrangements

ASC 310-10 contains guidance specific to ADC arrangements in which the lender has the right to participate in expected residual profit. Such a right can result in the lender having risks and rewards similar to those associated with an investment in real estate or a joint venture. This guidance addresses the determination and resultant accounting if the ADC arrangement constitutes an investment in real estate or a joint venture versus a loan. Participations in expected residual profits can take various forms, and the extent of participation can vary from one arrangement to the next. Examples include the lender being entitled to receive a stated percentage of any profit realized on the sale of property or to share in the gross rents or net cash flow of a property or project. The flowchart that follows demonstrates how one may navigate through this guidance to conclude on the accounting for a given ADC arrangement. It should be noted that when determining the accounting treatment for the purchase of an ADC arrangement (as opposed to the origination), the analysis should be based on a review of the transaction at the time of purchase, from the perspective of the purchaser and its individual percentage of expected residual profit. In other words, a participant who will not share in any of the expected residual profit is not subject to this guidance.



### 5.6.1 Characteristics implying investment in real estate or joint ventures

In addition to the lender’s participation in expected residual profit, the following characteristics are noted in ASC 310-10-25-19 that imply the risks and rewards of the arrangement are similar to those associated with an investment in real estate or a joint venture:

- a. The lender agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The lender funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The lender funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The lender's only security is the ADC project. The lender has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- e. In order for the lender to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.

- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

### 5.6.2 Characteristics implying loans

The following characteristics noted in ASC 310-10-25-20 suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

- a. The lender participates in less than a majority of the expected residual profit.
- b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances.
- c. The lender has either of the following:
  1. Recourse to substantial tangible, saleable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans
  2. An irrevocable letter of credit from a creditworthy, independent third party provided by the borrower to the lender for a substantial amount of the loan over the entire term of the loan.
- d. A take-out commitment for the full amount of the lender's loans has been obtained from a creditworthy, independent third party. If the commitment is conditional, the conditions should be reasonable and their attainment probable.
- e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

As indicated in ASC 310-10-25-21, the existence of a personal guarantee of the borrower alone rarely provides a sufficient basis to conclude that an ADC arrangement should be accounted for as a loan. Consideration should be given to the substance of the guarantee, including its magnitude, the intent and practicality of enforcing it, and the guarantor's ability to perform as evidenced by liquid assets placed in escrow, pledged marketable securities, irrevocable letters of credit from a creditworthy, independent third party, financial statements and other relevant information.

### 5.6.3 Accounting for an ADC arrangement

If the arrangement is accounted for as a loan, interest and fees should be recognized as income subject to recoverability. Proceeds from the sale of the lender's share of the expected residual profit should be recognized prospectively as additional interest over the remaining term of the loan.

If the arrangement is accounted for as a real estate joint venture, it should be accounted for in accordance with ASC 970-323 and ASC 835-20. ASC 970-835-35-1 provides guidance on the circumstances under which interest income should not be recognized. Income should be recognized in accordance with ASC 970 if the project continues into a permanent phase, generates positive cash flow and pays debt service currently. The guidance to consider upon the sale of a lender's interest in expected residual profit is outlined in ASC 310-10-40-4 and 40-5.

Regardless of the accounting treatment, appropriate allowances should be provided for uncollectible principal, accrued interest and fees.

#### 5.6.4 Reassessing the accounting treatment

The accounting treatment for an ADC arrangement should be reassessed if factors that were relevant in determining the accounting treatment at inception subsequently change. An example of this would be if the terms are renegotiated. As noted in ASC 310-10-35-56, an ADC arrangement that was originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50% of the expected residual profit in the project. Conversely, if the lender assumes further risks or rewards, the lender's position may change to that of an investor in real estate. Factors such as improvement or deterioration in the economic prospects for the project would not justify a change in classification. Changes in classification are expected to be infrequent, supported by appropriate documentation and accounted for prospectively. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, ASC 310-10-40-3 requires that the proceeds from the sale be recognized prospectively as additional interest over the remaining term of the loan. ASC 860 provides guidance for determining the accounting treatment for sales of the expected residual profit involving an ADC arrangement that is accounted for as an investment in real estate or joint venture.

Pursuant to ASC 310-10-40-5, a financial institution that was the seller of the property at the initiation of the project, is required to apply the guidance in ASC 360-10-40-3A through 40-3B to determine the accounting for the sale of the expected residual profit. However, if the sale is part of a sale and leaseback transaction, gain recognition, if any, is determined by reference to ASC 842-40.<sup>18</sup>

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<sup>18</sup> See ASC 842-10-65-1 for transition guidance related to the adoption of ASC 842 Leases.



## 6. Recognition and measurement of credit losses on financial assets measured at amortized cost and off-balance-sheet credit exposures

### Summary of key changes

- With the issuance of ASU 2016-13, the impairment guidance contained within ASC 320-10-35 for debt securities, ASC 310-10-35 for loans and other receivables, and ASC 310-30 for loans and debt securities acquired with deteriorated credit quality was superseded. New codification sections were created as follows:
  - ASC 326-20, to address the measurement of credit losses on financial assets measured at amortized cost, which is the focus of this chapter.
  - ASC 326-30, to address the measurement of credit losses on AFS debt securities, which is the focus of Chapter 4.
- ASC 326-20 differs from preexisting guidance in several key aspects including:
  - It requires an allowance for credit losses for losses that are expected to occur over the remaining life of a financial asset, rather than for incurred losses.
  - The risk of loss needs to be considered even if that risk of loss is remote, which typically results in day-one recognition of an allowance through credit loss expense for substantially all assets within its scope.
  - An allowance should be recognized for expected credit losses on HTM debt securities, regardless of the relationship between a security's fair value and amortized cost.
  - The concept of other-than-temporary impairment is no longer relevant for HTM debt securities.
  - An allowance should be recognized on purchased financial assets on the date of acquisition.
  - An entity cannot conclude no allowance is necessary based solely on the current value of collateral, unless justified through an allowable practical expedient.
  - Expected recoveries of amounts previously written off and expected to be written off should be factored into the allowance computation rather than recognized as received.
  - Financial assets (including HTM debt securities) and commitments to lend should be evaluated on a pool basis when similar risk characteristics exist.
  - Consideration should be given to reasonable and supportable forecasts about future conditions when estimating expected losses.
- Refer to Chapter 1 for effective date and transition considerations.

The following chart highlights the most significant differences between preexisting guidance and ASC 326-20 for various types of financial assets.

<b>HTM debt securities</b>	
<b>Legacy guidance (ASC 320-10-35)</b>	<b>ASC 326-20</b>
Debt securities were required to be evaluated individually to determine if impairment should be recognized. If the fair value of an individual security was less than amortized cost as of the reporting date, it was impaired. Impairment was recognized through a direct write-down to the amortized cost basis of the security if the impairment was deemed to be other than temporary. If the entity did not intend to sell the security, and it was more likely than not that it would not be required to sell the security before recovering its amortized cost basis, only the impairment associated with credit loss was recognized in earnings, with the amount related to all other factors recognized in OCI.	<p>HTM debt securities are required to be evaluated on a collective basis when similar risk characteristics exist. Additionally, expected credit losses need to be recognized regardless of the relationship of the fair value of a security to its amortized cost basis.</p> <p>The estimate of expected credit losses should include a measure for the expected risk of loss even if that risk is remote. As a consequence of this, the expectation is that circumstances in which an HTM security does not have an allowance for expected credit losses from the time of its initial purchase date would be rare (e.g., securities of the U.S government or its agencies). The concept of other than temporary and the intent or potential requirement to sell an HTM security are no longer relevant to the consideration and recognition of expected credit losses.</p>
For debt securities for which other-than-temporary impairment was recognized, subsequent increases in expected cash flows were recognized on a prospective basis as interest income.	Both subsequent increases and decreases in expected cash flows are reflected in net income immediately through credit loss expense.
<b>Loans and commitments to lend</b>	
<b>Legacy guidance (ASC 320-10-35, ASC 450-20)</b>	<b>ASC 326-20</b>
Credit losses on loans and commitments to lend were recognized when it was probable that a loss had been incurred.	Those losses that are expected to occur over the contractual life of the asset are recognized through the allowance.
In estimating the allowance for credit losses, historical loss ratios generally were qualitatively adjusted for current conditions.	In addition to adjusting historical loss ratios for current conditions, consideration should also be given to reasonable and supportable forecasts related to future conditions.
Entities had discretion in identifying loans to be evaluated individually for impairment versus aggregated with other loans with common risk characteristics when assessing and recognizing impairment. It was not uncommon to conclude that a loan that was individually evaluated required no allowance due to the collateral position or	Loans and commitments to lend are required to be evaluated on a collective basis when similar risk characteristics exist. For reasons discussed earlier, we believe that a loan typically would have some level of allowance for credit losses from its origination date and thereafter unless: (a) it qualifies for the practical expedient for collateral-dependent financial assets or financial assets secured by collateral maintenance provisions and (b) the fair value of the collateral (as

<p>other factors indicating a loss was not probable.</p>	<p>adjusted for estimated costs to sell, if appropriate) exceeds the financial asset's amortized cost basis at the measurement date.</p>
<p><b>Trade and other receivables (including contract assets)</b></p>	
<p><b>Legacy guidance (ASC 450-20, ASC 310-10-35)</b></p>	<p><b>ASC 326-20</b></p>
<p>Credit losses were recognized when it was probable that a loss had been incurred. No consideration was to be given to reasonable and supportable forecasts about future conditions. There was no explicit requirement to evaluate receivables with similar risk characteristics on a collective basis.</p>	<p>Receivables are required to be evaluated on a collective basis when similar risk characteristics exist. Life of asset expected credit losses are recognized rather than probable and incurred losses. There is an explicit requirement to consider certain information relevant to the collectibility of the assets, such as internal and external information relating to past events (e.g., historical loss rates on assets with similar risk characteristics), current conditions and reasonable and supportable forecasts. Additionally, the estimate of expected credit losses is required to include a measure for the expected risk of loss even if that risk is remote. As a consequence of this, the expectation is that substantially all receivables and contract assets will require an allowance for expected credit losses upon initial recognition and thereafter, including receivables from stellar customers with no history of nonpayment.</p>
<p><b>Purchased or acquired financial assets</b></p>	
<p><b>Legacy guidance (ASC 310-30, ASC 805)</b></p>	<p><b>ASC 326-20, ASC 805</b></p>
<p>An acquisition-date allowance was not recorded for purchased financial assets as the initial carrying amount (purchase price or fair value) was assumed to incorporate incurred losses. For those loans and debt securities acquired with deteriorated credit quality, contractual cash flows not expected to be collected were accounted for as a nonaccretable difference (rather than an allowance). While impairment that occurred subsequent to the acquisition was recognized as incurred (for debt securities, if other than temporary), increases in expected cash flows were accreted into interest income over the asset's remaining life.</p>	<p>The allowance for estimated credit losses is measured in the same manner regardless of whether an asset is originated or acquired. Given the need to consider the risk of loss no matter how remote, as well as ASC 326-20-30-5 prohibiting discounts that will be accreted into interest income from being offset against expected credit losses, the expectation is that most purchased assets will require recognition of an allowance for credit losses on the acquisition date. The allowance for PCD assets is recorded through an upward adjustment to the assets' initial carrying amounts rather than through credit loss expense, which would be the case for purchased assets that have not experienced such deterioration.</p> <p>Both favorable and unfavorable changes in expected cash flows are recognized immediately through credit loss expense rather than recognizing favorable changes as an adjustment to the accretable yield over the life of the instrument.</p>

## 6.1 Applicability and scope

This chapter applies to all entities that hold financial assets that are measured at amortized cost, including:

- Financing receivables (e.g., loans)
- HTM debt securities
- Receivables that result from revenue and other income transactions
- Receivables that relate to repurchase and securities lending agreements

This chapter also applies to:

- Reinsurance recoverables that result from insurance transactions within the scope of ASC 944
- Net investment in leases recognized by a lessor
- Off-balance-sheet credit exposures (e.g., unrecognized loan commitments, standby letters of credit, financial guarantees and similar instruments) that are not accounted for as insurance and not required to be accounted for as derivatives



### Spotlight: Interplay between ASC 606 and ASC 326-20

As is evident from ASC 606-10-45, not only receivables from revenue transactions are subject to ASC 326-20, but also contract assets. A receivable is an entity's right to consideration that is unconditional (i.e., only the passage of time is required before payment of that consideration is due). In contrast, a contract asset is the entity's right to consideration that is conditioned on something other than the passage of time (e.g., future performance).

One of the conditions for a contract to exist in ASC 606-10-25-1 is for it to be probable that the entity will collect substantially all of the consideration to which it will be entitled. However, because the thresholds used in the condition are *probable* and *substantially all* there is still a need to apply ASC 326-20 to receivables and contract assets and establish an allowance for credit losses through recognition of credit loss expense upon the initial recognition of the asset.

The following assets are specifically excluded from the scope of ASC 326-20 and therefore this chapter:

- Financial assets measured at fair value through net income<sup>19</sup>
- Loans held for sale
- AFS debt securities
- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Pledge receivables of a NFP entity
- Loans and receivables between entities under common control
- Operating lease receivables

<sup>19</sup> Upon transitioning to ASC 326-20, ASU 2019-05 permits a fair value option election for certain existing financial assets. Refer to Section 1.2 for additional information.

**Spotlight: Interplay between ASC 842 and ASC 326-20**

While operating lease receivables are evaluated for impairment under ASC 842 and excluded from the scope of ASC 326-20, the net investment in leases recognized by a lessor are within the scope of ASC 326-20. For a sales-type lease, the net investment in the lease is defined as the sum of the lease receivable and the unguaranteed residual asset. For a direct financing lease, it also consists of the lease receivable and the unguaranteed residual asset, but is net of any deferred selling profit. Keep in mind that a lease receivable includes not only the right to receive lease payments, but also any guaranteed amount that is expected to be derived from the underlying asset after the lease term.

As noted in ASC 842-30-35-3, when determining the allowance for the net investment, consideration should be given to its collateral, namely the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and after the end of the remaining lease term. Much of the discussion about loans in the chart at the beginning of this chapter applies to net investment in leases.

**6.2 Overview****ASC 326-20-30-1**

The allowance for credit losses is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. Expected recoveries of amounts previously written off and expected to be written off shall be included in the valuation account and shall not exceed the aggregate of amounts previously written off and expected to be written off by an entity. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

**ASC 326-20-30-2**

An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

The underlying premise of ASC 326-20 is that the allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The allowance for credit losses on financial assets is required to be presented separately on the balance sheet as a deduction from (or if negative, as an addition to) the asset's amortized cost basis, while estimated expected credit losses on off-balance-sheet financial instruments are recorded as a liability. Credit loss expense is recognized as necessary so that the carrying amount of the allowance or liability as of each reporting period end is reflective of management's current estimate of expected losses, with consideration given to expected recoveries.<sup>20</sup>

<sup>20</sup> Expected recoveries that are factored into the allowance should not exceed the aggregate of amounts previously written off and expected to be written off by the entity, and in some cases, may result in a negative allowance. Refer to Section 6.9 for an illustration.

Nearly all assets within the scope of ASC 326-20 are expected to have an allowance for credit losses.

The following discussion provides an overview of various key aspects ASC 326-20.

### 6.3 Methods for estimating expected credit losses



#### ASC 326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

#### ASC 326-20-30-4

If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If a financial asset is modified and is considered to be a continuation of the original asset, an entity shall use the post-modification contractual interest rate to derive the effective interest rate when using a discounted cash flow method. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge. If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables-nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

#### ASC 326-20-30-4A

As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments.

#### ASC 326-20-30-5

If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following:

- a. Amortized cost basis, excluding applicable accrued interest, premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance).
- b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge.
- c. Applicable accrued interest. See paragraph 326-20-30-5A for guidance on excluding accrued interest from the calculation of the allowance for credit losses.

**ASC 326-20-30-5A**

An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an allowance for credit losses for accrued interest receivables if the entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-35-8A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

ASC 326-20 does not prescribe specific methods or approaches that must be applied in estimating expected credit losses. Given concerns that were raised in the drafting phase of ASU 2016-13, the FASB was mindful of the need for ASC 326-20 to be scalable to the complexity and sophistication of each reporting entity. Methods used can and likely will vary from entity to entity, and even within an entity, for various reasons, including the type of financial asset, the entity’s ability to predict the timing of cash flows and the information that is available to the entity. Examples of methods mentioned in ASC 326-20 (but not defined) include discounted cash flow, loss-rate, roll-rate, probability-of-default and aging schedule, each of which are described below:

Method	Description
Discounted cash flow	Allowance for credit losses is computed by comparing the amortized cost of an asset to the present value of estimated future cash flows (inclusive of principal and interest) of that asset.
Loss-rate	Allowance for credit losses is computed by multiplying the amortized cost basis of the asset by an estimated loss rate relevant to that asset.
Roll-rate	Allowance for credit losses is estimated based on historical trends of delinquency or other credit quality related metrics.
Probability-of-default	Allowance for credit losses is computed by multiplying the probability-of-default within a given timeframe by the percentage of assets expected to be uncollectible due to default.
Aging schedule	Allowance for credit losses is computed using the due date of a receivable and related payment terms to understand the delinquency status or how long a receivable is outstanding (e.g., less than 31 days, 31-60 days, 61-90 days, more than 90 days). This approach is generally utilized to estimate the allowance for credit losses on trade receivables.

In January 2019, the FASB staff issued [FASB Staff Q&A, Topic 326, No. 1: Whether the Weighted-Average Remaining Maturity Method \(WARM\) is an Acceptable Method to Estimate Expected Credit Losses](#). The FASB Staff indicated in this Q&A document that the WARM method is one of many methods that could be used to estimate an allowance for credit losses for smaller, less complex financial asset pools under ASC 326-20. Among other questions, this document addresses the factors that should be

considered when determining whether to use the WARM method and illustrates how the allowance could be estimated using such a method.

Certain other methods are illustrated through examples that follow in this chapter.



### **Spotlight: Considering all components of the amortized cost basis**

Regardless of the method or methods that are used, the allowance for credit losses should reflect the expected losses associated with all components of an asset's amortized cost basis, which is defined to include accrued interest, unamortized premiums, discounts and net deferred fees or costs, as well as foreign exchange and certain fair value hedge accounting adjustments. These components of amortized cost can be incorporated into the computation individually or in totality. [Memo #8 of the meeting materials for the June 2018 Transition Resource Group \(TRG\) meeting](#) includes illustrations of these two approaches. As noted in paragraph BC14 of ASU 2019-04, the ability to measure the allowance for credit losses on a component, such as accrued interest, separately from the allowance on the unpaid principal balance and other components of the amortized cost basis does not alleviate the need to measure expected credit losses on the component on a collective (pool) basis when similar risk characteristics exist.

Lastly, with the issuance of ASU 2019-04, an accounting policy election can be made at the class of financing receivable or major security-type level, to not measure an allowance for credit losses for accrued interest if the entity writes off the uncollectible accrued interest balance in a timely manner. No guidance was provided to elaborate on what would be considered timely, necessitating the use of judgment based on the individual facts and circumstances. The FASB acknowledged in paragraph BC20 of ASU 2019-04 that accounting policies for writing off financial assets may vary depending on the type of financial asset and industry practices.

Entities electing this option would write off accrued interest receivable by reversing interest income, recognizing credit loss expense or both. The entity would present accrued interest receivable, net of its allowance, as either a separate balance sheet line item or include the accrued interest receivable account balance with another line item that includes other balances, with disclosure of the amount and location of the accrued interest receivable balance.

#### **6Q.3.1 *Should a lender consider expected payment of taxes and insurance premiums when estimating expected credit losses?***

If tax payments and insurance premiums are incurred or are expected to be incurred prior to foreclosure, they are considered period costs. As a result, they are not considered in determining the allowance for credit losses. If the borrower is required to reimburse the lender for the costs incurred, the lender would record a receivable for amounts due and estimate expected credit losses related to that receivable after it is recognized. If the borrower is not required to reimburse the lender, the lender would recognize an expense when it incurs the cost.

Costs that are incurred or are expected to be incurred after foreclosure are also not considered in determining the allowance for credit losses. This is because they are associated with the period that the lender has recognized a foreclosed asset, rather than the period that it holds a loan.



As indicated in ASC 326-20-30-5, discounts that will be accreted into interest income should not be offset against expected credit losses when determining the amount of allowance to be recorded. This is in contrast to current practice where certain entities assert that no allowance is necessary if the unamortized discount at the measurement date exceeds the amount of allowance that was otherwise computed.<sup>21</sup>

ASC 326-20 acknowledges that estimating expected credit losses is highly judgmental and illustrates this in ASC 326-20-55-6 by providing the following list of judgments that entities may need to make in the estimation process:

- a. The definition of default for default-based statistics
- b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest
- c. The approach to determine the appropriate historical period for estimating expected credit loss statistics
- d. The approach to adjusting historical credit loss experience to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period
- e. The methods of utilizing historical experience
- f. The method of adjusting loss statistics for recoveries
- g. How expected prepayments affect the estimate of expected credit losses
- h. How the entity plans to revert to historical credit loss experience for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses
- i. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.

As further elaborated in ASC 326-20-55-7, an entity should utilize estimation techniques that are practical and relevant in the circumstances. The methods used could vary depending on type of financial asset and the information available to the entity.



#### **Spotlight: Matters to consider upon adoption of ASU 2016-13**

An entity will need to reconsider and enhance its current business processes and related controls to ensure that the existing control activities and environment are adequate to determine whether the approaches used in determining expected credit losses are reasonably supported with appropriate documentation at each reporting date.

It is clear that a DCF method is not a requirement of ASC 326-20; however, if one is used to estimate expected credit losses, projected cash flows should be discounted based on the asset's effective interest rate (or for net investments in leases, the discount rate used in measuring the lease receivable), and the allowance should reflect the difference between the amortized cost basis of the asset and the present value of expected cash flows. If a financial asset is modified and is considered to be a continuation of the original asset (see Section 5.5.1), an entity is required to use the post-modification contractual interest rate to derive the effective interest rate when using a DCF method. ASC 815-25-35-10 through 35-12 address the interaction of fair value hedge accounting with the measurement of credit losses. ASC 326-

<sup>21</sup> In conjunction with the June 2018 TRG meeting, the FASB staff reiterated that an entity may not have a zero allowance as a consequence of the discount on a financial asset being greater than the expected losses on the financial asset, but acknowledged that the allowance on a financial asset at a premium or discount will be affected by that premium or discount because the entity has a larger or smaller amount of amortized cost basis to write off or lose upon default.

20-30-4A permits an accounting policy election that can be made by class of financing receivable or major security type to adjust the effective interest rate used to discount projected cash flows to consider the timing, and changes in timing, of expected prepayments on cash flows. This election to adjust the effective rate for expected prepayments may more appropriately isolate changes in cash flows attributable to credit losses for purposes of determining the allowance, but should not affect the effective interest rate used to recognize interest income. Additionally, an election can be made to present the change in present value attributable to the passage of time as interest income rather than as credit loss expense (or reversal thereof).

When applying a DCF method to a financial asset that has a contractual interest rate that varies based on subsequent changes in an independent factor, such as an index or rate (e.g., LIBOR), ASC 326-20-30-4 indicates that the effective interest rate used to discount expected cash flows should be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. That is, an entity can elect to use projections of future interest rate environments (e.g., forward yield curve or internally projected interest rates that are reasonable and supportable) to estimate future interest payments used in the calculation of expected cash flows or they can elect to estimate future interest payments using the current rate.

However, to properly isolate credit risk, if the entity chooses to project changes in the factor for purposes of estimating expected future cash flows, the same projections should be used to determine the effective interest rate used to discount those cash flows. Additionally, the entity is required to adjust the effective rate to consider the timing, and changes in timing, of expected prepayments on cash flows.



#### **Spotlight: Accounting policy election for prepayment assumptions**

##### **ASC 326-10-65-1(j)**

An entity that adjusts the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments in accordance with paragraphs 326-20-30-4 through 30-4A for TDRs that exist as of the date of adoption may, as an accounting policy election, calculate the prepayment-adjusted effective interest rate using the original contractual rate and the prepayment assumptions as of the date of adoption.

The following example illustrates application of the guidance in ASC 326-20-30-5 using a DCF method for a financial asset with a contractual interest rate that varies based on changes in an independent factor.



#### **Example 6-1: Measuring the allowance for expected credit losses of a variable-rate loan**

Assume that on January 1, 20X0, Lender ABC originated a five-year loan in the amount of \$50,000 with a contractual interest rate of one-year LIBOR plus 4%. The one-year LIBOR rate on January 1, 20X0, was 2% resulting in a total interest rate of 6%. Interest is payable periodically in arrears and the principal amount is due at maturity. All interest accrued during 20X0 (\$3,000) was collected on December 31, 20X0. Also on that date, the one-year LIBOR rate had increased to 3%, making the new total interest rate on the loan 7%. The new interest rate will be used to both project future interest cash flows and to discount those cash flows (including expected principal repayment) when using a discounted cash flow method to estimate credit losses.


Lender ABC estimates its expected cash flows, considering historical experience, current conditions and reasonable and supportable forecasts of future economic conditions. It expects only \$2,000 of interest to be collected in 20X3, no interest to be collected in 20X4 and only \$49,000 of the principal balance to be collected in 20X4.

The table below shows the original and revised cash flows expected to be collected beginning with year two (i.e., after the interest rate has been revised) and illustrates how Lender ABC will estimate the allowance for expected credit losses.

	Year	Remaining original cash flows expected to be collected at original interest rate	Cash flows expected to be collected at new interest rate, before estimate of expected credit losses	Cash flows expected to be collected at new interest rate, adjusted for expected credit losses
	20X1	\$ 3,000	\$ 3,500	\$ 3,500
	20X2	3,000	3,500	3,500
	20X3	3,000	3,500	2,000
	20X4	53,000	53,500	49,000
Total remaining cash flows (both principal and interest)		\$ 62,000	\$ 64,000	\$ 58,000
Present value of expected cash flows adjusted for expected credit losses and discounted at 7%				\$ 45,343
Amortized cost				50,000
Difference between amortized cost and present value of expected cash flows adjusted for expected credit losses				\$ 4,657

Based on management’s projections of expected cash flows discounted at an effective interest rate of 7%, Lender ABC would recognize an allowance for expected credit losses of \$4,657 as of December 31, 20X0.

#### 6.4 Requirement to consider past events, current conditions and reasonable and supportable forecasts



**ASC 326-20-30-7**

When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

**ASC 326-20-30-8**

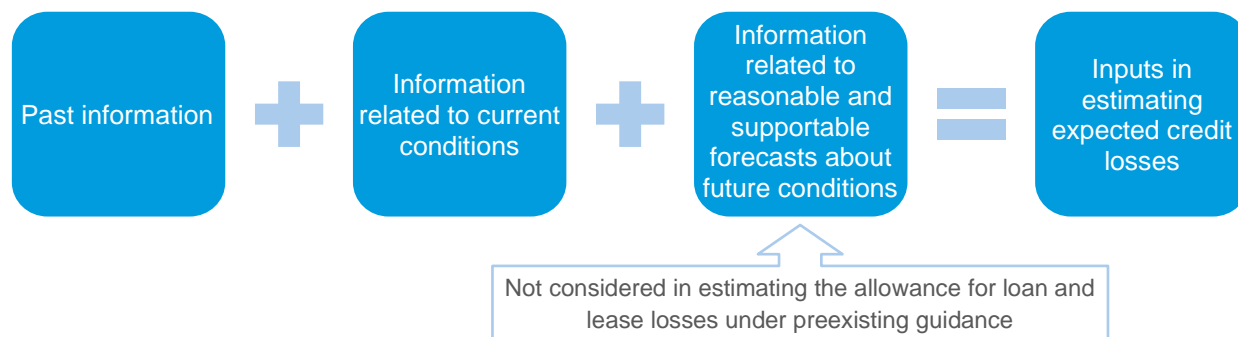
Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall

consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

**ASC 326-20-30-9**

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

While it is expected that the methods used to estimate expected losses and the approaches taken related to the preceding list of judgments will vary from entity to entity, there are certain underlying requirements of ASC 326-20 that need to be met. One of these requirements is that relevant available information should be considered when estimating expected losses, including information related to the borrower's creditworthiness, changes in lending strategies, underwriting practices and the current and forecasted direction of the economic and business environment. As discussed in ASC 326-20-30-7 and ASC 326-20-55-2, information to consider in satisfying this requirement includes internal information, external information or a combination of both relating to past events, current conditions and reasonable and supportable forecasts.



The expectation is that past information, such as historical credit loss experience for assets with similar risk characteristics, generally will serve as a foundation for estimating expected credit losses. As discussed in ASC 326-20-30-7, this historical credit loss information can be internal, external or a combination of both. An entity may select loss information from the historical periods that best represents management's expectations for future credit losses. In other words, it is not a requirement to use the most recent data available. It is important, however, that the information about historical credit loss data is

applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed.

An entity is not required to search all possible information, but is expected to consider relevant information that is reasonably available without undue cost and effort. In some cases, such as when the entity has a solid base of historical loss information for a particular type of asset, internal information about collectibility may suffice. Conversely, when an entity does not have a solid base of historical loss information, external information may be more relevant, which is illustrated in the example that follows.



#### **Example 6-2: Obtaining historical loss information for debt securities**

Company A has a diversified HTM debt security portfolio consisting of corporate bonds and bonds issued by states and municipalities. While Company A has had this portfolio in place for a number of years, it has not historically realized credit losses on any of the security types within the portfolio. Despite that, Company A knows that there is a risk of loss and decides that the most appropriate information that is reasonably available is published life-of-asset loss rates for bonds of similar credit ratings or quality as those it holds in its portfolio. Company A decides to aggregate its bonds by type and credit rating, and use the external data on loss rates as the starting point to estimate the expected losses for each pool.

Adjustments should be made to historical loss information to the extent the historical information used as the basis for the estimate is not representative of current conditions and reasonable and supportable forecasts about the future. Inherent in meeting this requirement is the need to identify the factors that are likely to influence the amount of cash flows that will ultimately be collected for a specific asset or pool of assets. ASC 326-20-55-4 provides the following list of factors that an entity may consider, while also acknowledging that the list is not all-inclusive and that not all factors may be relevant to every situation:

- a. The borrower's financial condition, credit rating, credit score, asset quality or business prospects
- b. The borrower's ability to make scheduled interest or principal payments
- c. The remaining payment terms of the financial asset(s)
- d. The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)
- e. The nature and volume of the entity's financial asset(s)
- f. The volume and severity of past due financial asset(s) and the volume and severity of adversely classified or rated financial asset(s)
- g. The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been utilized
- h. The entity's lending policies and procedures, including changes in lending strategies, underwriting standards and collection, writeoff and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- i. The quality of the entity's credit review system
- j. The experience, ability and depth of the entity's management, lending staff and other relevant staff
- k. The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as:
  1. Regulatory, legal or technological environment to which the entity has exposure
  2. Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure

3. Changes and expected changes in international, national, regional and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments.

The following example illustrates the factors considered in the context of a specific type of asset.



### Example 6-3: Identifying factors that impact expected credit losses

Bank A has a pool of residential mortgage loans with common risk characteristics. In examining information about past events, including historical losses, management determined that the level of losses realized on a pool of assets of this nature appears to be heavily impacted by collateral values, underwriting practices at the time the pool of assets was originated, credit scores and unemployment rates for the bank's market area. Management elects to start with historical loss data from the most recent economic cycle that it believes best represents its expectations for the future. Management compares the aforementioned factors that heavily impacted realized losses in the historical period to current conditions and its reasonable and supportable forecasts in determining the adjustments to make to historical losses in deriving expected losses.

As it relates to incorporating forecasts about the future, entities are only required to develop forecasts over the period of time that such forecasts are reasonable and supportable. We would anticipate that this period of time could vary from time to time, as well as from input to input, and therefore, should be continuously reassessed. There is no requirement for the forecast to extend through the contractual term of the financial asset; however, it would not be appropriate to ignore reliable forecasts and incorporate no expectations about the future. Some entities intend to use multiple scenarios and probability weight them, which is acceptable, but not required.

For periods that extend beyond the period for which an entity is able to make or obtain reasonable and supportable forecasts, the entity would revert to historical loss information. In other words, it would not be appropriate to adjust historical loss information for current or forecasted economic conditions for periods that extend beyond the reasonable and supportable period.

Reverting to historical loss information can be accomplished at the input level or based on the entire estimate. To illustrate using the fact pattern in the previous example, if management of Bank A can develop or obtain reasonable and supportable forecasts of unemployment rates for two years in the future and of collateral values for one year in the future, management can elect to revert to historical loss information: (a) after one year for the entire estimate or (b) after one year for just the input associated with collateral values and after two years for the input associated with unemployment rates. Entities should also exercise judgment when deciding whether it is more appropriate to revert to historical loss information immediately, on a straight-line basis or on another rational and systematic basis. The first two examples in Section 6.8 illustrate immediate reversion to historical loss information.<sup>22</sup>

In July 2019, the FASB staff issued [FASB Staff Q&A, Topic 326, No. 2: Developing an Estimate of Expected Credit Losses on Financial Assets](#). Reference should be made to this document for additional information on these aspects of the development of expected credit losses.

<sup>22</sup> The AICPA's Credit Losses Audit and Accounting Guide (AAG) includes information useful in determining the reasonable and supportable forecast period and how to revert back to historical information for periods that extend beyond that forecast period.



### Spotlight: Subsequent events

With the issuance of ASU 2016-13, the following changes were made to the subsequent events guidance in ASC 855-10-55-1:

Subsequent events affecting the realization of assets, such as ~~receivables and~~ inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time. ~~For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are issued or are available to be issued ordinarily will be indicative of conditions existing at the balance sheet date. Thus, the effects of the customer's bankruptcy filing shall be considered in determining the amount of uncollectible trade accounts receivable recognized in the financial statements at balance sheet date.~~

Numerous questions were raised related to the application of this revised guidance to estimates of expected credit losses. Refer to Section 6.16 for additional guidance, including SEC staff viewpoints, when evaluating subsequent events under ASC 326-20's credit losses estimation model.

## 6.5 Aggregation of assets with similar risk characteristics

ASC 326-20 indicates that credit losses should be measured on a collective or pool basis when similar risk characteristics exist and provides a reminder that the risk characteristics upon which the portfolio is aggregated should be consistent with the entity's policies for evaluating the credit risk characteristics of its financial assets. As such, management has the leeway to form pools for particular categories of assets based on the risk characteristics that are most determinative of expected credit losses for the particular category of assets (i.e., loss drivers). The following is a list of illustrative risk characteristics from ASC 326-20-55-5:

- a. Internal or external (third-party) credit score or credit ratings
- b. Risk ratings or classification
- c. Financial asset type
- d. Collateral type
- e. Size
- f. Effective interest rate
- g. Term
- h. Geographical location
- i. Industry of the borrower
- j. Vintage
- k. Historical or expected credit loss patterns
- l. Reasonable and supportable forecast periods.

The requirement to measure credit losses on a pool basis when similar risk characteristics exist extends to all assets within the scope of ASC 326-20. Example 17 from ASC 326-20-55 (shown below) illustrates some of the challenges that may exist in identifying similar risk characteristics in reinsurance receivables, and mentions factors such as standardized terms, similar insured risks and underwriting practices and counterparties with similar financial characteristics facing similar economic conditions as examples of similar risk characteristics in what might otherwise appear to be a dissimilar portfolio.



**Example 6-4: Identifying Similar Risk Characteristics in Reinsurance Recoverables  
(from ASC 326-20-55-81 to 55-85)**

There is no requirement to evaluate financial assets individually when a certain level of credit deterioration has occurred. However, the assessment of whether financial assets exhibit similar risk characteristics should be based on the relevant and appropriate facts and circumstances.

An entity may estimate expected credit losses for some financial assets on a collective (pool) basis and may estimate expected credit losses for other assets on an individual basis when similar risk characteristics do not exist. As a result, the method used to estimate expected credit losses for a financial asset may change over time. For example, a pool of homogeneous loans may initially use a loss-rate method, but certain individual loans no longer may have similar risk characteristics because of credit deterioration. When a financial asset no longer shares similar risk characteristics with the original pool of financial assets, an entity should evaluate that financial asset to determine whether it shares risk characteristics similar to other pools of loans. Expected credit losses of that financial asset should be measured individually if there are no similar risk characteristics with other loans. A discounted cash flow approach is one method to estimate expected credit losses of individual loans, but it is not a required method. Paragraphs 326-20-55-34 through 55-36 illustrate those concepts.

Reinsurance recoverables may comprise a variety of risks that affect collectability including:

- a. Credit risk of the reinsurer/assuming company
- b. Contractual coverage disputes between the reinsurer/assuming company and the insurer/ceding company including contract administration issues
- c. Other noncontractual, noncoverage issues including reinsurance billing and allocation issues.

In situations in which similar risk characteristics are not present in the reinsurance recoverables, the ceding insurer should measure expected credit losses on an individual basis. Similar risk characteristics may not exist because any one or a combination of the following factors exists, including, but not limited to:

- a. Customized reinsurance agreements associated with individual risk geographies
- b. Different size and financial conditions of reinsurers that may be either domestic or international
- c. Different attachment points among reinsurance agreements
- d. Different collateral terms of the reinsurance agreements (such as collateral trusts or letters of credit)
- e. The existence of state-sponsored reinsurance programs.

However, similar risk characteristics may exist for certain reinsurance recoverables because any one or combination of the following exists:

- a. Reinsurance agreements that have standardized terms
- b. Reinsurance agreements that involve similar insured risks and underwriting practices
- c. Reinsurance counterparties that have similar financial characteristics and face similar economic conditions.

Judgment should be applied by ceding insurers in determining if and when similar risks exist within their reinsurance recoverables.



Aggregating assets with similar risk characteristics will be an ongoing process given the need to continuously determine if each asset within a pool continues to exhibit similar risk characteristics. If not, the asset should be moved to a different pool of assets with similar risk characteristics or evaluated individually in the absence of other assets with similar risk characteristics. Changes in credit risk, changes in borrower circumstances, recognition of writeoffs and cash collections on nonaccrual assets are mentioned in ASC 326-20-35-2 as examples of circumstances that may warrant movement to a different pool or individual evaluation. This concept is illustrated in Example 4 from ASC 326-20-55, which is shown below.



**Example 6-5: Estimating Expected Credit Losses Using both a Collective Method and an Individual Asset Method (from Example 4 in ASC 326-20-55-32 to 55-36)**

There is no requirement to evaluate financial assets individually when a certain level of credit deterioration has occurred. However, the assessment of whether financial assets exhibit similar risk characteristics should be based on the relevant and appropriate facts and circumstances.

An entity may estimate expected credit losses for some financial assets on a collective (pool) basis and may estimate expected credit losses for other assets on an individual basis when similar risk characteristics do not exist. As a result, the method used to estimate expected credit losses for a financial asset may change over time. For example, a pool of homogeneous loans may initially use a loss-rate method, but certain individual loans no longer may have similar risk characteristics because of credit deterioration. When a financial asset no longer shares similar risk characteristics with the original pool of financial assets, an entity should evaluate that financial asset to determine whether it shares risk characteristics similar to other pools of loans. Expected credit losses of that financial asset should be measured individually if there are no similar risk characteristics with other loans. A discounted cash flow approach is one method to estimate expected credit losses of individual loans, but it is not a required method. Paragraphs 326-20-55-34 through 55-36 illustrate those concepts.

One loan program from Bank D provides unsecured commercial loans of up to \$75,000 to small businesses and entrepreneurs. Given the relative homogeneity of the borrowers (in terms of credit risk) and loans (in terms of type, amount, and underwriting standards) in the program, Bank D manages this loan program on a collective basis. However, Bank D concludes that the loss estimates for loans with credit deterioration is based on borrower-specific facts and circumstances because the repayment of those loans depends on facts and circumstances unique to each borrower. Therefore, Bank D estimates expected credit losses on an individual basis for loans that no longer exhibit similar risk characteristics because of credit deterioration. A loss-rate method for estimating expected credit losses on a pooled basis is applied for the loans in the portfolio segment that continue to exhibit similar risk characteristics.

To estimate expected credit losses for individual loans without similar risk characteristics, Bank D uses a discounted cash flow method for each loan. Frequently, Bank D has insight into the likelihood of a credit loss as a result of information provided by the borrower and recent discussions with the borrower given the elevated credit risk for these loans. Under a discounted cash flow method, the allowance for credit losses is estimated as the difference between the amortized cost basis and the present value of cash flows expected to be collected.

To estimate expected credit losses for the remainder of the loans that continue to exhibit similar risk characteristics, Bank D considers historical loss information (updated for current conditions and reasonable and supportable forecasts that affect the expected collectability of the amortized cost basis of the pool) using a loss-rate approach.

## 6.6 Determining the contractual term of the asset



### ASC 326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless the following applies:

- a. [Subparagraph superseded by Accounting Standards Update No. 2022-02].
- b. The extension or renewal options (excluding those that are accounted for as derivatives in accordance with Topic 815) are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

### ASC 326-20-30-6A

For net investment in leases recognized by a lessor in accordance with Topic 842, instead of applying the guidance in paragraph 326-20-30-6, an entity shall use the lease term as the contractual term.

The life of certain assets can differ significantly from their contractual terms, as it is common for assets such as 30-year mortgage loans to be paid off well in advance of maturity. It is also common in the financial institution industry for certain loans to have a one-year contractual life, with annual renewals if certain criteria are met such that the actual life of the loan turns out to be several years. ASC 326-20 requires the allowance to be based on estimated credit losses over the contractual term of the financial asset, with consideration given to estimated prepayments. If a DCF method is used, prepayments would be factored in when estimating the future expected principal and interest cash flows. If a DCF method is not used, prepayments could be incorporated as a separate input in the estimate or embedded in the credit loss experience on which the allowance is based. The latter approach is illustrated in Example 6-3 in Section 6.8. At its meeting in June 2018, the TRG considered whether an entity is required to use the loan modification guidance in ASC 310-20-35-9 to 35-14 to determine what constitutes a prepayment. The conclusion was reached that while an entity could consider this guidance for that purpose, it is not required to do so.

ASC 326-20-30-6 indicates that the contractual term should not be extended for expected extensions, renewals and modifications, unless there are extension or renewal options in the contract at the reporting date that are not unconditionally cancellable by the creditor (i.e., the borrower has a right to extend the maturity date or renew the loan that is either unconditional or conditional on events such as compliance with debt covenants that are beyond the creditor's control). Therefore, the likelihood that a contractual extension or renewal option that is not unconditionally cancellable by the creditor will be exercised should be considered when determining the expected contractual term. We anticipate it may be challenging for creditors that frequently renew or extend loans to determine this likelihood if they have not tracked such information in the past. We also anticipate it may be challenging for creditors to determine how to adjust historical loss information such that it is reflective of the contractual term as defined by ASC 326-20.

Discussions on determining the expected life of credit card receivables were held at the June 2017 TRG meeting and the October 2017 FASB meeting. The discussions related to how expected payments should be determined, and how they should be allocated to credit card receivable balances when making this determination. The merits of differing viewpoints about whether or not future credit card receivable balances that are not unconditionally cancellable should be considered when allocating future expected payments were discussed. (If future balances are considered and are expected to have components that

carry higher interest rates than the components of the measurement-date receivable, under the CARD Act, payments would be allocated to the highest interest rate portion of the balance first even if that portion is expected to occur in the future.) Discussions about the determination of expected future payments focused on whether they should encompass all or a portion of the payments expected to be collected from the borrower in light of the fact that some future payments relate to future draws rather than the measurement-date balance. At its October 4, 2017 meeting, the FASB decided that while entities are not limited to these approaches that were discussed, the discussed viewpoints are acceptable in any combination for both allocating payments and for determining the payment amounts when estimating the life of a credit card receivable. The FASB further indicated that methodologies should be applied consistently and faithfully estimate expected credit losses.

Reference can be made to the materials for these meetings for additional information.



#### **Spotlight: Interplay of ASC 842 and ASC 326**

ASC 326-20-30-6 requires that an entity estimate expected credit losses over the contractual term of the financial asset or assets, including specifying certain requirements that shorten the contractual term or extend the contractual term if certain conditions are met. However, for purposes of lease accounting under ASC 842, when a lessor has an option to extend (or not terminate) the lease, the time period beyond those option exercise dates are considered in determining the lease term. Specifically, when a lessee has the option to extend (or not terminate) a lease, that additional time period would be considered only if it was reasonably certain that the lessee will exercise the option to extend (or not terminate the lease). Therefore, the lease term under ASC 842 and the contractual term under ASC 326 potentially could be different.

ASU 2020-03 amended ASC 326-20 by adding ASC 326-20-30-6A to align the contractual term to measure expected credit losses for a net investment in a lease to be consistent with the lease term determined under ASC 842. Refer to Section 1.2 for information regarding the effective date and transition provisions of the ASU.

#### **6.6.1. Demand loans**

Demand loans are loans that can be called for repayment by the lender at any time. They do not have a fixed maturity date, and the borrower is expected to repay the loan promptly upon the lender's request. The contractual life of a demand loan should align with the lender's rights to demand repayment. If the lender has the unconditional ability to cancel the loan on demand or with short notice, the contractual life of the loan is defined by that period. For example, if:

- The lender can demand immediate repayment, the contractual life is considered to be one day
- The lender can demand repayment with 45 days' notice, the contractual life is considered to be 45 days

When estimating the allowance for credit losses under ASC 326-20 for demand loans, an entity needs to consider the borrower's ability to repay the loan if the lender demanded repayment as of the reporting date. Various factors should be taken into account when determining the allowance for credit losses, including past repayment patterns and credit loss experience for similar loans and the prevailing economic conditions at the time of the evaluation.

An entity may also need to consider the borrower's ability to refinance the loan with another lender if the demand for repayment is made. This involves evaluating the borrower's creditworthiness and the availability of alternative financing sources.

## 6.7 Consider expected risk of credit loss even if the risk is remote



### ASC 326-20-30-10

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

An entity's estimate of expected credit losses should include a measure of the expected risk of credit loss even if that risk is remote. However, it is noted in ASC 326-20 that a conclusion could be reached based on historical credit loss experience adjusted for current conditions and reasonable and supportable forecasts that the expectation for nonpayment of the amortized cost basis is zero. Example 8 in ASC 326-20-55 (shown below) illustrates this concept in the context of U.S. Treasury securities, while also noting that the applicability of the example is not intended to be limited to U.S. Treasury securities. As part of its Credit Losses AAG, the AICPA illustrates how this concept may be applied to Ginnie Mae and U.S. Agency mortgage-backed securities.



### Example 6-6: Estimating Expected Credit Losses When Potential Default Is Greater Than Zero, but Expected Nonpayment Is Zero (from Example 8 in ASC 326-20-55-48 to 55-50)

This Example illustrates one way, but not the only way, an entity may estimate expected credit losses when the expectation of nonpayment is zero. This example is not intended to be only applicable to U.S. Treasury securities.

Entity J invests in U.S. Treasury securities with the intent to hold them to collect contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.

Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J's management still believes that there is a possibility of default, even if that risk is remote. However, Entity J considers the guidance in paragraph 326-20-30-10 and concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity's currency is routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its U.S. Treasury securities at the end of the reporting period. The qualitative factors considered by Entity J in this Example are not an all-inclusive list of conditions that must be met in order to apply the guidance in paragraph 326-20-30-10.

ASC 326-20 points out that it is not appropriate to reach a conclusion that expected losses are zero based solely on the current value of collateral securing a financial asset, unless warranted based on the practical expedients discussed at Section 6.9. In the absence of qualifying for and applying a practical expedient, consideration should be given to the nature of the collateral, potential future changes in collateral values and historical loss experience for financial assets secured with similar collateral before concluding there are no expected losses.

## 6.8 Examples of how to estimate expected credit losses

The following examples are from ASC 326-20-55 and are included in this chapter to illustrate various ways an entity might estimate expected credit losses.



### **Example 6-7: Estimating expected credit losses using a loss-rate approach (collective evaluation) (from Example 1 in ASC 326-20-55-18 to 55-22)**

Community Bank A provides 10-year amortizing loans to customers. Community Bank A manages those loans on a collective basis based on similar risk characteristics. The loans within the portfolio were originated over the last 10 years, and the portfolio has an amortized cost basis of \$3 million.

After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A's historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts, but determined none were necessary.

In accordance with paragraph 326-20-55-4, Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates a 10-basis-point increase in credit losses incremental to the 1.5 percent historical lifetime loss rate due to the expected decrease in real estate values and a 5-basis-point increase in credit losses incremental to the historical lifetime loss rate due to expected deterioration in unemployment rates. Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment rates beyond the reasonable and supportable forecast period. Under this loss-rate method, the incremental credit losses for the current conditions and reasonable and supportable forecast (the 15 basis points) is added to the 1.5 percent rate that serves as the basis for the expected credit loss rate. No further reversion adjustments are needed because Community Bank A has applied a 1.65 percent loss rate where it has immediately reverted into historical losses reflective of the contractual term in accordance with paragraphs 326-20-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be \$49,500.



**Example 6-8: Estimating expected credit losses using a loss-rate approach (individual evaluation) (from Example 2 in ASC 326-20-55-24 to 55-27)**

Community Bank B principally provides residential real estate loans to borrowers in the community. In the current year, Community Bank B expanded a program to originate commercial loans. Community Bank B has a few commercial loans outstanding at period end. In evaluating the loans, Community Bank B determines that one of the commercial loans does not share similar risk characteristics with other loans outstanding; therefore, Community Bank B believes that it is inappropriate to pool this commercial loan for purposes of determining its allowance for credit losses. This commercial loan has an amortized cost of \$1 million. Historical loss information for commercial loans in the community with similar risk characteristics shows a 0.50 percent loss rate over the contractual term.

Community Bank B considers relevant current conditions and reasonable and supportable forecasts that relate to its lending practices and environment and the specific borrower. Community Bank B determines that the significant factors affecting the performance of this loan are borrower-specific operating results and local unemployment rates. Community Bank B considers other qualitative factors including national macroeconomic conditions but determines that they are not significant inputs to the loss estimates for this loan.

Community Bank B is able to reasonably forecast local unemployment rates and borrower-specific financial results for one year only. Community Bank B's reasonable and supportable forecasts of those factors indicate that local unemployment rates are expected to remain stable (based on the main employer in the community continuing to operate normally) and that there will be a deterioration in the borrower's financial results (based on an evaluation of rent rolls). Management determines that no adjustment is necessary for local unemployment rates because they are expected to be consistent with the conditions in the 0.50 percent loss-rate estimate. However, the current and forecasted conditions related to borrower-specific financial results are different from the conditions in the 0.50 percent loss-rate estimate, based on borrower specific information. Community Bank B determines that an upward adjustment of 10 basis points that is incremental to the historical lifetime loss information is appropriate based on those factors. Management estimates the 10-basis-point adjustment based on its knowledge of commercial loan loss history in the community when borrowers exhibit similar declines in financial performance. Management is unable to support its estimate of expectations for local unemployment and borrower-specific financial results beyond the reasonable and supportable forecast period. Under this loss-rate method, Community Bank B applies the same immediate reversion technique as in Example 1, where Community Bank B has immediately reverted into historical losses reflective of the contractual term in accordance with paragraphs 326-20-30-8 through 30-9.

The historical loss rate to apply to the amortized cost basis of the individual loan would be adjusted an incremental 10 basis points to 0.60 percent. The allowance for expected credit losses for the reporting period date would be \$6,000.



**Example 6-9: Estimating expected credit losses on a vintage-year basis (from Example 3 in ASC 326-20-55-29 to 55-31)**

Bank C is a lending institution that provides financing to consumers purchasing new or used farm equipment throughout the local area. Bank C originates approximately the same amount of loans each year. The four year amortizing loans it originates are secured by collateral that provides a relatively consistent range of loan-to-collateral-value ratios at origination. If a borrower becomes 90 days past due, Bank C repossesses the underlying farm equipment collateral for sale at auction.

Bank C tracks those loans on the basis of the calendar year of origination. The following pattern of credit loss information has been developed (represented by the nonshaded cells in the accompanying table) based on the amount of amortized cost basis in each vintage that was written off as a result of credit losses.

Year of Origination	Loss Experience in Years Following Origination					Total	Expected
	Year 1	Year 2	Year 3	Year 4			
20X1	\$50	\$120	\$140	\$30	\$340	-	
20X2	\$40	\$120	\$140	\$40	\$340	-	
20X3	\$40	\$110	\$150	\$30	\$330	-	
20X4	\$60	\$110	\$150	\$40	\$360	-	
20X5	\$50	\$130	\$170	\$50	\$400	-	
20X6	\$70	\$150	\$180	\$60	\$460	\$60	
20X7	\$80	\$140	\$190	\$70	\$480	\$260	
20X8	\$70	\$150	\$200	\$80	\$500	\$430	
20X9	\$70	\$160	\$200	\$80	\$510	\$510	

In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, Bank C considers its historical loss information. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans. It notes that historical loss experience has worsened since 20X3 and that loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5 despite the fact that the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5. In considering current conditions and reasonable and supportable forecasts, Bank C notes that there is an oversupply of used farm equipment in the resale market that is expected to continue, thereby putting downward pressure on the resulting collateral value of equipment. It also notes that severe weather in recent years has increased the cost of crop insurance and that this trend is expected to continue. On the basis of those factors, Bank C determines adjustments to historical loss information for current conditions and reasonable and supportable forecasts. The remaining expected losses (represented by the shaded cells in the table in paragraph 326-20-55-30 [the preceding table] in each respective year) reflect those adjustments, and Bank C arrives at expected losses of \$60, \$260, \$430, and \$510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively. Therefore, the allowance for credit losses for the reporting period date would be \$1,260.


**Example 6-10: Estimating expected credit losses for trade receivables using an aging schedule (from Example 5 in ASC 326-20-55-38 to 55-40)**

Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

- a. 0.3 percent for receivables that are current
- b. 8 percent for receivables that are 1–30 days past due
- c. 26 percent for receivables that are 31–60 days past due
- d. 58 percent for receivables that are 61–90 days past due
- e. 82 percent for receivables that are more than 90-days past due.

Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit-Loss Rate	Expected Credit Loss Estimate
Current	\$5,984,698	0.27%	\$16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	\$5,997,794		\$18,681

## 6.9 Practical expedients for certain collateralized assets

Entities may use the practical expedient in ASC 326-20-35-5 to determine the allowance for credit losses and net carrying amount of a collateral-dependent financial asset based on the fair value of the collateral at the reporting date, less estimated costs to sell if repayment or satisfaction of the financial asset depends on the sale, rather than operation, of the collateral. Consistent with existing guidance, this



method is required for those assets for which foreclosure is probable so the reporting of a credit loss is not delayed until actual foreclosure. In those circumstances in which the fair value of the collateral (less costs to sell, if applicable) at the reporting date exceeds the amortized cost basis of the collateral-dependent financial asset, a negative allowance would be recognized and added to the asset's carrying amount for this excess, but limited to previous writeoffs on that asset.<sup>23</sup> To illustrate, assume for example that a loan with an amortized cost basis of \$100,000 was written down to zero upon the customer's bankruptcy, given the nominal value of the collateral and the lender's expectations that the receivable is uncollectible. If at a later date, the fair value of the collateral (reduced for estimated costs to sell if applicable) increases to \$125,000, the net carrying amount of the loan can be increased from zero to \$100,000 through a debit to the allowance for credit losses and a credit to credit loss expense.

A collateral-dependent financial asset is defined in ASC 326-20-35-5 as "a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on an entity's assessment as of the reporting date." Assets that do not meet the definition are not eligible for the practical expedient, in which case consideration should be given to the nature of the collateral, potential future changes in collateral values and historical loss experience for financial assets secured with similar collateral when estimating the allowance for expected losses.

A similar practical expedient and measurement approach is permitted under ASC 326-20-35-6 for financial assets that are secured by collateral maintenance provisions whereby the borrower is required to continually adjust the amount of the collateral securing the financial asset as a result of fair value changes in the collateral. In these situations, if an entity reasonably expects the borrower to continue to replenish the collateral to meet the requirements of the contract, an entity may use, as a practical expedient, a method that compares the amortized cost basis with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. As a result, under the practical expedient, if an entity reasonably expects the borrower to continue to replenish the collateral as necessary to meet the requirements of the contract, then as of the reporting date:

- An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset, or
- an entity's estimate of expected credit losses is limited to the amount by which the amortized cost basis of the financial asset exceeds the fair value of the collateral.

Examples 6 and 7 in ASC 326-20-55 (shown below) illustrate the application of both practical expedients.



**Example 6-11: Estimating Expected Credit Losses—Practical Expedient for Collateral-Dependent Financial Assets (from Example 6 in ASC 326-20-55-41 to 55-44)**

This Example illustrates one way an entity may implement the guidance in paragraph 326-20-35-5 for estimating expected credit losses on a collateral-dependent financial asset for which the borrower is experiencing financial difficulty based on the entity's assessment.

Bank F provides commercial real estate loans to developers of luxury apartment buildings. Each loan is secured by a respective luxury apartment building. Over the past two years, comparable standalone luxury housing prices have dropped significantly, while luxury apartment communities have experienced an increase in vacancy rates.

<sup>23</sup> The fair value of the collateral of a collateral-dependent financial asset may change from one reporting period to the next. Pursuant to ASC 326-20-45-4, changes in the fair value of the collateral must be reported as credit loss expense or a reversal of credit loss expense when the guidance in ASC 326-20-35-4 through 35-6 is applied.

At the end of 20X7, Bank F reviews its commercial real estate loan to Developer G and observes that Developer G is experiencing financial difficulty as a result of, among other things, decreasing rental rates and increasing vacancy rates in its apartment building.

After analyzing Developer G's financial condition and the operating statements for the apartment building, Bank F believes that it is unlikely Developer G will be able to repay the loan at maturity in 20X9. Therefore, Bank F believes that repayment of the loan is expected to be substantially through the foreclosure and sale (rather than the operation) of the collateral. As a result, in its financial statements for the period ended December 31, 20X7, Bank F utilizes the practical expedient provided in paragraph 326-20-35-5 and uses the apartment building's fair value, less costs to sell, when developing its estimate of expected credit losses.



**Example 6-12: Estimating Expected Credit Losses—Practical Expedient for Financial Assets with Collateral Maintenance Provisions (from Example 7 in ASC 326-20-55-45 to 55-47)**

This Example illustrates one way an entity may implement the guidance in paragraph 326-20-35-6 for estimating expected credit losses on financial assets with collateral maintenance provisions.

Bank H enters into a reverse repurchase agreement with Entity I that is in need of short-term financing. Under the terms of the agreement, Entity I sells securities to Bank H with the expectation that it will repurchase those securities for a certain price on an agreed-upon date. In addition, the agreement contains a provision that requires Entity I to provide security collateral that is valued daily, and the amount of the collateral is adjusted up or down to reflect changes in the fair value of the underlying securities transferred. This collateral maintenance provision is designed to ensure that at any point during the arrangement, the fair value of the collateral continually equals or is greater than the amortized cost basis of the reverse repurchase agreement.

At the end of the first reporting period after entering into the agreement with Entity I, Bank H evaluates the reverse repurchase agreement's collateral maintenance provision to determine whether it can use the practical expedient in accordance with paragraph 326-20-35-6 for estimating expected credit losses. Bank H determines that although there is a risk that Entity I may default, Bank H's expectation of nonpayment of the amortized cost basis on the reverse repurchase agreement is zero because Entity I continually adjusts the amount of collateral such that the fair value of the collateral is always equal to or greater than the amortized cost basis of the reverse repurchase agreement. In addition, Bank H continually monitors that Entity I adheres to the collateral maintenance provision. As a result, Bank H uses the practical expedient in paragraph 326-20-35-6 and does not record expected credit losses at the end of the first reporting period because the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Bank H performs a reassessment of the fair value of collateral in relation to the amortized cost basis each reporting period.

**6.9.1 Common questions related to application of the collateral-dependent financial asset practical expedient**

**6Q.9.1.1: *Must an entity periodically reassess the collateral-dependent financial asset practical-expedient's applicability once it's elected?***

Yes. ASC 326-20-35-5 indicates that an entity may use the practical expedient to estimate the allowance for credit losses for a financial asset if based on the entity's assessment as of the reporting date the entity concludes that (a) the borrower is experiencing financial difficulty, and (b) repayment is expected to be provided substantially through the operation or sale of the collateral.

*6Q.9.1.2: Should an entity consider the existence of credit enhancements when estimating expected credit losses using the collateral-dependent financial asset practical expedient?*

Yes, but only credit enhancements that are embedded in the financial asset. According to ASC 326-20-35-5, an entity is required to consider any credit enhancements that meet the criteria in ASC 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses. The estimate of expected credit losses should reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity is precluded from combining a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) should not be offset by a freestanding contract (e.g., a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

*6Q.9.1.3: Can an entity apply the collateral-dependent financial asset practical expedient to a group (portfolio) of financial assets?*

No. We believe the practical expedient may only be applied at the individual financial asset level. Applying the practical expedient at the portfolio level could result in the expected credit losses from financial assets for which the fair value of the collateral is less than the amortized cost to be offset by gains from those financial assets for which the fair value of the collateral is greater than the amortized cost, which would be inappropriate.

*6Q.9.1.4: What types of costs should an entity consider when estimating selling costs?*

If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, ASC 326-20-35-5 requires that the fair value of the collateral be adjusted for estimated costs to sell. However, ASC 326-20 does not specify the types of costs an entity should consider when it estimates those costs. We believe that only incremental direct selling costs that are essential to effectuate the sale of the collateral should be considered. Broker commissions, legal fees and closing costs to transfer title to the collateral are some examples of costs that qualify if they represent costs the entity expects to incur solely to effectuate the sale. Costs that the entity expects to pay on behalf of the borrower that are attributed to operating or owning the collateral (e.g., real estate taxes, insurance premiums, utility bills, etc.) do not represent incremental direct selling costs, and therefore, should not be used to adjust the fair value of the collateral expected to be sold.

*6Q.9.1.5: Can an entity measure a loan's allowance for credit loss using the practical expedient described in ASC 326-20-35-5 if the entity does not expect to operate or sell the underlying collateral in order to obtain repayment?*

No. ASC 326-20-35-5 indicates that an entity may use, as a practical expedient, the fair value of the collateral at the reporting date to record the net carrying amount of a loan and determine the allowance for credit losses for a loan when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date and repayment of the loan is expected to be provided substantially through the operation or sale of the collateral.

For collateralized financial assets that do not meet the circumstances described in ASC 326-20-35-4 through 35-6, an entity should not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial assets. Instead, an entity should consider the nature of the collateral, potential future changes in collateral values and historical loss information for financial assets secured with similar collateral (see ASC 326-20-30-10).

## 6.10 Credit enhancements



### ASC 326-20-30-12

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

ASC 326-20-30-12 indicates that when estimating expected credit losses on a financial asset or group of financial assets, consideration should not be given to freestanding credit enhancements. In other words, it is not appropriate to combine a freestanding contract (which is defined in Appendix A) with a financial asset when estimating the expected losses on the financial asset. To further explain, when estimating expected losses on a financial asset, consideration should be given to the ability and willingness of a guarantor to pay and (or) whether any subordinated interests are expected to be capable of absorbing credit losses, under the assumption that these forms of credit enhancement are not freestanding. If, however, an entity purchases a freestanding credit-default swap to mitigate credit losses on a financial asset, no consideration would be given to that swap in estimating expected losses, and therefore the allowance, on the financial asset.

## 6.11 Off-balance-sheet credit exposures



### ASC 326-20-30-11

In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures. For that period of exposure, the estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life. If an entity uses a discounted cash flow method to estimate expected credit losses on off-balance-sheet credit exposures, the discount rate used should be consistent with the guidance in Section 310-20-35.

### ASC 326-20-45-2

For off-balance-sheet credit exposures within the scope of this Subtopic, an entity shall present the estimate of expected credit losses on the statement of financial position as a liability. The liability for credit losses for off-balance-sheet financial instruments shall be reduced in the period in which the off-balance-sheet financial instruments expire, result in the recognition of a financial asset, or are otherwise settled. An estimate of expected credit losses on a financial instrument with off-balance-sheet risk shall be recorded separate from the allowance for credit losses related to a recognized financial instrument.

The terminology *off-balance-sheet credit exposures* refers to credit exposures on contractual commitments to lend, which as the name implies, have not been recognized on the balance sheet given that the funding of the commitment has not yet occurred. Examples of off-balance-sheet commitments that are within the scope of ASC 326-20 include loan commitments, standby letters of credit, financial guarantees and other similar instruments that are not required to be accounted for as derivatives. Given that there is no recorded asset associated with an off-balance-sheet commitment, estimated expected credit losses are recorded as a liability rather than an allowance or contra-asset account. The accrual for off-balance-sheet credit exposures should consider expected losses over the period during which the entity has a contractual obligation to extend credit (i.e., an obligation that is not unconditionally cancellable by the creditor). In estimating expected losses for that period of time, consideration should be given to the likelihood that the obligation will be funded (in light of adverse change clauses and other relevant factors), as well as the amount likely to be funded, as there may be cases where only a portion of the committed balance is ultimately drawn. Example 10 in ASC 326-20-55 (shown below) illustrates the application of this guidance to unconditionally cancellable loan commitments. Upon funding, the liability for expected credit losses would be reclassified to an allowance for credit losses, and remeasured as necessary, given the elimination of the uncertainty associated with whether or not it would be funded.



**Example 6-13: Recognizing purchased financial assets with credit deterioration (from Example 10 in ASC 326-20-55-55 to 55-56)**

Bank M has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. Bank M's card holder agreements stipulate that the available credit may be unconditionally cancelled at any time.

When determining the allowance for credit losses, Bank M estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank M does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present contractual obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability.



**Spotlight: Interplay of ASC 460 and ASC 326-20**

Guarantees that are within both the scope of ASC 460 and ASC 326-20 (i.e., those that create off-balance-sheet credit exposure and are not accounted for as insurance or derivatives) are initially recognized by the guarantor as a liability at fair value for the noncontingent aspect of the guarantee and as a liability for expected credit losses for the contingent aspect [ASC 460-10-30-5]. The following example illustrates this accounting:

On January 1, 20X0, Company A issues a guarantee to Lender B that Borrower C will repay the \$250,000 borrowed from Bank B, plus interest, that is due December 31, 20X1. Company A and Lender B are unrelated parties and a \$10,000 premium that Company A receives from Lender B upon issuance of the guarantee is considered its fair value.

In accordance with ASC 460-10-30-2(a), Company A recognizes a \$10,000 guarantee liability for the premium received from Lender B for the noncontingent aspect of the guarantee.

Based on its historical experience with similar guarantees and consideration of current conditions and reasonable and supportable forecasts of future economic conditions, Company

A records a credit loss expense and a separate liability for the expected credit losses related to the contingent aspect of this guarantee of \$12,000, in accordance with ASC 326-20.

## 6.12 Purchased financial assets with credit deterioration



### Spotlight: FASB project

On June 27, 2023, the FASB issued a proposed ASU that would simplify the accounting for acquired financial assets. Assets that fall within the scope of the proposed ASU include most financial assets not measured at fair value, loans including trade receivables, credit card receivables and other revolving credit arrangements. Specifically, the proposed ASU would:

- Eliminate the distinction between PCD and non-PCD financial assets by no longer focusing on an acquired financial asset's degree of credit deterioration since its origination.
- Make the "gross-up" approach, which is currently applied only to PCD assets, required for financial assets recognized by consolidating a non-business VIE or through an asset acquisition if certain criteria are met. The proposed criteria are intended to differentiate between acquired financial assets that are in-substance originated assets (and therefore outside the scope of the proposed guidance) from "seasoned" assets, which are within the scope of the proposed guidance. Seasoning would be defined using principles-based criteria that consider the acquirer's involvement with the asset prior to acquisition, with a bright-line period of 90 days.
- Make the gross-up approach required for all financial assets acquired as part of a business combination. That is, financial assets acquired in a business combination would be presumed seasoned.
- Dictate that an entity that acquires financial assets considered to be in-substance loan originations would generally recognize an allowance for credit losses upon initial recognition of the assets, even if the purchase price is considered to be fair value. In contrast, the initial allowance under the gross-up approach would be recognized through an increase to the amortized cost basis of the asset rather than a debit to credit losses expense.
- Not change the measurement, presentation or disclosure requirements of the current gross-up approach.

A final ASU is expected to be issued during the first quarter of 2024.

Refer to [Financial Instruments—Credit Losses \(Topic 326\)—Acquired Financial Assets Tentative Board Decisions to Date](#) for the most current information related to this project.



### ASC 326-20-30-13

An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration in accordance with paragraphs 326-20-30-2 through 30-10, 326-20-30-12, and 326-20-30-13A. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. 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.

**ASC 326-20-30-13A**

The allowance for credit losses for purchased financial assets with credit deterioration shall include expected recoveries of amounts previously written off and expected to be written off by the entity and shall not exceed the aggregate of amounts previously written off and expected to be written off by the entity.

- a. If the entity estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4, expected recoveries shall not include any amounts that result in an acceleration of the noncredit discount.
- b. The entity may include increases in expected cash flows after acquisition.

(See Examples 18 and 19 in paragraphs 326-20-55-86 through 55-90.)

**ASC 326-20-30-14**

If an entity estimates expected credit losses using a discounted cash flow method, the entity shall discount expected credit losses at the rate that equates the present value of the purchaser's estimate of the asset's future cash flows with the purchase price of the asset. If an entity estimates expected credit losses using a method other than a discounted cash flow method, the entity shall estimate expected credit losses on the basis of the unpaid principal balance (face value) of the financial asset(s). See paragraphs 326-20-55-66 through 55-78 for implementation guidance and examples.

**ASC 326-20-30-15**

An entity shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets in accordance with paragraphs 326-20-30-1 through 30-10 and 326-20-30-12. An entity shall not apply the guidance in paragraphs 326-20-30-13 through 30-14 for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination.

ASU 2016-13 eliminated the separate accounting model in ASC 310-30 under which contractual cash flows not expected to be collected were accounted for as a nonaccretable difference rather than an allowance, with favorable changes in expected cash flows recognized as a yield adjustment over the remaining life of the asset. To reduce the complexity associated with multiple models and improve comparability, ASC 326-20 requires an allowance for estimated credit losses to be measured in the same manner regardless of whether an asset is originated or acquired, with both favorable and unfavorable changes in expected cash flows recognized immediately as a decrease or increase in credit loss expense. Thus, even though acquired assets are measured at fair value at the acquisition date, which presumably is reflective of expected credit losses, the expectation is that most assets within the scope of ASC 326-20 will have an acquisition-date allowance. As is pointed out in ASC 326-20-30-5, purchase discounts that will be accreted into interest income cannot be used to offset expected credit losses.

Despite this consistent measurement, it is still necessary for an acquirer to evaluate purchased financial assets to determine what, if any, assets as of the date of acquisition have experienced more-than-insignificant deterioration in credit quality subsequent to origination. The initial allowance for those assets that have experienced such deterioration is recorded through an upward adjustment to the assets' initial carrying amounts rather than through recognition of credit loss expense, which would be the case for purchased assets that had not experienced such deterioration. Additionally, if a DCF method is not used when estimating expected credit losses, the estimate should be based on the amount of unpaid principal balance that will not be collected, rather than the amortized cost basis for those assets that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination.



### Spotlight: Changes in terminology

Assets within the scope of ASC 310-30 are “loans with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which *it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable* [emphasis added],” referred to as *purchased credit impaired*, or *PCI*. In contrast, purchased financial assets with credit deterioration (PCD assets) are defined in part in the Master Glossary of the ASC as acquired financial assets “that, as of the date of acquisition, have experienced a *more-than-insignificant deterioration in credit quality* since origination [emphasis added].” The expectation is that the definition of PCD assets is more encompassing than PCI; however, the definition of PCD should be strictly applied. While in practice the guidance in ASC 310-30 was applied by analogy to assets which did not meet the definition of PCI, it is not appropriate to apply the PCD guidance in ASU 2016-13 to assets that do not meet the definition of PCD.

The complete definition of PCD assets is provided in Appendix A. Key aspects of the definition to focus on include: (a) it only applies to acquired assets (not originated), (b) the assets need to be acquired subsequent to their origination (as opposed to contemporaneously) and (c) the assets must have experienced more than insignificant deterioration in credit quality since origination (which will be a subjective determination). It is important to note that if the assets are acquired in a transaction that does not meet the requirements under ASC 860 for sale treatment, the transaction is viewed as the origination of new financial assets that are collateralized by the transferred assets rather than an acquisition of assets.<sup>24</sup>

See Spotlight: FASB project in Section 4.1.7 for a discussion on current standard-setting activity that may change the accounting requirements for purchased financial assets.

The transition provisions of ASU 2016-13: (a) require existing assets accounted for under ASC 310-30 to be accounted for as PCD assets on the date of adoption, with an allowance established through an adjustment to the amortized cost basis and (b) provide the ability to elect to maintain pools of loans accounted for under ASC 310-30 at adoption. At its June 2017 meeting, the TRG discussed whether entities could continue to maintain the pools post adoption, even if the assets no longer have similar risk characteristics. The conclusion was reached that the pools can be maintained post adoption, regardless of whether the assets have similar risk characteristics, and an entity should make an election on a pool-by-pool basis as to whether or not each pool will be maintained post adoption.

In making the important determination of whether a purchased asset experienced more-than-insignificant deterioration in credit quality, Example 11 in ASC 326-20-55-57 to 55-60 refers to factors such as delinquency, downgrades, nonaccrual status and widening credit spreads as indicators of deterioration.

The adjustment to the carrying amount of the PCD asset to establish the acquisition-date allowance, along with the asset’s purchase price or fair value, becomes the asset’s initial amortized cost basis. Any noncredit discount or premium resulting from acquiring a pool of such assets is required to be allocated to each individual asset and accreted or amortized as interest income. The acquisition-date discount attributable to expected credit losses is not recognized in interest income and also should not be reported as a credit loss expense upon acquisition.

In line with the general concepts of ASC 326-20, entities are not required to use DCF methodologies in measuring the allowance for credit losses on PCD assets, but in the event a DCF method is used,

<sup>24</sup> For additional information, refer to the [speech](#) of SEC staff member Robert B. Sledge at the 2017 AICPA Conference on Current SEC and PCAOB Developments.



expected credit losses should be discounted at the rate that equates the present value of the purchaser's estimate of the asset's future cash flows with the purchase price of the asset. If a DCF method is not used, expected credit losses should be estimated based on the unpaid principal balance of the asset. In other words, if a loss-rate approach is used, the loss rate would be applied to the unpaid principal amount at the date of recognition rather than the carrying amount of the asset. While the expectation generally is that the method that is initially selected would be consistently applied over time, as discussed in Example 13 in ASC 326-20-55-66, it should not be construed to be an irrevocable election. All changes in the allowance are reflected through a reduction or increase in credit loss expense as they occur. This is in contrast to ASC 310-30, which required favorable changes in expected cash flows to be accreted into interest income over the remaining life of the asset.

The following examples from ASC 326-20-55 illustrate the application of the guidance to PCD assets.



**Example 6-14: Recognizing purchased financial assets with credit deterioration (from Example 12 in ASC 326-20-55-63 to 55-65)**

Bank O records purchased financial assets with credit deterioration in its existing systems by recognizing the amortized cost basis of the asset, at acquisition, as equal to the sum of the purchase price and the associated allowance for credit loss at the date of acquisition. The difference between amortized cost basis and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the credit related discount is not accreted to interest income after the acquisition date.

Assume that Bank O pays \$750,000 for a financial asset with a par amount of \$1 million. The instrument is measured at amortized cost basis. At the time of purchase, the allowance for credit losses on the unpaid principal balance is estimated to be \$175,000. At the purchase, the statement of financial position would reflect an amortized cost basis for the financial asset of \$925,000 (that is, the amount paid plus the allowance for credit loss) and an associated allowance for credit losses of \$175,000. The difference between par of \$1 million and the amortized cost of \$925,000 is a non-credit-related discount. The acquisition-date journal entry is as follows:

Loan—par amount	\$1,000,000	
Loan—noncredit discount		\$75,000
Allowance for credit losses		175,000
Cash		750,000

Subsequently, the \$75,000 noncredit discount would be accreted into interest income over the life of the financial asset consistent with other Topics. The \$175,000 allowance for credit losses should be updated in subsequent periods consistent with the guidance in Section 326-20-35, with changes in the allowance for credit losses on the unpaid principal balance reported immediately in the statement of financial performance as a credit loss expense.



**Example 6-15: Using a loss-rate approach for determining expected credit losses and the discount rate on a purchased financial asset with credit deterioration (from Example 13 in ASC 326-20-55-67 to 55-71)**

Bank P purchases a \$5 million amortizing nonprepayable loan with a 6 percent coupon rate and original contract term of 5 years. All contractual principal and interest payments due of \$1,186,982 for each of the first 3 years of the loan's life have been received, and the loan has an unpaid balance of \$2,176,204 at

the purchase date at the beginning of Year 4 of the loan's life. The original contractual amortization schedule of the loan is as follows.

Original Amortization Table					
Period	Beginning Balance	Total Payment	Interest	Principal	Ending Balance
1	\$5,000,000	\$1,186,982	\$300,000	\$886,982	\$4,113,018
2	4,113,018	1,186,982	246,781	940,201	3,172,817
3	3,172,817	1,186,982	190,369	996,613	2,176,204
4	2,176,204	1,186,982	130,572	1,056,410	1,119,794
5	1,119,794	1,186,982	67,188	1,119,794	-
<b>Totals</b>		<b>\$5,934,910</b>	<b>\$934,910</b>	<b>\$5,000,000</b>	

At the purchase date, the loan is purchased for \$1,918,559 because significant credit events have been discovered. The purchaser expects a 10 percent loss rate, based on historical loss information over the contractual term of the loan, adjusted for current conditions and reasonable and supportable forecasts, for groups of similar loans. In accordance with paragraph 326-20-30-14, as a result of the expected credit losses, the allowance is estimated as \$217,620 by multiplying the 10 percent loss rate by the unpaid principal balance, or par amount of the loan (see beginning balance in Year 4 in the table above). The following journal entry is recorded at the acquisition of the loan.

Loan		\$2,176,204	
	Loan—noncredit discount		\$40,025
	Allowance for credit losses		217,620
	Cash		1,918,559

The contractual interest rate is adjusted for the noncredit discount of \$40,025 to determine the discount rate (consistent with paragraph 326-20-30-14) of 7.33 percent, which excludes the purchaser's assessment of expected credit losses at the acquisition date. The 7.33 percent (rounded from 7.3344 percent) is computed as the rate that equates the amortized cost of \$2,136,179 (computed by adding the purchase price of \$1,918,559 to the gross-up adjustment of \$217,620) with the net present value of the remaining contractual cash flows on the purchased asset (\$1,186,982 in each of Years 4 and 5).

A default occurs in the last year of the loan's life. The amortization of the purchased loan would be recorded as follows for the periods after the purchase date in Years 4 and 5 of the loan's life.

Book Amortization						
Period	Beginning Balance <sup>(a)</sup>	Total Payment <sup>(b)</sup>	Writeoff <sup>(c)</sup>	Accrued Interest <sup>(d)</sup>	Reduction <sup>(e)</sup>	Ending Balance <sup>(f)</sup>
4	\$2,136,179	\$1,186,982		\$156,676	\$1,030,306	\$1,105,873
5	1,105,873	969,362	\$217,620	81,109	1,105,873	-
<b>Totals</b>		<b>\$2,156,344</b>	<b>\$217,620</b>	<b>\$237,785</b>	<b>\$2,136,179</b>	

<sup>(a)</sup> The amortized cost at the purchase date is determined as the sum of the purchase price of \$1,918,559 and the allowance for credit losses of \$217,620.

<sup>(b)</sup> The cash received is consistent with the expectations at the purchase date.

- (c) The writeoff represents the default in the final year of the loan that is written off.
- (d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 7.33 percent (as determined in accordance with paragraph 326-20-55-69).
- (e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of \$1,186,982 and the actual cash flows of \$969,362.
- (f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

The rollforward of the allowance would be as follows.

Beginning allowance for credit losses	\$217,620
Plus, credit loss expense	-
Less, writeoffs	(217,620)
Ending allowance for credit losses	\$ -



**Example 6-16: Using a DCF approach for determining expected credit losses and the discount rate on a purchased financial asset with credit deterioration (from Example 14 in ASC 326-20-55-74 to 55-78)**

[The following example uses the same assumptions as those in Example 6-15:]

To determine the discount rate in accordance with paragraph 326-20-30-14, the expected cash flows would be estimated and discounted at a rate that equates the purchase price with the present value of expected cash flows. The expected cash flows, including the considerations for current conditions and reasonable and supportable forecasts, are expected to be \$1,186,982 in Year 4 and \$969,362 in Year 5. The discount rate that equates the purchase price with the cash flows expected to be collected is 8.46 percent (rounded from 8.455 percent). This also is the same rate that equates the amortized cost basis (purchase price plus the acquisition date allowance for credit losses) with the net present value of the future contractual cash flows. To determine the allowance for credit losses at the purchase date, the expected credit loss (that is, the contractual cash that an entity does not expect to collect) is discounted using the discount rate of 8.46 percent. The expected credit loss is \$217,620 in Year 5, as determined by finding the difference between the contractual cash flows of \$1,186,982 and the expected cash flows of \$969,362. The present value of the expected loss at the purchase date is \$185,012. The journal entry to record the purchase of this loan is as follows:

Loan	\$2,176,204	
Loan—noncredit discount		\$72,633
Allowance for credit losses		185,012
Cash		1,918,559

The amortization of the loan in the years following the purchase date is as follows.

Book Amortization						
Period	Beginning Balance <sup>(a)</sup>	Total Payment <sup>(b)</sup>	Writeoff <sup>(c)</sup>	Accrued Interest <sup>(d)</sup>	Reduction <sup>(e)</sup>	Ending Balance <sup>(f)</sup>
4	\$2,103,571	\$1,186,982		\$177,857	\$1,009,125	\$1,094,446
5	1,094,446	969,362	\$217,620	92,536	1,094,446	-
<b>Totals</b>		<b>\$2,156,344</b>	<b>\$217,620</b>	<b>\$270,393</b>	<b>\$2,103,571</b>	

<sup>(a)</sup> The amortized cost at the purchase date is determined as the sum of the purchase price of \$1,918,559 and the allowance for credit losses of \$185,012.

<sup>(b)</sup> The cash received is consistent with the expectations at the purchase date.

<sup>(c)</sup> The writeoff represents the default in the final year of the loan that is written off.

<sup>(d)</sup> The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 8.46 percent (as determined in accordance with paragraph 326-20-55-74).

<sup>(e)</sup> The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of \$1,186,982 and the actual cash flows of \$969,362.

<sup>(f)</sup> The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

The Day 1 allowance established at the purchase date was \$185,012. The allowance for credit losses was estimated on a discounted cash flow approach and, therefore, the allowance for credit losses needs to be adjusted for the time value of money. The rollforward of the allowance for credit losses is shown below.

Beginning allowance for credit losses	\$185,012	
Plus, credit loss expense	15,643	<sup>(a)</sup>
Less, writeoffs	-	
Ending allowance for credit losses (Year 4)	200,655	
Plus, credit loss expense	16,965	<sup>(a)</sup>
Less, writeoffs	(217,620)	<sup>(b)</sup>
Ending allowance for credit losses (Year 5)	\$ -	

<sup>(a)</sup> The provision for credit losses in Year 4 and Year 5 is determined by multiplying the beginning allowance for credit losses by the discount rate of 8.46 percent to adjust for the time value of money.

<sup>(b)</sup> The writeoff represents the default in Year 5. The default is the difference between the Year 5 contractual cash flows of \$1,186,982 and the actual cash flows received of \$969,362.

The net income effect of a loss-rate approach illustrated in Example 13 and of a discounted cash flow approach illustrated in this Example is the same (\$237,785 net income). The difference between the two approaches is that the Day 1 allowance for credit losses under a discounted cash flow approach explicitly reflects the time value of money. Therefore, it needs to be accreted to the future value of the loss that ultimately will occur. The change in the allowance for credit losses associated with the time value of money can be presented either as credit loss expense or as an adjustment to interest income in accordance with paragraph 326-20-45-3. Therefore, the discounted cash flow approach, over the life of the asset, presents interest income as \$270,393 but will require \$32,608 (\$15,643 in Year 4 plus \$16,965 in Year 5) of credit loss expense to be recorded for the time value of money, resulting in net interest income after credit loss expense of \$237,785. Under a loss-rate approach as illustrated in Example 13,

interest income over the life of the asset is \$237,785 but does not require credit loss expense to be recognized.



**Example 6-17: Determining the negative allowance for purchased financial assets with credit deterioration with no change in credit conditions (from Example 18 in ASC 326-20-55-87 to 55-89)**

Bank Q purchases a portfolio of loans with a par amount of \$10 million for \$2 million. At acquisition, Bank Q expects to collect \$2.5 million on the loan portfolio. Bank Q estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4. The acquisition-date journal entry is as follows.

Loan—par amount	\$10,000,000	
Loan—noncredit discount		\$500,000
Allowance for credit losses		7,500,000
Cash		2,000,000

After acquisition, Bank Q determines that each loan is deemed uncollectible on an individual unit-of-account basis and, therefore, writes off the loan portfolio. The following journal entries are recorded.

Provision expense	\$2,000,000	
Allowance for credit losses		\$2,000,000

Allowance for credit losses	\$9,500,000	
Loan—noncredit discount	500,000	
Loan—par amount		\$10,000,000

Although deemed uncollectible on an individual basis, when grouped together, the group of loans is expected to have some recoveries on an aggregate basis. Therefore, Bank Q records a negative allowance in accordance with paragraph 326-20-30-13A. Because Bank Q's expectation of credit conditions has not changed since acquisition, the expected recoveries of \$2.5 million must not result in the acceleration of the noncredit discount that existed immediately before being written off. Therefore, the following journal entry is recorded.

Allowance for credit losses	\$2,000,000	
Provision expense		\$2,000,000



**Example 6-18: Determining the negative allowance for purchased financial assets with credit deterioration after a change in credit conditions (from Example 19 in ASC 326-20-55-90)**

[The following example uses the same assumptions as those in Example 6-17:]

Bank Q subsequently determines that a change in credit conditions has occurred and expects to collect an additional \$600,000 (for a total of \$3.1 million) on the group of loans. Because Bank Q's expectation of

credit conditions has changed and it is determining the amount that it expects to collect using a method other than a discounted cash flow method, the expected recoveries of \$3.1 million would be reduced by the noncredit discount of \$0.5 million (that has not been accreted). This would result in Bank Q having an overall negative allowance of \$2.6 million. Therefore, the following journal entry is recorded.

Allowance for credit losses	\$600,000	
Provision expense		\$600,000

### 6.13 Beneficial interests in securitized financial assets

Modifications were made to the guidance in ASC 325-40 to incorporate the requirements of ASU 2016-13. Namely, the initial allowance for beneficial interests that either meet the definition of PCD assets or have a significant difference between contractual cash flows and expected cash flows at the date of recognition is recognized similar to PCD assets (i.e., through an increase to the amortized cost basis). During its June 2017 meeting, the TRG discussed whether contractual cash flows should consider expected prepayments for this determination. The conclusion was reached that contractual cash flows should consider prepayments that are expected to occur such that the difference when compared to expected cash flows would appropriately isolate credit risk. The TRG also discussed how contractual cash flows would be determined for a security that does not have contractually stated cash flows and concluded that consideration should be given to the contractual terms of the underlying assets.

As changes in expected cash flows occur on beneficial interests, the allowance for credit losses is remeasured in accordance with ASC 326-20 and the accretable yield is recalculated.

### 6.14 Loans subsequently identified for sale

If an entity decides to sell a loan that is not classified as held for sale, at the time of the decision, the loan should be transferred into the held-for-sale classification in accordance with Section 5.2.4.

### 6.15 Writeoffs and recoveries of financial assets

Full or partial writeoffs of financial assets should be recorded as a deduction from the allowance in the period in which the financial asset is deemed uncollectible. As noted in ASC 326-20-30-1, expected recoveries of amounts previously written off and expected to be written off should be factored into the allowance for expected credit losses. This could potentially result in a negative allowance; however, recoveries incorporated into the allowance computation, and the negative allowance that may result, should not exceed the aggregate of amounts previously written off and expected to be written off by the entity. Additionally, as noted in ASC 326-20-30-13A, when estimating expected credit losses on PCD assets using a method other than a DCF method, expected recoveries should not include any amounts that accelerate the recognition of the noncredit discount.

ASC 326-20-35-8A permits an accounting policy election, at the class of financing receivable or the major security-type level, to write off accrued interest receivables by reversing interest income or recognizing credit loss expense or a combination of both. This accounting policy election should be considered separately from the accounting policy election in ASC 326-20-30-5A. Importantly, an entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

The accounting for writeoffs and recoveries is illustrated in the following example. Refer also to Examples 6-14 to 6-18 within Section 6.12, which are relevant to PCD assets.


**Example 6-19: Recognizing writeoffs and recoveries (from Example 9 in ASC 326-20-55-52 to 55-53)**

Bank K currently evaluates its loan to Entity L on an individual basis because Entity L is 90 days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio. At the end of December 31, 20X3, the amortized cost basis for Entity L's loan is \$500,000 with an allowance for credit losses of \$375,000. During the first quarter of 20X4, Entity L issues a press release stating that it is filing for bankruptcy. Bank K determines that the \$500,000 loan made to Entity L is uncollectible. Bank K considers all available information that is relevant and reasonably available, without undue cost or effort, and determines that the information does not support an expectation of a future recovery in accordance with paragraph 326-20-30-7. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance in accordance with paragraph 326-20-35-8, as follows:

Credit loss expense	\$125,000	
Allowance for credit losses		\$125,000
Allowance for credit losses	\$500,000	
Loan receivable		\$500,000

During March 20X6, Bank K receives a partial payment of \$50,000 from Entity L for the loan previously written off. Upon receipt of the payment, Bank K recognizes the recovery in accordance with paragraph 326-20-35-8, as follows:

Cash	\$50,000	
Allowance for credit losses (recovery)		\$50,000

For its March 31, 20X6 financial statements, Bank K estimates expected credit losses on its financial assets and determines that the current estimate is consistent with the estimate at the end of the previous reporting period. During the period, Bank K does not record any change to its allowance for credit losses account other than the recovery of the loan to Entity L. To adjust its allowance for credit losses to reflect the current estimate, Bank K reports the following on March 31, 20X6:

Allowance for credit losses	\$50,000	
Credit loss expense		\$50,000

Alternatively, Bank K could record the recovery of \$50,000 directly as a reduction to credit loss expense, rather than initially recording the cash received against the allowance.

## 6.16 Evaluating subsequent events in the CECL model

ASC 855, *Subsequent Events*, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Under ASC 855, there are two types of subsequent events. Recognized subsequent events that require adjustments to amounts recorded in the financial statements to be issued (also referred to as "Type I" subsequent events), and nonrecognized subsequent events that are considered for disclosure (also referred to as "Type II" subsequent events).

In accordance with ASC 855-10-25-1, an entity should recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. For

example, a lender may receive information about the fair value (as of the balance sheet date) of collateral pledged on a collateral dependent loan after the balance sheet date but before the financial statements are issued. In this situation, the lender should consider that information in determining the allowance for credit losses as of the reporting date.

In contrast, an entity should not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued (see ASC 855-10-25-3). Changes in estimated credit losses on receivables arising after the reporting date but before the financial statements are issued (available to be issued) is an example of an event provided in ASC 855-10-55-2 that would not be reflected in the allowance for credit losses as of the reporting date.

The subsequent occurrence or non-occurrence of a forecasted event or condition may not require a change in an entity's estimated credit losses at the reporting date. Differences between an entity's forecasts and actual results will often occur due to the inherent impression of estimates that include assumptions and predictions about future events and conditions.

Applying the subsequent events guidance in ASC 855 to the forward-looking estimate of expected credit losses presents unique challenges. At the [2018 AICPA Conference on Current SEC and PCAOB Developments](#), SEC staff provided guidance on this topic by discussing conclusions reached in a consultation submission that involved three specific fact patterns. In each fact pattern, the referenced information was received after the balance sheet date but before the financial statements were issued and was significantly different from management's expectations.

The first fact pattern related to the receipt of a servicer report that showed the effects of payment experience (e.g., delinquencies and prepayments) that occurred on or before the balance sheet date. The second fact pattern related to the receipt of an appraisal report that showed information about the fair value of loan collateral as of the balance sheet date. In both of these fact patterns, the staff indicated they would object to an entity not considering this information in its estimate of expected credit losses. In other words, the staff considered the fact patterns to constitute a Type I subsequent event that should be recognized. The staff explained that an important consideration in both of these fact patterns was that the information about factual conditions that existed at the balance sheet date was loan-specific.

The third fact pattern related to the U.S. government's announcement of unemployment rates for a period that includes the balance sheet date. The staff indicated that they would not object to an entity either considering or not considering such rates in its estimate of expected credit losses. The staff believes that:

- Information relating to forecasting assumptions used in establishing expected credit losses that is received before an entity has completed an appropriate estimation process would be permitted to be included in the estimate, unless such information indicates a weakness or a deficiency in the registrant's estimation process, in which case the information would be recognized
- Information relating to forecasting assumptions used in establishing expected credit losses that is received after an entity has completed an appropriate estimation process would not be recognized, unless such information indicates a weakness or a deficiency in the entity's estimation process, in which case the information would be recognized.

When the differences between the actual results and the entity's assumptions are significant and not reflected in the credit loss estimate as of the reporting date (because they are considered Type II subsequent events), the SEC staff also reminded entities that additional disclosures of nonrecognized subsequent events may be necessary to prevent the financial statements from being misleading (see ASC 855-10-50-2 and 50-3).





**RSM COMMENTARY:** Entities need to apply judgment when evaluating the treatment of subsequent events when information is received after the reporting date but before the financial statements are issued (or available to be issued) that relates to forecasting assumptions included in the entity's estimated credit losses as of the reporting date.

An accounting policy should be developed in accordance with the requirements of ASC 855 and applied consistently. Among other things, the entity's policy should indicate the process for incorporating reasonable and supportable forecasts in its estimate of expected credit losses. When significant, such policy should be disclosed in the notes accompanying the financial statements. Actual results will often differ from forecasted estimates. When the differences are significant, entities should evaluate whether a weakness or deficiency exists in the entity's estimation process (which requires enhancements to its process and related internal controls) and whether the credit loss estimate as of the reporting date should be updated.

## 7. Fair value option

### 7.1 Overview

ASC 815-15 allows entities to elect to account for certain hybrid financial instruments at fair value in their entirety, rather than bifurcate an embedded derivative and account for it separately at fair value. Additionally, ASC 825-10 provides entities with the option to elect to account for certain assets and liabilities at fair value. With the exception of financial liabilities (for which the change in fair value that results from a change in instrument-specific credit risk is recognized in OCI), changes in fair value are recognized in net income.

### 7.2 Applicability and timing of election

#### 7.2.1 Fair value option under ASC 815-15

ASC 815-15-25-4 provides for a fair value option that can be elected on an instrument-by-instrument basis for hybrid financial instruments that contain an embedded derivative that absent the fair value election would require separation under ASC 815-15-25-1. However, under this guidance a determination needs to be made that an embedded derivative within a hybrid financial instrument needs to be bifurcated for the hybrid instrument to be eligible for this fair value option.



#### RSM COMMENTARY: RSM Observation

An entity can elect the fair value option under ASC 825-10, which is more expansive than the option in ASC 815-15 as it permits the fair value option to be applied to nearly all financial instruments, including those that do not have an embedded derivative that requires bifurcation. As a result, the election available under ASC 825-10 renders the fair value option limitation under ASC 815-15-25-4 effectively moot. See Section 7.2.2 for further discussion of the fair value option under ASC 825-10.

As noted in ASC 815-15-25-6, the hybrid instruments described in ASC 825-10-50-8 are not eligible for the fair value election under ASC 815-15.

The election to account for a hybrid financial instrument at fair value should be supported by concurrent documentation or a preexisting documented policy for automatic election and can be made at initial recognition or upon a remeasurement event.



#### RSM COMMENTARY: What constitutes a remeasurement event?

A remeasurement event (also referred to as a *new basis event*) is an event that requires a financial instrument to be measured at its fair value at the time of the event, but does not require fair value measurement on a continuous basis, with the change in fair value recognized in earnings. Business combinations and debt extinguishments are examples of remeasurement events. ASC 815-15-25-5 specifically indicates that the recognition of a credit loss on a financial asset or impairment loss on an equity security does not constitute a remeasurement event.

#### 7.2.2 Fair value option under ASC 825-10

As outlined in ASC 825-10-15-4, this fair value option can be elected for any of the following items:

- Recognized financial assets and financial liabilities that are not specifically excluded (see the next paragraph)

- Firm commitments that involve only financial instruments and would otherwise not be recognized at inception (e.g., forward purchase contracts for loans that are not readily convertible to cash, and as such, are not derivatives)
- Written loan commitments
- Rights and obligations under certain insurance contracts and warranties
- Host financial instruments that result from the separation of an embedded nonfinancial derivative from a nonfinancial hybrid instrument under ASC 815-15-25-1 (subject to the scope exceptions that follow)

ASC 825-10-15-5 provides the following list of items for which the fair value option *cannot* be elected:

- An investment in a subsidiary or interest in a variable interest entity that the entity is required to consolidate
- Certain employers' and plans' obligations or assets representing net overfunded positions for pension and other benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements
- Financial assets and financial liabilities recognized under leases as defined in ASC 840-10, or ASC 842 subsequent to its adoption. (This exception does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease.)
- Demand deposit liabilities of depository institutions such as banks
- Convertible instruments within the scope of ASC 470-20 that are, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity)

ASC 825-10-25-4 outlines the dates at which an election can be made to measure eligible items at fair value. Once elected for a particular instrument, the election is irrevocable unless a new election date occurs for that instrument (see discussion that follows). The election should be concurrently documented on an instrument-by-instrument basis or could be documented through a preexisting policy that indicates the specific types of eligible items that will be accounted for at fair value. If the fair value option is elected for an asset or liability, it needs to be applied to the entire instrument rather than just specified risks, specific cash flows or portions of the instrument.

The fair value option can be elected for an eligible item only on the date that one of the following occurs:

- The entity first recognizes the eligible item.
- The entity enters into an eligible firm commitment.
- Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting (e.g., an asset is transferred from a subsidiary subject to ASC 946-10 to another entity within the consolidated reporting entity that is not subject to ASC 946-10).
- The accounting treatment for an investment in another entity changes because the investment becomes subject to the equity method of accounting.
- An event that requires an eligible item to be measured at fair value at the time of the event, but does not require fair value measurement at each reporting date after that (excluding the recognition of impairment under lower-of-cost-or-market accounting or accounting for securities in accordance with either ASC 321 on equity securities or ASC 326 on measurement of credit losses).

Additionally, in conjunction with the adoption of ASU 2016-13, ASU 2019-05 permits a fair value election for financial assets (other than HTM debt securities) that are within the scope of ASC 326-20 and meet the eligibility requirements discussed at the beginning of this section.

ASC 825-10-25-5 lists the following as events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, thereby creating an election date for the fair value option:

- Business combinations
- Consolidation or deconsolidation of a subsidiary or VIE
- Significant modifications of debt, as defined in ASC 470-50 (i.e., those modifications accounted for using the extinguishment accounting model)

As noted in ASC 825-10-25-6, a decision made by an acquirer, parent or primary beneficiary about whether to apply the fair value option to eligible items of an acquiree, subsidiary or consolidated VIE applies only in the consolidated financial statements. Fair value option choices made by an acquired entity, subsidiary or VIE continue to apply in any separate financial statements of those entities.

As discussed previously, a fair value election is generally made on an instrument-by-instrument basis and can be made for a single eligible item without electing it for other identical items with the following four exceptions outlined in ASC 825-10-25-7:

- If multiple advances are made to one borrower pursuant to a single contract, such as a line of credit or construction loan, and the individual advances lose their identity and become part of a larger loan balance, the fair value option should be applied to the larger balance and not to each advance individually.
- If the fair value option is applied to an investment that would otherwise be accounted for under the equity method of accounting, it should be applied to all of the investor's financial interests in the same entity that are eligible items, including equity, debt and guarantees.
- If the fair value option is applied to an eligible insurance or reinsurance contract, it should be applied to all claims and obligations under the contract.
- If the fair value option is elected for an insurance contract (base contract) for which integrated or nonintegrated contract features or coverages (some of which are called riders) are issued either concurrently or subsequently, the fair value option must also be applied to those features or coverages. In other words, the fair value option cannot be elected for only the nonintegrated contract features or coverages, even though those features or coverages are accounted for separately under ASC 944-30.

ASC 825-10-25-10 to 25-13 provide additional guidance in determining the proper unit of account for electing and applying the fair value option, including guidance relevant to: (a) instruments issued or acquired in a single transaction, (b) loan syndication arrangements, (c) equity securities and (d) credit enhancements.

### 7.3 Initial and subsequent measurement

The initial and subsequent measurement for instruments for which the fair value option is elected is fair value, determined in accordance with ASC 820. ASC 815-15-45 and ASC 825-10-45 address presentation. With the exception of financial liabilities (discussed at Section 7.3.1), unrealized gains and losses are reported in earnings. As indicated in ASC 825-10-25-3, upfront costs and fees related to items for which the fair value option is elected are recognized in earnings as incurred and not deferred.

Neither ASC 815 nor ASC 825 address the recognition, measurement or presentation of dividends or interest. Although ASC 321-10-35-6 requires dividend income from investments in equity securities to be included in earnings, it does not prescribe whether that income should be presented separately from other changes in fair value within the statement of earnings. As noted in ASC 325-40-15-7, certain industries such as banks and investment companies report interest income or expense separately from other changes in fair value. Accordingly, consideration should be given to regulatory guidance and

industry practice when establishing relevant accounting policies for presenting dividends and interests from instruments that are reported at fair value with changes in fair value reported through earnings.

### 7.3.1 Application to financial liabilities

The portion of the change in the fair value of a financial liability accounted for under a fair value election that results from a change in the instrument-specific credit risk is presented separately in OCI rather than reflected in the income statement.



#### **RSM COMMENTARY: Counterintuitive effects of accounting for liabilities at fair value**

All other things being equal, the fair value of a financial liability decreases as credit risk increases, thereby resulting in gain recognition if the liability is written down to fair value. The requirement to recognize the portion of the change in fair value attributable to instrument-specific credit risk in OCI rather than through the income statement was brought about by the belief that recognizing a gain due to a deterioration in the entity's own creditworthiness was misleading to the financial statements in that typically these gains are not realized. Additionally, it is somewhat counterintuitive for an entity to recognize a loss when its creditworthiness improves and a gain when its credit worthiness deteriorates.

This guidance does not apply to financial liabilities of a consolidated collateralized financing entity measured using the measurement alternative in ASC 810-10-30-10 to 30-15 and ASC 810-10-35-6 to 35-8.

In quantifying the change in fair value attributable to instrument-specific credit risk, ASC 825-10-45-5 permits using the total change in fair value exclusive of the amount resulting from a change in a base market rate, such as a risk-free or benchmark interest rate. Entities can use other methods that faithfully capture the portion of the total change in fair value resulting from a change in instrument-specific credit risk; however, the method selected should be applied consistently to each financial liability from one period to the next.



#### **RSM COMMENTARY: Benchmark interest rate**

Benchmark interest rate is defined in the ASC Master Glossary as:

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

ASC 815-20-25-6A provides insights on what constitutes benchmark interest rates in the U.S.; namely, interest rates on direct Treasury obligations of the U.S. government, the LIBOR swap rate, the Fed Funds Effective Swap Rate (also referred to as OIS), the Securities Industry and Financial Markets Association Municipal Swap Rate, and the SOFR Overnight Index Swap Rate are considered to be benchmark interest rates. The prime rate and the FNMA (or Fannie Mae) Par Mortgage rate are listed as examples of rates that should not be used as the benchmark interest rate in the U.S.

When a financial liability subject to this guidance is derecognized, the cumulative amount of the gain or loss on the financial liability that resulted from changes in instrument-specific credit risk should be

reported in net income. In other words, amounts recognized in accumulated other comprehensive income would be reclassified to net income at the time the liability is settled.

## 8. Presentation and disclosure considerations

### Summary of key changes

- Upon the adoption of ASU 2016-13:
  - PBEs are required to further disaggregate financing receivables by year of origination in the credit quality disclosure.
  - Disclosures of delinquencies, credit quality indicators and allowance disclosures relevant to loans will also be required for HTM securities.
  - Impaired loan disclosures are no longer relevant or required.
- Refer to Chapter 1 for effective date and transition considerations.

### 8.1 Scope

Unless otherwise noted, the content of this chapter constitutes a summary of the general presentation and disclosure requirements in the ASC for the topics outlined in the scope considerations section of Chapter 1. Consideration should also be given to relevant industry and SEC guidance.

### 8.2 Balance sheet and income statement presentation

The content on presentation that follows is organized by form of financial asset. In addition to the asset-specific requirements that follow, ASC 825-10-45-1A requires separate presentation of financial assets by measurement category (e.g., fair value, amortized cost) and form (e.g., securities, loans, receivables), either on the balance sheet or in the notes to the financial statements.

Reporting entities that present classified balance sheets should keep in mind the requirement to classify assets between current and noncurrent as outlined in ASC 210-10. For example, an entity that presents a classified balance sheet should report individual HTM securities, individual AFS securities, and individual trading securities as either current or noncurrent, as appropriate, in accordance with the guidance in ASC 210-10-45. [ASC 320-10-45-2]

#### 8.2.1 Loans and other receivables

ASC 310-10-45 requires separate balance-sheet presentation for:

- Loans and receivables that are held for sale
- Notes or accounts receivable due from officers, employees or affiliated companies

Additionally, the following are required to be presented separately on the balance sheet or disclosed in the notes:

- Major categories of loans or trade receivables
- Foreclosed or repossessed assets (unless they will be subsequently utilized by the entity in its operations).



#### ASC 310-10-45-2

Nonmortgage loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables held for sale shall be a separate balance sheet category. Major categories of nonmortgage loans or trade receivables shall be presented separately either in the balance sheet or in the notes to financial statements. An entity shall

present the amounts reversed or established for the valuation allowance and the allowance for credit losses, as applicable, related to the transfer of nonmortgage loans (see paragraphs 310-10-35-48A through 35-48B) on a gross basis in the income statement. An entity may present those amounts on the income statement or in the notes to financial statements.

ASC 505-10-45-2 indicates that notes or other receivables related to equity contributions or sales should be deducted from equity unless there is substantial evidence of the intent and ability to pay within a short period of time or the asset is collected in cash before the financial statements are issued or available to be issued. Similar SEC staff views are expressed in ASC 310-10-S99-2 and in ASC 310-10-S99-3, whereby certain notes or other receivables from a parent or another affiliate are in substance deemed to be equivalent to unpaid subscriptions receivable for capital shares and should be deducted from stockholders' equity.

ASC 310-20-45 addresses the presentation of loan fees and costs. Specifically, unamortized loan fees and costs and purchase premiums and discounts that are recognized in interest income as an adjustment to the yield of the loan in accordance with ASC 310-20 should be presented on the balance sheet as part of the loan balance to which they relate. Commitment fees that meet the criteria of ASC 310-20-35-3 should be reported as service fee income, with the unearned portion classified as deferred income on the balance sheet.

An accounting policy election can be made at the class of financing receivable level to present accrued interest (net of any allowance for credit losses) separately on the balance sheet or within another line item on the balance sheet (e.g., other assets) rather than with the financial assets to which it relates. An allowance for credit losses on loans and receivables that are measured at amortized cost should be deducted from the asset's amortized cost basis and presented separately on the balance sheet. Recognized expected credit losses on off-balance-sheet credit exposures, such as commitments to lend, should be recognized as a liability. ASC 326-20-30-1 and ASC 326-20-45 indicate that changes in the allowance should be recognized through credit loss expense. Entities that use a DCF approach when estimating expected credit losses are permitted by ASC 326-20-45-3 to report the entire change in present value as an increase or decrease to credit loss expense or report the change in present value attributable to the passage of time as interest income with appropriate disclosure.

ADC arrangements that are accounted for as investments in real estate or joint ventures should not be combined with ADC arrangements that are accounted for as loans.

### 8.2.1.1 Unearned discounts



#### ASC 310-10-45-8

Unearned discounts (other than cash or quantity discounts and similar items), finance charges, and interest included in the face amount of receivables shall be shown as a deduction from the related receivables.

Pursuant to ASC 310-10-45-8, unearned discounts, finance charges and interest included in the face amount of receivables should be presented as a deduction from the related receivables on the balance sheet. For example, assume a distributor agrees to a 270-day non-interest bearing note receivable from a customer in exchange for the sale of goods. The distributor follows the guidance in ASC 310-10-30-3 to 30-6 to determine the present value of the note. The difference between the present value of the note and its face amount represents the unearned discount, which will be recognized over time as income using the effective interest method under ASC 835. If material, the distributor should present the unearned interest on its balance sheet as a deduction of the notes receivable.



## 8.2.2 Debt securities

ASC 320-10-45-1 addresses presentation for debt securities and indicates that AFS and trading securities, which are measured at fair value, should be reported separately on the balance sheet from HTM and other investments that are not subsequently measured at fair value. This can be accomplished either by reporting investments measured at fair value on a separate line item from investments that are not measured at fair value or aggregating them on the same line item and parenthetically disclosing the amount of investments measured at fair value that is included in the aggregate amount. ASC 320-10-45-13 clarifies that ASC 320-10 does not require the presentation of individual amounts for the three categories of investments on the face of the balance sheet, provided the information is disclosed in the notes. For example, entities that report certain investments in debt securities as cash and cash equivalents in accordance with ASC 230 can continue that practice as long as entities reconcile the reporting classifications used in the balance sheet to the disclosures in the notes to the financial statements.

An allowance for credit losses on HTM debt securities should be deducted from the securities' amortized cost basis and presented separately on the balance sheet. An accounting policy election can be made at the major security-type level to present accrued interest (net of any allowance for credit losses) separately on the balance sheet or within another line item (e.g., other assets), rather than with the security to which it relates. ASC 326-20-30-1 indicates that changes in the allowance should be recognized through credit loss expense. Entities that use a DCF approach when estimating expected credit losses are permitted by ASC 326-20-45-3 to report the entire change in present value as an increase or decrease to credit loss expense or report the change in present value attributable to the passage of time as interest income with appropriate disclosure.

As discussed in Section 3.4.2, ASC 320-10-45-8B requires any allowance for credit losses amounts reversed or established upon the transfer of debt securities between classification categories to be presented gross in the income statement or in the notes to the financial statements.

AFS debt securities should be reported on the balance sheet at fair value, with parenthetical presentation of amortized cost and the allowance for credit losses. If accrued interest is excluded from both the fair value and the amortized cost basis of the AFS security for the purposes of identifying and measuring an impairment, it can be presented separately on the balance sheet or within another line item, net of any allowance for credit losses. ASC 326-30-45-2 requires separate presentation of amounts reported in accumulated other comprehensive income for AFS securities for which an allowance for credit losses has been recorded. If the AFS security is designated as a hedged item in a fair value hedge, the change in fair value of the security that is attributable to the hedged risk is required to be recognized in earnings during the period of the hedge as an offset to the gain or loss on the hedging instrument, in accordance with ASC 815-25-35-6. The difference between the total change in the fair value of the AFS security and the change in fair value of the security that is attributable to the hedged risk is reported in OCI.

Increases or decreases in the fair value of AFS securities that do not result in recognition or reversal of an allowance for credit losses or write-down of the asset should be included in OCI. Changes in the allowance are recognized through credit loss expense. Similar to what is noted earlier for HTM securities, entities that use a DCF approach when estimating expected credit losses on AFS securities are permitted by ASC 326-30-45-3 to report the entire change in present value as an increase or decrease to credit loss expense or report the change in present value attributable to the passage of time as interest income, with appropriate disclosure.

ASC 740-20-45-11(b) provides guidance on reporting the tax effects of unrealized holding gains and losses reported in OCI.

### 8.2.3 Equity securities

Equity securities that are accounted for at fair value should be presented separately from equity securities accounted for under the measurement alternative provided by ASC 321-10-35-2.

### 8.2.4 Financial instruments accounted for under the fair value option

ASC 825-10-45 requires that the fair value of assets that are measured at fair value under a fair value option be reported separately on the balance sheet from the carrying amounts of similar assets that are not measured at fair value. This can be accomplished either by separate line-item presentation or by presenting the aggregate of fair value and non-fair-value amounts in the same line item on the balance sheet and parenthetically disclosing the amount measured at fair value that is included in the aggregate amount.

### 8.2.5 Receivables for issuance of equity

An entity may receive a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital. Reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of the investor's ability and intent to pay within a reasonably short period of time. As discussed in ASC 210-10-S99-1 (paragraphs 27 through 29), public entities are required to report the receivable as a deduction from equity. While this guidance applies to SEC registrants, we believe it is preferable for private companies to also follow this guidance. However, such notes may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued (see ASC 855-10-25).

## 8.3 Statement of cash flows presentation

The general requirements pertinent to the statement of cash flows are contained within ASC 230. Gross presentation of cash receipts and cash payments are generally required; however, an exception is made in ASC 230-10-45-9 for certain items, including investments and loans receivable that are due on demand or have an original maturity of three months or less, as well as certain credit card receivables. Additionally, ASC 942-230-45 permits net reporting by banks, savings institutions and credit unions of cash flows associated with deposits in other financial institutions, time deposit liabilities and customer loans. Any net amounts reported should not be combined with gross amounts that may be presented in consolidated statements (because, for example, the consolidated statements include an entity that is not permitted to report net cash flows for these items).

### 8.3.1 Loans and other receivables

Cash flows from loans or trade receivables that result from the sale of goods or services to customers are classified as operating cash flows (regardless of intent to hold for collection or sale) [ASC 230-10-45-16].

The cash flow classification for loans and other receivables that do not result from the sale of goods or services to customers is dependent upon whether the receivables were originated or purchased with the intent to be held for investment or sale. Cash flows associated with a loan or other receivable that is held for sale and carried at fair value, or the lower of cost or fair value, are classified in operating cash flows as required by ASC 230-10-45-21. Cash flows associated with a loan or receivable held for investment are classified as investing cash flows. As noted in ASC 230-10-45-12, this is the case even if the intent or purpose for holding the loans subsequently changes. Cash flows for interest on loans or other receivables are reported as operating cash flows.

### 8.3.2 Investment securities

ASC 320-10-45 addresses cash flow presentation for debt securities and indicates that cash flows from purchases, sales and maturities of AFS and HTM securities should be classified as cash flows from

investing activities and reported gross for each classification. (In other words, cash flows from AFS securities should not be combined with cash flows from HTM securities.)

Cash flows from equity securities within the scope of ASC 321 and trading debt securities should be classified based on the nature and purpose for which the securities were acquired (i.e., classified as operating cash flows if acquired for resale and as investing cash flows if acquired for investment). Unrealized gains and losses are reflected as an adjustment to net income under the indirect method of reporting cash flows.

Cash flows from interest and dividends are classified as operating cash flows. Transfers of debt securities from one classification to another are generally disclosed as noncash activity.

ASC 230-10-45-8 permits reporting activity in cash equivalents as a net change in the statement of cash flows. However, debt securities treated as cash equivalents are still subject to the accounting and disclosure requirements of ASC 320-10, such as disclosure of amortized cost and fair value by major security types. [ASC 320-10-45-12]

## 8.4 Disclosure requirements

### 8.4.1 Overview

In addition to the subtopics listed in the scope section of Chapter 1 that are the focus of this guide, there are disclosure requirements that are relevant to financial assets contained within various other ASC topics and subtopics including:

- ASC 275, which requires disclosures about estimates
- ASC 305, which requires disclosures about cash and cash equivalents
- ASC 820, which requires various disclosures for instruments that are measured at fair value on a recurring or nonrecurring basis, including equity securities that are adjusted to fair value under the measurement alternative in ASC 321-10-35-2
- ASC 825, which requires disclosures about concentrations of credit risk, instruments accounted for under the fair value option, and for PBEs, disclosures of the fair value of most financial instruments (whether recognized or not) and the level of the fair value hierarchy within which the fair value measurements are categorized
- ASC 835-30, which requires disclosure of the face amount and effective interest rate on notes
- ASC 860, which requires disclosures related to transfers of financial assets and collateral in secured lending arrangements

The content that follows highlights and illustrates the disclosure requirements pertinent to investment securities, loans and other receivables and provides a comprehensive list of the disclosure requirements in ASC 326 related to credit losses. Consideration should be given to relevant disclosure checklists or the official requirements for a comprehensive list or understanding of disclosure requirements, including ASC 250 and disclosures relevant to the adoption of a new accounting principle.

### 8.4.2 Loans and other receivables

Among other items, ASC 310-10-50 and ASC 310-20-50 require disclosures of:

- Significant accounting policies, including the following:
  - The basis for accounting of loans and trade receivables

- If major categories of loans or trade receivables are not presented separately in the balance sheet, they should be disclosed in the notes to the financial statements. [ASC 310-10-50-3]
- The method used in determining the lower of amortized cost basis or fair value of nonmortgage loans held for sale (i.e., aggregate or individual assets basis)
- The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment
- The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs
  - With respect to credit card fees and costs for both purchased and originated credit cards that are not private label credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s). [ASC 310-20-50-4]
- The amount of the allowance for credit losses and, as applicable, any unearned income, any unamortized premiums and discounts and any net unamortized deferred fees and costs
  - The unamortized net fees and costs should be reported as a part of each loan category. [ASC 310-20-50-3]
- Significant assumptions underlying the prepayment estimates of entities that anticipate prepayments in applying the interest method

Reference should be made to Section 8.4.5 for disclosure requirements associated with the allowance for credit losses.

#### **8.4.2.1 Loan modifications to debtors experiencing financial difficulty**

According to ASC 310-10-50-38, the objective of the disclosures required by ASC 310-10-50-42 through 50-44 is to provide financial statement users with information about (a) the type and magnitude of certain modifications of receivables made to debtors experiencing financial difficulty, (b) the financial effect of those modifications and (c) the degree of success of the modifications in mitigating potential credit losses. An entity must also consider whether additional disclosures are necessary to help financial statement users understand significant changes in the type or magnitude of modifications. The disclosure requirements of this section apply to modifications of receivables to borrowers experiencing financial difficulty in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension. For purposes of those disclosures, covenant waivers and modifications of contingent acceleration clauses would not be considered term extensions. [ASC 310-10-50-39]

According to ASC 310-10-50-40, the guidance in ASC 310-10-50-42 through 50-44 does not apply to the following financing receivables:

- a. Receivables measured at fair value with changes in fair value reported in earnings
- b. Receivables measured at lower of amortized cost basis or fair value
- c. Except for credit card receivables, trade accounts receivable that have both of the following characteristics:
  - i. They have a contractual maturity of one year or less
  - ii. They arose from the sale of goods or services.
- d. Participant loans in defined contribution pension plans.

The disclosures required in ASC 310-10-50-42 through 50-44 are applicable regardless of whether a modification of a receivable to a debtor experiencing financial difficulty results in recognition of a new loan in accordance with ASC 310-20-35-9 through 35-11 (see Section 5.5.2). An entity that has adopted the practical expedient in ASC 326-20, which allows an entity to exclude from the disclosures the accrued interest receivable balance that is included in the amortized cost basis of financing receivables, can do the same for the disclosures in ASC 310-10-50-42 through 50-44, but must disclose the total amount of accrued interest excluded from the disclosed amortized cost basis. See ASC 310-10-50-41.

For each period for which a statement of income is presented, an entity is required to disclose the following information related to modifications of receivables that are in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or a combination thereof) made to debtors experiencing financial difficulty during the reporting period: [ASC 310-10-50-42]

- a. By class of financing receivable, qualitative and quantitative information about:
  1. The types of modifications utilized by an entity, including the total period-end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to debtors experiencing financial difficulty relative to the total period-end amortized cost basis of receivables in the class of financing receivable.
  2. The financial effect of the modification by type of modification, which shall provide information about the changes to the contractual terms as a result of the modification and shall include the incremental effect of principal forgiveness on the amortized cost basis of the modified receivables, as applicable, or the reduction in weighted-average interest rates (versus a range) for interest rate reductions.
  3. Receivable performance in the 12 months after a modification of a receivable made to a debtor experiencing financial difficulty.
- b. By portfolio segment, qualitative information about how those modifications and the debtors' subsequent performance are factored into determining the allowance for credit losses.



### Receivables modified in more than one manner

#### ASC 310-10-50-43

Receivables may be modified in more than one manner. An entity that modifies the same receivable in more than one manner shall provide disclosures sufficient for users to understand the different types of combinations of modifications provided to borrowers. For example, a receivable may be modified to provide both principal forgiveness and an interest rate reduction. In that case, an entity shall disclose the period-end amortized cost basis of that receivable in a separate category that reflects that a combination of modification types has been granted. If another receivable was modified to provide both an interest rate reduction and a term extension, the period-end amortized cost basis of that receivable shall be presented in a different category. Multiple separate combination categories may be necessary if significant. The same receivable's period-end amortized cost basis shall not be presented in multiple categories.

For each period for which a statement of income is presented, an entity is required to disclose the following information about financing receivables that had a payment default during the period and had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or a combination thereof) within the previous 12 months preceding the payment default when the debtor was experiencing financial difficulty at the time of the modification: [ASC 310-10-50-44]

- a. By class of financing receivable, qualitative and quantitative information about the defaulted financing receivables, including the following:

1. The type of contractual change that the modification provided
  2. The amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted
- b. By portfolio segment, qualitative information about how those defaults are factored into determining the allowance for credit losses

In addition to the disclosure requirements described above, ASC 310-10-50-36 also requires that a creditor disclose either in the body of the financial statements or the accompanying notes, the amount of commitments, if any, to lend additional funds to debtors experiencing financial difficulty for which the creditor has modified the terms of the receivables in the current reporting period. For purposes of this disclosure, covenant waivers and modifications of contingent acceleration clauses are not considered term extensions.

The following example from ASC 310-10-55-12A illustrates some of the disclosure requirements of ASC 310-10-50-42 through 50-44.



**Example 8-1: Disclosures for debtors experiencing financial difficulty (from Example 3 in ASC 310-10-55-12A)**

The following example illustrates certain of the disclosures in paragraph 310-10-50-42 through 50-44.

The allowance for credit losses incorporates an estimate of lifetime expected credit losses and is recorded on each asset upon asset origination or acquisition. The starting point for the estimate of the allowance for credit losses is historical loss information, which includes losses from modifications of receivables to borrowers experiencing financial difficulty. Entity B uses a probability of default/loss given default model to determine the allowance for credit losses. An assessment of whether a borrower is experiencing financial difficulty is made on the date of a modification.

Because the effect of most modifications made to borrowers experiencing financial difficulty is already included in the allowance for credit losses because of the measurement methodologies used to estimate the allowance, a change to the allowance for credit losses is generally not recorded upon modification. Occasionally, Entity B modifies loans by providing principal forgiveness on certain of its real estate loans. When principal forgiveness is provided, the amortized cost basis of the asset is written off against the allowance for credit losses. The amount of the principal forgiveness is deemed to be uncollectible; therefore, that portion of the loan is written off, resulting in a reduction of the amortized cost basis and a corresponding adjustment to the allowance for credit losses.

In some cases, Entity B will modify a certain loan by providing multiple types of concessions. Typically, one type of concession, such as a term extension, is granted initially. If the borrower continues to experience financial difficulty, another concession, such as principal forgiveness, may be granted. For the real estate loans included in the "combination" columns below, multiple types of modifications have been made on the same loan within the current reporting period. The combination is at least two of the following: a term extension, principal forgiveness, and interest rate reduction.

The following table shows the amortized cost basis at the end of the reporting period of the loans modified to borrowers experiencing financial difficulty, disaggregated by class of financing receivable and type of concession granted (numbers in thousands):

Loan Modifications Made to Borrowers Experiencing Financial Difficulty		
Interest Rate Reduction		
Loan Type	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Real Estate–Commercial	\$ 40,000	2.0 %
Real Estate–Residential	-	0.0 %
Consumer	10,000	0.2 %
<b>Total</b>	<b>\$ 50,000</b>	
Term Extension		
Loan Type	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Real Estate–Commercial	\$ 0	0.0 %
Real Estate–Residential	-	0.0 %
Consumer	22,000	0.4 %
<b>Total</b>	<b>\$ 22,000</b>	
Principal Forgiveness		
Loan Type	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Real Estate–Commercial	\$ 20,000	1.0 %
Real Estate–Residential	-	0.0 %
Consumer	-	0.0 %
<b>Total</b>	<b>\$ 20,000</b>	

Combination–Term Extension and Principal Forgiveness		
Loan Type	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Real Estate–Commercial	\$ 0	0.0 %
Real Estate–Residential	5,000	0.8 %
Consumer	-	0.0 %
<b>Total</b>	<b>\$ 5,000</b>	

Combination-Term Extension and Interest Rate Reduction		
Loan Type	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Real Estate–Commercial	\$ 0	0.0 %
Real Estate–Residential	5,000	0.8 %
Consumer	-	0.0 %
<b>Total</b>	<b>\$ 5,000</b>	

The following table describes the financial effect of the modifications made to borrowers experiencing financial difficulty:

Interest Rate Reduction	
Loan Type	Financial Effect
Real Estate–Commercial	Reduced weighted-average contractual interest rate from 6% to 3%.
Real Estate–Residential	Reduced weighted-average contractual interest rate from 8% to 5%.
Consumer	Reduced weighted-average contractual interest rate from 4% to 1.5%.

Term Extension	
Loan Type	Loan Type
Real Estate–Residential	Added a weighted-average 2.4 years to the life of loans, which reduced monthly payment amounts for the borrowers.
Consumer	Provided six-month payment deferrals to borrowers through our standard deferral program. The six monthly payments were added to the end of the original loan terms of these borrowers.

Principal Forgiveness	
Loan Type	Financial Effect
Real Estate–Commercial	Reduced the amortized cost basis of the loans by \$20 million.
Real Estate–Residential	Reduced the amortized cost basis of the loans by \$5 million.

Upon Entity B's determination that a modified loan (or portion of a loan) has subsequently been deemed uncollectible, the loan (or a portion of the loan) is written off. Therefore, the amortized cost basis of the loan is reduced by the uncollectible amount and the allowance for credit losses is adjusted by the same amount.



The following table provides the amortized cost basis of financing receivables that had a payment default during the period and were modified in the 12 months before default to borrowers experiencing financial difficulty (numbers in thousands):

Amortized Cost Basis of Modified Financing Receivables That Subsequently Defaulted					
	Interest Rate Reduction	Term Extension	Principal Forgiveness	Combination-Term Extension and Principal Forgiveness	Combination-Term Extension and Interest Rate Reduction
<b>Loan Type</b>					
Real Estate—Commercial	\$ 1,500	\$ 0	\$ 0	\$ 0	\$ 0
Real Estate—Residential	-	-	-	-	-
Consumer	500	1,000	-	-	-
<b>Total</b>	<b>\$ 2,000</b>	<b>\$ 1,000</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>

Entity B closely monitors the performance of the loans that are modified to borrowers experiencing financial difficulty to understand the effectiveness of its modification efforts. The following table depicts the performance of loans that have been modified in the last 12 months (numbers in thousands):

Payment Status (Amortized Cost Basis)			
	Current	30-89 Days Past Due	90+ Days Past Due
<b>Loan Type</b>			
Real Estate—Commercial	\$ 55,000	\$ 3,500	\$ 1,500
Real Estate—Residential	6,000	4,000	-
Consumer	29,000	1,500	1,500
<b>Total</b>	<b>\$ 90,000</b>	<b>\$ 9,000</b>	<b>\$ 3,000</b>

#### 8.4.2.1.1 Loans restructured into two (or more) loan agreements

According to ASC 310-10-50-37, when a loan is restructured into two (or more) legally distinct loan agreements, the restructured loans are required to be considered separately in years after the restructuring when assessing the disclosure requirements of ASC 326-20-50 (see Section 8.4.5).

#### 8.4.2.1.2 Foreclosed and repossessed assets

ASC 310-10-50-11 requires an entity to disclose the carrying amount of foreclosed residential real estate properties held at the reporting date as a result of obtaining physical possession. Foreclosed and repossessed assets that are classified as other assets on the statement of financial position should be separately disclosed in the notes to the financial statements.

#### 8.4.2.1.3 Loans in process of foreclosure

If an entity is in process of completing formal foreclosure proceedings of consumer mortgage loans secured by residential real estate properties, the entity's recorded investment should be disclosed. [ASC 310-10-50-35].

### 8.4.3 Debt securities

ASC 320-10-50 contains the disclosure requirements for debt securities.<sup>25</sup> Pursuant to ASC 320-10-50-2 and ASC 320-10-50-5 to 50-5A, certain disclosures are required to be made by major security type and classification for AFS and HTM securities, respectively, as of the balance sheet date presented, including information about the following:

AFS securities	HTM securities
<ul style="list-style-type: none"> <li>• Amortized cost basis</li> <li>• Aggregate fair value</li> <li>• Total allowance for credit losses</li> <li>• Total unrealized gains for securities with net gains in accumulated other comprehensive income</li> <li>• Total unrealized losses for securities with net losses in accumulated other comprehensive income</li> <li>• Information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented</li> </ul>	<ul style="list-style-type: none"> <li>• Amortized cost basis</li> <li>• Total allowance for credit losses</li> <li>• Net carrying amount</li> <li>• Gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the HTM securities</li> <li>• Information about the contractual maturities of those securities as of the date of the most recent statement of financial position presented.</li> </ul> <p>Public business entities are also required to disclose the following:</p> <ul style="list-style-type: none"> <li>• Aggregate fair value</li> <li>• Gross unrecognized holding gains</li> <li>• Gross unrecognized holding losses</li> </ul>

If accrued interest is excluded from the amortized cost basis of debt securities for the purposes of identifying and measuring impairment, as a practical expedient, it can be excluded from the applicable amortized cost basis disclosures. If this practical expedient is elected, the total amount of accrued interest, net of any allowance for credit losses, excluded from the amortized cost basis should be disclosed. [ASC 320-10-50-2A and 50-5C]

As it relates to the determination of major security type, ASC 320-10-50-1B provides the following guidance:

Major security types shall be based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity shall consider all of the following:

- a. (Shared) activity or business sector
- b. Vintage
- c. Geographic concentration
- d. Credit quality
- e. Economic characteristic.

<sup>25</sup> The disclosures in ASC 320-10-50 are required for all interim and annual periods when a complete set of financial statements are provided. If an entity provides summarized interim financial information, these disclosures are not required. The minimum disclosure requirements for summarized interim financial information issued by PBEs are established in ASC 270-10-50-1. [ASC 320-10-50-1A]

ASC 942-320-50-2 outlines the following major security types that should be disclosed by financial institutions, while acknowledging that additional types may also be necessary.

- a. Equity securities, segregated by any one of the following:
  1. Industry type
  2. Entity size
  3. Investment objective.
- b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- c. Debt securities issued by states of the United States and political subdivisions of the states
- d. Debt securities issued by foreign governments
- e. Corporate debt securities
- f. Residential mortgage-backed securities
- ff. Commercial mortgage-backed securities
- fff. Collateralized debt obligations
- g. Other debt obligations.

ASC 942-320-50-3 requires financial institutions to disclose the fair value and net carrying amount of debt securities (if different) based on the following maturity groupings, at a minimum. (Financial institutions that are not PBEs are not required to disclose the fair value of HTM debt securities.)

- a. Within 1 year
- b. After 1 year through 5 years
- c. After 5 years through 10 years
- d. After 10 years

For the purpose of this disclosure, securities such as mortgage-backed securities that do not have a single maturity date can be disclosed in the aggregate on one line item rather than allocating them over several maturity groupings. If allocated, the basis used for the allocation should be disclosed.

Refer to Section 8.4.5 for disclosure requirements associated with the allowance for credit losses.

#### **8.4.3.1 Sales and transfers of debt securities**

For each period for which an income statement is presented, an entity should disclose all of the following: [ASC 320-10-50-9]

- a. The proceeds from sales of AFS securities and the gross realized gains and gross realized losses that have been included in earnings as a result of those sales
- b. The basis on which the cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (i.e., specific identification, average cost, or other method used)
- c. The gross gains and gross losses included in earnings from transfers of securities from the AFS category into the trading category
- d. The amount of the net unrealized holding gain or loss on AFS securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period

- e. The portion of trading gains and losses for the period that relates to trading securities still held at the reporting date. Example 8-2 below illustrates how the portion of trading gains and losses for the period related to trading securities still held at the reporting date is calculated.



**Example 8-2: Calculating the portion of unrealized gains and losses that relate to trading securities that continue to be held at the reporting date**

The following example from ASC 320-10-50-14 illustrates how to calculate the portion of trading gains and losses for the period related to trading securities still held at the reporting date.

Net gains and losses recognized during the period on trading securities	\$105
Less: Net gains and losses recognized during the period on trading securities sold during the period	(80)
Unrealized gains and losses recognized during the reporting period on trading securities still held at the reporting date	<u>\$25</u>

For any sales or transfers of securities classified as HTM, an entity is required to disclose all of the following in the notes accompanying the financial statements for each period that an income statement is presented: [ASC 320-10-50-10]

- The net carrying amount of the sold or transferred security
- The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the HTM security
- The related realized or unrealized gain or loss
- The circumstances leading to the decision to sell or transfer the security.

These disclosures are required regardless of the treatment of the remaining HTM securities. Section 3.3.3.3 addresses the circumstances involving sales or transfers of HTM securities that do not call into question an entity's intent to hold other securities to maturity, including the conditions under which sales of debt securities may be considered maturities for purposes of the disclosure requirements described above.

#### 8.4.4 Equity securities

ASC 321-10-50 outlines disclosure requirements for equity securities, including the portion of unrealized gains and losses that relate to equity securities that continue to be held at the reporting date, which are required for each interim and annual period presented. According to ASC 321-10-50-2B, to the extent that the disclosure requirements in ASC 321-10-50 achieve the fair value disclosure requirements described in ASC 820-10-50 on disclosing fair value measurement, an entity need not duplicate the related fair value disclosure.

An entity that applies the guidance in ASC 321-10-35-2 for equity securities without readily determinable fair values is required to disclose all of the following: [ASC 321-10-50-3]

- The carrying amount of investments without readily determinable fair values
- The amount of impairments and downward adjustments, if any, both annual and cumulative
- The amount of upward adjustments, if any, both annual and cumulative
- As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the

information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.

For each period for which the results of operations are presented, an entity is required to disclose the portion of unrealized gains and losses for the period that relates to equity securities still held at the reporting date. ASC 321-10-50-4 illustrates how the portion of unrealized gains and losses for the period related to equity securities still held at the reporting date is calculated.<sup>26</sup>



### Example 8-3: Calculating the portion of unrealized gains and losses that relate to equity securities that continue to be held at the reporting date

The following example from ASC 321-10-50-4 illustrates how to calculate the portion of unrealized gains and losses during the reporting period that relate to equity securities that continue to be held at the reporting date:

Net gains and losses recognized during the period on equity securities	\$105
Less: Net gains and losses recognized during the period on equity securities sold during the period	<u>(80)</u>
Unrealized gains and losses recognized during the reporting period on equity securities still held at the reporting date	<u>\$25</u>

## 8.4.5 Allowance for credit losses

The charts at the end of this section summarize the allowance related disclosure requirements for: (a) financial assets within the scope of ASC 326-20 (primarily financial assets measured at amortized cost) and (b) financial assets within the scope of ASC 326-30 (AFS debt securities).

Certain disclosure information is required to be presented for financing receivables by portfolio segment or class, and for debt securities, by major security type. (Refer to Section 8.4.3 for additional information on determining major security types.) Additionally, the amortized cost of certain assets is required to be aggregated and disclosed by credit quality indicator, and for PBEs, by year of origination. As such, definitions for, and guidance on determining, the class of financing receivable, portfolio segment, credit quality indicator and year of origination follow.

### 8.4.5.1 Portfolio segment

Portfolio segment is defined in the Master Glossary of the ASC as “the level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses.” Examples of segments noted in ASC 326-20-55-10 are type of financing receivable, industry sector of the borrower and risk rating.

### 8.4.5.2 Class of financing receivable

By definition, class of financing receivable should be determined on the basis of both the risk characteristics of the financing receivable and method used by the entity to monitor and assess credit risk. The following implementation guidance is included in ASC 326-20-55-11 to 55-14 to aid in the understanding of how classes of financing receivables should be determined.

This implementation guidance addresses application of the term class of financing receivable. An entity should base its principal determination of class of financing receivable by disaggregating to the level

<sup>26</sup> Pursuant to ASC 321-10-50-2a, the disclosure guidance in ASC 321-10-50-4 is not required for entities within the scope of ASC 958 on not-for-profit entities.

that the entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables. In its assessment, the entity should consider the risk characteristics of the financing receivables.

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. An entity could further disaggregate its financing receivables portfolio by considering numerous factors. Examples of factors that the entity should consider include any of the following:

- a. Categorization of borrowers, such as any of the following:
  1. Commercial loan borrowers
  2. Consumer loan borrowers
  3. Related party borrowers.
- b. Type of financing receivable, such as any of the following:
  1. Mortgage loans
  2. Credit card loans
  3. Interest-only loans
  4. Finance leases.
- c. Industry sector, such as either of the following:
  1. Real estate
  2. Mining.
- d. Type of collateral, such as any of the following:
  1. Residential property
  2. Commercial property
  3. Government-guaranteed collateral
  4. Uncollateralized (unsecured) financing receivables.
- e. Geographic distribution, including both of the following:
  1. Domestic
  2. International.

An entity also may consider factors related to concentrations of credit risk as discussed in Section 825-10-55.

Classes of financing receivables generally are a disaggregation of a portfolio segment. For determining the appropriate classes of financing receivables that are related to a portfolio segment, the portfolio segment is the starting point with further disaggregation in accordance with the guidance in paragraphs 326-20-55-11 through 55-13. The determination of class for financing receivables that are not related to a portfolio segment (because there is no associated allowance) also should be based on the guidance in those paragraphs.

An example disclosure of past-due status by class of financing receivable follows from ASC 326-20-55-80.



**Example 8-4: Disclosing past-due status (from Example 16 in ASC 326-20-55-80)**

The following table illustrates certain of the required disclosures in paragraph 326-20-50-14 for financial assets that are past due by class of financing receivable and major security type.

	Age Analysis of Past-Due Financial Assets As of December 31, 20X5 and 20X4				Current	Total	Amortized Cost > 90 Days and Accruing
	Past Due						
	30–59 Days	60–89 Days	Greater Than 90 Days	Total			
<b>20X5:</b>							
Commercial	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX
Commercial real estate:							
Commercial real estate— construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer— credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer— other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer— auto	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
<b>20X4:</b>							
Commercial	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX	\$XX,XXX
Commercial real estate:							
Commercial real estate— construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer— credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer— other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer— auto	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

### 8.4.5.3 Credit quality indicator

Credit quality indicator is defined in the Master Glossary of the ASC simply as “a statistic about the credit quality of a financial asset.” Judgment should be used in determining the appropriate credit quality indicator for each class of financing receivable and major security type. The credit quality indicator information disclosed should be based on the most current information the entity has obtained as of each balance-sheet date.

The following examples of credit quality indicators are provided in ASC 326-20-55-15:

- a. Consumer credit risk scores
- b. Credit-rating-agency ratings
- c. An entity’s internal credit risk grades
- d. Debt-to-value ratios
- e. Collateral
- f. Collection experience
- g. Other internal metrics.

The objectives of the credit quality information disclosure requirements are to provide information to financial statement users that enables them to (a) understand how management monitors the credit quality of its financial assets and (b) assess the quantitative and qualitative risks arising from the credit quality of its financial assets. To meet those disclosure objectives, ASC 326-20-50-5 requires an entity to provide quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets within the scope of ASC 326 (excluding off-balance-sheet credit exposures and repurchase agreements and securities lending agreements within the scope of ASC 860), including all of the following:

- a. A description of the credit quality indicator(s)
- b. The amortized cost basis, by credit quality indicator
- c. For each credit quality indicator, the date or range of dates in which the information was last updated for the credit quality indicator.

The credit quality information disclosures in ASC 326-20-50-4 and 50-5 are not required for receivables measured at the lower of amortized cost basis or fair value, or trade receivables due in one year or less, except credit card receivables that result from revenue recognition within the scope of ASC 606.

If an entity discloses internal risk ratings, then the entity should provide qualitative information about how those internal risk ratings relate to the likelihood of loss. The following example illustrates the disclosure requirements of ASC 326-20-50-8:



#### **RSM COMMENTARY: Example Basis of Presentation of Financial Statements Note Disclosure for a Manufacturer**

The Company establishes allowances for credit losses on accounts receivable, unbilled receivables and customer financing receivables. The adequacy of these allowances for credit losses are assessed each reporting period through consideration of factors including, among others:

- Customer credit ratings
- Bankruptcy filings



- Published or estimated credit default rates
- Age of the receivable
- Expected loss rates
- Collateral exposures

The Company assigns internal credit ratings for all customers and determines the creditworthiness of each customer based upon publicly available information and information obtained directly from our customers. The Company's risk rating methodology assigns risk ratings ranging from 1 to 5, where a higher rating represents higher risk.

#### 8.4.5.3.1 Year of origination (vintage)



##### **ASC 326-20-50-6**

When disclosing credit quality indicators of financing receivables and net investment in leases (except for reinsurance recoverables and funded or unfunded amounts of line-of-credit arrangements, such as credit cards), a public business entity shall present the amortized cost basis within each credit quality indicator by year of origination (that is, vintage year).<sup>[27]</sup> For purchased financing receivables and net investment in leases, an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition. For origination years before the fifth annual period, a public business entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate. For interim-period disclosures, the current year-to-date originations in the current reporting period are considered to be the current-period originations. A public business entity shall present the gross writeoffs recorded in the current period, on a current year-to-date basis, for financing receivables and net investments in leases by origination year. For origination years before the fifth annual period, a public business entity may present the gross writeoffs in the current period for financing receivables and net investments in leases in the aggregate. The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for an entity that is not a public business entity.

##### **ASC 326-20-50-6A**

For the purpose of the disclosure requirement in paragraph 326-20-50-6, a public business entity shall present the amortized cost basis of line-of-credit arrangements that are converted to term loans in a separate column (see Example 15 in paragraph 326-20-55-79). A public business entity shall disclose in each reporting period, by class of financing receivable, the amount of line-of-credit arrangements that are converted to term loans in each reporting period and the total of these financing receivables that were written off in the current reporting period in accordance with paragraph 326-20-50-6.

##### **ASC 326-20-50-7**

Except as provided in paragraph 326-20-50-6A, a public business entity shall use the guidance in paragraphs 310-20-35-9 through 35-11 when determining whether a modification, extension, or renewal of a financing receivable should be presented as a current-period origination. A public business entity shall use the guidance in paragraphs 842-10-25-8 through 25-9 when determining whether a lease modification should be presented as a current-period origination.

<sup>27</sup> As noted in Section 1.2, smaller reporting companies that are not required to adopt ASU 2016-13 until fiscal years beginning after December 15, 2022, are only required to show the most recent three years of origination information in the year of adoption, followed by four years of origination information in the year subsequent to adoption, and the full five years of origination information thereafter.

The following example from ASC 326-20-55-79 illustrates the disclosure requirements for the credit quality indicators by year of origination.



**Example 8-5: Disclosing credit quality indicators of financing receivables by amortized cost basis (from Example 15 in ASC 326-20-55-79)**

The following Example illustrates the presentation of credit quality disclosures for a financial institution with a narrow range of loan products offered to local customers—both consumer and commercial. Depending on the size and complexity of an entity’s portfolio of financing receivables, the entity may present disclosures that are more or less detailed than the following Example. An entity may choose other methods of determining the class of financing receivable and may determine different credit quality indicators that reflect how credit risk is monitored. Some entities may have more than one credit quality indicator for certain classes of financing receivables.

As of December 31, 20X5	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term Loans Amortized Cost Basis	Total
	20X5	20X4	20X3	20X2	20X1	Prior			
<b>Residential mortgage:</b>									
Risk rating:									
1–2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
<b>Total residential mortgage loans</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Residential mortgage loans:</b>									
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Consumer:</b>									
Risk rating:									
1–2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-

<b>Total consumer</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Consumer loans</b>									
Current period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial business:</b>									
Risk rating:									
1–2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
<b>Total commercial business</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial business loans:</b>									
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial mortgage:</b>									
Risk rating:									
1–2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
<b>Total commercial mortgage</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial mortgage loans:</b>									
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

Points to keep in mind when preparing this disclosure include:

- This disclosure is not required for entities that are not public business entities<sup>28</sup>
- The initial issuance date should be used to determine the year of origination, including for purchased or acquired assets (i.e., the acquisition date should not be used).
- The guidance in ASC 310-20-35-9 to 35-11 (for financing receivables) and ASC 842-10-25-8 and 25-9 (for leases) should be referred to when determining if a modification, extension or renewal should be presented as a current-period origination.
  - An exception to this is line-of-credit arrangements that are converted to term loans, which should be presented in a separate column. [ASC 326-20-50-6A]
- As demonstrated in the preceding example, origination years that precede the fifth annual period may be aggregated for disclosure purposes.
- For interim-period disclosures, year-to-date originations should be reported for the current period.
- Accrued interest that is included on the balance sheet in the amortized cost basis of the assets to which it relates can be disclosed in total rather than presenting it by class of financing receivable and year of origination.
- Disclosure about recoveries is not required (following adoption of ASU 2022-02).<sup>29</sup>

#### 8.4.5.4 Allowance disclosures relevant to financial assets measured at amortized cost

The following is a summary of the disclosure requirements for financial assets and off-balance-sheet credit exposures within the scope of ASC 326-20. The purpose of these disclosures is to provide information to the users of the financial statements to (a) understand management's method for developing its allowance for credit losses, (b) understand the information that management used in

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<sup>28</sup> Paragraph BC114 of ASU 2016-13 explains the disclosure objectives of ASC 326-10-50-6 and why entities that are not public business entities are exempted from this requirement. "The Board concluded that the vintage disclosure requirements for financing receivables and net investment in leases will allow users to understand the credit quality trends within the portfolio from period to period. In addition, by utilizing information disclosed in other areas in the financial statements and assumptions from public sources, users may be able to derive their own rollforward of the balances and related allowance for credit losses for each origination year. This will provide useful information because it will help users develop estimates of (a) originations by period for each class of financing receivable, (b) an estimate of the initially expected credit losses and subsequent changes to the estimate and (c) an estimate of the current-period provision that is attributable to originations and changes in expected credit losses on previously originated loans. This disclosure requirement is applicable to public business entities only because investors in private companies generally have greater access to management to obtain the information they believe is necessary. The Board considered exempting public business entities that are not SEC filers because small community banks may meet the public business entity definition, but the Board concluded that a distinction among public business entities (that is, public business entities that are not SEC filers) is inappropriate. The Board believes the disclosures are relevant for users in all public business entities; however, given cost considerations, the Board decided to allow public business entities that are not SEC filers further transition relief in order to prepare for the disclosure requirements and decided not to require this disclosure for entities that are not public business entities."

<sup>29</sup> Paragraph BC36 of ASU 2022-02 explains that the Board decided that an entity should disclose gross writeoff information within the vintage disclosure table because the information is most valuable to users and the cost of providing this information would not outweigh the benefits. However, on the basis of users' feedback that recovery information was less decision useful and because preparers identified significant additional complexities in producing the data, the Board concluded that the benefits of this information did not justify the costs. Therefore, the amendments in this Update [ASU 2022-02] do not require that an entity disclose gross recoveries. However, an entity may determine that recovery information provides financial statement users with the most complete vintage information and, therefore, may voluntarily disclose this information.

developing its current estimate of expected credit losses and (c) understand the circumstances that caused changes to the allowance for credit loss. ASC 326-20-50-3B provides a practical expedient whereby accrued interest that is included in the amortized cost basis of financing receivables and HTM securities can be excluded from the disaggregated amortized cost basis disclosures that follow.

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<b>Accrued interest disclosures</b>		
<ul style="list-style-type: none"> <li>If accrued interest is presented within another balance-sheet line item (e.g., other assets), the amount of the accrued interest (net of any allowance for credit losses) and the balance-sheet line item within which it is presented</li> <li>If presented on the balance sheet with the financial assets to which it relates, but is excluded for the purpose of the amortized cost disclosures that follow, the total amount of accrued interest excluded from the disclosure of amortized cost basis</li> <li>An accounting policy election to not measure an allowance for credit losses for accrued interest that is written off in a timely manner, as well as information about the time periods that are considered timely for each class of financing receivable or major security type</li> <li>An accounting policy election to write off accrued interest by reversing interest income or recognizing credit loss expense or a combination of both, as well as the amount of accrued interest written off by reversing interest income, by portfolio segment or major security type</li> </ul>	Not applicable unless specifically noted	None
<b>Credit quality information</b>		
Amortized cost basis by credit quality indicator (CQI), with description of CQI, date or range of dates in which CQI information was last updated	<ul style="list-style-type: none"> <li>Class of financing receivable and year of origination for financing receivables and net</li> </ul>	Receivables measured at lower of amortized cost or fair value, certain trade receivables due in one year

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<p>and, if internal risk ratings are used, qualitative information on how the internal risk ratings relate to the likelihood of loss</p>	<p>investments in leases other than those noted in the next bullet point<sup>30</sup></p> <ul style="list-style-type: none"> <li>• Class of financing receivable for reinsurance receivables and line-of-credit arrangements</li> <li>• Major security type for debt securities</li> </ul>	<p>or less, repurchase agreements, securities lending arrangements and off-balance-sheet commitments are excluded from this requirement</p> <p>Entities who are not PBEs are not required to present amortized cost basis by year of origination</p>
<b>Allowance for credit losses</b>		
<ul style="list-style-type: none"> <li>• A description of how expected loss estimates are developed</li> <li>• Accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management’s current estimate of expected credit losses, including past events, current conditions and reasonable and supportable forecasts about the future</li> <li>• Risk characteristics relevant to each portfolio segment</li> <li>• Changes in the factors that influenced management’s current estimate of expected credit losses and the reasons for those changes</li> <li>• Changes to accounting policies in accordance with ASC 250-10, changes to the methodology from the prior period and the rationale for those changes</li> <li>• Reasons for significant changes in the amount of writeoffs, if applicable</li> </ul>	<p>Portfolio segment and major security type</p>	<p>Off-balance-sheet commitments are excluded from these requirements</p>

<sup>30</sup> The amortized cost basis for origination years before the fifth annual period can be presented in the aggregate. Additionally, as noted in Section 1.2, in the year ASU 2016-13 is adopted, a PBE that is not an SEC filer is only required to show origination information for the most recent three years, followed by four years in the year subsequent to adoption, and the full five years thereafter.

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<ul style="list-style-type: none"> <li>The reversion method applied for periods beyond the reasonable and supportable forecast period</li> <li>The amount of any significant financial assets purchased, sold or reclassified to held for sale during each reporting period</li> </ul>		
The amount recorded in interest income associated with the change in present value attributable to the passage of time	None required	Applies only for assets for which a DCF method is used to measure expected credit losses and the change in present value attributable to the passage of time is reported as interest income
Activity in the allowance for credit losses, including (as applicable): <ul style="list-style-type: none"> <li>Beginning balance</li> <li>Current-period provision</li> <li>The initial allowance recognized on purchased financial assets with credit deterioration</li> <li>Writeoffs</li> <li>Recoveries collected</li> <li>Ending balance</li> </ul>	Portfolio segment and major security type	Applies to all assets within the scope of ASC 326-20
<b>Past-due status</b>		
Aging analysis of amortized cost basis of past-due financial assets as of the reporting date and disclosure of when an asset is considered to be past due	Class of financing receivable and major security type	Receivables measured at lower of amortized cost or fair value and certain trade receivables due in one year or less are excluded from this requirement
<b>Nonaccrual status</b>		
Quantitative disclosure of: <ul style="list-style-type: none"> <li>Amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period</li> <li>Interest income recognized during the reporting period on nonaccrual financial assets</li> </ul>	For quantitative disclosures, class of financing receivable and major security type	Receivables measured at lower of amortized cost or fair value and certain trade receivables due in one year or less are excluded from this requirement

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<ul style="list-style-type: none"> <li>Amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date</li> <li>Amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses as of the reporting date</li> </ul> <p>Accounting policies related to:</p> <ul style="list-style-type: none"> <li>Discontinuing and resuming accrual of interest and for recording payments received on nonaccrual assets</li> <li>Determining past-due or delinquency status</li> <li>Recognizing writeoffs within the allowance for credit losses</li> </ul>		
<b>PCD assets</b>		
<p>Reconciliation of the difference between the purchase price and par value of the financial assets, including:</p> <ul style="list-style-type: none"> <li>Purchase price</li> <li>Allowance for credit losses at the acquisition date based on the acquirer’s assessment</li> <li>Discount (or premium) attributable to other factors</li> <li>Par value</li> </ul>	None required	Applies to purchases of financial assets with credit deterioration occurring during the reporting period
<b>Collateral-dependent financial assets</b>		
Qualitative descriptions of the type of collateral, the extent to which it secures the financial assets and explanation of significant changes in the extent to which it secures the financial assets, whether because of a general deterioration or otherwise	Class of financing receivable and major security type	Applies to financial assets for which, as of the reporting date, repayment is expected to be provided substantially through the operation or sale of the collateral, and the borrower is experiencing financial difficulty



Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<b>Off-balance-sheet credit exposures</b>		
Accounting policies and methodology used to estimate the liability and related charges for off-balance-sheet credit exposures, including identifying the factors that influenced management’s judgment and a discussion of risk elements relevant to particular categories of financial instruments	As appropriate for the particular facts and circumstances	Applies to off-balance-sheet instruments within the scope of ASC 326-20

**8.4.5.5 Allowance disclosures relevant to AFS debt securities**

A summary of the disclosure requirements of ASC 326-30-50, which are applicable to AFS debt securities, is provided in the chart that follows. The objective of those disclosures is to enable a user of financial statements to understand (a) the credit risk inherent in AFS debt securities, (b) management’s estimate of credit losses and (c) changes in the estimate of credit losses that have taken place during the reporting period. An entity needs to determine how much detail to provide to satisfy the disclosure requirements, including how it disaggregates information by major security types. That is, an entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist a financial statement user to understand an entity’s securities and allowance for credit losses.

ASC 326-30-50-3B provides a practical expedient whereby accrued interest that is included in the amortized cost basis of the security for balance-sheet presentation purposes, but is excluded from both the fair value and the amortized cost basis of the security for the purposes of identifying and measuring an impairment, can be excluded from the amortized cost basis disclosures that follow.

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<b>Accrued interest disclosures</b>		
<ul style="list-style-type: none"> <li>If an accounting policy election is made to present accrued interest within another balance sheet-line item (e.g., other assets), its carrying amount (net of any allowance for credit losses) and the line item in which that amount is presented</li> <li>If the practical expedient is elected to exclude accrued interest that is included in the amortized cost basis of securities for balance-sheet presentation purposes from</li> </ul>	Not applicable unless specifically noted in the summary of disclosure requirements	None

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<p>the amortized cost basis disclosures that follow, the total amount of excluded accrued interest, net of any allowance for credit losses</p> <ul style="list-style-type: none"> <li>• An accounting policy election to not measure an allowance for credit losses for accrued interest that is written off in a timely manner, as well as information about the time periods that are considered timely for each major security type</li> <li>• An accounting policy election to write off accrued interest by reversing interest income or recognizing credit loss expense or a combination of both, as well as the amount of accrued interest written off by reversing interest income, by major security type.</li> </ul>		
<b>Securities in unrealized loss positions without an allowance for credit losses</b>		
<p>Quantitative information in tabular form of the aggregate fair value of investments with unrealized losses and the aggregate amount of unrealized losses</p>	<p>Major security type and period of time for which the investments have been in a continuous unrealized loss position (less than 12 months and 12 months or longer)</p>	<p>Applies to AFS debt securities that are in an unrealized loss position for which an allowance for credit losses has not been recorded</p>
<p>Narrative form discussion (to supplement the required quantitative disclosures) about the information considered in reaching the conclusion that an allowance for credit losses is unnecessary (a detailed list of potential content for this discussion is included in ASC 326-30-50-4)</p>	<p>The disclosures may be aggregated by investment categories, with the exception of individually significant unrealized losses</p>	<p>Applies to AFS debt securities that are in an unrealized loss position for which an allowance for credit losses has not been recorded</p>

Summary of disclosure requirements	Level of disaggregation	Additional scope considerations
<b>Allowance for credit losses</b>		
Methodology and significant inputs used to measure credit losses and the accounting policy for recognizing writeoffs (examples of significant inputs for this discussion are included in ASC 326-30-50-7)	Major security type	Applies to periods in which an allowance is recorded
The amount recorded in interest income that represents the change in present value attributable to the passage of time	None required	Applies only for those securities for which the change in present value attributable to the passage of time is reported as interest income rather than credit loss expense
Tabular rollforward of the allowance for credit losses that includes the components listed in ASC 326-30-50-9, at a minimum	Major security type	None
<b>Purchased financial assets with credit deterioration</b>		
Reconciliation of the difference between the purchase price and par value of the financial assets, including: <ul style="list-style-type: none"> <li>• Purchase price</li> <li>• Allowance for credit losses at the acquisition date based on the acquirer's assessment</li> <li>• Discount (or premium) attributable to other factors</li> <li>• Par value</li> </ul>	None required	Applies to purchases of financial assets with credit deterioration occurring during the reporting period

The following example from ASC 326-30-55-8 and 55-9 illustrates the required disclosures for AFS debt securities in an unrealized loss position with no credit losses reported.



**Example 8-6: Disclosures about investments in AFS debt securities in an unrealized loss position with no credit losses reported (from Example 2 in ASC 326-30-55-8 and 55-9)**

This Example illustrates the guidance in Section 326-30-50 with a table followed by illustrative narrative disclosures. The table shows the gross unrealized losses and fair value of Entity B's investments with unrealized losses that are not deemed to have credit losses (in millions), aggregated by investment

category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 20X3. This Example illustrates the application of paragraphs 326-30-50-4 through 50-6 and, in doing so, describes Entity B's rationale for not reporting all or a portion of unrealized losses presented in the table as credit losses. In the application of paragraph 326-30-50-4(b), Entity B should provide meaningful disclosure about individually significant unrealized losses. To facilitate the narrative disclosures and for simplicity, this Example presents only the quantitative information as of the date of the latest statement of financial position. However, in accordance with paragraphs 326-30-50-4 through 50-6, that information is required as of each date for which a statement of financial position is presented.

Description of Securities	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$172	\$2	\$58	\$1	\$230	\$3
Federal agency mortgage-backed securities	367	5	18	1	385	6
Corporate bonds	150	7	-	-	150	7
Total	\$689	\$14	\$76	\$2	\$765	\$16

Following are illustrative narrative disclosures that would follow the illustrative table.

**U.S. Treasury obligations.** The unrealized losses on Entity B's investments in U.S. Treasury obligations and direct obligations of U.S. government agencies were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Entity B does not intend to sell the investments and it is not more likely than not that Entity B will be required to sell the investments before recovery of their amortized cost bases.

**Federal agency mortgage-backed securities.** The unrealized losses on Entity B's investment in federal agency mortgage-backed securities were caused by interest rate increases. Entity B purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of Entity B's investments. Entity B does not intend to sell the investments and it is not more likely than not that Entity B will be required to sell the investments before recovery of their amortized cost bases.

**Corporate bonds.** Entity B's unrealized loss on investments in corporate bonds relates to a \$150 investment in Entity C's Series C Debentures. Entity C is a manufacturer. The unrealized loss was primarily caused by a recent decrease in profitability and near-term profit forecasts by industry analysts resulting from intense competitive pricing pressure in the manufacturing industry and a recent sector downgrade by several industry analysts. The contractual terms of those investments do not permit Entity C to settle the security at a price less than the amortized cost basis of the investment. While Entity C's credit rating has decreased from A to BBB (Standard & Poor's), Entity B currently does not expect Entity C to settle the debentures at a price less than the amortized cost basis of the investment (that is, Entity B expects to recover the entire amortized cost basis of the security). Entity B does not intend to sell the investment and it is not more likely than not that Entity B will be required to sell the investment before recovery of its amortized cost basis.

## Appendix A: Definitions, acronyms and literature references

Several acronyms and key terms are used throughout this guide and many references are made to specific topics and subtopics in the ASC. This appendix includes: (a) an acronym legend, which lists the acronyms and their corresponding definitions, (b) a list of key terms and their corresponding definitions in the Master Glossary of the ASC and (c) a literature listing of ASUs, topics and subtopics in the ASC and other guidance referred to throughout this guide with their corresponding titles.

### Acronym legend

Acronym	Definition
AAG	Audit and Accounting Guide
ADC	Acquisition, development and construction
AFS	Available-for-sale
AICPA	American Institute of Certified Public Accountants
ASC	FASB's Accounting Standards Codification
ASU	Accounting Standards Update
CECL	Current Expected Credit Losses
DCF	Discounted cash flows
FASB	Financial Accounting Standards Board
FNMA	Federal National Mortgage Association
GAAP	Generally accepted accounting principles
HTM	Held-to-maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
LIBOR	London Interbank Offered Rate
NASDAQ	National Association of Securities Dealers Automated Quotations
NAV	Net asset value
NFP	Not-for-profit
OCI	Other comprehensive income
OIS	Overnight Index Swap Rate
OTC	Over-the-counter
PBE	Public business entity
PCAOB	Public Company Accounting Oversight Board
PCD	Purchased with credit deterioration
SAB	Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SOFR	Secured Overnight Financing Rate
TDR	Troubled debt restructuring
TRG	Transition Resource Group

Acronym	Definition
VIE	Variable interest entity

### Key terms and definitions

Term	Definition in the Master Glossary of the ASC
Acquisition, development and construction arrangements	Acquisition, development, or construction arrangements, in which a lender, usually a financial institution, participates in expected residual profit from the sale or refinancing of property.
Amortized cost basis	The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.
Available-for-sale securities	Investments not classified as either trading securities or as held-to-maturity securities.
Beneficial interests	Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following: <ol style="list-style-type: none"> <li>Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through</li> <li>Premiums due to guarantors</li> <li>Commercial paper obligations</li> <li>Residual interests, whether in the form of debt or equity.</li> </ol>
Carrying amount	For a receivable, the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs and also an allowance for uncollectible amounts and other valuation accounts.
Cash equivalents	Cash equivalents are short-term, highly liquid investments that have both of the following characteristics: <ol style="list-style-type: none"> <li>Readily convertible to known amounts of cash</li> <li>So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.</li> </ol> <p>Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).</p>

Term	Definition in the Master Glossary of the ASC
Class of financing receivable	<p>A group of financing receivables determined on the basis of both of the following:</p> <ul style="list-style-type: none"> <li>a. Risk characteristics of the financing receivable</li> <li>b. An entity’s method for monitoring and assessing credit risk.</li> </ul> <p>See paragraphs 326-20-55-11 through 55-14 and 326-20-50-3.</p>
Contract asset	<p>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).</p>
Credit quality indicator	<p>A statistic about the credit quality of a financial asset.</p>
Debt security	<p>Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:</p> <ul style="list-style-type: none"> <li>a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor</li> <li>b. A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position</li> <li>c. U.S. Treasury securities</li> <li>d. U.S. government agency securities</li> <li>e. Municipal securities</li> <li>f. Corporate bonds</li> <li>g. Convertible debt</li> <li>h. Commercial paper</li> <li>i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits</li> <li>j. Interest-only and principal-only strips.</li> </ul> <p>The term debt security excludes all of the following:</p> <ul style="list-style-type: none"> <li>a. Option contracts</li> <li>b. Financial futures contracts</li> <li>c. Forward contracts</li> <li>d. Lease contracts</li> <li>e. Receivables that do not meet the definition of <i>security</i> and, so, are not debt securities, for example: <ul style="list-style-type: none"> <li>1. Trade accounts receivable arising from sales on credit by industrial or commercial entities</li> <li>2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions</li> </ul> </li> </ul>

Term	Definition in the Master Glossary of the ASC
Direct loan origination costs	<p>Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:</p> <ol style="list-style-type: none"> <li>a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan</li> <li>b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:                             <ol style="list-style-type: none"> <li>1. Evaluating the prospective borrower's financial condition</li> <li>2. Evaluating and recording guarantees, collateral, and other security arrangements</li> <li>3. Negotiating loan terms</li> <li>4. Preparing and processing loan documents</li> <li>5. Closing the transaction.</li> </ol> </li> </ol> <p>The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.</p>
Discount	<p>The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. See <i>premium</i>.</p>
Effective interest rate	<p>The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.</p>
Equity security	<p>Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:</p> <ol style="list-style-type: none"> <li>a. Written equity options (because they represent obligations of the writer, not investments)</li> <li>b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)</li> <li>c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.</li> </ol>



Term	Definition in the Master Glossary of the ASC
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Financial asset	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: <ol style="list-style-type: none"> <li>a. Receive cash or another financial instrument from a second entity</li> <li>b. Exchange other financial instruments on potentially favorable terms with the second entity.</li> </ol>
Financing receivable	A financing arrangement that has both of the following characteristics: <ol style="list-style-type: none"> <li>a. It represents a contractual right to receive money in either of the following ways:                             <ol style="list-style-type: none"> <li>1. On demand</li> <li>2. On fixed or determinable dates.</li> </ol> </li> <li>b. It is recognized as an asset in the entity's statement of financial position.</li> </ol> See paragraphs 310-10-55-13 through 55-15 for more information on the definition of financing receivable, including a list of items that are excluded from the definition (for example, debt securities within the scope of Topic 320).
Freestanding contract	A freestanding contract is entered into either: <ol style="list-style-type: none"> <li>a. Separate and apart from any of the entity's other financial instruments or equity transactions</li> <li>b. In conjunction with some other transaction and is legally detachable and separately exercisable.</li> </ol>
Holding gain or loss	The net change in fair value of a security. The holding gain or loss does not include dividend or interest income recognized but not yet received, writeoffs, or the allowance for credit losses.
Interest method	The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.
Lease	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.
Lease term	The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following: <ol style="list-style-type: none"> <li>a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option</li> <li>b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option</li> <li>c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.</li> </ol>

Term	Definition in the Master Glossary of the ASC
Lessee	An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration.
Lessor	An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration.
Line-of-credit arrangement	A line-of-credit or revolving-debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment).
Loan	A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.
Loan commitment	<p>Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can be either of the following:</p> <ol style="list-style-type: none"> <li>a. Revolving (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)</li> <li>b. Nonrevolving (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).</li> </ol> <p>Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement.</p>
Loan origination fees	<p>Origination fees consist of all of the following:</p> <ol style="list-style-type: none"> <li>a. Fees that are being charged to the borrower as prepaid interest or to reduce the loan's nominal interest rate, such as interest buy-downs (explicit yield adjustments)</li> <li>b. Fees to reimburse the lender for origination activities</li> <li>c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)</li> <li>d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 310-20-25-19)</li> </ol>

Term	Definition in the Master Glossary of the ASC
	<p>e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.</p>
Mortgage-backed securities	<p>Securities issued by a governmental agency or corporation (for example, Government National Mortgage Association [GNMA] or Federal Home Loan Mortgage Corporation [FHLMC]) or by private issuers (for example, Federal National Mortgage Association [FNMA], banks, and mortgage banking entities). Mortgage-backed securities generally are referred to as mortgage participation certificates or pass-through certificates. A participation certificate represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA participation certificates are backed by the U.S. government. Periodic payments on FHLMC and FNMA certificates are guaranteed by those corporations, but are not backed by the U.S. government.</p>
Orderly transaction	<p>A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).</p>
Portfolio segment	<p>The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. See paragraphs 326-20-50-3 and 326-20-55-10.</p>
Premium	<p>The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See discount.</p>
Public business entity	<p>A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.</p> <ol style="list-style-type: none"> <li>a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).</li> <li>b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.</li> <li>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.</li> <li>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.</li> <li>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly</li> </ol>

Term	Definition in the Master Glossary of the ASC
	<p>available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.</p> <p>An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.</p>
Purchased financial assets with credit deterioration	<p>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. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.</p>
Readily determinable fair value	<p>An equity security has a readily determinable fair value if it meets any of the following conditions:</p> <ol style="list-style-type: none"> <li>a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.</li> <li>b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.</li> <li>c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.</li> </ol>
Recorded investment	<p>The amount of the investment in a loan, which is not net of a valuation allowance, but which does reflect any direct write-down of the investment. However, if a loan is a hedged item in a fair value hedge, the amount of that loan's recorded investment should include the unamortized amount of the cumulative fair value hedge adjustments.</p>
Reinsurance recoverable	<p>All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits.</p>
Retrospective interest method	<p>A method of interest income recognition under which income for the current period is measured as the difference between the amortized cost at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period.</p>
Securities and Exchange	<p>An entity that is required to file or furnish its financial statements with either of the following:</p>

Term	Definition in the Master Glossary of the ASC
Commission (SEC) Filer	<p>a. The Securities and Exchange Commission (SEC)</p> <p>b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.</p> <p>Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.</p>
Security	<p>A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:</p> <p>a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.</p> <p>b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.</p> <p>c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.</p>
Standby letter of credit	<p>A letter of credit (or similar arrangement however named or designated) that represents an obligation to the beneficiary on the part of the issuer for any of the following:</p> <p>a. To repay money borrowed by or advanced to or for the account of the account party</p> <p>b. To make payment on account of any evidence of indebtedness undertaken by the account party</p> <p>c. To make payment on account of any default by the account party in the performance of an obligation.</p> <p>A standby letter of credit would not include the following:</p> <p>a. Commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not guarantee payment of a money obligation</p> <p>b. A guarantee or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M of the Federal Reserve Board.</p>
Structured note	<p>A debt instrument whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. Structured notes are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private entities. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.</p>

Term	Definition in the Master Glossary of the ASC
Trading	An activity involving securities sold in the near term and held for only a short period of time. The term trading contemplates a holding period generally measured in hours and days rather than months or years. See paragraph 948-310-40-1 for clarification of the term trading for a mortgage banking entity.
Trading securities	Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
Troubled debt restructuring	A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.
Underlying asset	An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset.

### Literature listing

ASC topic or subtopic	Title
210-10	Balance Sheet – Overall
230	Statement of Cash Flows
230-10	Statement of Cash Flows – Overall
250	Accounting Changes and Error Corrections
250-10	Accounting Changes and Error Corrections – Overall
275	Risks and Uncertainties
305	Cash and Cash Equivalents
310	Receivables
310-10	Receivables – Overall
310-20	Receivables – Nonrefundable Fees and Other Costs
310-30	Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality
310-40	Receivables – Troubled Debt Restructurings by Creditors
320	Investments—Debt Securities
320-10	Investments—Debt Securities – Overall
321	Investments—Equity Securities
321-10	Investments—Equity Securities – Overall
323	Investments—Equity Method and Joint Ventures

ASC topic or subtopic	Title
325	Investments—Other
325-30	Investments—Other – Investments in Insurance Contracts
325-40	Investments—Other – Beneficial Interests in Securitized Financial Assets
326	Financial Instruments—Credit Losses
326-10	Financial Instruments—Credit Losses – Overall
326-20	Financial Instruments—Credit Losses – Measured at Amortized Cost
326-30	Financial Instruments—Credit Losses – Available-for-Sale Debt Securities
350	Intangibles—Goodwill and Other
450-20	Contingencies – Loss Contingencies
460	Guarantees
470-20	Debt – Debt with Conversion and Other Options
470-50	Debt – Modifications and Extinguishments
505-10	Equity – Overall
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers – Overall
805	Business Combinations
810-10	Consolidations – Overall
815	Derivatives and Hedging
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
820	Fair Value Measurement
820-10	Fair Value Measurement – Overall
825	Financial Instruments
825-10	Financial Instruments – Overall
825-20	Financial Instruments – Registration Payment Arrangements
835	Interest
835-20	Interest – Capitalization of Interest
835-30	Interest – Imputation of Interest
840-10	Leases – Overall
842	Leases
842-10	Leases – Overall

ASC topic or subtopic	Title
842-30	Leases – Lessor
855	Subsequent Events
855-10	Subsequent Events – Overall
860	Transfers and Servicing
860-10	Transfers and Servicing – Overall
860-20	Transfers and Servicing – Sales of Financial Assets
860-30	Transfers and Servicing – Secured Borrowing and Collateral
905-310	Agriculture – Receivables
905-325	Agriculture – Investments—Other
910-310	Contractors—Construction – Receivables
912-310	Contractors—Federal Government – Receivables
940-320	Financial Services—Brokers and Dealers – Investments—Debt and Equity Securities
940-325	Financial Services—Brokers and Dealers – Investments—Other
940-340	Financial Services—Brokers and Dealers – Other Assets and Deferred Costs
942-230	Financial Services—Depository and Lending – Statement of Cash Flows
942-310	Financial Services—Depository and Lending – Receivables
942-320	Financial Services—Depository and Lending – Investments—Debt and Equity Securities
942-325	Financial Services—Depository and Lending – Investments—Other
944	Financial Services—Insurance
944-30	Financial Services—Insurance – Acquisition Costs
944-310	Financial services—Insurance – Receivables
946	Financial Services—Investment Companies
946-10	Financial Services—Investment Companies – Overall
946-310	Financial Services—Investment Companies – Receivables
946-320	Financial Services—Investment Companies – Investments—Debt and Equity Securities
946-325	Financial Services—Investment Companies – Investments—Other
948-310	Financial Services—Mortgage Banking – Receivables
954-310	Health Care Entities – Receivables
954-325	Health Care Entities – Investments—Other
958-310	Not-for-Profit Entities – Receivables



ASC topic or subtopic	Title
958-320	Not-For-Profit Entities – Investments—Debt Securities
958-321	Not-for-Profit Entities – Investments—Equity Securities
958-325	Not-for-Profit Entities – Investments—Other
960-310	Plan Accounting—Defined Benefit Pension Plans – Receivables
960-325	Plan Accounting—Defined Benefit Pension Plans – Investments—Other
962-310	Plan Accounting—Defined Contribution Pension Plans – Receivables
962-325	Plan Accounting—Defined Contribution Pension Plans – Investments—Other
965	Plan Accounting—Health and Welfare Benefit Plans
965-310	Plan Accounting—Health and Welfare Benefit Plans – Receivables
965-320	Plan Accounting—Health and Welfare Benefit Plans – Investments—Debt and Equity Securities
965-325	Plan Accounting—Health and Welfare Benefit Plans – Investments—Other
970	Real Estate—General
970-323	Real Estate—General – Investments—Equity Method and Joint Ventures
970-835	Real Estate—General – Interest
976-310	Real estate—Retail Land – Receivables
978-310	Real Estate—Time-Sharing Activities – Receivables

Other literature	Title
ASU 2016-13	Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments
ASU 2018-19	Codification Improvements to Topic 326, Financial Instruments—Credit Losses
ASU 2019-04	Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments
ASU 2019-05	Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief
ASU 2019-10	Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates
ASU 2019-11	Codification Improvements to Topic 326, Financial Instruments—Credit Losses
ASU 2020-02	Financial Instruments – Credit Losses (Topic 326) and Leases (Topic 842) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)

Other literature	Title
ASU 2020-03	Codification Improvements to Financial Instruments
ASU 2020-08	Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable Fees and other Costs
ASU 2022-01	Derivatives and Hedging (Topic 815), Fair Value Hedging—Portfolio Layer Method
ASU 2022-02	Financial Instruments – Credit Losses (Topic 326)
ASU 2022-06	Reference Rate Reform (Topic 848)
Credit Losses AAG	AICPA's Audit and Accounting Guide, <i>Credit Losses</i>
IAS 28	Investments in Associates and Joint Ventures
IFRS 9	Financial Instruments (July 2014)

## Appendix B: SAB Topic 6.M, Financial Reporting Release No. 28

ASU 2020-02 amended ASC 326 to include the following text from SAB Topic 6.M, Financial Reporting Release No. 28 – Accounting for Loan Losses by Registrants Engaged in Lending Activities Subject to FASB ASC 326, in ASC 326-20-S99-1.



**RSM COMMENTARY:** The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) issued an interagency policy statement on allowances for credit losses (ACLs). The agencies issued the interagency policy statement in response to changes to ASU 2016-13.

Similar to SAB Topic 6.M, Financial Reporting Release No. 28, the interagency policy statement describes the measurement of expected credit losses under the current expected credit losses methodology and the accounting for impairment on AFS debt securities in accordance with ASC 326; the design, documentation and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate ACLs; the responsibilities of boards of directors and management; and examiner reviews of ACLs.

### 1. Measuring current expected credit losses

**General:** This staff interpretation applies to all registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial condition.<sup>FN74</sup>

FASB ASC Subtopic 326-20 addresses the measurement of current expected credit losses for financial assets measured at amortized cost basis, net investments in leases recognized by lessors, reinsurance recoverables, and certain off-balance-sheet credit exposures.<sup>FN75</sup>

At each reporting date, an entity shall record an allowance for credit losses on financial assets measured at amortized cost basis and net investments in leases recognized by lessors and shall record a liability for credit losses on certain off-balance-sheet exposures not accounted for as insurance or derivatives, including loan commitments, standby letters of credit and financial guarantees.<sup>FN76</sup>

For financial asset(s), the allowance for credit losses is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset(s).<sup>FN77</sup>

The allowance for credit losses is an estimate of current expected credit losses considering available information relevant to assessing collectibility of cash flows over the contractual term of the financial asset(s).<sup>FN78</sup>

Information relevant to establishing an estimate of current expected credit losses includes historical credit loss experience on financial assets with similar risk characteristics, current conditions and reasonable and supportable forecasts that affect the collectability of the remaining cash flows over the contractual term of the financial assets. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses and liabilities for credit losses on off-balance-sheet credit exposures for management's current estimate of expected credit losses.<sup>FN79</sup>

This staff guidance is applicable upon a registrant's adoption of FASB ASC Topic 326.<sup>FN80</sup> Upon a registrant's adoption of FASB ASC Topic 326, the staff guidance in SAB Topic 6, Section L: – *Accounting for Loan Losses by Registrants Engaged in Lending Activities*<sup>FN81</sup> will no longer be applicable.

On November 15, 2019, the FASB delayed the effective date of FASB ASC Topic 326 for certain small public companies and other private companies. As amended, the effective date of ASC Topic 326 was delayed until fiscal years beginning after December 15, 2022 for SEC filers that are eligible to be smaller reporting companies under the SEC's definition, as well as private companies and not-for-profit entities. Nothing in this staff interpretation should be read to accelerate or delay the effective dates of the standard as modified by the FASB.

FN74 This staff interpretation relates to Financial Reporting Release No. 28 – Accounting for Loan Losses by Registrants Engaged in Lending Activities, Release No. 33-6679 (Dec. 1, 1986), (hereinafter “FRR 28”).

FN75 See ASC paragraphs 326-20-15-2 and 326-20-15-3.

FN76 *Ibid.*

FN77 See ASC paragraph 326-20-30-1.

FN78 As indicated in ASC paragraph 326-20-30-11, the liability for expected credit losses for off-balance-sheet credit exposures shall be based on the contractual period in which the entity is exposed to credit risk via a present obligation to extend credit, unless the obligation is unconditionally cancellable by the issuer.

FN79 See ASC paragraphs 326-20-30-1, 326-20-30-6, 326-20-30-7 and 326-20-30-11.

FN80 See ASC paragraphs 326-10-65-1, 326-10-65-2, and 326-10-65-3.

FN81 Originally added to the Codification of SABs in Topic 6, Section L, by SAB No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues, 66 FR 36457 (July 12, 2001).

## 2. Development, governance, and documentation of a systematic methodology

**Facts:** Registrant A is developing (or subsequently reviewing) its allowance for credit losses methodology for its loan portfolio.

**Question 1:** What are some of the factors or elements that the staff normally would expect Registrant A to consider when developing (or subsequently performing an assessment of) its methodology for determining its allowance for credit losses under GAAP?

**Interpretive Response:** The staff normally would expect a registrant to have a systematic methodology to address the development, governance and documentation to determine its provision and allowance for credit losses.

It is critical that allowance for credit losses methodologies incorporate management's current judgments about the credit losses expected from the existing loan portfolio, including reasonable and supportable forecasts about changes in credit quality of these portfolios, on a disciplined and consistently-applied basis.

A registrant's allowance for credit losses methodology is influenced by entity-specific factors, such as an entity's size, organizational structure, access to information, business environment and strategy, management's risk assessment, complexity of the loan portfolio, loan administration procedures and management information systems. Management is responsible for the estimate of expected credit losses, and therefore also responsible for determining whether any allowance methodologies developed by third parties are consistent with GAAP.

While different registrants may use different methods,<sup>FN82</sup> there are certain common elements that the staff would expect in any methodology:

- Identify relevant risk characteristics and pool loans on the basis of similar risk characteristics;<sup>FN83</sup>
- Consider available information relevant to assessing the collectibility of cash flows;<sup>FN84</sup>

- Consider expected credit losses over the contractual term<sup>FN85</sup> of all existing loans (whether on an individual or group basis), and measure expected credit losses on loans on a collective (pool) basis when similar risk characteristics exist;<sup>FN86</sup>
- Require that analyses, estimates, reviews and other allowance for credit losses methodology functions be performed by competent and well-trained personnel;
- Be based on reliable and relevant data and an analysis of current conditions and reasonable and supportable forecasts;
- Include a systematic and logical method to consolidate the loss estimates that allows for the allowance for credit losses balance to be recorded in accordance with GAAP.

The staff believes an entity's management should review, on a periodic basis, whether its methodology for determining its allowance for credit losses is appropriate. Additionally, for registrants that have audit committees, the staff believes that oversight of the financial reporting and auditing of the allowance for credit losses by the audit committee can strengthen the registrant's process for determining its allowance for credit losses.

A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its allowance for credit losses.<sup>FN87</sup> Accordingly, the staff normally would expect registrants to adjust their allowance for credit losses balance, either upward or downward, in each period for differences between the results of the systematic methodology and the unadjusted allowance for credit losses balance in the general ledger.<sup>FN88</sup>

**Question 2:** In the staff's view, what aspects of a registrant's allowance for credit losses internal accounting controls would need to be appropriately addressed in its written policies and procedures?

**Interpretive Response:** Registrants may utilize a wide range of policies, procedures and control systems in their allowance for credit losses processes, and these policies, procedures and systems are tailored to the size and complexity of the registrant and its loan portfolio.

However, the staff believes that, in order for a registrant's allowance for credit losses methodology to be effective, the registrant's written policies and procedures for the systems and controls that maintain an appropriate allowance for credit losses would likely address the following:

- The roles and responsibilities of the registrant's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors and others, as applicable) who determine or review, as applicable, the allowance for credit losses to be reported in the financial statements;
- The registrant's selected methods and policies for developing the allowance for credit losses and determining significant judgments;
- The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its allowance for credit losses (see Question 4 below for further discussion); and
- How the system of internal controls related to the allowance for credit losses process provides reasonable assurance that the allowance for credit losses is in accordance with GAAP.

The staff normally would expect internal accounting controls<sup>FN89</sup> for the allowance for credit losses estimation process to:

- Include measures to provide reasonable assurance regarding the reliability and integrity of information and compliance with laws, regulations and internal policies and procedures;<sup>FN90</sup> and

- Operate at a level of precision sufficient to provide reasonable assurance that the registrant's financial statements are prepared in accordance with GAAP.

**Question 3:** Assume the same facts as in Question 1. What would the staff normally expect Registrant A to include in its documentation of its allowance for credit losses methodology?

**Interpretive Response:** In FRR 28, the Commission provided guidance for documentation of loan loss provisions and allowances for registrants engaged in lending activities. The staff believes that appropriate written supporting documentation for the provision and allowance for credit losses facilitates review of the allowance for credit losses process and reported amounts, builds discipline and consistency into the allowance for credit losses methodology, and helps to evaluate whether relevant factors are appropriately considered in the allowance analysis.

The staff, therefore, normally would expect a registrant to document the relationship between its detailed analysis of the characteristics and credit quality of the portfolio and the amount of the allowance for credit losses reported in each period.<sup>FN91</sup>

The staff normally would expect registrants to maintain written supporting documentation for the following decisions and processes:

- Policies and procedures over the systems and controls that maintain an appropriate allowance for credit losses;
- Allowance for credit losses methodology and key judgments, including the data used, assessment of risk, and identification of significant assumptions in the allowance estimation process;
- Summary or consolidation of the allowance for credit losses balance;
- Validation of the allowance for credit losses methodology; and
- Periodic adjustments to the allowance for credit losses.

**Question 4:** What elements of a registrant's allowance for credit losses methodology would the staff normally expect to be described in the registrant's written policies and procedures?

**Interpretive Response:** The staff normally would expect a registrant's written policies and procedures to describe the primary elements of its allowance for credit losses methodology. The staff normally would expect that, in order for a registrant's allowance for credit losses methodology to be effective, the registrant's written policies and procedures would describe all primary elements needed to support a disciplined and consistently-applied methodology, which may include, but is not limited to:<sup>FN92</sup>

- How portfolio segments are determined (e.g., by loan type, industry, risk rating, etc.)<sup>FN93</sup> and the methodology used for each portfolio segment;<sup>FN94</sup>
- The approach used to pool loans based on similar risk characteristics;
- For accounting policy or practical expedient elections set forth in FASB ASC Subtopic 326-20, documentation of the elections made;
- The method(s) used to determine the contractual term of the financial assets, including consideration of prepayments and when the contractual term is extended;<sup>FN95</sup>
- If a loss-rate method is used, the historical data used to develop the components of the loss rate and how that rate is applied to the amortized cost basis of the financial asset as of the reporting date;<sup>FN96</sup>
- The method for estimating expected recoveries when measuring the allowance for credit losses;<sup>FN97</sup>
- The approach used to determine the appropriate historical period for estimating expected credit loss statistics;

- The approach used to determine the reasonable and supportable period;
- The approach used to adjust historical information for current conditions and reasonable and supportable forecasts;<sup>FN98</sup>
- How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses;<sup>FN99</sup> and
- The approach used to determine when a purchased financial asset would qualify to be accounted for as a purchased financial asset with credit deterioration.<sup>FN100</sup>

FN82 ASC paragraph 326-20-30-3 states that “the allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule.”

FN83 See ASC paragraph 326-20-55-5 for a list of risk characteristics that may be applicable.

FN84 See ASC paragraph 326-20-30-7.

FN85 See ASC paragraph 326-20-30-6.

FN86 See ASC paragraph 326-20-30-2.

FN87 ASU 2016-13, BC63 states that “the Board decided that an entity should determine at the reporting date an estimate of credit loss that best reflects its expectations (or its best estimate of expected credit loss).”

FN88 See ASC paragraphs 326-20-35-1 and 326-20-35-3. Registrants should also refer to the guidance on materiality in SAB Topic 1.M.

FN89 Public companies are required to comply with the books and records and internal controls provisions of the Exchange Act. See Sections 13(b)(2) - (7) of the Exchange Act.

FN90 Section 13(b)(2) - (7) of the Exchange Act.

FN91 FRR 28, Section II states that “the specific rationale upon which the loan loss allowance and provision amount actually reported in each individual period is based — *i.e.*, the bridge between the findings of the detailed review of the loan portfolio and the amount actually reported in each period — would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods.”

FN92 See also, ASC paragraph 326-20-55-6 for additional judgments a registrant may make.

FN93 FASB ASC Subtopic 326-20-20 defines a portfolio segment as the “level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses.”

FN94 See ASC paragraph 326-20-30-3 for examples of expected loss estimation methods that may be used.

FN95 See ASC paragraph 326-20-30-6.

FN96 See ASC paragraph 326-20-30-5.

FN97 See ASC paragraph 326-20-30-1.

FN98 See ASC paragraphs 326-20-30-8 and 326-20-30-9.

FN99 See ASC paragraph 326-20-30-9.

FN100 See ASC paragraphs 326-20-30-13 through 326-20-30-15.

### 3. Documenting the results of a systematic methodology

**Question 5:** What documentation would the staff normally expect a registrant to prepare to support its allowance for credit losses for its loans under FASB ASC Subtopic 326-20?

**Interpretive Response:** Regardless of the method used to determine the allowance for credit losses under FASB ASC Subtopic 326-20, the staff normally would expect a registrant to demonstrate in its documentation that the loss measurement methods and assumptions used to estimate the allowance for credit losses for its loan portfolio are determined in accordance with GAAP as of the financial statement date.

The staff normally would expect a registrant to maintain as sufficient evidence written documentation to support its measurement of expected credit losses under FASB ASC Subtopic 326-20. That documentation should reflect the method(s) used to estimate expected credit losses for each portfolio segment.<sup>FN101</sup>

The staff normally would expect registrants to follow a systematic and consistently-applied approach to select the most appropriate expected credit loss measurement methods and support its conclusions and rationale with written documentation. Typically, registrants decide the methods to use based on many factors, which vary with their business strategies as well as their information system capabilities.

As economic and other business conditions change, registrants often modify their business strategies, which may necessitate adjustments to the methods used to estimate expected credit losses. The staff normally would expect a registrant to maintain a process to evaluate whether adjustments to the methodology are necessary and, if so, maintain documentation to support adjustments to the methodology used.

A registrant's methodology should produce an estimate that is consistent with GAAP. The staff normally would expect that, before employing an expected loss method, a registrant would evaluate and modify, as needed, the method's assumptions related to the current estimate of expected credit losses. Also, the staff expects that registrants would typically document the evaluation, the conclusions regarding the appropriateness of estimating expected credit losses with that method and the objective support for adjustments to the method or its results.

A registrant shall measure expected credit losses on a collective (pool) basis when similar risk characteristic(s) exist.<sup>FN102</sup> The staff normally would expect a registrant to maintain documentation to support its conclusion that the loans in each pool have similar characteristics.

One method of estimating expected credit losses for a pool of loans is through the application of loss rates to the pool's aggregate loan balances.<sup>FN103</sup> Such loss rates should generally reflect the registrant's historical credit loss experience consistent with the remaining contractual terms<sup>FN104</sup> for each pool of loans, adjusted to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated.<sup>FN105</sup>

If a registrant utilizes external data, the staff normally would expect that the registrant would demonstrate in its documentation the relevance and reliability of the external data. The registrant should consider whether the external loss experience data comes from loans with credit attributes similar to those of the loans included in the registrant's portfolio and is consistent with the registrant's assumptions regarding current and forecasted economic conditions.<sup>FN106</sup> The staff normally would expect a registrant to maintain supporting documentation for assumptions and data used to develop its loss rates, including its evaluation of the relevance and reliability of any external data.

If a registrant uses the present value of expected future cash flows to measure expected credit losses,<sup>FN107</sup> the staff normally would expect supporting documentation for the assumptions and data used



to develop the amount and timing of expected cash flows and the effective interest rate used to discount expected cash flows.

If a registrant uses the fair value of collateral to measure expected credit losses, the staff normally would expect the registrant to document:

- The basis for its conclusion that the loan qualifies under GAAP for measurement of expected credit losses based on the fair value of the collateral;<sup>FN108</sup>
- How it determined the fair value of the collateral, including policies relating to the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; and
- The recency and reliability of the appraisal or other valuation.

Regardless of the method used, the underlying assumptions used by registrants to develop expected credit loss measurements should consider current conditions and reasonable and supportable forecasts. The staff normally would expect a registrant to document the factors used in the development of the assumptions and how those factors affected the expected credit loss measurements.<sup>FN109</sup> Factors to be considered include the following:

- Levels of and trends in delinquencies and performance of loans;
- Levels of and trends in write-offs and recoveries collected;
- Trends in volume and terms of loans;
- Effects of any changes in reasonable and supportable economic forecasts;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
- Experience, ability and depth of lending management and other relevant staff;
- Available relevant information sources that support or contradict the registrant's own forecast;
- Effects of changes in prepayment expectations or other factors affecting assessments of loan contractual term;
- Industry conditions; and
- Effects of changes in credit concentrations.

Factors affecting collectibility that are not reflected in the registrant's historical loss information should be evaluated to determine whether an adjustment is necessary so that the expected credit loss measurement considers those factors.<sup>FN110</sup> For any adjustment of loss measurements based on current conditions and reasonable and supportable forecasts, the staff normally would expect a registrant to maintain sufficient evidence to (a) support the amount of the adjustment and (b) explain why the adjustment is necessary to reflect current conditions and reasonable and supportable forecasts in the expected credit loss measurements. Supporting documentation for adjustments may include relevant economic reports, economic data and information from individual borrowers.

The staff normally would expect that, as part of the registrant's allowance for credit losses methodology, it would create a summary of the amount and rationale for the adjustment factor for review by management prior to the issuance of the financial statements. The staff normally would expect the nature of the adjustments, how they were measured or determined and the underlying rationale for making the changes to the allowance for credit losses balance to be documented. The staff also normally would expect appropriate documentation of the adjustments to be provided to management for review of the final allowance for credit losses amount to be reported in the financial statements.

Similarly, the staff normally would expect that registrants would maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of expected credit losses and that this documentation would also be made available to the registrant's independent accountants. If changes frequently occur during management or credit committee reviews of the allowance for credit losses, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the registrant uses.

**Facts:** Registrant H has completed its estimation of its allowance for credit losses for the current reporting period, in accordance with GAAP, using its established systematic methodology.

**Question 6:** What summary documentation would the staff normally expect Registrant H to prepare to support the amount of its allowance for credit losses to be reported in its financial statements?

**Interpretive Response:** The staff normally would expect that, to verify that the allowance for credit losses balances are presented fairly in accordance with GAAP and are auditable, management would prepare a document that summarizes the amount to be reported in the financial statements for the allowance for credit losses,<sup>FN111</sup> and that such documentation also include sufficient evidence to support the allowance and internal controls over the allowance. Common elements that the staff normally would expect to find documented in allowance for credit losses summaries include:

- The reasonable and supportable economic forecasts used;
- The estimate of the expected credit losses using the registrant's methodology or methodologies;
- A summary of the current allowance for credit losses balance;
- The amount, if any, by which the allowance for credit losses balance is to be adjusted; and
- Depending on the level of detail that supports the allowance for credit losses analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Generally, a registrant's review and approval process for the allowance for credit losses relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the allowance for credit losses methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of expected credit losses. These changes may occur as a result of holistically evaluating the individual components of the estimation process and considering the overall estimate of the allowance for credit losses as a whole or due to information not known at the time of the initial loss estimate. It would be important that these adjustments be consistent with GAAP and be reviewed and approved by appropriate personnel. Additionally, it would typically be appropriate for the summary to provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, the staff normally would expect management to document the nature of any adjustments and the underlying rationale for making the changes.

The staff also normally would expect this documentation to be provided to those among management making the final determination of the allowance for credit losses amount.

FN101 See *supra* note 20.

FN102 See paragraph 326-20-30-2. Also refer to ASC paragraph 326-20-55-5 for a list of risk characteristics that may be applicable.

FN103 See ASC paragraphs 326-20-55-18 through 326-20-55-22 for an example illustrating one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

FN104 See ASC paragraph 326-20-30-6 for guidance on determining the contractual term.

FN105 See ASC paragraph 326-20-30-9 for guidance related to adjusting historical loss information.

FN106 See ASC paragraph 326-20-30-8.

FN107 See ASC paragraph 326-20-30-4.

FN108 See ASC paragraphs 326-20-35-4 through 326-20-35-6 for guidance regarding when it is appropriate to measure expected credit losses based on the fair value of the collateral as of the reporting date.

FN109 See ASC paragraph 326-20-55-4 for examples of factors to consider.

FN110 See ASC paragraph 326-20-30-9 for guidance on when it is not appropriate to make adjustments to historical loss information for forecasted economic conditions.

FN111 See *supra* note 16.

#### 4. Validating a systematic methodology

**Question 7:** What is the staff's guidance to a registrant on validating, and documenting the validation of, its systematic methodology used to estimate allowance for credit losses?

**Interpretive Response:** The staff believes that a registrant's allowance for credit losses methodology is considered reasonable when it results in a valuation account that adjusts the net amount of its existing portfolio to cash flows expected to be collected.<sup>FN112</sup>

The staff normally would expect the registrant's systematic methodology to include procedures to assess the continued relevance and reliability of methods, data and assumptions used to estimate expected cash flows.

To verify that the allowance for credit losses methodology is reasonable and conforms to GAAP, the staff believes it would be appropriate for management to establish internal control policies, appropriate for the size of the registrant and the type and complexity of its loan products and modeling methods.

These policies may include procedures for a review, by a party who is independent of the allowance for expected credit losses estimation process, of the allowance methodology and its application in order to confirm its effectiveness.

While registrants may employ many different procedures when assessing the reasonableness of the design and performance of its allowance for credit losses methodology and appropriateness of the data and assumptions used, the procedures should allow management to determine whether there may be deficiencies in its overall methodology. Examples of procedures may include:

- A review of how management's prior assumptions (including expectations regarding loan delinquencies, troubled debt restructurings, write-offs and recoveries) have compared to actual loan performance;
- A review of the allowance for credit losses process by a party that is independent and possesses competencies on the subject matter. This often involves the independent party reviewing, on a test basis, source documents and underlying data and assumptions to determine that the established methodology develops reasonable loss estimates;
- A retrospective analysis of whether the models used performed in a manner consistent with the intended purpose of developing an estimate of expected credit losses; and
- When the fair value of collateral is used, an evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

The staff believes that management should support its validation process with documentation of the specific validation procedures performed, including any findings of an independent reviewer. The staff

normally would expect that, if the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes would be maintained.

FN112 See ASC paragraph 326-20-30-1.

## Appendix C: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition:

### Chapter 1: Overview

- Streamlined the chapter by removing dated discussion about how ASU 2016-01 amended the accounting for investments in debt and equity securities.

### Chapter 2: Accounting for equity securities (including certain options and forward contracts to purchase equity securities)

- Section 2.1.2 question and answer 2Q.1.2.1 has been updated to reflect SEC adopted amendments to certain rules governing money market funds.
- Section 2.2.6, *Accounting for short sales of equity securities*, is new.
- Section 2.2.7, *Accounting for simple agreement for future equity (SAFE) investments*, is new.

### Chapter 3: Accounting for debt securities (including certain options and forward contracts to purchase debt securities)

- Section 3.3.3.1 has been expanded to incorporate additional guidance from the FASB's Accounting Standards Codification about circumstances not consistent with held-to-maturity classification.
- Section 3.3.3.3 has been expanded to incorporate additional guidance from the FASB's Accounting Standards Codification about circumstances that are consistent with held-to-maturity classification.
- Section 3.3.3.3.1, *Sale or transfer due to a significant deterioration in the issuer's creditworthiness*, is new.
- Section 3.3.3.3.2, *Sale or transfer due to a change in tax law*, is new.
- Section 3.3.3.3.3, *Sale or transfer due to a major business combination or major disposition*, is new.
- Section 3.3.3.3.4, *Sale or transfer due to change in statutory or regulatory requirements*, is new.
- Section 3.3.4, *Accounting for other investments in an equity method investee*, is new.
- Section 3.5.1 has been updated to include an expanded discussion about the treatment of commissions and fees incurred to purchase debt securities.

### Chapter 4: Recognition of credit losses on AFS debt securities

- Section 4.1.7 has been updated to include a discussion about a FASB project that may change the accounting for purchased financial assets and to address and clarify application of the current purchase credit deteriorated accounting guidance to acquisitions of pools of assets.

### Chapter 5: Accounting for loans and other receivables

- Section 5.4.3.4.1 has been expanded to include reminders about the accounting for fees and direct origination costs.
- Section 5.4.3.5.9, *Loans with teaser rates*, is new.
- Section 5.5.1 has been updated to include question and answer 5Q.5.1.1 about the accounting for blended-rate loans.
- Section 5.5.7, *Conversion of a loan into a debt security in a debt restructuring*, is new.

## **Chapter 6: Recognition and measurement of credit losses on financial assets measured at amortized cost and off-balance-sheet credit exposures**

- Section 6.3 has been updated to include question and answer 6Q.3.1 about consideration of expected payment of taxes and insurance premiums when estimating expected credit losses.
- Section 6.6.1, *Demand loans*, is new.
- Section 6.9.1 has been updated to include question and answer 6Q.9.1.5 about the applicability of the collateral-dependent financial assets practical expedient in ASC 326-20-35-5.
- Section 6.12 has been updated to include a discussion about a FASB project that may change the accounting for purchased financial assets.
- Section 6.16, *Evaluating subsequent events in the CECL model*, is new.

## **Chapter 8: Presentation and disclosure considerations**

- Section 8.2.1.1 has been updated to include an expanded discussion about unearned discounts.
- Section 8.2.5, *Receivables for issuance of equity*, is new.

# A GUIDE TO ACCOUNTING FOR INVESTMENTS, LOANS AND OTHER RECEIVABLES

This edition of A guide to accounting for investments, loans and other receivables has been produced by the National Professional Standards Group of RSM US LLP.

We would like to acknowledge the efforts of the contributors to the December 2023 edition of this publication:

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