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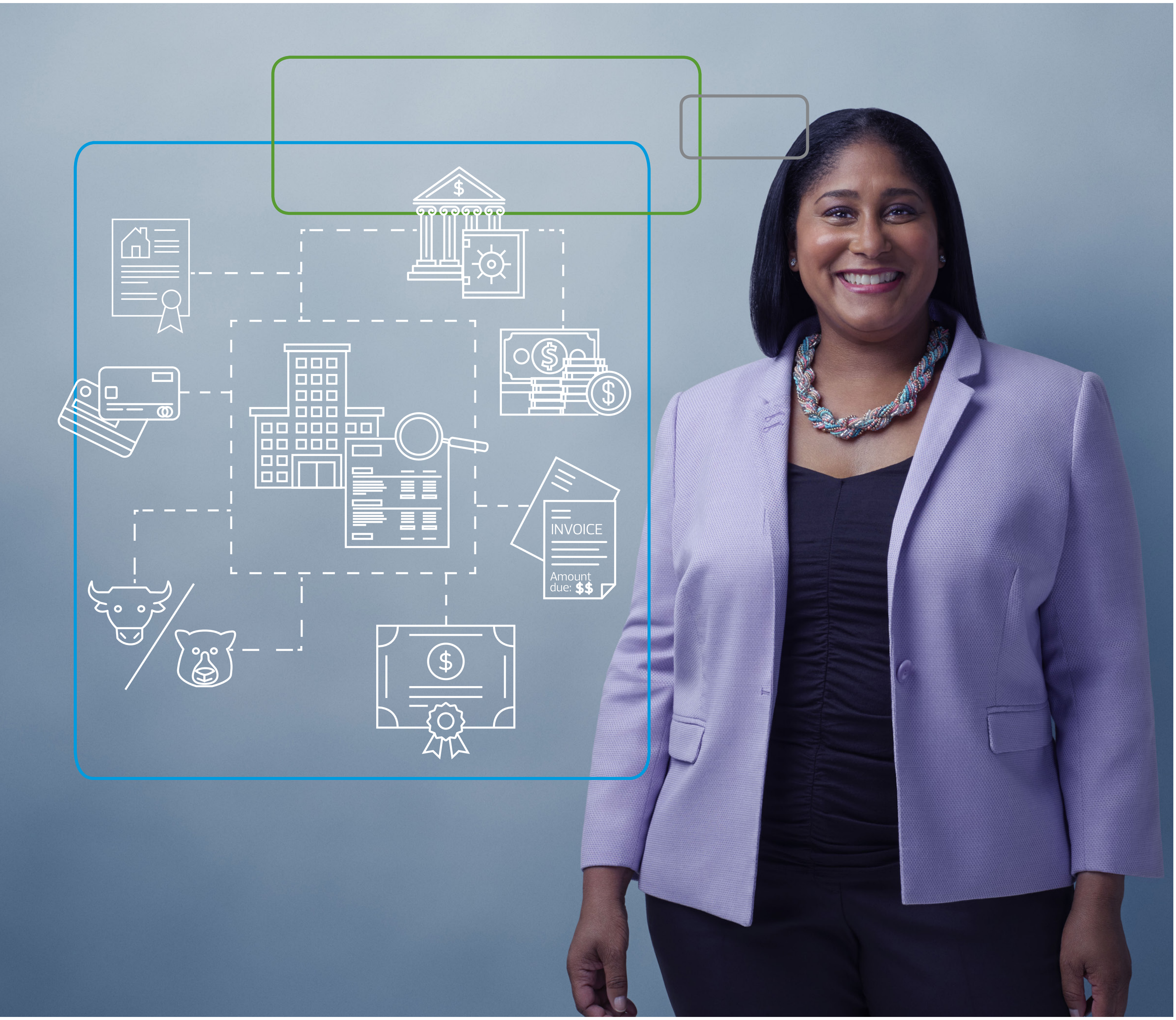


# A GUIDE TO ACCOUNTING FOR INVESTMENTS, LOANS AND OTHER RECEIVABLES

## Under the new guidance affecting the accounting for financial assets

Second Edition

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# A GUIDE TO ACCOUNTING FOR INVESTMENTS, LOANS AND OTHER RECEIVABLES

Under the new guidance affecting the accounting for financial assets

SECOND EDITION
December 2019

# A GUIDE TO ACCOUNTING FOR INVESTMENTS, LOANS AND OTHER RECEIVABLES

Under the new guidance affecting the accounting for financial assets

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December 2019

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# Chapter 1: Overview

## 1.1 Overview

This guide provides a high-level overview of the accounting for investment securities, loans and other receivables and is organized as follows:

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| Chapter 2 | Accounting for equity securities |
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| Chapter 4 | Recognition of credit losses on AFS debt securities |
| Chapter 5 | Accounting for loans and other receivables |
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## 1.2 Recent standard setting

In 2016, the FASB issued two ASUs of major significance to the accounting for financial assets, namely ASU 2016-01 to address recognition and measurement of financial assets and financial liabilities, and ASU 2016-13 to address the measurement of credit losses.

The table that follows: (a) provides a high-level overview of ASU 2016-01 and ASU 2016-13, along with subsequently issued ASUs that amended or clarified their provisions, (b) summarizes the effective dates for both PBEs and other entities and (c) summarizes the early adoption and transition provisions. Each chapter that follows begins with a summary of key changes to preexisting guidance brought about by these ASUs.

| | PBEs | Other entities |
|---|---|---|
| **ASU 2016-01** | | |
| **Overview** | Among other provisions, requires equity securities to be measured at fair value, with changes in fair value recognized through earnings. An election can be made to account for certain equity securities that do not have a readily determinable fair value at cost, with adjustments to fair value through earnings if indications of impairment are present or upon the occurrence of an observable price change in an orderly transaction for the identical or similar investment of the same issuer. Refer to Chapter 2 for additional information. | |
| **Effective date** | Fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. | Fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. |
| **Early adoption provisions** | Certain provisions could be adopted upon issuance, and entities that are not PBEs can early adopt in totality on the effective date for PBEs. | |
| **Transition provisions** | Transition for equity securities measured at fair value is through a cumulative-effect adjustment to the balance sheet as of the beginning of | |

| | PBEs | Other entities |
|---|---|---|
| | the first reporting period in which the guidance is applied. Transition is prospective for qualifying equity securities for which the measurement alternative is elected.<br><br>Insurance entities that elect the measurement alternative for any equity securities that do not have a readily determinable fair value will face transition nuances associated with any amounts that are recorded in OCI for these securities on the date of adoption. (Due to industry guidance contained in ASC 944-325-35-1, insurance entities subject to its scope were required to report unrealized gains and losses on equity securities that do not have a readily determinable fair value in OCI.) The methodology selected to prospectively remove any amounts in OCI should be applied consistently to all equity securities for which the measurement alternative is elected. | |
| **ASU 2018-03** | | |
| **Overview** | Clarifies the guidance brought forth by ASU 2016-01 to:<br>• Permit a change to fair value measurement for a security accounted for under the measurement alternative through an irrevocable election that would apply to the security for which it is elected, as well as all identical or similar investments of the same issuer that are held currently or in the future.<br>• Indicate that adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place.<br>• Indicate that the entire value of forward contracts and purchased options should be remeasured when observable transactions occur on the underlying equity securities.<br>• Indicate that the prospective transition approach for equity securities without a readily determinable fair value applies only for securities for which the measurement alternative is elected, and that insurance entities should apply the same transition method consistently for all securities accounted for under the measurement alternative. | |
| **Effective date** | Fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. | Same as ASU 2016-01. |
| **Early adoption provisions** | Permitted for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as ASU 2016-01 has been adopted. | |
| **Transition provisions** | Cumulative-effect adjustment from the beginning of the fiscal year for PBEs with fiscal years beginning in the period between December 15, 2017, and June 15, 2018, or other entities that have early adopted ASU 2016-01. All other entities that have not adopted ASU 2016-01 should follow its transition provisions. | |

| | PBEs | Other entities |
|---|---|---|
| **ASU 2019-04 (as it relates to modifications to ASU 2016-01)** | | |
| **Overview** | Clarifies the guidance brought forth by ASU 2016-01 to:<br>• Specifically state that health and welfare plans subject to ASC 965 are outside the scope of ASC 320-10 and ASC 321-10.<br>• Remove the requirement for entities that are not PBEs to disclose the aggregate fair value and gross unrecognized holding gains and losses of HTM debt securities.<br>• Indicate that the remeasurement of an equity security accounted for under the measurement alternative due to an orderly transaction identified for the identical or similar security of the same issuer is a nonrecurring fair value measurement, subject to the relevant measurement and disclosure requirements of ASC 820.<br>• Address the functional currency remeasurement of equity securities accounted for under the measurement alternative. | |
| **Effective date** | The amendments related to ASU 2016-01 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. | |
| **Early adoption provisions** | Permitted in any interim period after issuance as long as the entity has adopted all of the amendments in ASU 2016-01. | |
| **Transition provisions** | With the exception of the amendments related to equity securities accounted for under the measurement alternative, for which transition is prospective, transition is modified retrospective through a cumulative-effect adjustment to the opening retained earnings balance as of the date the entity adopted all of the amendments in ASU 2016-01. | |
| **ASU 2016-13 (as amended by ASU 2018-19 and ASU 2019-10)** | | |
| **Overview** | Created new guidance for the measurement of credit losses on 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 of this guide for an in-depth analysis of the provisions of ASU 2016-13, including comparisons of its provisions to the guidance it replaced. | |

<table>
<tr><th></th><th>PBEs</th><th>Other entities</th></tr>
<tr><td>Effective date</td><td>PBEs that are SEC filers, except for entities that are eligible to be smaller reporting companies (as defined by the SEC)[1]:<br>Fiscal years beginning after December 15, 2019, including interim periods within those years.</td><td>All other entities:<br>Fiscal years beginning after December 15, 2022, including interim periods within those years.</td></tr>
<tr><td>Early adoption provisions</td><td colspan="2">Permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.</td></tr>
<tr><td>Transition provisions</td><td colspan="2">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><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><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 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>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</td></tr>
</table>

[1] 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]).

| | PBEs | Other entities |
|---|---|---|
| | 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. | |
| **ASU 2019-04 (as it relates to modifications to ASU 2016-13)** | | |
| **Overview** | Amends the guidance brought forth by ASU 2016-13 to:<br>• 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.<br>• 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).<br>• 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.<br>• 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.<br>• Clarify that all reinsurance recoverables within the scope of ASC 944 are within the scope of ASC 326-20.<br>• Permit projections of future interest rate environments when using a DCF method to measure expected credit losses on variable-rate financial assets, with the same assumptions used to determine a prepayment adjusted discount rate.<br>• Address the consideration that should be given to estimated costs to sell when foreclosure on a financial asset is probable.<br>• Address the presentation of line-of-credit arrangements that are converted to term loans in the vintage disclosures.<br>• 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. | |
| **Effective date** | 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. | |
| **Early adoption provisions** | Permitted in any interim period after issuance of this ASU as long as the entity has adopted ASU 2016-13. | |
| **Transition provisions** | 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. | |

| | PBEs | Other entities |
|---|---|---|
| **ASU 2019-05** | | |
| **Overview** | 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 HTM securities. | |
| **Effective date** | 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. | |
| **Early adoption provisions** | Early adoption is permitted in any interim period after issuance as long as ASU 2016-13 is early adopted. | |
| **Transition provisions** | 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. | |
| **ASU 2019-11** | | |
| **Overview** | Amends the guidance brought forth by ASU 2016-13 to, amongst other provisions:<br>• 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.<br>• Provide transition relief by permitting an accounting policy election to adjust the effective interest rate on existing TDRs using prepayment assumptions on the date of adoption, rather than the prepayment assumptions in effect immediately before the restructuring.<br>• 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.<br>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. | |
| **Effective date** | 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 | |

| | PBEs | Other entities |
|---|---|---|
| | amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. | |
| **Early adoption provisions** | Early adoption is permitted in any interim period after issuance as long as ASU 2016-13 is early adopted. | |
| **Transition provisions** | 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. | |

## 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 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 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 subtopics | Focus of guidance |
|---|---|
| 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) |
| Plan accounting guidance in ASC 960-310, 962-310 and 965-310 | Plan receivables |
| Plan accounting guidance in ASC 960-325, 962-325 and 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 December 2019, 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. It also includes the Transition Resource Group for Credit Losses webpage, which includes meeting minutes and materials useful in understanding views on various implementation issues. The AICPA's Credit Loss Standard (CECL) Issues webpage contains useful information, including a summary of implementation issues identified by the Depository Institutions and Insurance Expert Panel members. Reference should also be made to the AICPA's Credit Losses AAG.

### 1.5 Comparison of pre-existing and amended U.S. GAAP to IFRS

In 2014, the IASB completed its project on financial instruments by issuing amendments to IFRS 9. Convergence was not achieved, despite the fact that financial instruments began as a joint project of the IASB and the FASB. 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 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 its scope 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 no longer subject to derivative bifurcation requirements, which are beyond the scope of this guide.
- 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. The introductory section of each of the other chapters in this guide contains a more in-depth comparison of preexisting U.S. GAAP to amended U.S. GAAP.

| Financial instruments | Preexisting U.S. GAAP | Amended U.S. GAAP | IFRS 9 |
|---|---|---|---|
| Equity securities with readily determinable fair values (excluding those accounted for under the equity method) | Classified as trading securities and accounted for at fair value through net income or classified as AFS securities and accounted for at fair value through OCI.<br><br>For AFS equity securities that were determined to be OTTI, the full amount of impairment was recognized in net income. | 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. |

| Financial instruments | Preexisting U.S. GAAP | Amended U.S. GAAP | IFRS 9 |
|---|---|---|---|
| Equity securities that do not have readily determinable fair values (excluding those accounted for under the equity method) | Accounted for under the cost method with recognition of OTTI. | Accounted for at fair value through net income, except for those securities that qualify for the measurement alternative, which if elected are 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. | No change to preexisting U.S. GAAP. | Accounted for under the equity method as described in IAS 28. |
| Debt security | Classified as trading, AFS or HTM and accounted for at:<br>• Fair value through net income if trading<br>• Fair value through OCI if AFS<br>• Amortized cost if HTM<br><br>Impairment was recognized on AFS and HTM debt securities if they were OTTI. If the entity intended to sell the security or more likely than not would be required to sell the security before recovery, full impairment was recognized in net income. Otherwise, credit loss was recognized in net income, and the remainder was recognized in OCI. | No change to preexisting U.S. GAAP related to classification and measurement.<br><br>As it relates to impairment, preexisting U.S. GAAP was retained for AFS debt securities with some modification, including that credit losses will be 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. The concept of *other than temporary* is no longer relevant.<br><br>Expected credit losses on HTM debt securities will be recognized through an allowance regardless of whether fair value is below amortized cost. | 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.<br><br>Impairment is recognized under the IASB impairment provisions summarized earlier. |

| Financial instruments | Preexisting U.S. GAAP | Amended U.S. GAAP | IFRS 9 |
|---|---|---|---|
| Loans and other receivables | Accounted for at either amortized cost or lower of cost or fair value if held for sale.<br><br>Impairment was recognized for probable losses through an allowance. | No change to preexisting U.S. GAAP for classification and measurement.<br><br>Credit losses that are expected to occur over the life of an asset carried at amortized cost will be recognized through an allowance. | 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.<br><br>Impairment is recognized under the IASB impairment provisions summarized earlier. |
| Fair value option | Can elect for most recognized financial assets. | No change from current U.S. GAAP related to its applicability to financial assets. | Can elect for financial assets if doing so eliminates or significantly reduces an accounting mismatch. |

## Chapter 2: Accounting for equity securities

### 2.0 Summary of key changes

- With the issuance of ASU 2016-01, ASC 321 was created to address the accounting for equity securities and replace the guidance previously contained within ASC 320-10 that pertained to equity securities.
- Refer to Chapter 1 for effective date and transition considerations.
- In the context of equity securities, the most notable changes brought about by the issuance of ASU 2016-01 include:
  - The elimination of the AFS classification and the cost method for equity securities.
  - Requirement for changes in fair value to be recognized through net income rather than OCI.
  - Election available to measure certain equity securities at cost, with adjustments for impairment and observable price changes.
    - Impairment of securities accounted for under this election is evaluated through a new one-step model.

### 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: (a) preferred, common and other ownership interests in entities, including partnerships, joint ventures and limited liability companies and (b) 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.[2] It should be noted that 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 definition of equity securities excludes written equity options, cash-settled options and options on equity-based indexes, as well as preferred stock that, by its contractual terms, 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 (e.g., warrants that have cashless exercise provisions or are to purchase shares that are actively traded)
- 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

[2] ASC 815-10 addresses the accounting for derivatives and also provides incremental guidance within the subsections entitled *Certain Contracts on Debt and Equity Securities* for contracts to purchase securities that are within the scope of ASC 320 or ASC 321 that are not derivatives.

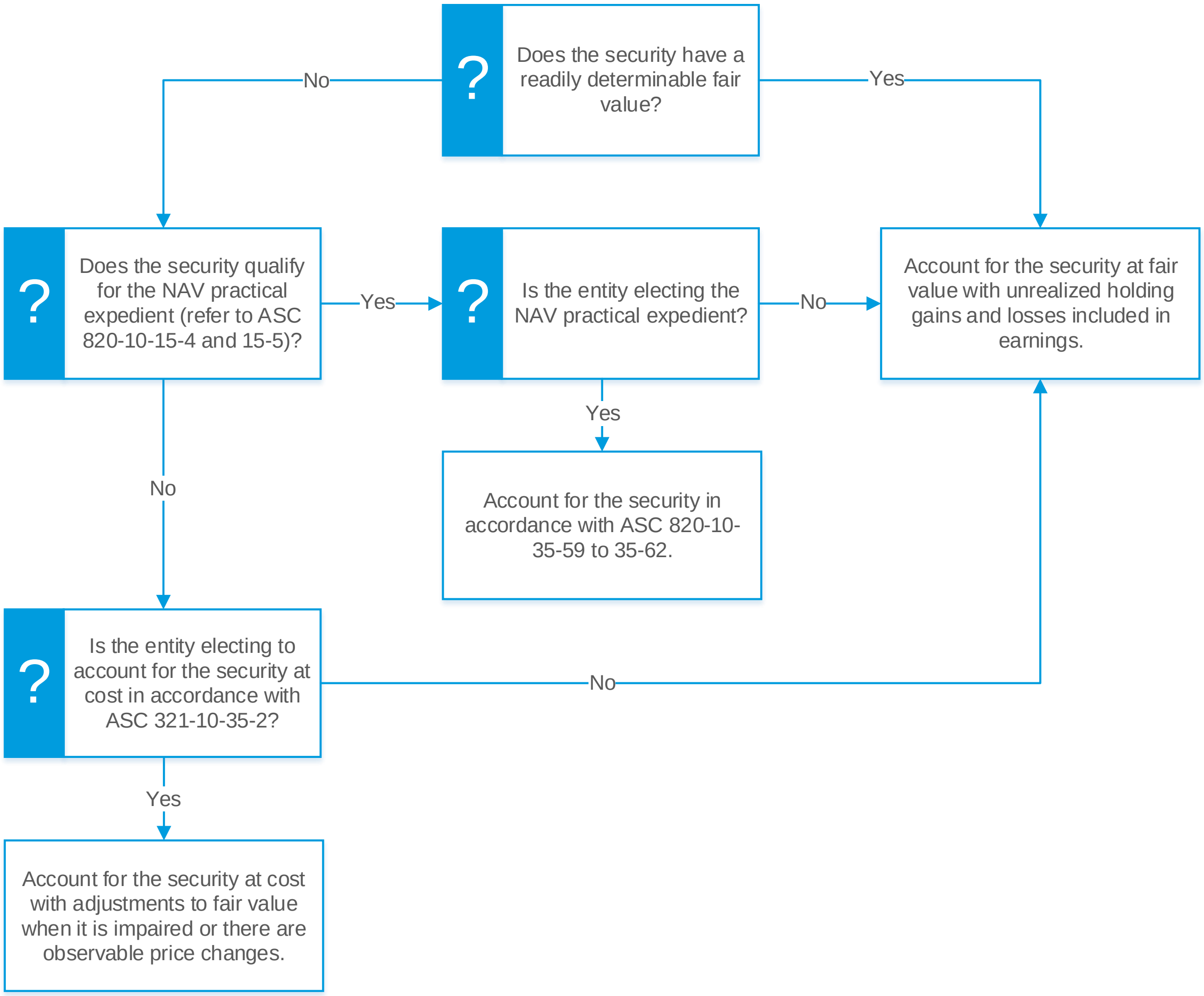
- Investments in Federal Home Loan Bank and Federal Reserve Bank stock that are accounted for in accordance with ASC 942-325-35[3]

## 2.2 Initial recognition and subsequent measurement

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.

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. 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 on the next page. These elections can be made on a security-by-security basis and, once elected, should be consistently applied.

[3] 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.




### 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 elaborated on 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 at 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 measure securities at cost as adjusted for impairment and observable price changes

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. 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 securities for which the election is made to measure them at cost are 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 at 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 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 is pointed out in ASC 815-10-35-6, forward contracts and purchased options that are measured at cost are required to be remeasured at fair value when the underlying securities are impaired.

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

ASC 321-10-55-8 and 55-9 elaborate on the requirement to adjust the carrying amount of securities measured at cost 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.

**Spotlight: 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 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 not constitute an observable price change in an orderly transaction[4]:

- 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 at ASC 815-10-35-6, if the measurement alternative is elected for a forward contract or purchased option, the entire fair value of the forward contract or purchased option should be remeasured when observable transactions occur on the underlying securities.

In evaluating if a security issued by the same issuer is similar to an equity security held by the reporting entity, consideration should be given to the different rights and obligations of the securities, such as rights related to voting, distributions, liquidation preferences and conversion. While this determination is inherently subjective, in practice, it appears that a security is viewed as similar if any differences would either: (a) not be expected to have a significant impact on the valuation of the security or (b) not make it difficult to derive the value of the actual security from an observable price associated with the potentially similar security.

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.

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.

#### 2.2.3.3 Deciding whether to elect to measure securities at cost adjusted for impairment and observable price changes

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.

[4] 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.

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. Keep in mind that while these efforts could be significant and require considerable use of judgment, this election is designed and expected to be less burdensome than determining a fair value estimate in accordance with ASC 820 at the end of each reporting period.

## Chapter 3: Accounting for debt securities

### 3.0 Summary of key changes

- With the issuance of ASU 2016-01, ASC 320-10 was amended to pertain solely to debt securities. The content pertaining to equity securities was eliminated, and ASC 321 was created to replace the equity securities guidance (see Chapter 2).
- 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.

### 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 at 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, 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 (e.g., in a TDR)
- 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[5]
- 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 at 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).

[5] ASC 815-10 provides incremental guidance within the subsections entitled *Certain Contracts on Debt and Equity Securities* for contracts to purchase debt securities that are within the scope of ASC 320.

### 3.3 Classification and measurement of debt securities

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.

Debt securities are required to be classified in one of three categories at the time of 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. Classification is primarily based on management's intent, which should be documented. The classification categories, descriptions and subsequent measurement for each category are 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:

| 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. Expected credit losses are recognized on other impaired securities through an allowance for credit losses. |

| ASC 326-20 (HTM securities) | ASC 326-30 (AFS securities) |
|---|---|
| | 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 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. 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. ASC 320-10-25-5 lists specific scenarios that a debt security should not be classified as HTM. The sale or transfer of an HTM security under these scenarios calls into question a 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[6] 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 elaborated on at 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

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[6] Consideration should be given to ASC 815 as this prepayment feature may need to be given separate recognition as a derivative.

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.

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.

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 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.
- Change in tax law that eliminates or reduces the tax-exempt status of interest on the security.
- 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. Such sales should occur concurrent with or shortly after the business combination or disposition. There are not quantitative thresholds provided for what constitutes a major business combination or disposition; however, it is explicitly stated that the following transactions would *not* qualify for this exception:
  - Purchases or sales of large pools of financial assets.
  - Sales of HTM securities to fund an acquisition or disposition or in anticipation of or otherwise before a major business combination or disposition.
  - Sales of HTM securities in response to an unsolicited tender offer from the issuer (unless that event is isolated, nonrecurring and unusual and could not have been reasonably anticipated as discussed later).
- Changes in regulatory requirements that apply to the industry (as opposed to regulatory orders directed to a particular institution) that: (a) significantly modify either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, (b) significantly increase regulatory capital requirements causing the entity to downsize or (c) increase the regulatory risk weights of the securities.
- Sales due to events that are all of the following: (a) isolated, (b) nonrecurring, (c) unusual for the reporting entity and (d) could not have been reasonably anticipated. The expectation is that absent an extremely remote disaster scenario (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 scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. (For variable-rate securities, the scheduled payments would be equal absent a change in interest rates.)

## 3.4 Reassessment of classification and accounting for transfers

The appropriateness of the classification of securities should be reassessed at each reporting date as is elaborated on beginning at ASC 320-10-35-5. If an entity no longer has the ability to hold securities to maturity, their continued classification as HTM would not be appropriate. 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. Transfers from HTM should be rare except for transfers occurring due to one of the circumstances outlined in ASC 320-10-25-6(a) to 25-6(f), which are listed in Section 3.3.1. As indicated at Section 3.3.1, 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.

Given the nature of trading securities, transfers into or from the trading category should also 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 that 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 company'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.

### 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.

### 3.4.2 Transfers from HTM to AFS

ASC 320-10-35-10A addresses the transfer of a debt security from HTM to AFS, indicating that any previous allowance for credit losses should be reversed through credit loss expense, and the security transferred to the AFS category at its amortized cost basis (reduced for any previous writeoffs). Upon transfer, consideration should be given to ASC 326-30 (refer to Chapter 4) for the establishment of an allowance for credit losses that would be recognized through credit loss expense. ASC 320-10-45-8B requires any allowance amounts reversed and established upon the transfer to be presented gross in the income statement or in the notes to the financial statements. An unrealized gain or loss at the date of transfer (exclusive of the amount recognized as an allowance) is recognized in OCI. The amortized cost basis of the security carries over for the purposes of subsequently amortizing the historical premium or discount, determining the security's unrealized holding gain or loss by comparing it to the security's fair value and satisfying the required disclosures of amortized cost.

### 3.4.3 Transfers from AFS to HTM

ASC 320-10-35-10B addresses the transfer of a debt security from AFS to HTM, indicating that any previous allowance for credit losses should be reversed through credit loss expense, and the security transferred to the HTM category at its amortized cost basis reduced for any previous writeoffs, with any remaining unrealized holding gain or loss reported in accumulated other comprehensive income. Upon transfer, an allowance for credit losses determined in accordance with ASC 326-20 (refer to Chapter 6) should be recognized through credit loss expense. As indicated in Section 3.4.2, any allowance amounts reversed and established upon the transfer are required to be presented gross in the income statement or in the notes to the financial statements. The gain or loss reported in AOCI should be amortized over the remaining life of the security as a yield adjustment, consistent with the amortization of any premium or discount, and will offset the effect of the amortization of any premium or discount that may have been created through amortized cost accounting. (Refer to Section 5.4 for additional discussion of the amortization of premiums and discounts and ASC 320-10-55-24 for an illustration of the accounting for a transfer from AFS to HTM.)

## 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.

### 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.) Upon the adoption of ASU 2017-08[7], premiums on debt securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates should be amortized to the earliest call date, rather than the maturity date. (Discounts continue to be amortized to the debt security's maturity date.) If the call option is not exercised on that date, the effective yield should be reset using the payment terms of the security.

Premium and discount recognition is not relevant for trading securities given that they are accounted for at fair value through net income. The guidance beginning at 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.

[7] ASU 2017-08 is effective for PBEs for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, ASU 2017-08 is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted.

For debt securities that are considered to be PCD assets as explained at Section 4.1.7 for AFS securities and at Section 6.13 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 at Section 4.1.7 for AFS securities and at Section 6.13 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 at ASC 320-10-55-10. Use of the retrospective interest method is required for structured notes 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.

This guidance does not apply to:

- 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) given that as mentioned at ASC 320-10-35-38(h), these 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 zero percent effective yield.

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.

### 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. To account for the sale of an AFS security, the carrying amount of the security should first be adjusted for any changes in fair value that occurred to the sale date, after which the amount recorded in OCI, representing the unrealized gain or loss at the date of sale, is reversed into earnings, with deferred tax accounts adjusted accordingly. 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.

## Chapter 4: Recognition of credit losses on AFS debt securities

### 4.0 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 preexisting guidance and ASC 326-30.

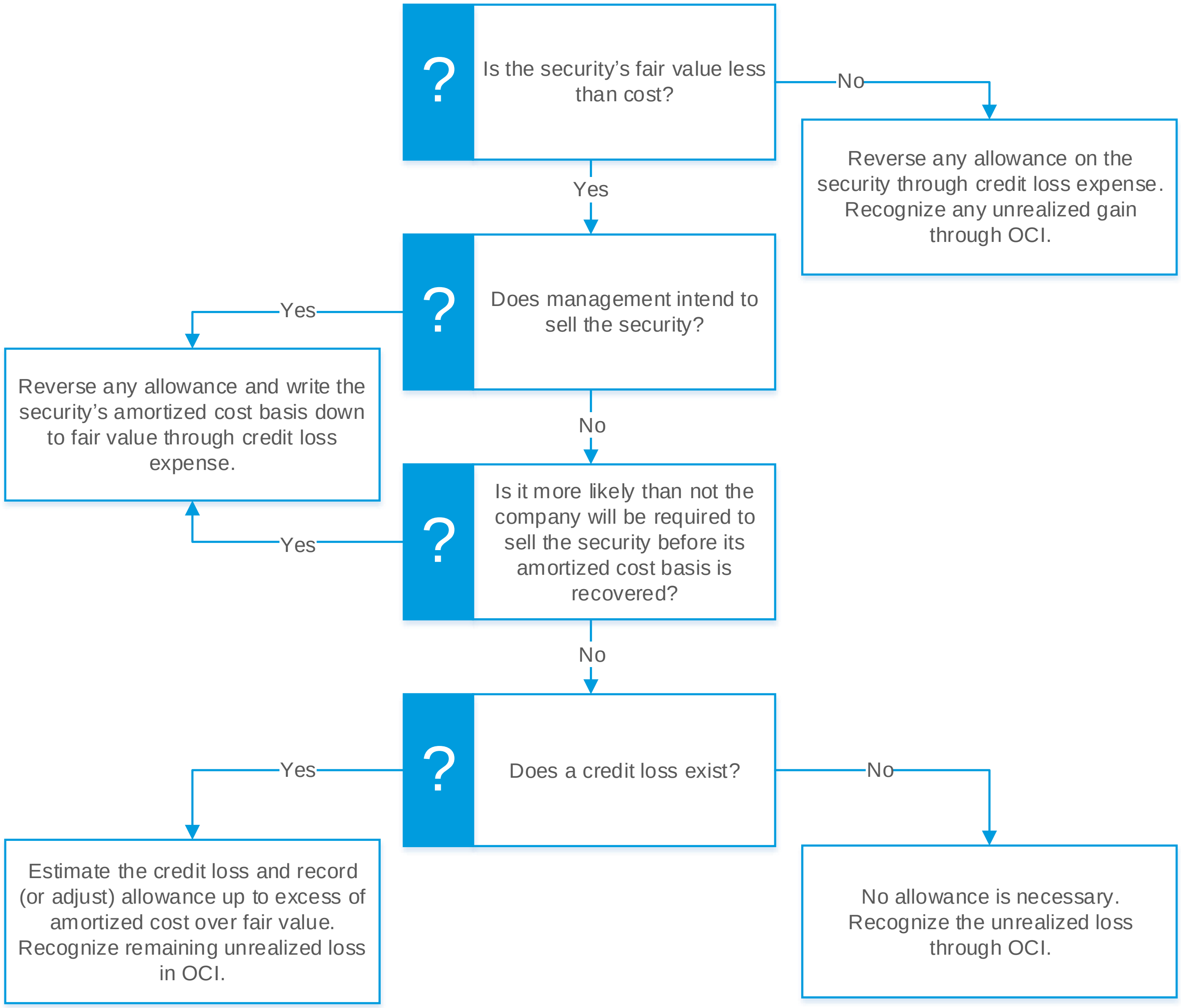
| ASC 320-10-35 (Preexisting guidance) | ASC 326-30 |
|---|---|
| Debt securities are required to be evaluated individually to determine if impairment should be recognized. If the fair value of an individual security is less than amortized cost as of the reporting date, it is impaired. Impairment was 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 does not intend to sell the security, and more likely than not will not be required to sell the security before recovering its amortized cost basis, only the impairment associated with credit loss is recognized in earnings, with the amount related to all other factors recognized in OCI. | 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.[8] The concept of *other than temporary* is no longer relevant, and the expectation is that the recognition of losses will be accelerated. |
| 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.<br><br>The effective rate to use in discounting expected cash flows could not be adjusted for expected prepayments. | 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.<br><br>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. |
| 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 a reduction or increase in credit loss expense. |

[8] Paragraph BC82 of ASU 2016-13.

| ASC 320-10-35 (Preexisting guidance) | ASC 326-30 |
|---|---|
| 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 asset's initial carrying amount.<br><br>Both subsequent increases and decreases in expected cash flows on such a security are reflected in net income immediately through a reduction or increase in credit loss expense. |

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

This chapter applies solely to AFS debt securities (including loans that meet the definition of debt securities and are classified as AFS) 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. Impairment is recognized in the income statement (rather than through OCI) in the following three circumstances (each of which are elaborated on in this chapter): (1) management intends to sell the security, (2) it is more likely than not that the security will be required to be sold before its amortized cost basis is recovered and (3) a credit loss exists. The accounting analysis is rather involved and the flowchart on the next page outlines one approach that may be followed in navigating through this guidance. Supplemental discussion follows the flowchart.




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

ASC 326-30-35-4 points out that AFS debt securities are required to be assessed for impairment at the individual security level. Debt securities with the same CUSIP 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. 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) and further analysis is necessary to determine if and to what extent impairment should be recognized in the income statement rather than through OCI. 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 should be reversed through credit loss expense. The security's carrying amount would then be adjusted to fair value through 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 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 credit losses.

### 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 credit losses.

**Commonly asked questions related to an intent or likely requirement to sell**

*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:

- At 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 at 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.

*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.

### 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. This guidance 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 at 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 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 that are outlined at 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
  - 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 on the next page to illustrate how an entity may want to estimate expected cash flows and determine the allowance amount that should be recorded.

**Example 4-1: 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

Both increases and decreases to the allowance for credit losses should be recognized through an increase or decrease to credit loss expense.

#### 4.1.6.1 Writeoffs

ASC 326-20-35-8 provides that financial assets should 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 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 at 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 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

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 at 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.

# Chapter 5: Accounting for loans and other receivables

## 5.0 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.
- 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.

## 5.2 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. Mortgage loans that are classified as held-for-long-term-investment are also carried at amortized cost. ASC 948-310 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 in accordance with Section 5.2.3.)

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

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 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.

ASC 948-310 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"). 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. This guidance 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 light of ASC 815-10-15-71. Any other types of commitments to lend are excluded from derivative requirements under ASC 815-10-15-69. 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 contracts meet the definition of a derivative and are within the scope of ASC 815. Forward commitments 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). This guidance indicates that if the settlement date for a standby commitment is within a reasonable period (e.g., a normal loan commitment period), and 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. If this is the case, the loans purchased through the commitment would be recognized on the settlement date, net of the commitment fee received. If both of these conditions 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.

## 5.3 Sales or other transfers of receivables

### 5.3.1 General

ASC 860 addresses transfers of financial assets, with ASC 860-10-40 containing the criteria that should be considered in determining if 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 loans or receivables 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 can 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.

## 5.4 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 is pointed out at 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 effective rate is determined based on the contractual terms (e.g., maturity) of the asset. There are certain exceptions to the general rule; namely, upon the adoption of ASU 2017-08[9], premiums on debt securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates should be amortized to the earliest call date, rather than the maturity date. (Discounts continue to be amortized to the debt security's maturity date.) If the call option is not exercised on that call date, the effective yield should be reset using the payment terms of the security.

Another exception to the general rule of using the contractual maturity date is provided by ASC 310-20-35-26. As discussed more fully within Section 5.4.3.2, entities that hold a large number of similar loans, securities or receivables for which prepayments are probable and can be reasonably estimated are permitted to estimate prepayments when computing the effective rate for the group of similar assets.

An illustration of the application of the interest method, adapted from the example beginning at ASC 310-20-55-20, follows on the next page.

[9] ASU 2017-08 is effective for PBEs for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, and for all other entities, for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted.

**Example 5-1: Amortization based on contractual payment terms (from ASC 310-20-55-20 to 55-22)**

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 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[a] | 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%) [b] | | | | | | | |
| 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) | | | | | | | |

[a] $6 rounding adjustment.

[b] 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.

#### 5.4.2.2 Increasing and variable rate loans

There are certain nuances in applying the interest method to increasing and variable rate loans. 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, with consideration given to prepayment penalties in effect throughout the loan term. It should be noted that this limitation does not apply to the recognition of direct loan origination costs and purchase premiums associated with such loans.

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, 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. The method selected should be applied consistently over the life of the loan. Examples 8 and 9 at ASC 310-20-55-40 illustrate the application of the two different approaches.

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

ASC 310-10-35-53B through 53C provide guidance on interest income recognition for PCD assets (refer to Section 6.13 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 310-20-25-23 provide additional guidance relevant to the purchase of loans and permit the purchase price to be allocated to the individual loans or accounted for in the aggregate. Costs incurred in connection with acquiring purchased loans or committing to purchase loans should be expensed as incurred given that the costs are not loan origination costs, which are addressed in the next section.

### 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 at 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[b] | Yes |
| Loans held for sale | Lower of amortized cost basis or fair value[b] | 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[a] | Fair value, changes in value reported in OCI | Yes |

[a] This includes financial assets subject to prepayment as defined in paragraph 310-10-35-45 and debt securities classified as AFS under Topic 320.

[b] 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

For loans held for investment, ASC 310-20 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 is elaborated on 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.

Origination fees and direct loan origination costs associated with loans held for sale are deferred as part of the asset's amortized cost basis and recognized as part of the gain or loss on sale.

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 the next paragraph) 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 should be 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 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.

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. 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.

ASC 310-20-35-30 outlines a number of characteristics to be considered when aggregating loans. 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.

If a loan that is a part of a group is subsequently sold, in the absence of specific records for the remaining net fees and costs associated with the sold loan, 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.

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. Various examples illustrating the application of the interest method are included in the implementation guidance beginning at ASC 310-20-55-19.

**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 points out 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 at 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 at 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. Additional guidance on what constitutes an independent third party is included at ASC 310-20-55-9.)
- Certain costs directly related to specified activities performed by the lender for that loan. Those activities 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 elaborated on at 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.

For additional guidance related to loan origination costs:

- ASC 310-20-25-8 to 25-10 address the use of standard costing and estimating loans in process that will progress to origination.
- The guidance beginning at ASC 310-20-55-11, which contains additional examples of loan origination costs that can be deferred and activities that are contemplated in the definition of these costs.

As indicated at 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

#### 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 320-10 provides guidance specific to the recognition of commitment fees to purchase or originate loans. 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.

**5.4.3.5.3 Lines of credit.** Guidance specific to lines of credit is included at 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 at 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.** An example is provided at ASC 310-20-55-50 of the accounting for deferred fees and costs on a credit facility that provides for multiple, unscheduled drawdowns (or loans) with varying maturities and does not have the characteristics of a revolving line of credit (i.e., repayments of amounts borrowed are not available for re-borrowing). If drawdowns are anticipated on the facility, the 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.

**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. If there is no significant fee, a one-year period should be used. (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.

**5.4.3.5.8 Loan refinancing or restructuring.** ASC 310-20 provides the guidance relevant to determining if a refinanced or restructured loan should be considered to be a new loan. This guidance is not relevant to TDRs, which are not considered to be new loans, and are addressed at Section 5.5. The determination of whether a refinanced loan is a new loan impacts the recognition of any unamortized net fees or costs that remain from the original loan. 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.

To make this determination, 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.

Additionally, for it to be considered a new loan, the modifications to the original debt instrument need to be more than minor. 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. 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 modification is more than minor.

## 5.5 Troubled debt restructurings (TDRs)

**Important note on key changes**

With the issuance of ASU 2016-13 and the creation of a new model for recognizing credit losses, the designation of a loan (including TDRs) as impaired is no longer relevant. As such, the references to impaired loans in ASC 310-40-35 are superseded by ASU 2016-13. Refer to Chapter 6 for the recognition of credit losses on loans, including TDRs.

### 5.5.1 Applicability

ASC 310-40 contains the guidance relevant to the identification of and accounting for TDRs from the perspective of the creditor. As pointed out in ASC 310-40-15, a TDR can involve various types of receivables, including trade accounts receivable, notes, debentures and bonds. In other words, it is not limited solely to loans or debt. Modifications to lease agreements and employment related agreements are excluded from the scope of this guidance as are delays in collection or payment that do not involve an agreement between the two parties to restructure. ASC 470-60 addresses the accounting for TDRs from the debtor perspective. The accounting by the creditor and debtor is not always symmetrical in that a restructuring can be a TDR for one party to the arrangement but not the other due to differences in the applicable guidance as well as other factors.

### 5.5.2 What is and is not a TDR

By definition in ASC 310-40-20, a TDR is a restructuring for which 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. In other words, to be a TDR, the debtor needs to be experiencing financial difficulties, and because of these difficulties, the creditor grants a concession. As is more fully elaborated on in ASC

310-40-25-2, a TDR can also occur when the debt of another entity or person is substituted for the troubled debtor or another debtor is added as a joint debtor.

Examples of what is not a TDR include:

- If the debtor could obtain funds from other sources at market interest rates at or near those for nontroubled debtors
- If a debtor transfers assets in settlement of its obligation that have a fair value that is at least equal to the creditor's amortized cost basis, or the debtor's carrying amount of the payable
- Interest rate reductions that are reflective of a decrease in market rates or risk with a debtor that can readily obtain funds from other sources at the current market rate

#### 5.5.2.1 Understanding what is a concession

Concessions are typically granted by the creditor in an attempt to protect as much of its investment as possible and may stem from an agreement between the two parties or be imposed by law or a court. As is pointed out at ASC 310-40-15-13, a concession is deemed to have been granted if, as a result of the restructuring, the creditor does not expect to collect all amounts due, including interest accrued at the contractual rate. In determining if all amounts due will be collected, the current value of collateral should be considered if the payment of principal at the original maturity is primarily dependent on that collateral.

Concessions can take various forms, including reducing or deferring payments, modifying the interest rate, extending the maturity date or accepting assets with a value less than the debt amount in satisfaction of the debt. In determining whether a concession has been granted, a creditor is not permitted to apply the effective interest rate test in ASC 470-60 that is applicable to the borrower in determining if a TDR occurred.

If the creditor receives something from the debtor in exchange for restructuring a debt (e.g., additional collateral or guarantees), consideration should be given to the nature and amount of that additional collateral or those additional guarantees to determine if a concession occurred. In other words, if what was given to the creditor is not adequate compensation for what the creditor gave up, a concession was made. When evaluating guarantees that are received in exchange for a restructuring, consideration should be given to the guarantor's ability and willingness to pay the balance owed.

An increase in the contractual interest rate in a restructuring does not necessarily mean that a concession did not occur given that the new contractual interest rate may still be below a market interest rate for new debt with similar risk characteristics. A creditor should consider all aspects of the restructuring in determining whether it has granted a concession.

A restructuring that results in only insignificant payment delays does not constitute a concession. The following factors contained at ASC 310-40-15-17, 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, consideration should be given to the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant. Examples from ASC 310-40-55-16 to 55-25 follow to illustrate what is and is not considered an insignificant payment delay.

**Example 5-2: Commercial real estate debt with balloon payment (from ASC 310-40-55-16 to 55-19)**

A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 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 5-3: Residential mortgage debt—temporary payment deferral (from ASC 310-40-55-20 to 55-22)**

A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 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 5-4: Commercial line of credit—short-term extension before the finalization of renegotiated terms (from ASC 310-40-55-23 to 55-25)**

A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 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.

If no concession was granted, the restructuring is not considered to be a TDR. If a concession was granted, consideration should be given to the section that follows to determine if the borrower is experiencing financial difficulties.

### 5.5.2.2 Determining whether a borrower is experiencing financial difficulties

In evaluating whether the borrower is experiencing financial difficulties at the time of a restructuring, consideration should be given to the following indicators (which are not intended to be all-inclusive) outlined at ASC 310-40-15-20:

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 borrower has declared or is in the process of declaring bankruptcy.

c. There is substantial doubt as to whether the borrower will continue to be a going concern.

d. The borrower 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 borrower's current capabilities, the creditor forecasts that the borrower'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 borrower 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 borrower.

If the conclusion is reached that a concession was made and the borrower was experiencing financial difficulties at the time of the restructuring, the restructuring should be accounted for as a TDR.

### 5.5.3 Accounting for TDRs

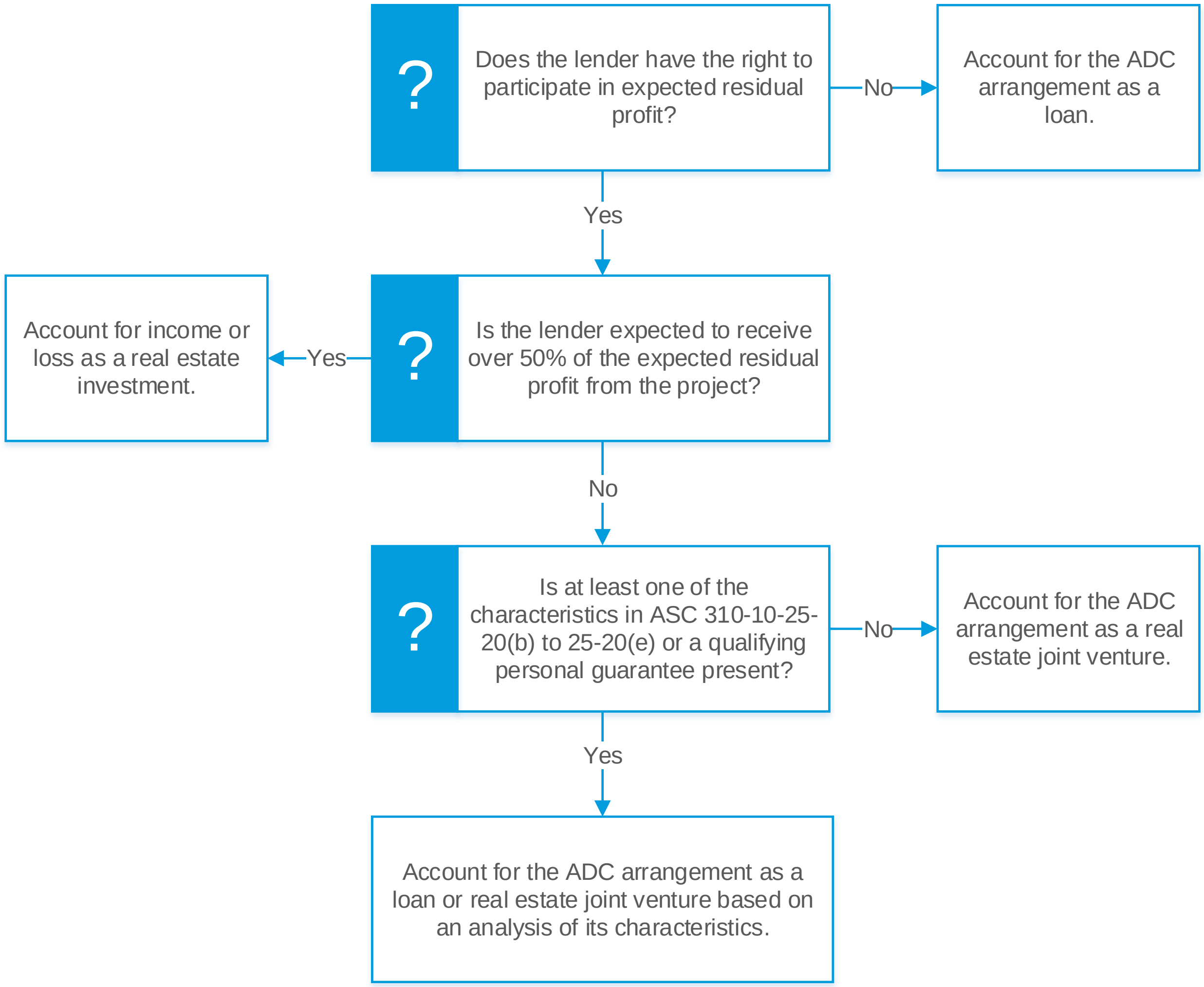
As pointed out at ASC 310-40-35-10, a TDR should not be accounted for as a new loan given that it arises from the creditor's attempt to recover its investment in the original loan. As such, the unamortized portion of deferred fees or costs associated with the original loan carry over. ASC 310-20-35-12 addresses the accounting treatment for fees received and costs incurred in conjunction with a TDR. Fees that are received should be applied as a reduction of the loan's carrying amount. Any legal fees and other direct costs incurred by the creditor to effect a TDR should be charged to expense as incurred.

ASC 326, the subject of Chapter 6, provides guidance on the recognition and measurement of credit losses on financial assets, including concessions given to the borrower in a TDR, which is the focus of Section 6.11. The effective interest rate used to discount expected cash flows (if a DCF approach is employed) would be the same discount rate used on the original loan.

Assets received in conjunction with the full or partial settlement of a TDR should be recognized in accordance with ASC 310-40-35 or ASC 310-40-40, as appropriate, which indicates such assets should generally be recognized at fair value less costs to sell, if relevant. Assets received in partial (rather than full) settlement of the loan are applied as a reduction to the amortized cost basis of the receivable. Assets received in full satisfaction of a TDR, including situations involving a substitute debtor, 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, which would include equity interests and payments to be received from a substitute debtor (if applicable). 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. TDRs are subject to the disclosure requirements of ASC 310-40-50, which are summarized in Section 8.4.2.1.

## 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 on the next page 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 at 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 at 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 at 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 is further elaborated on at 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.

# Chapter 6: Recognition and measurement of credit losses on financial assets measured at amortized cost and off-balance-sheet credit exposures

## 6.0 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.
  - 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) 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.

| **HTM debt securities** | |
|---|---|
| **Preexisting guidance (ASC 320-10-35)** | **ASC 326-20** |
| 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 | 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. |

| HTM debt securities | |
|---|---|
| **Preexisting guidance (ASC 320-10-35)** | **ASC 326-20** |
| 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 more likely than not 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. | 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. |
| 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. |

| Loans and commitments to lend | |
|---|---|
| **Preexisting guidance (ASC 320-10-35, ASC 450-20)** | **ASC 326-20** |
| 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 other factors indicating a loss was not probable. | Loans and commitments to lend are required to be evaluated on a collective basis when similar risk characteristics exist. For reasons elaborated on 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 adjusted for estimated costs to sell, if appropriate) exceeds the financial asset’s amortized cost basis at the measurement date. |

| Trade and other receivables (including contract assets) | |
|---|---|
| **Preexisting guidance (ASC 450-20, ASC 310-10-35)** | **ASC 326-20** |
| 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. | 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. |
| **Purchased or acquired financial assets** | |
| **Preexisting guidance (ASC 310-30, ASC 805)** | **ASC 326-20, ASC 805** |
| 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. | 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.<br><br>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. |

## 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[10]
- 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

[10] 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

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.[11]

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 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 specifically mentioned in ASC 326-20 include the following:

- DCF
- Loss-rate
- Roll-rate
- Probability-of-default
- Aging schedule

[11] 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.

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 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 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.

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.[12]

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

[12] 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.

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.

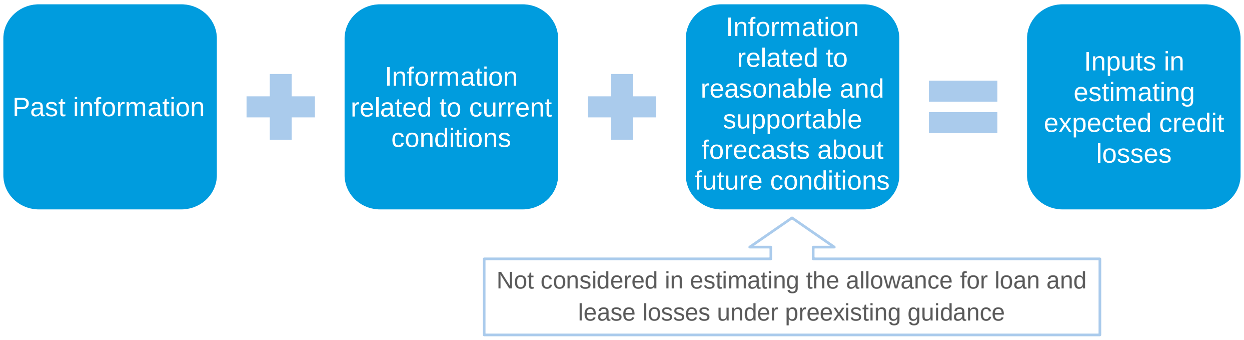
It is clear that a DCF method is not a requirement of ASC 326-20; however, if one is used to estimate expected credit losses, projected cash flows should be discounted based on the asset's effective interest rate (or for net investments in leases, the discount rate used in measuring the lease receivable), and the allowance should reflect the difference between the amortized cost basis of the asset and the present value of expected cash flows. ASC 326-20-30-4A 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.[13] 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 an interest rate that varies based on an independent factor (e.g., LIBOR), ASC 326-20-30-4 indicates that the effective rate used to discount expected cash flows should be calculated based on the factor as it changes over the life of the financial asset. However, an entity is permitted to project changes in the factor for purposes of estimating expected future cash flows, and if the entity chooses to do so, the same projections should be used to determine the effective 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.

## 6.4 Requirement to consider past events, current conditions and reasonable and supportable forecasts

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.

[13] As noted in ASC 326-20-30-4A, the effective interest rate for a TDR should not be adjusted because of subsequent changes in expected timing of cash flows.




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 6-1: 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 6-2: 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.[14]

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.

**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. The following viewpoints were expressed by SEC staff member Kevin L. Vaughn in a speech he gave at the 2018 AICPA Conference on Current SEC and PCAOB Developments, which pertain to information received after the balance-sheet date, but before the financial statements are issued that is significantly different from management's expectations:

- Loan-specific information about factual conditions that existed at the balance-sheet date should be recognized. Specific examples include a servicer report that showed delinquencies and prepayments that occurred on or before the balance-sheet date and the receipt of an appraisal that showed information about the fair value of loan collateral as of the balance-sheet date.
- Information relating to forecasting assumptions that are used in establishing expected credit losses that is received before the estimation process is complete may be included in the estimate. If the information is indicative of a weakness or deficiency in the registrant's estimation process, it should be recognized regardless of whether it is received before or after the estimation process is complete.

It was noted that consideration should be given to materiality and the specific facts and circumstances. Information not recognized may warrant disclosure as a subsequent event.

## 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:

[14] The AICPA's Credit Losses 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.

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 320, including TDRs that under preexisting guidance were evaluated individually. Example 17 in ASC 326-20-55 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.

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 in ASC 326-20-55.

## 6.6 Determining the contractual term of the asset

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 the entity has a reasonable expectation at the reporting date that it will execute a TDR with the borrower, or there are extension or renewal options 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). 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.

### 6.7 Consider expected risk of credit loss even if the risk is remote

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 applies 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.

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 6-3: Estimating expected credit losses using a loss-rate approach (collective evaluation) (from 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 6-4: Estimating expected credit losses using a loss-rate approach (individual evaluation) (from 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 6-5: Estimating expected credit losses on a vintage-year basis (from 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 | | | | | |
|---|---|---|---|---|---|---|
| | Year 1 | Year 2 | Year 3 | Year 4 | Total | Expected |
| 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 6-6: Estimating expected credit losses for trade receivables using an aging schedule (from 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, as a practical expedient, 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. 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. 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.

Examples 6 and 7 in ASC 326-20-55 illustrate the application of both practical expedients.

## 6.10 Credit enhancements

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 Troubled debt restructurings (TDRs)

The identification of, and accounting for, TDRs is addressed in Section 5.5. The allowance for TDRs should be measured consistent with the overall guidance of this chapter and take into consideration the impact of any economic concessions brought about by the restructuring. Given that a TDR is a continuation of the original loan, if a DCF method is used in estimating the allowance for credit losses, the original effective rate should be used as the discount rate rather than the post-restructuring rate.

At its September 6, 2017 meeting, the FASB addressed various questions associated with the recognition of credit losses on TDRs and made the following decisions:

- When a loan is individually identified as a reasonably expected TDR, all effects of the TDR should be reflected in the allowance for credit losses.
- A DCF (or reconcilable) method must be used if the TDR involves a concession that can only be captured using a DCF method.
- If an entity uses a DCF method to measure credit losses on a performing loan portfolio, any effects of TDRs that are incremental to what is embedded in the historical loss information should not be incorporated as an input to the DCF method until a TDR is individually identified. However, if certain effects of TDRs are embedded in the historical loss information, adjustments may be made to account for differences between historical TDR activity and reasonable and supportable forecasts of future TDR activity.

The FASB staff also noted that these decisions have no effect on the timing of when TDRs should be reflected in the applicable disclosures, which will continue to be at the time of execution.

The transition provisions in ASC 326-10-65-1 permit entities that use a DCF method when measuring expected credit losses on TDRs and adjust the effective interest rate used to discount expected cash flows for expected prepayments to make an accounting policy election to calculate the prepayment-adjusted effective interest rate using prepayment assumptions as of the date of adoption rather than calculating the prepayment-adjusted effective interest rate for each TDR using prepayment assumptions as of the date preceding the loan's restructure.

## 6.12 Off-balance-sheet credit exposures

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 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.

**Spotlight: Interplay of ASC 460 and ASC 360-20**

Guarantees that are within both the scope of ASC 460 and ASC 360-20 (i.e., those that create off-balance-sheet credit exposure) 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.

## 6.13 Purchased financial assets with credit deterioration

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 at 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.[15]

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, it may be useful to refer to Example 11 in ASC 326-20-55-57 to 55-60, which 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.

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, 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.

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[15] 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.

**Example 6-7: Recognizing purchased financial assets with credit deterioration (from 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 6-8: Using a loss-rate approach for determining expected credit losses and the discount rate on a purchased financial asset with credit deterioration (from ASC 326-20-55-66 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 | - |
| **Totals** | | **$5,934,910** | **$934,910** | **$5,000,000** | |

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 [(a)]** | **Total Payment [(b)]** | **Writeoff [(c)]** | **Accrued Interest [(d)]** | **Reduction [(e)]** | **Ending Balance [(f)]** |
| 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 | - |
| **Totals** | | **$2,156,344** | **$217,620** | **$237,785** | **$2,136,179** | |

[(a)] 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.

[(b)] 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 6-9: Using a DCF approach for determining expected credit losses and the discount rate on a purchased financial asset with credit deterioration (from ASC 326-20-55-74 to 55-78)**

The following example uses the same assumptions as those in Example 6-8:

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 [a] | Total Payment [b] | Writeoff [c] | Accrued Interest [d] | Reduction [e] | Ending Balance [f] |
| 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 | - |
| **Totals** | | **$2,156,344** | **$217,620** | **$270,393** | **$2,103,571** | |

[a] 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.

[b] 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 8.46 percent (as determined in accordance with paragraph 326-20-55-74).

[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 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 | (a) |
| Less, writeoffs | - | |
| Ending allowance for credit losses (Year 4) | 200,655 | |
| Plus, credit loss expense | 16,965 | (a) |
| Less, writeoffs | (217,620) | (b) |
| Ending allowance for credit losses (Year 5) | $ - | |

[a] 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.

[b] 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 6-10: Determining the negative allowance for purchased financial assets with credit deterioration with no change in credit conditions (from ASC 326-20-55-86 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 6-11: Determining the negative allowance for purchased financial assets with credit deterioration after a change in credit conditions (from ASC 326-20-55-90)**

The following example uses the same assumptions as those in Example 6-10:

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 |

### 6.14 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.

### 6.15 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.

### 6.16 Writeoffs and recoveries of financial assets

Writeoffs of full or partial financial assets should be recorded as a deduction from the allowance in the period in which the financial asset is deemed uncollectible. 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. The accounting for writeoffs and recoveries is illustrated in the following example. Refer also to Examples 6-7 to 6-11 within section 6.13, which are relevant to PCD assets.

**Example 6-12: Recognizing writeoffs and recoveries (from 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.

# Chapter 7: Fair value option

## 7.0 Summary of key changes

- The issuance of ASU 2016-01 impacted the accounting for financial liabilities for which an election was made to account for the liabilities at fair value. Specifically, rather than recognizing all changes in fair value through net income, ASU 2016-01 requires the change in the fair value of the liability that results from a change in the instrument-specific credit risk to be recognized in OCI.
- An irrevocable fair value election can be made for certain assets upon the adoption of ASC 326.
- Refer to Chapter 1 for effective date and transition considerations.

## 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. In other words, 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.

As noted in ASC 815-15-25-6, there is a lengthy list of instruments at ASC 825-10-50-8 that are not eligible for this election, which includes (in part) investments accounted for under the equity method, noncontrolling interests and equity investments in consolidated subsidiaries, and equity instruments that are issued by the entity and classified in stockholders' equity.

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.

**Spotlight: 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 at 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 470-20that 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 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 pointed out 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 at 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 at 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. Consideration should be given to regulatory guidance and industry practice when establishing relevant accounting policies. As is evident from 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.

### 7.3.1 Application to financial liabilities

Upon the adoption of ASU 2016-01, 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.

> **Spotlight: 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 counter-intuitive 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.

> **Spotlight: 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 SIFMA 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.

# Chapter 8: Presentation and disclosure considerations

## 8.0 Summary of key changes

- Upon the adoption of ASU 2016-01:
  - Private companies are no longer required to disclose the fair value of financial instruments that are measured at amortized cost. PBEs remain subject to this disclosure requirement, and the fair value measurements are required to be determined based on the exit price. However, PBEs are no longer required to disclose the methods and significant assumptions used to estimate the fair value of financial instruments that are measured at amortized cost.
  - Separate presentation of financial assets by measurement category and form is required, either on the balance sheet or in the notes to the financial statements.
  - Cash flows from equity securities should be classified based on the nature and purpose for which the securities were acquired.
- 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 high-level 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.

### 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 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 at ASC 310-10-S99-2 and at 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.

### 8.2.2 Debt securities

ASC 320-10-45 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.

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.

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.

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.

### 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 nonfair-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.

## 8.3 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 at 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 investment or sell).

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 is pointed out at 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.

## 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 some of 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
- The amount of the allowance for credit losses
- Unamortized amounts of unearned income, deferred fees and costs and premiums and discounts
- Major categories of loans and trade receivables if not separately presented in the balance sheet

Reference should be made to Section 8.4.5 for disclosure requirements associated with the allowance for credit losses.

#### 8.4.2.1 Troubled debt restructurings

ASC 310-10-50 contains required disclosures about the nature and financial effect of modifications associated with TDRs, including their impact on the allowance for credit losses. Reference should be made to ASC 310-10-50-31 to 50-34 for the specific requirements and their scope. The following illustration is provided at ASC 310-10-55-12.

The following table illustrates certain of the disclosures required by paragraphs 310-10-50-33 through 50-34:

| **Modifications<br>As of December 31, 20X1, and 20X0** | | | | | | |
|---|---|---|---|---|---|---|
| | **20X1** | | | **20X0** | | |
| | **Number of Contracts** | **Pre-Modification Outstanding Recorded Investment** | **Post-Modification Outstanding Recorded Investment** | **Number of Contracts** | **Pre-Modification Outstanding Recorded Investment** | **Post-Modification Outstanding Recorded Investment** |
| Troubled Debt Restructurings | | | | | | |
| Residential—prime | XXX | $XX,XXX | $XX,XXX | XXX | $XX,XXX | $XX,XXX |
| Residential—subprime | XXX | XX,XXX | XX,XXX | XXX | XX,XXX | XX,XXX |
| Consumer—other | XXX | XX,XXX | XX,XXX | XXX | XX,XXX | XX,XXX |
| Finance leases | XXX | XX,XXX | XX,XXX | XXX | XX,XXX | XX,XXX |
| | **Number of Contracts** | **Recorded Investment** | | **Number of Contracts** | **Recorded Investment** | |
| Troubled Debt Restructurings That Subsequently Defaulted | | | | | | |
| Troubled debt restructurings: | | | | | | |
| Residential—prime | XXX | $XX,XXX | | XXX | $XX,XXX | |
| Residential—subprime | XXX | XX,XXX | | XXX | XX,XXX | |
| Consumer—other | XXX | XX,XXX | | XXX | XX,XXX | |
| Finance leases | XXX | XX,XXX | | XXX | XX,XXX | |

ASC 310-40-50 requires disclosure of any commitments to lend additional funds to debtors owing receivables under terms that have been modified in a TDR. It also provides guidance on how to apply the allowance for credit losses related disclosure requirements in ASC 326-20-50 (discussed in Section 8.4.5) when a loan is restructured into two or more loans as part of a TDR. Namely, the restructured loans should be separately considered when assessing the applicability of these requirements, and the creditor would continue to measure credit losses based on the contractual terms of the original loan agreement.

### 8.4.3 Debt securities

ASC 320-10-50 contains the disclosure requirements for debt securities. Certain disclosures are required to be made by major security type and classification as AFS and HTM, including information about amortized cost, fair value, allowance for credit losses, gross holding gains and losses and contractual maturities. 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. With the issuance of ASU 2019-04, entities that are not PBEs are not required to disclose the fair value and unrecognized holding gains and losses on HTM securities.

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.

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

g. Commercial mortgage-backed securities

h. Collateralized debt obligations

i. 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.

ASC 320-10-50 also contains disclosure requirements related to sales and transfers of securities and trading gains and losses on trading securities that continue to be held on the reporting date.

Reference should be made to Section 8.4.5 for disclosure requirements associated with the allowance for credit losses.

### 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. The carrying amount of equity securities that are measured in accordance with ASC 321-10-35-2, is required to be disclosed, as well as the amount of annual and cumulative impairments that were recognized, downward and upward adjustments to the carrying amount and narrative discussion about the information considered in arriving at the adjustments due to observable price changes.

### 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 at 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 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 from ASC 326-20-55-80 is on the next page.

**Example 8-1: Disclosing past-due status (from ASC 326-20-55-80)**

The following table illustrates certain of the disclosures in paragraph 326-20-50-14 by class of financing receivable.

| | Age Analysis of Past-Due Financial Assets As of December 31, 20X5, and 20X4 Past Due | | | | | | |
|---|---|---|---|---|---|---|---|
| | 30–59 Days | 60–89 Days | Greater Than 90 Days | Total | Current | Total | Amortized Cost > 90 Days and Accruing |
| **20X5** | | | | | | | |
| 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 |
| **20X4:** | | | | | | | |
| 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 at 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.

#### 8.4.5.4 Year of origination (vintage)

ASC 326-20-50-6 requires disclosure of the amortized cost basis of financing receivables and net investment in leases within its scope to be presented within each credit quality indicator by year of origination (i.e., vintage year).[16] Disaggregation by year of origination is optional for entities that are not PBEs. An example of this disclosure from ASC 326-20-55-79 begins on the next page. Reference should be made to ASC 326-20-50-5 to 50-9 for the text of the requirement and its applicability.

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[16] 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.

**Example 8-2: Disclosing credit quality indicators of financing receivables by amortized cost basis (from 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.

| | Term Loans Amortized Cost Basis by Origination Year | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **As of December 31, 20X5** | **20X5** | **20X4** | **20X3** | **20X2** | **20X1** | **Prior** | **Revolving Loans Amortized Cost Basis** | **Revolving Loans Converted to Term Loans Amortized Cost Basis** | **Total** |
| **Residential mortgage:** | | | | | | | | | |
| Risk rating: | | | | | | | | | |
| 1–2 internal grade | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| 3–4 internal grade | - | - | - | - | - | - | - | - | - |
| 5 internal grade | - | - | - | - | - | - | - | - | - |
| 6 internal grade | - | - | - | - | - | - | - | - | - |
| 7 internal grade | - | - | - | - | - | - | - | - | - |
| **Total residential mortgage loans** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Residential mortgage loans:** | | | | | | | | | |
| Current-period gross writeoffs | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Current-period recoveries | - | - | - | - | - | - | - | - | - |
| **Current-period net writeoffs** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Consumer:** | | | | | | | | | |
| Risk rating: | | | | | | | | | |
| 1–2 internal grade | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| 3–4 internal grade | - | - | - | - | - | - | - | - | - |
| 5 internal grade | - | - | - | - | - | - | - | - | - |
| 6 internal grade | - | - | - | - | - | - | - | - | - |
| 7 internal grade | - | - | - | - | - | - | - | - | - |
| **Total consumer** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Consumer loans:** | | | | | | | | | |
| Current-period gross writeoffs | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Current-period recoveries | - | - | - | - | - | - | - | - | - |
| **Current-period net writeoffs** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |

| 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 | | | |
| **Commercial business:** | | | | | | | | | |
| Risk rating: | | | | | | | | | |
| 1–2 internal grade | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| 3–4 internal grade | - | - | - | - | - | - | - | - | - |
| 5 internal grade | - | - | - | - | - | - | - | - | - |
| 6 internal grade | - | - | - | - | - | - | - | - | - |
| 7 internal grade | - | - | - | - | - | - | - | - | - |
| **Total commercial business** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Commercial business loans:** | | | | | | | | | |
| Current-period gross writeoffs | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Current-period recoveries | - | - | - | - | - | - | - | - | - |
| **Current-period net writeoffs** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Commercial mortgage:** | | | | | | | | | |
| Risk rating: | | | | | | | | | |
| 1–2 internal grade | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| 3–4 internal grade | - | - | - | - | - | - | - | - | - |
| 5 internal grade | - | - | - | - | - | - | - | - | - |
| 6 internal grade | - | - | - | - | - | - | - | - | - |
| 7 internal grade | - | - | - | - | - | - | - | - | - |
| **Total commercial mortgage** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| **Commercial mortgage loans:** | | | | | | | | | |
| Current-period gross writeoffs | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Current-period recoveries | - | - | - | - | - | - | - | - | - |
| **Current-period net writeoffs** | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ - |

Points to keep in mind when preparing this disclosure include:

- 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 35-12 (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.
- 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.
- While this example includes disclosure of gross writeoffs and recoveries by year of origination, ASC 326-20-50 does not require the disaggregation of writeoffs and recoveries in this manner. At its April 3, 2019 meeting, the FASB directed its staff to conduct additional outreach and research on the costs and benefits of disclosing gross writeoffs and gross recoveries in this disclosure table.
- 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.

#### 8.4.5.5 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. 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 |
|---|---|---|
| **Accrued interest disclosures** | | |
| • 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<br>• 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<br>• 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 | Not applicable unless specifically noted | None |

| Summary of disclosure requirements | Level of disaggregation | Additional scope considerations |
|---|---|---|
| of financing receivable or major security type<br>• 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 | | |
| **Credit quality information** | | |
| Amortized cost basis by credit quality indicator (CQI), with description of CQI, date or range of dates in which CQI information was last updated and, if internal risk ratings are used, qualitative information on how the internal risk ratings relate to the likelihood of loss | • Class of financing receivable and year of origination for financing receivables and net investments in leases other than those noted in the next bullet point[17]<br>• Class of financing receivable for reinsurance receivables and line-of-credit arrangements<br>• Major security type for debt securities | Receivables measured at lower of amortized cost or fair value, certain trade receivables due in one year or less, repurchase agreements, securities lending arrangements and off-balance-sheet commitments are excluded from this requirement.<br>Entities who are not PBEs are not required to present amortized cost basis by year of origination. |
| **Allowance for credit losses** | | |
| • A description of how expected loss estimates are developed<br>• 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 | Portfolio segment and major security type | Off-balance-sheet commitments are excluded from these requirements. |

[17] 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 |
|---|---|---|
| reasonable and supportable forecasts about the future<br>• Risk characteristics relevant to each portfolio segment<br>• Changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes<br>• Changes to accounting policies in accordance with ASC 250-10,changes to the methodology from the prior period and the rationale for those changes<br>• Reasons for significant changes in the amount of writeoffs, if applicable<br>• The reversion method applied for periods beyond the reasonable and supportable forecast period<br>• The amount of any significant financial assets purchased, sold or reclassified to held for sale during each reporting period | | |
| 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):<br>• Beginning balance<br>• Current-period provision<br>• The initial allowance recognized on purchased financial assets with credit deterioration<br>• Writeoffs<br>• Recoveries collected<br>• Ending balance | Portfolio segment and major security type | Applies to all assets within the scope of ASC 326-20 |

| Summary of disclosure requirements | Level of disaggregation | Additional scope considerations |
|---|---|---|
| **Past-due status** | | |
| Aging analysis of amortized cost basis of past-due financial assets 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. |
| **Nonaccrual status** | | |
| Quantitative disclosure of:<br>• Amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period<br>• Interest income recognized during the reporting period on nonaccrual financial assets<br>• 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<br>• Amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses as of the reporting date<br>Accounting policies related to:<br>• Discontinuing and resuming accrual of interest and for recording payments received on nonaccrual assets<br>• Determining past-due or delinquency status<br>• Recognizing writeoffs within the allowance for credit losses | 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. |
| **PCD assets** | | |
| Reconciliation of the difference between the purchase price and par value of the financial assets, including: | None required | Applies to purchases of financial assets with credit deterioration occurring during the reporting period |

| Summary of disclosure requirements | Level of disaggregation | Additional scope considerations |
|---|---|---|
| • Purchase price<br>• Allowance for credit losses at the acquisition date based on the acquirer's assessment<br>• Discount (or premium) attributable to other factors<br>• Par value | | |
| **Collateral-dependent financial assets** | | |
| 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 |
| **Off-balance-sheet credit exposures** | | |
| 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 |

#### 8.4.5.6 Allowance disclosures relevant to AFS debt securities

A summary of the disclosure requirements of ASC 326-30, which are applicable to AFS debt securities, is provided in the chart that follows. 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 |
|---|---|---|
| **Accrued interest disclosures** | | |
| • If an accounting policy election is made to present accrued interest within another balance sheet-line item (e.g., other assets), its | Not applicable unless specifically noted | None |

| Summary of disclosure requirements | Level of disaggregation | Additional scope considerations |
|---|---|---|
| carrying amount (net of any allowance for credit losses) and the line item in which that amount is presented<br>• 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 the amortized cost basis disclosures that follow, the total amount of excluded accrued interest, net of any allowance for credit losses<br>• 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<br>• 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. | | |
| **Securities in unrealized loss positions without an allowance for credit losses** | | |
| Quantitative information in tabular form of the aggregate fair value of investments with unrealized losses and the aggregate amount of unrealized losses | 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) | Applies to AFS debt securities that are in an unrealized loss position for which an allowance for credit losses has not been recorded |
| Narrative form discussion (to supplement the required quantitative disclosures) about the information considered in reaching the conclusion that an allowance for credit losses is | The disclosures may be aggregated by investment categories, with the exception of individually significant unrealized losses. | Applies to AFS debt securities that are in an unrealized loss position for which an allowance for credit losses has not been recorded |

| Summary of disclosure requirements | Level of disaggregation | Additional scope considerations |
|---|---|---|
| unnecessary (a detailed list of potential content for this discussion is included in ASC 326-30-50-4) | | |
| **Allowance for credit losses** | | |
| Methodology and significant inputs used to measure credit losses and the accounting policy for recognizing writeoffs | 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 |
| **Purchased financial assets with credit deterioration** | | |
| Reconciliation of the difference between the purchase price and par value of the financial assets, including:<br>• Purchase price<br>• Allowance for credit losses at the acquisition date based on the acquirer's assessment<br>• Discount (or premium) attributable to other factors<br>• Par value | None required | Applies to purchases of financial assets with credit deterioration occurring during the reporting period |

The following examples from ASC 326-30-55-8 and 55-9 illustrate the required disclosures for AFS debt securities in an unrealized loss position with no credit losses reported.

**Example 8-3: Disclosures about investments in AFS debt securities in an unrealized loss position with no credit losses reported (from 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.

| | Less Than 12 Months | | 12 Months or Greater | | Total | |
|---|---|---|---|---|---|---|
| Description of Securities | 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 |
| CUSIP | Committee on Uniform Security Identification Procedures |
| 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 |
| OTTI | Other-than-temporary impairment |
| PBE | Public business entity |
| PCAOB | Public Company Accounting Oversight Board |
| PCD | Purchased with credit deterioration |
| SEC | Securities and Exchange Commission |
| SOFR | Secured Overnight Financing Rate |
| SIFMA | Securities Industry and Financial Markets Association |
| TDR | Troubled debt restructuring |
| TRG | Transition Resource Group |

## 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 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. |
| 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:<br>a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through<br>b. Premiums due to guarantors<br>c. Commercial paper obligations<br>d. Residual interests, whether in the form of debt or equity. |
| 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. |
| Class of financing receivable | A group of financing receivables determined on the basis of both of the following:<br>a. Risk characteristics of the financing receivable<br>b. An entity's method for monitoring and assessing credit risk. |
| Contract asset | 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). |
| Credit quality indicator | A statistic about the credit quality of a financial asset. |
| Debt security | Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:<br>a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor<br>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<br>c. U.S. Treasury securities<br>d. U.S. government agency securities |

| Term | Definition in the Master Glossary of the ASC |
|---|---|
| | e. Municipal securities<br>f. Corporate bonds<br>g. Convertible debt<br>h. Commercial paper<br>i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits<br>j. Interest-only and principal-only strips.<br>The term debt security excludes all of the following:<br>a. Option contracts<br>b. Financial futures contracts<br>c. Forward contracts<br>d. Lease contracts<br>e. Receivables that do not meet the definition of *security* and, so, are not debt securities, for example:<br>1. Trade accounts receivable arising from sales on credit by industrial or commercial entities<br>2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions |
| Direct loan origination costs | Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:<br>a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan<br>b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:<br>1. Evaluating the prospective borrower's financial condition<br>2. Evaluating and recording guarantees, collateral, and other security arrangements<br>3. Negotiating loan terms<br>4. Preparing and processing loan documents<br>5. Closing the transaction.<br>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. |
| Discount | The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. See *premium*. |
| Effective interest rate | 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 |

| Term | Definition in the Master Glossary of the ASC |
|---|---|
| | 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. |
| Equity security | 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:<br>a. Written equity options (because they represent obligations of the writer, not investments)<br>b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)<br>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. |
| 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:<br>a. Receive cash or another financial instrument from a second entity<br>b. Exchange other financial instruments on potentially favorable terms with the second entity. |
| Financing receivable | A financing arrangement that has both of the following characteristics:<br>a. It represents a contractual right to receive money in either of the following ways:<br>1. On demand<br>2. On fixed or determinable dates.<br>b. It is recognized as an asset in the entity's statement of financial position.<br>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). |
| Freestanding contract | A freestanding contract is entered into either:<br>a. Separate and apart from any of the entity's other financial instruments or equity transactions<br>b. In conjunction with some other transaction and is legally detachable and separately exercisable. |
| 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. |

| Term | Definition in the Master Glossary of the ASC |
|---|---|
| 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. |
| 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 | 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:<br>a. Revolving (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)<br>b. Nonrevolving (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).<br>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. |
| Loan origination fees | Origination fees consist of all of the following:<br>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)<br>b. Fees to reimburse the lender for origination activities<br>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)<br>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)<br>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, |

| Term | Definition in the Master Glossary of the ASC |
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| | 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. |
| Mortgage-backed securities | 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. |
| Orderly transaction | 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). |
| Portfolio segment | 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. |
| Premium | The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See discount. |
| Purchased financial assets with credit deterioration | 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. |
| Readily determinable fair value | An equity security has a readily determinable fair value if it meets any of the following conditions:<br>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.<br>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.<br>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 |

| Term | Definition in the Master Glossary of the ASC |
|---|---|
| | venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions. |
| Recorded investment | 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. |
| Reinsurance recoverable | 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. |
| Security | 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:<br>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.<br>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.<br>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. |
| Standby letter of credit | 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:<br>a. To repay money borrowed by or advanced to or for the account of the account party<br>b. To make payment on account of any evidence of indebtedness undertaken by the account party<br>c. To make payment on account of any default by the account party in the performance of an obligation.<br>A standby letter of credit would not include the following:<br>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<br>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. |
| Structured note | 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 |

| Term | Definition in the Master Glossary of the ASC |
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| | 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. |
| 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. |

### 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 |
| 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 |
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| 350 | Intangibles—Goodwill and Other |
| 450-20 | Contingencies – Loss Contingencies |
| 460 | Guarantees |
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| 470-50 | Debt – Modifications and Extinguishments |
| 470-60 | Debt – Troubled Debt Restructurings by Debtors |

| ASC topic or subtopic | Title |
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| 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 |
| 835-20 | Interest – Capitalization of Interest |
| 835-30 | Interest – Imputation of Interest |
| 840-10 | Leases – Overall |
| 842 | Leases |
| 842-10 | Leases – Overall |
| 842-30 | Leases – Lessor |
| 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 |

| ASC topic or subtopic | Title |
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| 944-325 | Financial Services—Insurance – Investments—Other |
| 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 |
| 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 2016-01 | Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities |
| ASU 2016-13 | Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments |
| ASU 2017-08 | Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities |
| ASU 2018-03 | Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities |

| Other literature | Title |
|---|---|
| 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 |
| Credit Losses AAG | AICPA's Audit and Accounting Guide, *Credit Losses* |
| IAS 28 | Investments in Associates and Joint Ventures |
| IFRS 9 | Financial Instruments (July 2014) |

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