FASB EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: September 22, 2016
Comments Due: November 28, 2016

Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20)

Premium Amortization on Purchased Callable Debt Securities

The Board issued this Exposure Draft to solicit public comment on proposed changes to Subtopic 310-20 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to "Technical Director, File Reference No. 2016-340, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Financial Accounting Standards Board

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until November 28, 2016. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing comments to director@fasb.org, File Reference No. 2016-340
- Sending a letter to "Technical Director, File Reference No. 2016-340, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Proposed Accounting Standards Update

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Premium Amortization on Purchased Callable Debt Securities

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The Board is issuing this proposed Update to amend the amortization period for callable debt securities purchased at a premium. The Board is proposing to shorten the amortization period for the premium to the earliest call date. Under current generally accepted accounting principles (GAAP), entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument.

Stakeholders have raised concerns that current GAAP excludes callable debt securities from consideration of early repayment of principal even if the holder is certain that the call will be exercised. As a result, upon the exercise of a call on a callable debt security purchased at a premium, the unamortized premium is recorded as a loss in earnings. Additionally, stakeholders have told the Board that there is diversity in practice (1) in the amortization period for premiums of callable debt securities and (2) in how the potential for exercise of a call is factored into current impairment assessments.

Stakeholders have noted that generally, in the United States, callable debt securities are quoted, priced, and traded assuming a model that incorporates consideration of calls (also referred to as “yield-to-worst” pricing). The Board also heard from financial statement users that the amendment to the amortization period in this proposed Update would provide more decision-useful information because it would align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would affect all entities that purchase callable debt securities at a premium.

What Are the Main Provisions?

The amendments in this proposed Update would shorten the amortization period for callable debt securities purchased at a premium. Specifically, the proposed amendments would require the premium to be amortized to the earliest call date. The proposed amendments would not require an accounting change for securities purchased at a discount; the discount would continue to be amortized to maturity.

How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

Under current GAAP, premiums and discounts on callable debt securities generally are amortized to the maturity date. An entity must have a large number of similar loans to consider estimates of future principal prepayments when applying the interest method. However, an entity that purchases an individual callable debt security at a premium may not amortize that premium to the earliest call date. If that callable debt security is subsequently called, the entity would record a loss equal to the unamortized premium.

The amendments in this proposed Update would require that an entity amortize the premium to the earliest call date. The proposed amendments would not require an accounting change associated with callable debt securities purchased at a discount; an entity would continue to amortize to the maturity date the discount associated with the purchase of a callable debt security.

This approach would more closely align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities. In most cases, market participants price securities to the call date when the coupon is above current market rates (that is, the security is trading at a premium) and price securities to maturity when the coupon is below market rates (that is, the security is trading at a discount) in anticipation that the borrower will act in its economic best interest. As a result, the proposed approach would more closely align interest income recorded on bonds at a premium or a discount with the economics of the underlying instrument.

When Would the Amendments Be Effective?

An entity would apply the proposed amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified retrospective approach). Additionally, in the period of adoption, an entity would provide disclosures about a change in accounting principle.

The Board will determine the effective date and whether the proposed amendments may be applied before the effective date after it considers stakeholder feedback.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Do you agree that premiums on purchased callable debt securities should be amortized to the earliest call date? Please explain why or why not.

Question 2: How much time would be needed to implement the proposed amendments? Should entities other than public business entities be provided more time? Should early adoption be permitted?

Question 3: Do you agree with the proposed transition method and disclosures in paragraph 310-20-65-1(c)? Please explain why or why not.

Amendments to the *FASB Accounting Standards Codification*®

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table provides a summary of the proposed amendments to the Accounting Standards Codification.

Codification Paragraphs	Action	Description of Changes
310-20-35-33 Receivables—Nonrefundable Fees and Other Costs—Subsequent Measurement	Amended	The proposed amendments would amend the amortization period for premiums on purchased callable debt securities.
310-20-65-1 Transition and Open Effective Date Information	Added	The proposed amendments would provide information about the transition and effective date.
942-320-35-1 Financial Services—Depository and Lending—Investments—Debt and Equity Securities—Subsequent Measurement	Amended	The proposed amendments would amend the amortization period for premiums on purchased callable debt securities.
946-320-35-20 Financial Services—Investment Companies—Investments—Debt and Equity Securities—Subsequent Measurement	Amended	The proposed amendments would clarify that the amortization of premiums and discounts must be in accordance with the guidance in Subtopic 310-20.

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–6. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Subtopic 310-20

3. Amend paragraph 310-20-35-33, with a link to transition paragraph 310-20-65-1, as follows:

[Note: The definition of *Debt Security* is shown for convenience.]

Debt Security (first definition)

Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
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
c. U.S. Treasury securities
d. U.S. government agency securities
e. Municipal securities
f. Corporate bonds
g. Convertible debt
h. Commercial paper
i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
j. Interest-only and principal-only strips.

The term debt security excludes all of the following:

a. Option contracts
b. Financial futures contracts
c. Forward contracts
d. Lease contracts
e. Receivables that do not meet the definition of *security* and, so, are not debt securities (unless they have been securitized, in which case they would meet the definition of a security), for example:
    1. Trade accounts receivable arising from sales on credit by industrial or commercial entities
    2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.

Receivables—Nonrefundable Fees and Other Costs

Subsequent Measurement

> Estimating Principal Prepayments

310-20-35-33 Assuming that an entity purchases an individual callable **debt security** ~~bond~~ at a premium, the premium shall ~~may not~~ be amortized to the earliest call date. After the earliest call date, if the call option is not exercised, the entity shall reset the yield using the payment terms required by the debt security. Under paragraph 310-20-35-26, an entity must have a large number of similar loans in order to consider estimates of future principal prepayments when applying the interest method.

4. Add paragraph 310-20-65-1 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 201X-XX, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*

310-20-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 201X-XX, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities:*

a. The pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those fiscal years, beginning after [date to be inserted after exposure].
b. An entity shall apply the pending content that links to this paragraph through a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period in which the pending content that links to this paragraph is effective.
c. An entity shall provide the disclosures about a change in accounting principle in paragraphs 250-10-50-1 through 50-3 in the period of adoption.

Amendments to Subtopic 942-320

5. Amend paragraph 942-320-35-1, with a link to transition paragraph 310-20-65-1, as follows:

Financial Services—Depository and Lending—Investments—Debt and Equity Securities

Subsequent Measurement

> Amortization or Accretion Period

942-320-35-1 The period of amortization or accretion for debt securities shall generally extend from the purchase date to the maturity date, <u>unless the security was purchased at a premium and is callable. In that case, the amortization period for the premium shall extend from the purchase date to the earliest</u> ~~not an earlier~~ call date.

Amendments to Subtopic 946-320

6. Amend paragraph 946-320-35-20, with a link to transition paragraph 310-20-65-1, as follows:

Financial Services—Investment Companies—Investments—Debt and Equity Securities

Subsequent Measurement

> Premiums and Discounts

946-320-35-20 Premiums and discounts shall be amortized <u>in accordance with the guidance in Subtopic 310-20 on receivables—nonrefundable fees and other costs</u> ~~using the interest method~~.

The amendments in this proposed Update were approved for publication by six members of the Financial Accounting Standards Board. Mr. Siegel voted against publication of the amendments. His alternative view is set out at the end of the basis for conclusions.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Daryl E. Buck
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information, Basis for Conclusions, and Alternative View

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. Under Subtopic 310-20, any difference between the initial investment and the principal amount of a purchased loan or debt security must be recorded as an adjustment of yield over the contractual life of the instrument (in other words, yield to maturity). Paragraph 310-20-35-26 states that prepayments shall not be anticipated in calculating the constant effective yield necessary to apply the interest method for recognizing interest income, except if an entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. In addition to instruments that fall within the scope of paragraph 310-20-35-26, prepayments are considered in estimating the effective yield for financial instruments within the scope of Subtopic 325-40, Investments—Other—Beneficial Interests in Securitized Financial Assets.

BC3. Stakeholders have raised concerns that certain callable debt securities would not meet the requirements necessary under the guidance in paragraph 310-20-35-26 or within Subtopic 325-40 to be able to consider anticipated early repayments in calculating effective yield, even if the holder is certain that the borrower would repurchase the security at the call date. Stakeholders have said that the existing amortization period for premiums on callable debt securities does not reflect the economics of the underlying transactions. Preparers have noted that in the United States pricing quotes for securities are based on a model that incorporates consideration of calls. In most cases, investors price securities to the call date when the coupon is above current market rates (that is, the security is trading at a premium) and price securities to maturity when the coupon is below market rates (that is, the security is trading at a discount) in anticipation that the borrower will act in its economic best interest. As a result, in most cases the proposed approach would better align interest income recorded on bonds at a premium with the economics of the underlying instrument.

BC4. The Board considered whether amortizing premiums to the earliest call date would be appropriate in circumstances in which a security was not called as expected on the purchase date. In that situation, interest income would be lower in the periods before the earliest call date, because of the amortization of the premium, and higher after the earliest call date, because of interest income being reset to the coupon rate. If the security was not called at the earliest call date, it would likely be because of market interest rates rising above the security's coupon rate. Therefore, resetting the interest rate to the coupon rate after the earliest call would reflect the rise in market interest rates. The Board determined that this approach would be appropriate because this outcome would be consistent with the market economics of the security.

Scope

BC5. Stakeholders originally raised concerns about municipal securities, which make up the majority of the callable premium securities market. Municipal issuers typically sell bonds with 30-year maturities and 10-year issuer-par-call options at premium dollar prices often because of investor demand that is driven by tax law. Tax-exempt bonds acquired at a certain discount are subject to ordinary income tax rates on their appreciation back to par, while bonds purchased and disposed of at prices above par are subject to a capital gains rate. Therefore, tax laws incentivize investors to demand that municipalities issue bonds at a premium. Furthermore, absent increases in market interest rates, the effect of the tax laws provides the incentive for municipalities to call the bonds at the earliest call date as a result of issuing bonds at a premium.

BC6. The Board considered whether the scope of the amortization period change should include all callable debt securities or callable municipal securities only. The Board decided that the scope should include all callable debt securities, primarily because it concluded that there is no economic difference between callable municipal securities and other types of callable debt securities when purchased at a premium; therefore, there was no conceptual basis for limiting the scope to only callable municipal securities. Furthermore, the Board believes that this scope will be clearer to users of financial statements and more operable for preparers of financial statements. Both preparers and users indicated that they preferred a scope of all callable debt securities because the accounting would be consistent for similar instruments.

Amortization Period

BC7. In determining the proposed amortization period, the Board considered the cost and complexity of a management expectation model similar to the International Financial Reporting Standards (IFRS) guidance under IFRS 9, *Financial Instruments*. IFRS differs from GAAP in that, under IFRS, prepayment options are factored into the calculation of the effective interest rate in most cases for financial instruments measured at amortized cost. Under IFRS 9, measuring the amortized cost of a financial instrument with prepayment options is based on the notion of the instrument's expected life. Therefore, IFRS 9 requires an entity to estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call, and similar options). However, the Board determined that the increased cost and complexity of this model may not justify the benefits when applied only to callable debt securities.

BC8. Therefore, the Board determined that the proposed premium amortization period to earliest call improves the usefulness of the information provided to users of financial statements while reducing the cost and complexity of the effective interest model. Furthermore, the Board considered the pricing of such securities (based upon a yield-to-worst pricing methodology) and concluded that this approach is more likely to align with the market economics of those securities.

Disclosures

BC9. In addition to amending the amortization period for purchased callable debt securities, the Board considered disclosures that could enhance the transparency of the components that make up interest income on purchased debt securities and loans.

BC10. The Board considered whether to split effective yield into (a) contractual interest and (b) other adjustments or to incorporate a reconciliation of the difference between the purchase price of the financial assets and the par value of the financial assets similar to a disclosure that is required for purchased financial assets with credit deterioration in accordance with Topic 326, Financial Instruments—Credit Losses*.*

BC11. The Board decided not to propose any new interest income disclosures at this time because some Board members believe that they do not presently have sufficient information to conclude whether the proposed disclosures would continue to be relevant after Topic 326 is adopted. The guidance in Topic 326 would prevent the credit discount from affecting interest income specifically for purchased financial assets with credit deterioration. Also, other Board members wanted to ensure that the disclosure requirements captured the necessary elements that would be useful to users of financial statements. Accordingly, any further disclosure considerations would be made as a part of preagenda research.

Benefits and Costs

BC12. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC13. The Board does not anticipate that entities will incur significant costs as a result of the amendments in this proposed Update. The proposed amendments would not require the use of new methodologies or information that is not already available, because current pricing methodologies already consider call information. The Board believes that the proposed amendments to the amortization period for debt securities purchased at a premium would provide better information to users of financial statements. Similarly, preparers have indicated a preference for the change to financial reporting, noting that it is similar to the pricing methodology employed by market participants and regulators. In addition, preparers noted that because amortized cost and fair value of a callable debt security would be better aligned, the potential for accounting outcomes to influence an investor's economic decisions about whether to hold or sell a security would be reduced.

Effective Date and Transition

BC14. The Board decided that the amendments in this proposed Update should be applied through a modified-retrospective transition approach that would require a cumulative-effect adjustment to the opening retained earnings in the statement of financial position as of the date of adoption. Acknowledging the practicability concerns of full retrospective application, the Board decided that this transition would allow an entity to use the same basis of accounting for all purchased callable debt securities. Additionally, in the period of adoption, an entity would provide disclosures about a change in accounting principle.

BC15. The Board will decide on the effective date after it considers stakeholders' feedback on how much time they believe would be necessary to adopt the proposed amendments.

Alternative View

BC16. Mr. Siegel does not support the amendments in this proposed Update because he believes that they fail to address the original objective of the project to provide additional disclosures about interest income on purchased debt securities and loans. Mr. Siegel's concern is further heightened because the Board also decided to remove from its technical agenda any further consideration of these disclosures, thereby failing to address a challenge that many financial statement users face in comparing interest income and the sufficiency of the allowance for loan losses of purchased debt securities and loans with interest income and the allowance for other instruments.

BC17. Mr. Siegel agrees with the amendments in this proposed Update about the premium amortization on purchased callable debt securities. However, he believes that the Board has squandered an opportunity to address issues raised by many investors, including several members of the FASB's Investor Advisory Committee, who agreed with the project objective when it was added to the technical agenda. The original project objective was "to enhance the transparency and usefulness of the information provided in the notes to the financial statements about interest income on purchased debt securities and loans." On September 16, 2015, the Board expanded the scope of the project to consider targeted improvements about the accounting for the amortization of premiums for purchased callable debt securities but did not remove the objective related to transparency of interest income on purchased debt securities and loans. While the proposed amendments address the premium amortization issue that was added to the project's scope in September 2015, Mr. Siegel's concern is that the original project objective has not been resolved and is no longer on the technical agenda.

BC18. Mr. Siegel notes that in many forums over the last several years, including multiple meetings of the Investor Advisory Committee, investors have raised concerns about the effect on financial statement trends of purchasing material amounts of financial assets that are not within the scope of Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality. Historical trends of important ratios such as the loan allowance to gross loan ratio and net interest margin ratio can be significantly affected by large purchases of loan portfolios. Mr. Siegel believes that this concern has been exacerbated with an increasing number of bank consolidations following the financial crisis. Mr. Siegel acknowledges that the recently finalized guidance in Topic 326 allows for the gross up of more-than-insignificant purchase credit discounts, partially addressing the issue of credit discounts flowing through interest income by capturing more purchased financial assets within its scope. However, he remains concerned that interest income will continue to be affected by purchased loans because of the sheer volume of loans with credit discounts that may not qualify for gross-up treatment. Additionally, the earliest time the new guidance in Topic 326 will be applied is 2019.

BC19. Mr. Siegel would have preferred that the proposed amendments address the original problem embedded in the original project objective. To do that in the most cost-effective manner, Mr. Siegel would limit the scope of his suggested disclosure improvements to purchased loans. Those proposed disclosure improvements would have included, at a minimum, a requirement in a period in which an entity purchased loans to disclose a reconciliation of the difference between the purchase price of the loan and the par value of the loan, including (a) the purchase price, (b) the discount (or premium), and (c) the par value. Mr. Siegel notes that an identical reconciliation is required under Topic 326 for purchased financial assets with credit deterioration. Proposing similar requirements for purchased loans that have not experienced credit deterioration would help users with comparing and evaluating interest income and the allowance for loan losses across the loan portfolio and in addressing the initial issue that was embedded in the original project objective. In addition to this reconciliation, Mr. Siegel also would have preferred that the Board propose disclosure of the weighted-average remaining life of the loans. Mr. Siegel believes that those two disclosures could be implemented before the effective date of Topic 326 and that they would be a cost-effective way to help financial statement users understand the effect of the acquired portfolio on trends in the ratio of allowance for loan losses to gross loans as well as the potential effect on future net interest margin.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). We welcome comments on these proposed changes to the Taxonomy through ASU Taxonomy Changes provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the Taxonomy will be made available for public comment at www.fasb.org and finalized as part of the annual release process.