FASB FINANCIAL ACCOUNTING STANDARDS BOARD

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Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post-Issuance**
Issue(s)	**Accrued Interest**

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Memo Purpose

1. Stakeholders have informed the staff of questions on the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, relating specifically to the inclusion of accrued interest in the definition of *amortized cost basis* and the reversal of recognized but uncollected interest on nonperforming financial assets. This memo summarizes implementation questions in this area and provides the staff's analysis of the issues. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG) on these implementation questions.

Question for TRG Members
1. Does the TRG have feedback on the staff's interpretations and recommendations on the issues in this memo?

Background and Description

Accrued Interest

Current Practice

2. Entities accumulate interest earned but not yet collected on financial assets as an accrued interest receivable. Many entities currently present this receivable on the balance sheet in the "Other current assets" line item because the amount is usually immaterial to the balance sheet and would not require separate presentation.[1] Generally, systems that calculate interest income and accrue for amounts not yet collected are separate from the systems that manage credit risk for outstanding loan balances in many sophisticated financial organizations.

Amendments of Update 2016-13

3. In the May 2010 Exposure Draft, the Board proposed calculating interest income by applying the effective interest rate (EIR) (determined based on contractual cash flows and ignoring credit loss expectations) to the loan's amortized cost balance less the associated allowance for credit losses. In the comment letter feedback, respondents overwhelmingly opposed the proposed method of calculating interest income because of the effect it would have on the net interest margin metric. Moreover, users almost universally asserted that they prefer to analyze credit losses separate from net interest margin because it allows them to incorporate their own expectation of credit quality of loans in their projections.

4. Subsequently in redeliberations, the Board decided not to change guidance on interest income recognition, which is calculated as the EIR applied to the amortized cost basis without consideration of a valuation allowance or accrued interest. The Board decided to keep the interest income recognition model and the credit losses model separate because the Board agreed with the feedback that viewing the models separately provided more decision useful information for the users of financial statements. Specifically, the Board noted in paragraph BC99 of the basis for conclusions in Update 2016-13 that "interest income is greater for riskier assets, and seeing an increase in interest income that is not reflected in comparable peers gives users insight into the financial institution's current credit lending practices."

5. Finally, the amendments in Update 2016-13 require entities to present financial assets measured at amortized cost basis at the net amount expected to be collected. To accomplish this presentation, the amendments require the measurement of the allowance for credit losses, which is a valuation account, to be deducted from the amortized costs basis of the financial asset(s). The Master Glossary defines *amortized cost basis* as the following:

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[1] S-X 210.5-02.8 requires that other current assets be stated separately, in the balance sheet or in a note thereto, any amounts in excess of five percent of total current assets.

> The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for *applicable accrued interest*, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments. [Emphasis added.]

Because the amortized cost basis of a financial asset would include the accrued interest on that financial asset, the measurement of an allowance for credit losses on the amortized cost basis of that asset will include an allowance for the applicable accrued interest of the financial asset.

6. The Board explained that the amortized cost basis is the basis for measurement of credit losses in the basis for conclusions as follows:

> BC62. Consistent with the basis for conclusions in FASB Statement No.114, *Accounting by Creditors for Impairment of a Loan*, the Board concluded that a financial asset's effective interest rate should be the rate used to discount expected cash flows when expected credit losses are estimated using a discounted cash flow method. The Board also concluded that the credit loss measurement should reflect only expected credit losses. The Board decided that the credit loss measurement should not reflect changes in market rates of interest, because that would fundamentally change the measurement method from amortized cost. The Board observed that the amortized cost basis of a financial asset is the present value of the contractual future cash inflows**—***both those designated as principal and those as interest***—**discounted at the financial instrument's effective interest rate. Thus, the measurement basis for credit losses will be the same as the measurement basis for the amortized cost basis of the same financial asset. [Emphasis added.]

7. The definition of *amortized cost basis* was refined during the balloting process of Update 2016-13 based on external reviewers' feedback. The Board noted that the following two terms were used before Update 2016-13 to describe the basis for which to calculate an impairment: *amortized cost basis* (used for debt securities) and *recorded investment* (used for loans). *Recorded investment*, as defined in paragraph 310-10-35-24, included accrued interest while the superseded definition of *amortized cost basis* in Subtopic 320-10 did not. Thus, the Board decided to incorporate one term, *amortized cost basis*, for measuring impairment of financial assets (debt securities and loans) under Topic 326 and to refine its definition in the Master Glossary to include applicable accrued interest. Through paragraph BC62, the Board articulated its clear intent to include accrued interest as a contractual future cash inflow from the financial asset. The amount is undiscounted as it is currently due.

Nonaccrual Practices

Current Practice

8. Regulated entities must follow the regulatory instructions regarding the accrual and nonaccrual of interest income. These entities often follow the same regulatory instructions for GAAP financial reporting purposes. The general rule for a loan to be placed on nonaccrual status is as follows:

> General rule—Banks should not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (a) that is maintained on a cash basis because of deterioration in the financial condition of the borrower, (b) for which payment in full of principal or interest is not expected, or (c) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. [2]

9. Additionally, these regulatory instructions provide for the reversal of previously accrued interest when an asset is placed in nonaccrual status, as follows:

> Treatment of previously accrued interest—The reversal of previously accrued but uncollected interest applicable to any asset placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes a reversal of all previously accrued but uncollected interest applicable to assets placed in a nonaccrual status against appropriate income and balance sheet accounts. For example, one acceptable method of accounting for such uncollected interest on a loan placed in nonaccrual status is (1) to reverse all of the unpaid interest by crediting the "accrued interest receivable" account on the balance sheet, (2) to reverse the uncollected interest that has been accrued during the calendar year-to-date by debiting the appropriate "interest and fee income on loans" account on the income statement, and (3) to reverse any uncollected interest that had been accrued during previous calendar years by debiting the "allowance for loan and lease losses" account on the balance sheet. The use of this method presumes that bank management's additions to the allowance through charges to the "provision for loan and lease losses" on the income statement have been based on an evaluation of the collectability of the loan and lease portfolios and the "accrued interest receivable" account.

10. Because many regulated entities follow the regulatory instructions for purposes of GAAP reporting, the current practice for reversing accrued interest is to debit the appropriate interest income line item in the income statement, regardless of whether the interest was accrued in the current period or a prior period. These financial institutions have systems and processes in place that track accrued interest separately from the individual loan balances.

11. Additionally, many nonregulated entities that engage in substantial lending activities have established internal nonaccrual policies that are similar in form to those policies established by the regulatory instructions. These nonaccrual policies may not have the bright line requirements that the regulatory instructions provide pertaining to the number of days in default in order to place loans on nonaccrual status. Instead, they provide more subjective guidelines about when an entity does not expect to collect all of the stated principal or interest amounts. In practice, however, they function similarly to the nonaccrual policies established by the regulatory instructions.

Amendments of Update 2016-13

12. In its December 2012 proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15),* the Board included guidance on when an entity would be required to stop accruing

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[2] Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)—Glossary. The staff notes that there is an exception to the general rule for consumer loans.

interest income on a financial asset and how an entity recognizes cash flows received on a financial asset in which the recognition of interest income has ceased. The purpose of this proposed guidance was to enhance the comparability between regulated and nonregulated entities. However, during redeliberations on Update 2016-13, the Board decided to exclude the proposed nonaccrual guidance from the CECL model. This decision was made based on feedback that nonaccrual practices are well understood in practice and that the application of the proposed guidance would, in fact, create inconsistencies between reporting under GAAP and regulatory instructions because of language differences. Additionally, the addition of nonaccrual guidance was not part of the principal focus of the credit losses project, and, thus, the Board decided to consider adding as pre-agenda research whether GAAP should include nonaccrual guidance.

13. Therefore, none of the regulatory instructions providing the nonaccrual guidance, including guidance on the reversal of accrued interest, were incorporated into GAAP by Update 2016-13. Additionally, the Board stated in paragraph BC99 of the basis for conclusions of Update 2016-13 that it "decided as a result of feedback received that existing nonaccrual practices may continue."

14. However, in Update 2016-13, the Board decided to retain the requirements to write off assets if they are deemed uncollectible. Additionally, the Board included in paragraph 326-20-35-8 that "Writeoffs of financial assets, which may be full or partial writeoffs, shall be *deducted from the allowance*" (emphasis added). As a component of the amortized cost basis of a financial asset, this paragraph requires that the applicable accrued interest on the financial asset be written off in the same manner as the principal or other components of amortized cost basis, that is, through the allowance for credit losses.

Issues Raised in TRG Submission

15. Stakeholders have indicated to the staff through submission of an issues paper to the TRG (the submission) that the inclusion of accrued interest in the definition of amortized cost basis will be operationally burdensome and costly. They state that many loan systems do not track accrued interest amounts on the individual loan level needed for CECL pooling and vintage disclosure requirements. In consideration of these issues, stakeholders asked whether the inclusion of accrued interest in the definition of amortized cost basis is appropriate.

16. Additionally, the submission asserts that a conflict exists between current nonaccrual practices and the amendments of Update 2016-13, specifically the writeoff guidance in paragraph 326-20-35-8, regarding the accounting for previously accrued but unpaid interest applicable to loans placed in nonaccrual status. While the writeoff guidance in Update 2016-13 would require the reversal of that accrued interest through the allowance, current nonaccrual policies specifically allow the reversal of that accrued interest through interest income. The submission states that because most regulated

entities follow the regulatory guidance for nonaccrual assets for GAAP reporting purposes, there is uncertainty about how to account for the reversal of accrued interest moving forward.

17. Through the submission, stakeholders have requested clarification on the reversal of accrued interest applicable to loans placed in nonaccrual status. Specifically, stakeholders have asked where that reversal of accrued interest should be reflected in the statement of operations.

18. In the following paragraphs, the staff will discuss stakeholders' feedback and outreach and the staff's analysis and recommendations separately for the following two issues raised by the submission:

    (a) Issue 1: Inclusion of accrued interest in the definition of amortized cost basis

    (b) Issue 2: Reversal of accrued interest on nonaccrual loans.

Issue 1: Inclusion of Accrued Interest in the Definition of *Amortized Cost Basis*

Feedback and Outreach

19. Stakeholders indicated that systems and processes that are in place to account for accrued interest may be different across various types of financing receivables. However, for the purposes of this memo, the discussion will not detail specific asset types and, instead will focus on the broad application to accrued interest of any financing receivable.

20. Currently, these systems generally do not disaggregate accrued interest amounts to the individual asset level, except for credit card receivables. Preparers asserted that they would need to change their existing systems and controls to begin tracking accrued interest at the individual loan or asset level to follow certain requirements of Update 2016-13 as written. Stakeholders argued that the required changes to their systems would be extensive and that the high operational costs would outweigh the benefits of changing the accounting treatment for a relatively small accrued interest amount compared with the loan balance. The following paragraphs will present these issues categorized by their accounting effect, that is, by measurement, presentation and disclosure.

Measurement

21. First and foremost, under the amendments in Update 2016-13, the estimate of expected credit losses is required to be measured on a pool basis when similar risk characteristics exist between financial assets. If the financial asset no longer exhibits similar risk characteristics with the original pool, an entity must evaluate whether the financial asset has similar risk characteristics with other pools of financial assets. If the financial asset does not share similar risk characteristics with other assets, the entity will perform an individual assessment for estimating expected credit losses. To accomplish potential re-pooling of financial assets or an individual allowance determination, an entity must be able to determine the amortized cost basis on an individual asset level, and, thus, also must be able to determine the accrued interest amount attributable to a financial asset on the individual asset level.

22. Secondly, the amendments in Update 2016-13 permit various methods for the measurement of expected credit losses. Many of these methods will use historical loss and writeoff data as a starting point for forecasting expected credit loss. Preparers state that losses or writeoffs of accrued interest are not typically reflected in this historical data set because of the regulatory guidance noted in paragraph 9 above. That is, accrued interest is reversed when a financial asset is placed on non-accrual and, therefore, the writeoff does not include interest in many cases. Therefore, entities would need to adjust the historical data for the effects of accrued interest, which they state would be operationally complex and burdensome.

Presentation

23. It is common practice to present the interest earned but not collected as an accrued interest receivable in other assets on the balance sheet, separate and apart from the loan balance. Under Update 2016-13 as written, entities are required to present the accrued interest amount in the amortized cost basis of the loans on the balance sheet in the same line item. While it could be permissible to parenthetically note the amount of accrued interest included in the balance, this presentation requires entities to change their systems and processes to accurately present the accrued interest in the loans line item on the balance sheet, which stakeholders state will be costly and burdensome.

Disclosure

24. Finally, using today's systems, it would be operationally difficult to include accrued interest amounts in the origination-year loan balances that are required to be disclosed for the vintage disclosure requirement under the amendments of Update 2016-13. The specific disclosure requirements are as follows:

> **326-20-50-5** To meet the objectives in paragraph 326-20-50-4, an entity shall provide quantitative and qualitative information by **class of financing receivable** and major security type about the credit quality of financial assets within the scope of this Subtopic (excluding off-balance-sheet credit exposures and repurchase agreements and securities lending agreements within the scope of Topic 860), including all of the following:
>
> a. A description of the **credit quality indicator(s)**
> b. The **amortized cost basis**, by credit quality indicator
> c. For each credit quality indicator, the date or range of dates in which the information was last updated for that credit quality indicator.
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> **326-20-50-6** When disclosing credit quality indicators of **financing receivables** and net investments in leases (except for **reinsurance receivables** and funded or unfunded amounts of **line-of-credit arrangements**, such as credit cards), an entity shall present the amortized cost basis within each credit quality indicator by year of origination (that is, vintage year) ….

25. Therefore, for the purposes of this disclosure, entities will be required to trace accrued interest amounts outstanding as of the current period that relate to each specific loan balance by credit quality

indicator and loan origination year. Again, stakeholders have stated that the benefits of disaggregation of the accrued interest amount to this level of detail do not outweigh the costs.

Stakeholder Request

26. Some stakeholders requested that the definition of *amortized cost basis* be amended to exclude accrued interest. They asserted that removing accrued interest from the definition of amortized cost basis will resolve the issues noted above regarding accrued interest. Specifically, entities will not have to incur major costs to reconfigure multiple entity-wide systems and processes to comply with the additional measurement, presentation, and disclosure requirements that result from the inclusion of accrued interest in the amortized cost. However, the staff notes that the accrued interest receivable separate from the amortized cost of the associated loan would still be a financing receivable and, as such, it would fall within the scope of the CECL model and be subject to all other CECL requirements.

27. Additionally, other stakeholders suggested that the Board could provide an option of how to account for accrued interest. Under that option, the definition would remain the same, but entities would be relieved from implementing costly and burdensome systems changes.

Staff Analysis

28. Based on stakeholders' feedback, the staff has developed the following alternatives to address the question of whether including the applicable accrued interest in the definition of amortized cost basis is appropriate:

    Alternative 1: Maintain the definition of amortized cost basis.

    Alternative 2: Maintain the definition of amortized cost basis. However, the Board could provide a practical expedient that would allow entities to:

    (a) Perform a CECL evaluation for the accrued interest amounts separately from their associated loan balances

    (b) Continue their current practices for the presentation of accrued interest (such as, in "other assets" on the balance sheet)

    (c) Disclose the accrued interest amounts included in amortized cost for the vintage disclosure table by either (i) including the amounts in the vintage year and class of financing receivable amounts, (ii) including the amounts in the class of financing receivable amounts only, or (iii) not including them in any amounts and adding a footnote to the table that states the total amount.

    Alternative 3: Remove accrued interest from the definition of amortized cost basis.

29. The staff notes that Alternatives 2 and 3 would require the Board to amend the guidance in Topic 326 while Alternative 1 would not require any additional standard setting. Under Alternative 2, the

Board would clarify its intent with respect to accrued interest. That is, the Board would emphasize that the accrued interest is a part of the amortized cost basis, but that it did not intend to impose significant systems costs on entities for accrued interest. Alternative 3 would require significant standard-setting activities because the Board would have to redefine the amortized cost basis and amend guidance for any follow-on ramifications of that change.

30. The staff believes that it was the Board's intent to clearly separate the interest income recognition model and the credit losses model when it issued Update 2016-13. Therefore, under separate models, interest income would be recognized on contractual cash flows, a portion of which may not be expected to be collected for the purposes of estimating expected credit losses under the CECL model. Conceptually, the Board decided in paragraph BC62 and highlighted in paragraph 6 above that the amortized cost basis is the present value of the contractual cash inflows, whether designated as principal or interest, discounted at the financial instrument's effective interest rate. The Board did not make a distinction between the future interest cash flows, that is, whether they have currently been earned and accrued but not yet collected or whether they will be earned and accrued in the future. Furthermore, the Board stated that the measurement basis for credit losses would be the same as the measurement basis for the amortized cost basis of a financial asset. As such, the Board decided in Update 2016-13 that entities should include applicable accrued interest in amortized cost basis and provide an allowance for credit losses for the accrued interest recorded but not expected to be collected.

31. The staff understands that the Board decided to maintain separate models for interest income recognition and credit losses based on a cost-benefit assessment for the stakeholders. Specifically, the Board agreed that the resulting operational issues from merging the two models would not justify the benefits of a superior conceptual approach. Through a similar cost-benefit assessment, the staff believes that the Board should consider providing relief from the operational costs to overhaul existing systems and processes for accrued interest.

Staff Recommendation

32. Based on the analysis above, the staff recommends Alternative 2 such that the applicable accrued interest remains in the definition of the amortized cost basis and a practical expedient is granted. The staff believes that the Board's intent in defining amortized cost basis was to reflect a financial asset on the balance sheet at the net amount of future contractual cash inflows of the financial asset that the entity expects to collect. To stay true to this intent, the contractual interest earned but not yet received on the asset should be included in the amortized cost basis and the allowance for credit losses should include an amount that reduces that portion of amortized cost to reflect the amount expected to be received.

33. However, the staff believes that the Board did not intend to impose significant systems and operational changes because of the definitional change. Therefore, the staff recommends that practical solutions be provided for the measurement, presentation, and disclosure challenges in transitioning to the CECL model for accrued interest. The staff recommends that the Board provide practical expedients to alleviate the aforementioned operational burdens that could be added as Codification improvements. The staff believes that these amendments could be handled as Codification improvements because the amendments are clarifying the Board's intent about the definition of amortized cost while providing a practical means to implement the standard.

34. Specifically, the staff recommends that, as a practical expedient, entities should be allowed to perform an assessment of collectibility and determine the expected cash flows for accrued interest separately from the associated loan balance and other components of amortized cost.[3] Furthermore, entities should be able to continue presenting the accrued interest receivable outside of the loan balance on the balance sheet. However, the staff recommends that the Board require entities availing themselves of the practical expedient to disclose the amount of accrued interest and where the amount is located on the balance sheet.

35. Finally, the staff believes that, as a practical expedient, entities may be relieved from tracing accrued interest amounts included in amortized cost to each origination year and by class of financing receivable in the vintage disclosure required by paragraph 326-20-50-6 by disclosing the total amount of accrued interest included in amortized cost as a footnote to that vintage table.

Issue 2: Reversal of Accrued Interest on Nonaccrual Loans

Feedback and Outreach

36. The stakeholders provided two alternative views about where the reversal of accrued interest applicable to loans placed in nonaccrual status or otherwise deemed uncollectible should be reflected in the income statement. An example in Appendix A may help to visualize each view and their effects on the amounts recorded in the balance sheet and income statement.

    View A: Interest income. The reversal of accrued interest applicable to a loan placed in nonaccrual status should be accomplished through a debit to interest income and a credit to the amortized cost basis of the loan. The reversal would include a reduction to the allowance against the credit loss expense that will reverse any amount of allowance previously established for outstanding amounts of accrued interest.

[3] The staff notes that View C under Issue 2 in paragraph 47 below would permit certain entities to be exempt from measuring an allowance for credit losses on accrued interest.

View B: Credit loss writeoff. For all entities, regardless of whether they adhere to nonaccrual policies, the reversal of accrued interest applicable to loans placed in nonaccrual status or otherwise deemed uncollectible should be accomplished through a debit to the allowance for credit losses and a credit to the amortized cost basis of the loan, identical to a partial writeoff of a portion of the principal balance of the loan. There should be no effect on the interest income line item for the reversal of accrued interest applicable to loans placed in nonaccrual status or otherwise deemed uncollectible because the loss would be reflected entirely in the credit loss expense line item.

37. Both View A and View B would result in the same amount recognized on the balance sheet for the amortized cost basis of the loan and the allowance for credit losses after the reversal of accrued interest. Additionally, the net effect to net income would be the same. For entities that follow nonaccrual policies, the views differ in the gross amounts recognized in interest income and credit loss expense line items on the income statement. View B would portray a higher interest income and credit loss expense than View A because of the differences in how accrued interest would be reversed.

38. Proponents of View A (primarily financial institutions) stated that this alternative would result in a better reflection of interest income than View B and would more accurately reflect the earnings potential of a financial asset. These proponents stated that interest income and metrics based on interest income (specifically, net interest margin, or "NIM") are important to users of the financial statements of financial services companies. The proponents stated that the accounting under View A would allow for consistency and comparability to prior period financial statements and call reports.

39. Stakeholders emphasized in outreach that a change to the reporting of net interest margin was not anticipated by their investors and analysts and would require them to provide explanations for the change. While the amount is not expected to be large relative to the loans balance on the balance sheet, the amount reversed potentially could be significant to the interest income line item and thereby distort net interest margin.

40. The proponents of View A also argued that the treatment would be similar to the current application of the regulatory instructions wherein entities reverse applicable accrued interest through the interest income line item on the income statement. These stakeholders stated that nonaccrual practices for regulated entities is well understood in practice. The proponents stated that View A would be consistent with the Board's intent not to change current practice for financial assets placed on nonaccrual status.

41. Conceptually, proponents of View A noted that the issue is similar to revenue recognition concepts for recognizing revenue based on an assessment of ultimate collectibility. As such, these stakeholders stated that the interest income (analogous to revenue) should not be recognized for amounts that an entity does not expect to collect. Thereby, a reduction to the interest income line

item would not overinflate the interest income line item for amounts that should never have been included because of collectibility uncertainties.

42. Finally, proponents of View A stated that a change to current practice for reversing accrued interest would be especially costly because of systems changes necessary to accomplish the accounting. These stakeholders noted the same costs to change accounting systems for accrued interest altogether that were addressed in Issue 1. However, they stated that additional systems changes would be required specific to the reversal of accrued interest because their current systems automatically reverse the amount against interest income upon the associated loan being placed in nonaccrual status.

43. Proponents of View B argued that because the definition of amortized cost basis includes accrued interest, the reversal of accrued interest is a partial writeoff and should be accounted for as such, that is, deducted from the allowance in accordance with paragraph 326-20-35-8. These stakeholders stated that it does not make sense to recognize a credit loss and allowance related to the amount of accrued interest included in amortized cost if prior to the writeoff of that accrued interest both the allowance and provision for credit loss is reversed, which would be the case under View A. Proponents of View B noted that the guidance in Topic 326 is clear and that the associated accounting treatment was the Board's intent.

Staff Analysis

44. The staff understands that the Board stated in its basis for conclusions for Update 2016-13 that it did not intend to change existing nonaccrual practices. The staff notes that this statement was specifically in reference to the changes proposed in the December 2012 proposed Update, which related to when an entity should put a loan on nonaccrual status and how an entity should account for cash flows received while a loan is on nonaccrual status. The changes did not contemplate the reversal of previously accrued interest applicable to loans placed on nonaccrual status. However, the staff believes it was not the Board's intent to change nonaccrual practices broadly, without limit to these two specific issues addressed in the December 2012 proposed Update.

45. Therefore, the staff believes that existing practices related to the reversal of previously accrued interest on loans that are placed on nonaccrual status should be maintained, which would be most consistent with View A for regulated entities that are required to follow the nonaccrual guidance in the regulatory instructions. Based on feedback in developing Update 2016-13, stakeholders indicated that current nonaccrual practices are well understood in practice and changing these practices was not the Board's intent.

46. However, the staff notes that Update 2016-13 applies to both regulated entities and nonregulated entities that have financial assets measured at amortized cost and that may or may not have a nonaccrual policy similar to those established by financial institutions. For nonregulated entities, the

staff believes that current practice should be maintained. Through outreach, the staff understands that many nonregulated entities adhere to internal nonaccrual policies. The staff believes that if the nonaccrual policy followed by a nonregulated entity is sufficient to limit the accrual of interest that is ultimately deemed uncollectible and if timely reversal of interest income or writeoff of any amount accrued occurs, that entity should be able to retain its current accounting for the reversal, whether through interest income or allowance for credit losses. If an entity does not have a sufficient nonaccrual policy, that entity should account for the reversal through the allowance for credit losses as a partial writeoff of amortized cost basis in accordance with paragraph 326-20-35-8 as currently written.

47. To provide a practical solution for all entities, the staff developed an alternative view that incorporates elements of both views provided by stakeholders, as follows:

View C: Interest income, if the entity follows a nonaccrual policy. If not, credit loss writeoff.

For entities that abide by nonaccrual policies, the reversal of accrued interest applicable to a loan placed in nonaccrual status may be accomplished through a debit to interest income and a credit to the amortized cost basis of the loan. Because the accrued interest that will not be collected will be reversed through interest income, it should not be required for these entities to measure an allowance on accrued interest.

For entities that do not follow a nonaccrual policy, the reversal of accrued interest should be accomplished through a partial writeoff of the amortized cost basis, that is, by debiting the allowance and crediting the amortized cost basis. Because the accrued interest amounts will be reversed through the allowance, these entities would be required to measure an allowance on accrued interest.

48. The staff understands that certain financial assets may have terms and conditions that allow interest to accrue unpaid for a significant period of time without requiring that the loan be placed on nonaccrual status (such as a student loan with a deferment period). The example provided in the capitalized interest submission (included in TRG Memo 8, paragraph 14)[4] highlights one such situation. The staff expects that an entity's nonaccrual policies would contemplate these scenarios in which it would be appropriate to measure an allowance for credit losses on a significant amount of accrued interest that is not timely reversed against interest income because of the terms and conditions of the arrangement. The regulatory instructions highlighted in paragraph 9 above specifically require that interest accrued during a prior calendar year should be reversed through the

[4] For context, the submission provided an example to articulate the views. Entity A underwrites a loan that requires interest to be paid only at the end of the contractual term of four years. The par/principal amount is $60 and interest that will be due at the end of 4 years is $40. The ultimate result is at the end of Year 4, the $40 will be capitalized into the principal balance of the loan. Entity A does not apply nonaccrual policies. Entity A determined its historical loss given default, based on the amortized cost at the date of writeoff (not the initial amortized cost), is 40 percent and the probability of default is 5 percent. Entity A projects that defaults (if any) would occur at the end of the contractual term.

allowance account and, thus, that an entity should measure an allowance on interest that accrues over a significant period. Therefore, the staff believes that an entity's nonaccrual policy should dictate whether the measurement of an allowance is required on accrued interest for financial assets based on the terms and conditions of each arrangement, which should generally require that measurement when a significant amount of interest accrues unpaid from prior periods. Additionally, the staff notes that an entity with a material accrued interest balance (such as the example referenced in this paragraph) should consider disclosing the amount of the allowance for credit losses that relates to the accrued interest if it is presented separately from the loan balance on the statement of financial position.

49. The staff believes that if an entity (regulated or not) with a sufficient nonaccrual policy was required to reverse the accrued interest as shown in View B, the interest income line item would be overstated from a user perspective. It also would require a user to adjust comparative data from prior periods in which an entity reversed the accrued interest through the interest income line item. The staff understands that both this line item and NIM are important metrics to users for financial institutions' financial statements. Therefore, it is not pragmatic to users or preparers to require a different treatment than current practice for the reversal of interest income.

50. Additionally, the staff agrees with proponents of View B who asserted that it does not make sense for an entity that will reverse the accrued interest through interest income to measure and recognize an allowance and subsequently reverse the allowance upon reversal of the accrued interest amount. Therefore, the staff believes there is little reason for an entity with a nonaccrual policy to measure an allowance for accrued interest.

51. However, for entities that do not follow a nonaccrual policy, the staff believes the guidance of Topic 326 should apply as written, that is, entities should measure an allowance for credit losses applicable to the accrued interest. Furthermore, entities that do not follow a nonaccrual policy should writeoff amounts not expected to be collected against the allowance in accordance with the credit losses writeoff guidance in paragraph 326-20-35-8 as currently written.

52. The staff believes that View C is a pragmatic solution that considers the cost burden associated with adopting the standard for some entities that apply established nonaccrual policies that are understood while providing a solution that works for all entities (that is, regulated and non-regulated). The staff notes that View C will require the Board to amend the codification to clarify its intent not to change nonaccrual practices broadly. The staff believes these changes can be handled through a Codification improvements project because the amendments would clarify the Board's original intent.

Next Steps

53. The staff acknowledges that the recommendations included within this memo will require making amendments to the Codification. However, the staff believes that the recommendations in this memo

provide a pragmatic approach to addressing stakeholders' concerns regarding the changes to the definition of amortized cost basis and those changes effect on the accounting for accrued interest including measurement, presentation, and disclosure.

Appendix A—Example of Views A, B, and C

54. The following example represents the accounting for reversal of accrued interest on loans placed on nonaccrual status under Views A, B, and C.

    Loan Principal Amount: $1,000

    Coupon Interest: 12% Annually, accrued monthly

    Nonaccrual policy of 90 days past due

    No premiums, discounts, deferred fees or costs, or fair value hedge accounting adjustments are applicable.

Assume for simplicity no expected credit losses at loan origination or at 12/31/X1. Assume the borrower is current on all payments for the first year. The borrower pays interest for January but misses the February and March monthly payments in Q1 of Year 2.

<u>1/1/X1:</u>

Dr. Loan	$1,000	
Cr. Cash		$1,000

To recognize the issuance of the loan (assumed no Day 1 allowance, for simplicity).

<u>12/31/X1:</u>

Dr. Cash	$120	
Cr. Interest Income		$120

To recognize the interest earned and collected on the loan in Year 1.

<u>1/31/X2:</u>

Dr. Cash	$10	
Cr. Interest Income		$10

To recognize the interest earned and collected on the loan in January, Year 2.

<u>2/28/X2:</u>

Dr. Accrued Interest	$10	
Cr. Interest Income		$10

To recognize the interest earned but not yet collected in cash on the loan in February, Year 2.

<u>3/31/X2:</u>

Dr. Accrued Interest	$10	
Cr. Interest Income		$10

To recognize the interest earned but not yet collected in cash on the loan in March, Year 2.

Assume at 3/31/X2 the lender expects to collect $900 on the principal amount of the loan and $0 on the accrued interest earned but not collected. Therefore, an allowance for credit losses of $120 is established ($100 from the principal amount and $20 from the accrued interest), as follows:

Views A and B (all entities), and View C (nonregulated entities that <u>do not</u> follow nonaccrual policies):

<u>3/31/X2:</u>

Dr. Credit Loss Expense	$120	
Cr. Allowance for Credit Losses		$120

To recognize an allowance for credit losses <u>for principal and accrued interest</u> not expected to be collected as of 3/31/X2.

View C (regulated entities and nonregulated entities that follow nonaccrual policies):

3/31/X2:
Dr. Credit Loss Expense $100
  Cr. Allowance for Credit Losses $100
To recognize an allowance for credit losses for only the principal not expected to be collected as of 3/31/X2.

Assume the borrower misses the April payment in Q2 of Year 2. The lender puts the loan on nonaccrual status in accordance with its policies on 4/30/X2 (when it is 90 days past due). The following entry is recorded to accrue interest for April of Year 2:

All Views:

4/30/X2:

Dr. Accrued Interest $10
  Cr. Interest Income $10
To recognize the interest earned but not yet collected in cash on the loan in April, Year 2.

Assume the lender still expects to collect $900 on the principal amount of the loan. The following journal entries show the accounting for the writeoff or reversal of accrued interest and how that should be reflected in the financial statements.

4/30/X2:

View A (for all entities):

Dr. Interest Income $30
  Cr. Accrued Interest $30
To reverse the accrued interest against interest income.

Dr. Allowance for Credit Losses $20
  Cr. Credit Loss Expense $20
To reduce the allowance to reflect the reduction in amortized cost basis without any effect on the amount expected to be collected.

Balance Sheet Amounts:
  Cash $1,130
  Loan (Amortized Cost Basis) $1,000
  Allowance for Credit Losses ($100)
Income Statement Amounts:
  Interest income $130
  Credit loss expense ($100)

View B (for all entities):

Dr. Credit Loss Expense $10
  Cr. Allowance for Credit Losses $10
To gross up the allowance for accrued interest that will be written off.
Dr. Allowance for Credit Losses $30
  Cr. Accrued Interest $30
To write-off accrued interest against the allowance for credit losses.

Balance Sheet Amounts:
  Cash $1,130
  Loan (Amortized Cost Basis) $1,000

Allowance for Credit Losses	($100)	
Income Statement Amounts:		
Interest income	$160	
Credit loss expense	($130)	

View C (regulated entities and nonregulated entities that follow nonaccrual policies):

Dr. Interest Income	$30	
Cr. Accrued Interest		$30

To reverse the interest income.

Balance Sheet Amounts:	
Cash	$1,130
Loan (Amortized Cost Basis)	$1,000
Allowance for Credit Losses	($100)
Income Statement Amounts:	
Interest income	$130
Credit loss expense	($100)

View C (nonregulated entities that <u>do not</u> follow nonaccrual policies):

Dr. Credit Loss Expense	$10	
Cr. Allowance for Credit Losses		$10

To gross up the allowance for accrued interest that will be written off.

Dr. Allowance for Credit Losses	$30	
Cr. Accrued Interest		$30

To write off accrued interest against the allowance for credit losses.

Balance Sheet Amounts:	
Cash	$1,130
Loan (Amortized Cost Basis)	$1,000
Allowance for Credit Losses	($100)
Income Statement Amounts:	
Interest income	$160
Credit loss expense	($130)

Appendix B—Relevant Literature

Amortized Cost Basis (Pending Content): The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.

Amortized Cost Basis (Superseded): The amount at which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange, and fair value hedge accounting adjustments.

310-10-35-24 The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the **recorded investment** in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense. The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

326-20-35-8 Writeoffs of **financial assets**, which may be full or partial writeoffs, shall be deducted from the allowance. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible. Recoveries of financial assets and trade receivables previously written off shall be recorded when received.

326-20-50-5 To meet the objectives in paragraph 326-20-50-4, an entity shall provide quantitative and qualitative information by **class of financing receivable** and major security type about the credit quality of financial assets within the scope of this Subtopic (excluding off-balance-sheet credit exposures and repurchase agreements and securities lending agreements within the scope of Topic 860), including all of the following:

a. A description of the **credit quality indicator(s)**

b. The **amortized cost basis**, by credit quality indicator

c. For each credit quality indicator, the date or range of dates in which the information was last updated for that credit quality indicator.

326-20-50-6 When disclosing credit quality indicators of **financing receivables** and net investment in leases (except for **reinsurance recoverables** and funded or unfunded amounts of **line-of-credit arrangements**, such as credit cards), an entity shall present the **amortized cost basis** within each credit quality indicator by year of origination (that is, vintage year). For purchased financing receivables and net investment in leases an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition. For origination years before the fifth annual period, an entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate. For interim-period disclosures, the current year-to-date originations in the current reporting period are considered to be the current-period originations. The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for an entity that is not a **public business entity**.

BC62. Consistent with the basis for conclusions in FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, the Board concluded that a financial asset's effective interest rate should be the rate used to discount expected cash flows when expected credit losses are estimated using a discounted cash flow method. The Board also concluded that the credit loss measurement should reflect only expected credit losses. The Board decided that the credit loss measurement should not reflect changes in market rates of interest, because that would fundamentally change the measurement method from amortized cost. The Board observed that the amortized cost basis of a financial asset is the present value of the contractual future cash inflows—both those designated as principal and those as interest—discounted at the financial instrument's effective interest rate. Thus, the measurement basis for credit losses will be the same as the measurement basis for the amortized cost basis of the same financial asset.

BC99. In the May 2010 proposed Update, the Board proposed that interest income should always be calculated on the basis of the amortized cost less any allowance for credit impairments of the financial asset. This proposed change was strongly opposed by many stakeholders, including preparers, some auditors, regulators, and many investors. Stakeholders noted that the existing approach to recognizing interest income and credit losses separately provides users with relevant information about the credit risk of the underlying assets. Interest income is greater for riskier assets, and seeing an increase in interest income that is not reflected in comparable peers gives users insight into the financial institution's current credit lending practices. Users consistently asserted that interest income should not be further diluted for changes in cash flows related to credit losses. Therefore, in its redeliberations, the Board decided not to amend the guidance on interest income recognition in GAAP. The Board decided as a result of feedback received that existing nonaccrual practices may continue and decided to exclude from the amendments in this Update the nonaccrual guidance that was proposed as part of the December 2012 Exposure Draft. Respondents to the nonaccrual guidance proposed in the December 2012 Exposure Draft expressed concern that the guidance could add complexity for certain financial assets that currently are not placed on nonaccrual, such as credit cards. Additionally, there was concern about possible application inconsistencies

with the proposed nonaccrual guidance proposed in the December 2012 Exposure Draft and regulatory guidance.