FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO		Memo No.	**10**
		Issue Date	**June 1, 2018**
		Meeting Date(s)	**TRG Meeting June 11, 2018**

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Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post-Issuance**
Issues	**Transfer of Loans from Held for Sale to Held for Investment and Transfer of Credit Impaired Debt Securities from Available-for-Sale to Held-to-Maturity**

Disclaimer: *This paper has been prepared for discussion at a public meeting of the Transition Resource Group for Credit Losses. It does not purport to represent the views of any individual members of the Board or staff. Comments on the application of generally accepted accounting principles (GAAP) do not purport to set out acceptable or unacceptable application of GAAP. Stakeholders are strongly encouraged to listen to feedback about this staff paper from TRG members and Board members during the TRG meeting and to read the meeting summary, which will be prepared by the staff after the meeting.*

Memo Purpose

1. Stakeholders have informed the staff of two questions on the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Specifically, how the expected credit loss guidance should be applied upon transferring loans classified as held for sale (HFS) to loans held as long-term investments (HFI) and, similarly, how should the expected credit loss guidance be applied when transferring credit impaired debt securities classified as available-for-sale (AFS) to held-to-maturity (HTM). This memo summarizes implementation questions in this area and provides the staff's analysis of the issue. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG) on these implementation questions.

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

Issue Background

2. To address the questions raised by stakeholders, TRG members should consider the various background information related to the accounting of (a) HFS loans, HFI loans, and loans not held for sale and (b) debt securities classified as AFS and debt securities classified as HTM.

Subtopic 948-310, Mortgage Banking—Receivables

3. Measurement guidance in paragraph 948-310-35-1 requires that mortgage loans HFS should be reported at the lower of amortized cost basis or fair value, at the balance sheet date. The amount by which amortized cost basis exceeds fair value should be accounted for as a valuation allowance and changes in the valuation allowance should be included in the determination of net income of the period in which the change occurs.
4. Paragraph 948-310-30-4 requires that mortgage loans transferred to loans HFI should be measured upon transfer at the lower of amortized cost basis or fair value on the transfer date. Before the issuance of Update 2016-13, Subtopic 948-310 required entities to determine in subsequent periods if the ultimate recovery of the carrying amount of a mortgage loan HFI is doubtful and the impairment was considered other than temporary, then the carrying amount of the loan should be reduced to the expected collectible amount, which becomes the new cost basis.
5. One of the initiatives of the expected credit loss standard was to replace the other-than-temporary impairment assessment with an allowance for expected credit losses. This change was made because an other-than-temporary impairment would cause distortion in interest income when there was a subsequent increase in the amount expected to be collected on the loan. The expected credit loss model would eliminate distorting interest income by requiring an allowance for expected credit losses that could be subsequently adjusted for changes in expectations (both favorably or unfavorably) without distorting interest income. Therefore, paragraph 948-310-35-5 was superseded and replaced with paragraph 948-310-35-5A, which requires entities to evaluate loans HFI for expected credit losses under Subtopic 326-20.

Subtopic 310–10, Overall—Receivables

6. Subtopic 310-10 provides guidance on how entities should account for loans not held for sale, nonmortgage loans HFS, and loans that were previously not held for sale.
7. Loans Not Held for Sale—Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at the outstanding principal adjusted for any writeoffs, the allowance for credit losses, any deferred fees or costs on originated loans, and any unamortized premiums or discounts on the purchased loans.
8. Nonmortgage Loans Held for Sale—Nonmortgage loans HFS should be reported at the lower of amortized cost basis or fair value.
9. Loans Not Previously Held for Sale—This guidance applies to both mortgage and nonmortgage loans. Once a decision has been made to sell loans not previously classified as HFS, those loans should be transferred into the HFS category and carried at the lower of cost or fair value. At the time of the transfer into HFS classification, any amount by which cost exceeds fair value should be accounted for as a valuation allowance. The guidance for loans not previously held for sale was superseded by Update 2016-13; therefore, the only relative guidance remaining for loans not previously classified as HFS can be found in Subtopic 948-310, which appears to be applicable only to mortgage loans.

Subtopic 326-20, Credit Losses—Measured at Amortized Cost, and Subtopic 326-30, Credit Losses—Available-for-Sale Debt Securities

10. Paragraph 320-10-35-1 describes the measurement of investments in debt securities, in particular, those debt securities classified as HTM. Investments in debt securities classified as HTM should be measured at amortized cost in the statement of financial position. Paragraph 326-20-15-2 states that the expected credit loss guidance applies to financial assets measured at amortized cost, which includes debt securities classified as HTM.
11. Like all other financial assets included in Subtopic 326-20, an entity is required to measure the expected credit loss on a collective (pool) basis when similar risk characteristic(s) exist. The allowance for expected credit losses can be measured by following a discounted cash flow method or by other means, as described in paragraphs 326-20-30-4 through 30-5.
12. Existing GAAP guidance, specifically paragraph 320-10-35-10, requires that when a debt security is transferred into the HTM category from the AFS category, any unrealized holding gain or loss at the date of the transfer should continue to be reported as a separate component of shareholder's equity, such as accumulated other comprehensive income (AOCI), but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount. The unrealized gain or loss should be amortized as an adjustment of yield in accordance

with Subtopic 310-20, that is by following the interest method. The staff will point out that the unrealized gain or loss represents the fair value adjustment of the AFS debt security but excludes the allowance for credit losses that was established under paragraph 326-30-35-2.

13. Paragraph 326-30-35-2 states that for individual debt securities classified as AFS, an entity should determine whether a decline in fair value below the amortized cost basis has resulted from credit losses or other factors. An entity should record an impairment for credit losses through an allowance for credit losses. However, the allowance is limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses is recorded through other comprehensive income (OCI), net of applicable taxes. The Board understood that the value of an investment in debt securities classified as AFS could be realized through the collection of contractual cash flows or through the sale of the security. Therefore, the amendments limited the amount of the allowance for credit losses to the amount by which fair value is below amortized cost basis because the classification as AFS is premised on an investment strategy that recognizes that the investment could be sold at fair value.
14. Subsequently, an entity should reassess the allowance for credit losses each reporting period and record subsequent changes to the allowance in credit loss expense on AFS debt securities. An entity should not reverse a previously recorded allowance for credit losses to an amount below zero (that is, the allowance for credit losses related to debt securities classified as AFS cannot be negative at the individual level).

Issue Description

15. Stakeholders have asked two questions regarding the measurement of expected credit losses: (a) How the expected credit loss guidance should be applied upon transferring loans classified as HFS to loans HFI and (b) how should the expected credit loss guidance be applied when transferring credit impaired debt securities classified as AFS to HTM?

Credit Impaired Debt Securities Transferred from AFS to HTM

16. Stakeholders raised concerns for debt securities classified as AFS and subsequently transferred to HTM. For individual AFS debt securities, Subtopic 326-30 requires an entity to determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. Any impairment relating to credit losses should be recorded through an allowance for credit losses. However, the allowance is limited, or floored, at the debt security's fair value. Any changes in fair value unrelated to credit losses are recorded through other comprehensive income (OCI) as unrealized gains or losses.

17. In accordance with paragraph 320-10-35-10, at the date of transfer from AFS to HTM, the debt security is recorded at its fair value, which becomes the security's new amortized cost basis. Any unrealized gain or loss in OCI (that is, those amounts that have not been recorded through an allowance for credit losses) remain in OCI and are accreted or amortized to income over the remaining life similar to the treatment of a discount or premium (that is, the amount directly affects yield).

18. Stakeholders noted that because the transfer from AFS to HTM is not considered to be an acquisition, the debt securities cannot be accounted for as purchased financial assets with credit deterioration (PCD) when the transfer is made. Stakeholders raised concerns about applying the expected credit loss guidance to the debt security that was transferred from AFS and HTM. Specifically, they are concerned about the requirement to record an expected credit loss under Subtopic 326-20, even though they have previously recorded an allowance for the AFS debt security. Stakeholders' concern with the expected credit loss guidance is similar to that stated below for loans, that is, entities do not believe that an additional expected credit loss allowance should be recorded when transferring a debt security from AFS to HTM if the entity had previously recorded an allowance for credit losses (using fair value inputs) when the debt security was classified as AFS.

Loans Classified as HFS and Transferred to HFI

19. Stakeholders noted that loans classified as HFS are not in the scope of the expected credit loss standard. Instead, those loans are reported at the lower of the amortized cost basis or fair value. The amount at which the amortized cost basis exceeds the fair value should be accounted for as a valuation allowance and changes in the valuation allowance should be reported in the period of the change in net income. When a loan HFS is transferred to a loan HFI, it must be transferred at the lower of the amortized cost basis or fair value. Because the transfer from HFS to HFI is not considered to be an acquisition, the loan cannot be accounted for as a PCD asset.

20. Stakeholders raised concerns that when a loan classified as HFS with a valuation allowance is transferred to a loan classified as HFI, an entity will be required to record an expected credit loss under Subtopic 326-20. Stakeholders believe that recording an expected credit loss after the transfer from HFS to HFI is unnecessary if the entity had previously recorded a valuation allowance for the HFS loan.

Views Provided by Stakeholders

21. Stakeholders provided several views that they believe could resolve the questions on how to account for loan and debt security transfers:

    (a) View A (Day 1 Loss Approach) – Under this view, an allowance and related credit loss expense for lifetime expected credit losses is required at the time of the transfer.

(b) View B (Discount Reduces Allowance)—Under this view, an allowance for credit losses is required at the time of the transfer; however, unlike View A, the amount of the allowance for credit losses would be reduced by any discount attributable to losses already recognized in the income statement while classified as a loan HFS or an AFS debt security.

(c) View C (Direct Write down)—This view would be applicable only to loans. Under this view, the valuation allowance established while classified as HFS is treated as a direct write down upon transfer to HFI. As a result, no allowance is required upon transfer or at subsequent reporting dates unless the expected credit losses exceed the amount of the write down. Stakeholders indicated that this view would not be applicable to debt securities because the guidance in paragraph 320-10-35-10(d) requires the discount for the difference between the fair value and amortized cost to be recognized subsequently using the interest method.

22. Certain stakeholders suggested a fourth approach whereby entities would be permitted to treat loan and debt security transfers as PCD assets. The staff dismissed this view for the following reasons:

(a) As noted in paragraph BC89 of Update 2016-13, certain supporters of a gross-up model for originated assets stated that the credit risk is priced into the interest rate for those assets. The Board acknowledged this; however, the Board placed more weight on preparers' operability concerns as well as users' feedback that interest income should be recognized as the effective interest rate and that credit risk should be measured separately.

(b) Allowing PCD treatment for loan or debt security transfers raises concerns for potential abuse because an entity could classify a loan as HFS at the origination date and subsequently determine that the loan is no longer HFS, but rather is HFI. In this situation, the entity would be able to split the valuation allowance that was recorded on a HFS loan into two components: (a) expected credit loss component and (b) a discount component. The discount component would be accreted into income as an adjustment to the yield, but the expected credit loss component would be added to the loans amortized cost basis. This effectively could establish a means of applying PCD accounting for originated loans, which the Board clearly rejected during deliberations.

Stakeholder Feedback

23. The staff recently performed outreach with a number of organizations, including auditors and financial statement preparers. Stakeholders generally stated that the issue of transfers between HFS and HFI loans and AFS and HTM debt securities is not currently a pervasive issue, but in certain economic cycles transfers may become pervasive. The staff shared the views that were recommended by the group of auditors and preparers who raised the question with outreach participants. These participants agreed that View A is what the expected credit loss guidance requires; however, View A would result in double counting expected credit losses if the entity had previously recorded a valuation allowance

for the HFS loan or when fair valuing the AFS debt security. Stakeholders stated that View C, the writeoff approach, would not be in line with the spirit of the expected credit loss standard because entities are supposed to have flexibility in adjusting the allowance for credit losses for loans or debt securities and that flexibility should be applicable to any loan or debt security regardless if it were transferred to a new classification.

24. Most stakeholders who participated in outreach seemed to agree with a separately suggested alternative approach (not included in the submission) whereby an entity that transfers a loan or debt security would reverse any outstanding valuation allowance when transferring a loan from HFS to HFI and similarly for a debt security transferred from AFS to HTM and establish an allowance for credit losses by following the guidance in Subtopic 326-20. The staff believes this suggested alternative is similar to View B, except that the entity would not carryover the valuation allowance that was recorded for the loan or debt security. Stakeholders who supported the reversal approach stated that it would require the Board to amend the guidance, but it would be a simple approach and would address stakeholders' concerns about loan and debt security transfers and the approach would be consistent. The staff did ask outreach participants if they had a view on how to present the reversal and whether a gross or net basis should be required. Most stakeholders participating in the outreach supported a net presentation, instead of a gross presentation.

Staff Analysis and Recommendations

Issue 1: Transferring Debt Securities with Recorded Credit Losses from AFS to HTM

25. The guidance in paragraph 326-30-35-2 states that for individual debt securities classified as AFS, an entity should determine whether a decline in fair value below the amortized cost basis has resulted from credit losses or other factors. If an entity determines that the fair value of an AFS debt security is below the amortized cost basis of that security, the entity must then determine if the decline in fair value was related to credit losses. Any credit loss is recorded as an allowance for credit losses, and any remaining reduction in fair value is recorded as an unrealized loss in OCI.

26. As noted above, HTM debt securities are included in the scope of Subtopic 326-20; therefore, entities must evaluate those HTM debt securities for expected credit losses on a pool basis. The staff believes that upon a transfer of debt securities from AFS to HTM an entity should:

    (a) Reclassify the allowance for credit losses that was recorded for the AFS debt security.

    (b) Any unrealized loss should continue to be reported as a separate component of shareholders equity, such as AOCI, but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

(c) Transfer the AFS debt security to HTM at the debt security's amortized cost less any remaining unrealized loss (or gain) at the transfer date. An entity should then evaluate the HTM debt security for an expected credit loss in accordance with Subtopic 326-20.

27. The staff believes this approach is a simplified method for accounting for transfers between AFS and HTM debt securities. Regardless of the AFS or HTM classification, a debt security must be evaluated for credit losses, the only difference is that the AFS debt security is floored at the fair value of the debt instrument and the evaluation is done on an individual basis. Whereas, an HTM debt security is evaluated by following the expected credit loss guidance in Subtopic 326-20, which is a best estimate model with no fair value floor, and this evaluation is done on a pool basis. With regards to the allowance for credit loss balance, the staff believes in most instances there will not be a significant increase or decrease between the allowance for credit losses when transferring between AFS and HTM classifications.

28. The staff disagreed with the views shared by those stakeholders who raised the question on how to account for transfers of loans and debt securities for the following reasons:

(a) View A would result in potentially double counting the allowance for credit losses because credit losses or default risk would be a factor in the fair value valuation allowance.

(b) View B would require entities to unwind or accrete any valuation allowance to income over the remaining life of the loan or debt security and separately determine if an allowance for expected credit losses is necessary. The staff believes this approach would be overly complex and reversing any previous valuation allowance or credit loss allowance would be a simplified approach that can be applied to both loans and debt securities transferred in and out of various categories.

(c) Although this View C was not applicable to debt securities, it appears to conflict with the spirit of the expected credit loss guidance. If the guidance was developed to eliminate the other-than-temporary impairment tests for debt securities, then writing off a portion of the debt security upon a transfer from AFS to HTM, or vice versa, would seem to conflict with the benefits of the guidance in Subtopic 326-20. If the allowance that was recorded for the AFS debt security was reversed and a portion of the debt security was written off, entities would subsequently raise the question on how to account for improvements in the value of the debt security. In addition, requiring a writeoff of the valuation allowance when transferring AFS debt securities to HTM would limit entities' ability to transfer debt securities from one classification to another.

29. The staff's recommended approach described in paragraph 26 is illustrated in Appendix A. For discussion on presentation or disclosure of transfers between categories see Issue 3.

Issue 2: Transferring an HFS Loan to an HFI Loan

30. As noted above, any loan classified as HFS is reported at the lower of amortized cost basis or fair value. Guidance in Subtopic 948-310 applies to mortgage loans; if the amortized cost basis is greater than the fair value, an entity is required to record a valuation allowance and changes in the valuation allowance are included in the determination of net income in the period of change. The valuation allowance for HFS mortgage loans differs from an allowance for credit losses under Subtopic 326-20 in two ways: (a) the HFS guidance requires a valuation allowance that considers losses beyond those caused by credit deterioration and (b) the inputs used to measure the valuation allowance for loans classified as HFS are based on market inputs, instead of internally generated or best estimate inputs. For nonmortgage loans, the HFS guidance in Subtopic 310-10 does not specify whether a valuation allowance is recorded for the reduction to fair value. However, when looking at the transfers not previously within the HFS guidance, a reference is made to using a valuation allowance in situations in which amortized cost is greater than fair value of the loan.

31. Subtopic 310-10 goes on to state that loans that management has the intent and ability to hold for the foreseeable future are reported in the balance sheet at the outstanding principal amount adjusted for any writeoffs, the allowance for credit losses, any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans—these loans are categorized as loans not held for sale. The guidance in Subtopic 948-310 requires that a mortgage loan transferred to a long-term investment classification should be transferred at the lower of amortized cost basis or fair value.

32. The staff believes that transfers of mortgage and nonmortgage loans between categories should be accounted for as follows:

    (a) Entities that transfer nonmortgage loans not HFS to nonmortgage loans HFS should reverse any previous allowance for credit loss that was recorded[1], reclassify the nonmortgage loan as HFS, and determine if a valuation allowance is needed by comparing the amortized cost basis to the fair value of the loan.

    (b) Entities that transfer nonmortgage loans HFS to nonmortgage loans not HFS should reverse any previous valuation allowance that was recorded, reclassify the nonmortgage loan as not HFS, and determine if an allowance for credit loss is needed by following the guidance in Subtopic 326-20.

    (c) Entities that transfer mortgage loans HFI to mortgage loans HFS should reverse any previous allowance for credit loss that was recorded, reclassify the mortgage loan as HFS and determine if a valuation allowance is needed by comparing the amortized cost basis to the fair value of the loan.

[1] This assumes that no writeoff was taken at the point of transfer as required in paragraph 326-20-35-7.

(d) Entities that transfer mortgage loans HFS to mortgage loans HFI should reverse any previous valuation allowance that was recorded, reclassify the mortgage loan as HFI, and determine if an allowance for credit loss is needed by following the guidance in Subtopic 326-20.

33. For similar reasons noted above, the staff dismissed Views A–C shared by those stakeholders who questioned how to account for loan and debt security transfers. The staff's recommended changes are a simplified approach that would not hinder comparability and would retain the core requirements in Subtopic 326-20 without creating unnecessary guidance for one-off transactions.

34. The staff's recommended approach described in paragraph 32 is illustrated in Appendix A. For discussion on presentation or disclosure of transfers between categories see Issue 3.

Issue 3: Presentation and Disclosures of Transfers Between Categories

35. In discussions with preparers and auditors, the staff asked stakeholders to share their views on how an entity should present the effect of transferring loans between HFS and HFI and for transferring debt securities between AFS to HTM under the suggested alternative. Most stakeholders participating in the outreach supported a net presentation, instead of a gross presentation.

36. The presentation and disclosure guidance for loans and debt securities is as follows:

Mortgage and Nonmortgage Loans

(a) Paragraph 310-10-45-2 allows entities to present loans on the balance sheet as aggregated amounts. However, loans HFS are required to be separately presented in the balance sheet or the notes to the financial statements.

(b) Subtopic 948-310 requires entities to distinguish between mortgage loans HFS and mortgage loans HFI on the balance sheet.

(c) Paragraph 210-10-45-13 requires valuation allowances related loans HFS to be deducted from the asset or group of assets to which the allowance relates.

Debt Securities

(a) Subtopic 320-10 requires entities to report AFS and trading securities separately from similar assets that are subsequently measured using another attribute on the face of the statement of financial position. This can be done by either aggregating those fair and non-fair-value amounts in the same line item and parenthetically disclosing the amount of fair value included in the aggregate amount or presenting two separate line items to display fair value and non-fair-value carrying amounts.

(b) Paragraph 326-30-45-1 requires an entity to present AFS debt securities on the statement of financial position at fair value. In addition, an entity should present parenthetically the amortized cost basis and the allowance for credit losses.

(c) Paragraph 326-20-45-1 requires an entity to separately present on the statement of financial position the allowance for credit losses that is deducted from the asset's amortized cost basis.

37. Considering the volume of presentation and disclosure guidance that is currently required, the staff believes that entities should follow existing GAAP requirements with regards to presenting loans and debt securities on the statement of financial position or in the notes to the financial statements. From a balance sheet perspective, entities will already be required to present a transfer between categories on a gross basis, either on the balance sheet or in the notes to the financial statements. For example, if an entity aggregates its loan balance, but separately presents loans HFS on its statement of financial position, then that entity should gross up both balances when transferring loans between the various balance sheet categories. For the income statement, the entity also should gross up the respective line items that are used to record changes in the valuation allowance and the allowance for credit losses.

38. The staff dismissed the net basis approach because the presentation guidance and the disclosure guidance required in existing GAAP were intended to increase transparency for financial statement users, while also providing entities with some latitude in determining how the transparent information should be provided on the face of the financial statements or in the notes to the financial statements.

Next Steps

39. The staff acknowledges that the recommendations included within this memo will require amendments to the Codification. However, the staff believes that the recommendations in this memo provide a simplified and consistent way to address stakeholders' concerns regarding transfers between categories for both loans and debt securities resulting from the transition to a current expected credit loss model for financial assets carried at amortized cost and the improved model for AFS debt securities.

Appendix A: Transfers Between Categories—Illustrations

A1. This appendix provides the TRG members with an illustration of the staff's recommended approach to addressing the question on transfers between categories. These illustrations ignore journal entries and the accounting for tax effects and interest accruals that may be present in a transfer.

Illustration 1—Debt Security Transfer from AFS to HTM

In 20X1, an entity purchases a debt security and classifies the security as AFS. The entity purchased the debt security at par for $1,000,000. At year end, the entity reports that the fair value of the debt security has declined below the amortized cost basis to $900,000. Part of the decline has resulted from a credit loss, which the entity estimates is $80,000.

Accounting Entries - 20X1		
DR. AFS Security	1,000,000	
CR. Cash		1,000,000
Purchase of Debt Security		
DR. Provision	80,000	
CR. ALCL-AFS		80,000
Record Allowance for Credit Losses		
DR. Unrealized Loss – AFS	20,000	
CR. AFS Security		20,000
Remainder of Fair Value Loss - Recorded to OCI		

Balance Sheet - Year End 20X1	
Assets	
AFS - Debt Secuity (Net of Allowance for Credit Losses and Unrealized Loss, 80,000 and 20,000, respectively)	900,000
Other Comprehensive Income	
Unrealized Loss - AFS Debt Security	20,000

Income Statement - Year End 20X1	
Expenses	
Provision - Debt Security	80,000

At the beginning of year 20X2, the entity decides to transfer the debt security from AFS to HTM. The following illustrates the accounting entries proposed by the staff to transfer a credit impaired AFS debt security to HTM. This illustration ignores the accretion of the unrealized loss. In addition, the allowance for the HTM debt security is the same as the allowance previously established for the AFS debt security. Therefore, no income statement impact is required because of the reclassification of the allowance. Any effect on income statement ("true up") from a change in allowance upon transfer would be reflected in earnings as of the transfer point.

While this illustration is a simple one security transfer, the measurement of allowance for credit losses on HTM securities is performed on a pool basis, which would change the allowance and transfer calculations. However, the mechanics of the transfer are reflected through this illustration.

Accounting Entries - 20X2		
DR. HTM Security	980,000	
CR. AFS Security		980,000
Transfer Debt Security to HTM		
DR. ALCL-AFS	80,000	
CR. ALCL-HTM		80,000
Reclassify Allowance on the AFS Debt Security		

Balance Sheet - Year End 20X2	
Assets	
HTM - Debt Secuity (Net of Allowance for Credit Losses and Unrealized Loss, 80,000 and 20,000, respectively)	900,000
Other Comprehensive Income	
Unrealized Loss - Debt Security	20,000

Illustration 2—Loan transferred from HFS to HFI

In 20X1, an entity issues a loan and classifies the loan as HFS. The entity issued the loan at par for $1,000,000. At year end, the entity reports that the fair value of the loan has declined below the amortized cost basis to $900,000.

Accounting Entries - 20X1		
DR. Loan - HFS	1,000,000	
CR. Cash		1,000,000
Issuance of Loan at Par		
DR. Other Expense	100,000	
CR. Valuation Allowance - Loan - HFS		100,000
Record Valuation Allowance		

Balance Sheet - Year End 20X1	
Assets	
Loan - HFS (Net of Valuation Allowance, 100,000)	900,000

Income Statement - Year End 20X1	
Expenses	
Other Expense - Loans - HFS	100,000

At the beginning of Year 20X2, the entity decides to transfer the loan from HFS to HFI. The entity determines the valuation allowance for the HFS loan is higher than the allowance for credit losses required for the HFS loan. Specifically, the entity believes the allowance for credit losses will be $80,000. The following illustrates the accounting entries proposed by the staff to transfer a HFS loan with a valuation allowance to HFI.

Accounting Entries - 20X2		
DR. Loan - HFI	1,000,000	
CR. Loan - HFS		1,000,000
Transfer Loan from HFS to HFI		
DR. Valuation Allowance - HFS	100,000	
CR. Other Expense - HFS		100,000
Reverse Valuation Allowance on the HFS		
DR. Provision Expense	80,000	
CR. ALCL - HFI		80,000
Record Allowance for Credit Losses on the HFI		

Balance Sheet - Year End 20X2	
Assets	
Loan - HFI (Net of Allowance for Credit Losses, 80,000)	920,000

Income Statement - Year End 20X1	
Expenses	
Provision - Loans - HFI	80,000
Other Expense - Loans - HFS	(100,000)

Appendix B—Relevant Literature

310-10-45-2 Loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables held for sale shall be a separate balance sheet category. Major categories of loans or trade receivables shall be presented separately either in the balance sheet or in the notes to the financial statements.

310-10-35-47 Loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff shall be reported in the balance sheet at outstanding principal adjusted for any writeoffs, the allowance for credit losses, any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans. (Discounts offered as a result of the pricing of a sale or a product or service may be termed sales discounts. This Subsection does not address these discounts.)

310-10-35-48 Nonmortgage loans held for sale shall be reported at the lower of **amortized cost basis** or fair value. This paragraph applies only to nonmortgage loans. See Topic 948 for guidance related to mortgage loans classified as held for sale.

320-10-35-1 Investments in **debt securities** shall be measured subsequently as follows:

a. **Trading securities**. Investments in debt securities that are classified as **trading** shall be measured subsequently at **fair value** in the statement of financial position. Unrealized **holding gains and losses** for trading securities shall be included in earnings.

b. **Available-for-sale securities**. Investments in debt securities that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraphs 815-25-35-1 through 35-4.

c. Held-to-maturity securities. Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to Subtopic 830-20.

320-10-35-10 The transfer of a security between categories of investments shall be accounted for at fair value. At the date of the transfer, the security's unrealized **holding gain or loss** shall be accounted for as follows:

a. For a security 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 shall not be reversed.

b. For a security transferred into the trading category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings shall be recognized in earnings immediately.

c. For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer shall be reported in other comprehensive income.

d. For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer shall continue to be reported in a separate component of shareholders' equity, such as accumulated other comprehensive income, but shall be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount. The amortization of an unrealized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount (discussed in the following sentence) for that held-to-maturity security. For a debt security transferred into the held-to-maturity category, the use of fair value may create a premium or discount that, under amortized cost accounting, shall be amortized thereafter as an adjustment of yield pursuant to Subtopic 310-20.

320-10-35-11 Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances identified in paragraph 320-10-25-6(a) through (f).

320-10-35-15 When a security is transferred from held-to-maturity to available-for-sale, the security's **amortized cost basis** carries over to the available-for-sale category for all of the following purposes:

a. The subsequent amortization of the historical premium or discount

b. The comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses under paragraph 320-10-35-1

c. The required disclosures of amortized cost.

320-10-35-16 When a security is transferred from available-for-sale to held-to-maturity, the difference between the par value of the security and its fair value at the date of transfer is amortized as a yield adjustment in accordance with Subtopic 310-20. That fair value amount, adjusted for subsequent amortization, becomes the security's amortized cost basis for the disclosures required by paragraphs 320-10-50-2 through 50-3, 320-10-50-5, and 320-10-50-10.

326-20-35-7 Once a decision has been made to sell **loans** not currently classified as held for sale, those loans shall be transferred into the held-for-sale classification. The application of the writeoff guidance in paragraph 326-20-35-8 may result in a portion of the amortized cost basis being written off before the loan has been transferred to the held-for-sale classification. Upon transfer, an entity shall measure a valuation allowance equal to the amount by which the **amortized cost basis** (which is reduced by any previous writeoffs but excludes the allowance for credit losses) exceeds the **fair value**. This paragraph applies to both mortgage and nonmortgage loans.

326-30-35-2 For individual **debt securities** classified as **available-for-sale securities**, an entity shall determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. An entity shall record impairment relating to credit losses through an allowance for credit losses. However, the allowance shall be limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses shall be recorded

through other comprehensive income, net of applicable taxes. An entity shall consider the guidance in paragraphs 326-30-35-6 and 326-30-55-1 through 55-4 when determining whether a credit loss exists.

948-310-30-4 A mortgage loan transferred to a long-term-investment classification shall be measured upon transfer at the lower of amortized cost basis or fair value on the transfer date.

948-310-35-1 Mortgage loans held for sale shall be reported at the lower of amortized cost basis or fair value, determined as of the balance sheet date. If a mortgage loan has been the hedged item in a fair value hedge (as addressed in Topic 815), the loan's amortized cost basis used in lower-of-amortized-cost-basis-or-fair value accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 815-25-35-1.

948-310-35-4 Any difference between the carrying amount of the loan and its outstanding principal balance shall be recognized as an adjustment to yield by the interest method. The interest method shall be applied as set forth in paragraphs 310-20-35-18, 310-20-35-26, and 310-20-50-2.

948-310-35-5A See Subtopic 326-20 for guidance on the measurement of credit losses for financial instruments measured at amortized cost basis.