Statement of Financial Accounting Standards No. 91

[FAS91 Status Page]
[FAS91 Summary]

Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases

(an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17)

December 1986

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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CONTENTS

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FAS 91 Summary

This Statement establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. This project was undertaken in response to an AICPA Issues Paper that indicated a diversity in practice in the accounting for nonrefundable fees and costs associated with lending activities.

The provisions of this Statement apply to all types of loans (including debt securities) as well as to all types of lenders (including banks, thrift institutions, insurance companies, mortgage bankers, and other financial and nonfinancial institutions). This Statement also specifies the accounting for fees and initial direct costs associated with leasing.

The Statement specifies that:

- Loan origination fees shall be recognized over the life of the related loan as an adjustment of yield.
- Certain direct loan origination costs shall be recognized over the life of the related loan as a reduction of the loan's yield.
- All loan commitment fees shall be deferred except for certain retrospectively determined fees; commitment fees meeting specified criteria shall be recognized over the loan commitment period; all other commitment fees shall be recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.
- Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual terms of the loan. However, prepayments may be anticipated in certain specified circumstances.

This Statement changes the practice of recognizing loan origination and commitment fees at or prior to inception of the loan. It rescinds FASB Statement No. 17, *Accounting for Leases—Initial Direct Costs*, and amends FASB Statements No. 13, *Accounting for Leases*; No. 60, *Accounting and Reporting by Insurance Enterprises*; and No. 65, *Accounting for Certain Mortgage Banking Activities*.

This Statement shall be applied prospectively to all lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1987 with earlier application encouraged in fiscal years for which annual financial statements have not previously been issued. Retroactive application with restatement of the financial statements for all prior years presented is encouraged but not required.

INTRODUCTION

1. This project was undertaken in response to a request by the Accounting Standards Executive Committee (AcSEC) of the AICPA to address the accounting for nonrefundable fees and costs associated with lending activities. AcSEC indicated that existing accounting pronouncements specify different guidance for similar transactions by various types of financial services entities.

SCOPE

2. This Statement establishes standards of financial accounting and reporting for nonrefundable fees and costs associated with lending activities and loan purchases. Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, syndicating loans, and leasing activities are "lending activities" for purposes of this Statement. The lender's activities that precede the disbursement of funds can generally be distinguished between (a) efforts to identify and attract potential borrowers and (b) efforts necessary to originate a loan or loan commitment after a potential borrower requests a loan or loan commitment. Nonrefundable fees have many different names in practice, such as **origination fees**,[1] points, placement fees, **commitment fees**, application fees, management fees, restructuring fees, and syndication fees, but, for purposes of this Statement, they are referred to as loan origination fees, commitment fees, or syndication fees.

3. This Statement addresses the recognition and the balance sheet classification of nonrefundable fees and costs associated with lending activities. The accounting for discounts, premiums, and commitment fees associated with the purchase of loans and other debt securities such as corporate bonds, Treasury notes and bonds, groups of loans, and loan-backed securities (such as pass-through certificates, collateralized mortgage obligations, and other so-called

"securitized" loans) is also addressed by this Statement. This Statement does not apply to loan origination or commitment fees that are refundable; however, this Statement does apply when such fees subsequently become nonrefundable. It also does not apply to costs that are incurred by the lender in transactions with independent third parties if the lender bills those costs directly to the borrower. It does not apply to nonrefundable fees and costs associated with originating or acquiring loans that are carried at market value.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General

4. An enterprise may acquire a loan by lending (originating the loan) or by purchasing (acquiring a loan from a party other than the borrower). This Statement applies to both a lender and a purchaser. This Statement shall be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted if the provisions of paragraph 19 are met or if the resulting recognition does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis.

Loan Origination Fees and Costs

5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield [2] (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

6. Direct loan origination costs of a completed loan shall include only (a) **incremental direct costs** of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,[3] the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.
b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

10. Available lines of credit under credit card and similar charge card arrangements are loan commitments, and fees collected in connection with such cards (**credit card fees**) are viewed in part as being loan commitment fees. However, those fees generally cover many services to cardholders. Accordingly, fees that are periodically charged to cardholders shall be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card. This accounting shall also apply to other similar card arrangements that involve an extension of credit by the card issuer.

Syndication Fees

11. The enterprise managing a loan syndication (the syndicator) shall recognize loan syndication fees when the syndication is complete unless a portion of the syndication loan is

retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator shall defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

Fees and Costs in Refinancings or Restructurings

12. If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans.[4] Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted.

13. If the refinancing or restructuring does not meet the condition set forth in paragraph 12 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan shall consist of the remaining net investment in the original loan,[5] any additional amounts loaned, any fees received, and direct loan origination costs set forth in paragraph 6 associated with the refinancing or restructuring.

14. Fees received in connection with a modification of terms of a troubled debt restructuring as defined in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, shall be applied as a reduction of the recorded investment in the loan for purposes of applying paragraph 30 of that Statement. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

16. In applying the provisions of this Statement to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts shall be used to apply the interest method, except as set forth in paragraph 19. If prepayments are not

anticipated pursuant to paragraph 19 and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount shall be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.[6] Under the provisions of this Statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)
b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)
c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.[7] (Refer to Appendix B.)

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.
b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[8]

Balance Sheet Classification

21. The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield pursuant to this Statement shall be reported on the enterprise's balance sheet as part of the loan balance to which it relates.

Income Statement Classification

22. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield shall be reported as part of interest income. Amortization of other fees, such as commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires, shall be reported as service fee income.

Application to Leasing Activities

23. The provisions of paragraphs 5-9 of this Statement shall apply to lessors in determining the net amount of *initial direct costs* as that term is used in FASB Statement No. 13, *Accounting for Leases*. Lessors shall account for initial direct costs as part of the investment in a direct financing lease. The practice of recognizing a portion of the unearned income at inception of the lease to offset initial direct costs shall no longer be acceptable.

Amendments to Other Pronouncements

24. This Statement rescinds FASB Statement No. 17, *Accounting for Leases—Initial Direct Costs* (which amended the definition of initial direct costs in Statement 13), and replaces the definition of initial direct costs in paragraph 5(m) of Statement 13 with the following:

> *Initial direct costs*.* Only those costs incurred by the lessor that are (a) costs to originate a lease incurred in transactions with independent third parties that (i) result directly from and are essential to acquire that lease and (ii) would not have been incurred had that leasing transaction not occurred and (b) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are: evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs shall not include administrative costs, rent, depreciation, any other occupancy and equipment costs and employees' compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.

*Initial direct cost shall be offset by nonrefundable fees that are yield adjustments as prescribed in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

25. Statement 13 is further amended as follows for the accounting and disclosure of initial direct costs of direct financing leases:

a. The first sentence of paragraph 18(a) is amended to read as follows:

> The sum of (i) the minimum lease payments (net of amounts, if any, included therein with respect to executory costs to be paid by the lessor, together with any profit thereon), (ii) the unguaranteed residual value accruing to the benefit of the lessor, and (iii) the initial direct costs shall be recorded as the gross investment in the lease.

b. The third sentence of paragraph 18(b), which reads as follows, is deleted:

> Initial direct costs (as defined in paragraph 5(m)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period.

c. The term *remaining* is deleted from the fourth sentence of paragraph 18(b), which then reads as follows:

> The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[21]

d. Subparagraph (a)(i) of paragraph 23 is superseded by the following to add disclosure of initial direct costs for direct financing leases:

> The components of the net investment in sales-type and direct financing leases as of the date of each balance sheet presented:
> (a) Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any profit thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable.
> (b) The unguaranteed residual values accruing to the benefit of the lessor.
> (c) For direct financing leases only, initial direct costs (see paragraph 5(m)).
> (d) Unearned income (see paragraphs 17(b) and 18(b)).

e. Subparagraph (a)(iii) of paragraph 23 is deleted.

26. Paragraph 49 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is superseded by the following:

Loan origination and commitment fees and direct loan origination costs shall be accounted for as prescribed in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

27. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is amended as follows:

a. The second sentence of paragraph 6 is superseded by the following:

Any difference between the carrying amount of the loan or security and its outstanding principal balance shall be recognized as an adjustment to yield by the interest method.[2]

b. Footnote 2 is superseded by the following:

[2]The interest method shall be applied as set forth in paragraphs 18 and 19 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

c. Paragraph 21 and its heading are superseded by the following:

Loan Origination Fees and Costs

If the loan is held for resale, loan origination fees and the direct loan origination costs as specified in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, shall be deferred until the related loan is sold. If the loan is held for investment, such fees and costs shall be deferred and recognized as an adjustment of yield as specified in paragraphs 18-20 of Statement 91.

d. The first sentence of paragraph 23 is superseded by the following:

Fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers shall be accounted for as prescribed in paragraph 8 of Statement 91. Fees paid to permanent investors to ensure the ultimate sale of the loans (residential or commercial loan commitment fees) shall be recognized as expense when the loans are sold to permanent investors or when it becomes evident the commitment will not be used.

e. Paragraph 25 and its heading are superseded by the following:

Fees and Costs Relating to Loans Not Held for Sale

Fees and costs associated with originating or acquiring or committing to originate or acquire loans for investment shall be accounted for as prescribed in Statement 91.

f. Paragraphs 14 and 26 and the heading for paragraph 14 are deleted.

Effective Date and Transition

28. This Statement shall be applied prospectively to lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1987 and interim periods within those fiscal years. Retroactive application, by restating all prior years presented, is encouraged but not required. Earlier application is encouraged in fiscal years for which financial statements have not previously been issued. In the year that this Statement is first applied, the financial statements shall disclose the nature of accounting changes adopted to conform to the provisions of this Statement and their effect on income before extraordinary items, net income, and related per share amounts for the current year and for each restated year presented. If adopted prospectively, disclosure of the accounting change and the prior accounting policies shall be continued in financial statements of subsequent years in which outstanding loans accounted for under the prior policy are material.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Wyatt dissented.

Mr. Wyatt dissents to issuance of this Statement because it provides for the deferral and amortization of various costs incurred by an entity that originates loans based on the nature of the parties to whom payments are made rather than on the nature of the costs incurred or the nature of the activities for which the costs are incurred. Paragraph 6 distinguishes between costs incurred in transactions with independent third parties and costs related to specified activities performed by the lender. The specified activities are intended to limit deferral to only those costs incurred directly on loan origination activities. No such limitation of activities is prescribed, however, for costs incurred in transactions with independent third parties. As a result, the attempt to limit deferral of costs to only specified loan origination activities is rendered ineffective by permitting deferral of a variety of nonorigination costs so long as payments for them are made to third parties. Costs incurred for advertising and solicitation activities (as well as for certain other activities) are deferred if payments for them are made to third parties but are charged to expense if paid to employees. That distinction is likely to encourage entities to engage third parties to undertake certain activities that are presently undertaken by employees to achieve an accounting result rather than for otherwise sound business reasons.

Mr. Wyatt believes that costs of origination to be deferred and amortized should be related to origination activities, as defined in paragraph 6, regardless of whether the payments for those services are made to outside third parties or to employees. In his view, such an approach would accomplish better the objective of accounting for similar activities in a similar, or consistent, fashion.

Those portions of the standard that provide guidance for accounting for fees received in connection with originating a loan or committing to lend will result in significantly improved reporting of revenues by more closely relating them to services provided than to receipts of cash. The guidance provided for the deferral and amortization of various costs incurred, however, is likely to counteract the improvements made in revenue recognition. As a result, little, if any, improvement is likely to result from this Statement for accounting for nonrefundable fees and costs associated with loan origination activities.

Mr. Wyatt also believes that the central thrust of the transition provisions is misplaced. The comparability of financial presentations achieved by applying new standards on a retroactive basis for all years presented is an objective that Board standards should strive to achieve. In some instances, practical considerations and costs to be incurred to restate may suggest that prospective application is also acceptable. Paragraph 28 implies that prospective application is preferable. Mr. Wyatt believes the transition should call for retroactive application, with prospective application permitted in this standard for practical reasons. While the net effect of such a transition would be the same as is likely to flow from application of paragraph 28, that transition approach would indicate better the most desirable transition priorities for new financial accounting standards.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Victor H. Brown
Raymond C. Lauver
David Mosso
C. Arthur Northrop
Robert J. Swieringa
Arthur R. Wyatt

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Paragraph Numbers

Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

29. This appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement. It includes descriptions of alternatives considered by the Board with reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

30. Accounting guidance for loan fees and costs is provided in AICPA Audit and Accounting Guides and Statements of Position and FASB Statements. Each of those sources generally provides guidance for only a specific type of entity in the financial services industry.

31. In the late 1970s and early 1980s, AcSEC reviewed proposed revisions to the AICPA Audit and Accounting Guides for banks, savings and loan associations, and finance companies. During its review, AcSEC observed that the individual Guides contain differing guidance for accounting for fees and costs for similar lending transactions. Because of those inconsistencies, AcSEC formed a task force to study the issues applicable to all of the financial services industry. That task force prepared an Issues Paper, "Accounting for Nonrefundable Fees of Originating or Acquiring Loans and Acquisition Costs of Loan and Insurance Activities," which AcSEC submitted to the FASB. In September 1984, the Board issued an Invitation to Comment, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans*, incorporating the Issues Paper, to solicit information from interested parties prior to Board deliberations on the subject. The Board received 206 letters of comment in response to the Invitation to Comment. In December 1985, the Board issued an Exposure Draft, *Accounting for Nonrefundable Fees and Costs Associated with Originating and Acquiring Loans*, for a 120-day comment period. The Board received comments from 822 individuals and organizations and held a public hearing in July 1986 at which 55 of those organizations appeared.

Scope

32. After reviewing the nature of the lending process, the Board concluded that accounting for loan origination fees and costs should be consistent for all types of lending. That conclusion was generally supported by respondents to the Exposure Draft. No compelling arguments were made supporting a conclusion that the lending process for consumer, mortgage, commercial, and other loans or leases is fundamentally different. Nor were any substantive arguments made suggesting

that different types of lenders should account for loans differently or that financial statement users for a particular industry or size of entity would be better served by accounting that differs from that of other lenders.

33. Some respondents urged that purchases of debt securities, such as corporate bonds, notes, debentures, and government debt instruments, should not be subject to this Statement. The Board did not agree. An enterprise may acquire an investment in a loan or other interest-earning asset by lending (originating the asset) or by purchasing. When a loan is purchased, the price paid to purchase the loan (including any fees received from the seller or paid by the buyer to take delivery of the loan, such as commitment or delivery fees) frequently differs from the loan's principal amount. The difference between the net cost and the principal amount adjusts the nominal rate on the loan to a yield that the purchaser is willing to accept. The Board concluded that premiums and discounts on purchased loans are fundamentally similar to net fees collected and costs incurred to originate a loan. Both must be considered to reflect accurately the asset's acquisition cost and income on the investment.

34. The Board concluded that this Statement should not apply to fees and costs and premiums or discounts associated with loans that are carried at market value, because carrying loans at market values obviates the need for accounting guidance for recognition of fees and costs and premiums or discounts associated with those loans.

Loan Origination Fees and Costs

35. The cost of originated loans is not limited to the net cash outflow to the borrower (principal amount of the loan less fees collected from the borrower in connection with the loan). The lender generally performs certain activities to process a borrower's request for credit. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The Board concluded that these activities are initiated upon the prospective borrower's request for credit, are for the benefit of the lender or subsequent investor, and relate directly to originating the loan; they are, therefore, integral to lending.

36. The Board received considerable comment about the variety of fees collected by a lender in connection with lending. The Board divided such fees for loan origination into two principal categories: (a) fees associated with origination of a loan and (b) fees associated with committing to lend. Origination fees consist of:

a. Fees that are being charged to the borrower as "prepaid" interest or to reduce the loan's nominal interest rate, such as interest "buy-downs" (explicit yield adjustments)
b. Fees to reimburse the lender for origination activities
c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend

quickly)

d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 11).

Designation of a fee or cost as an origination fee or cost for a loan that is purchased is inappropriate because a purchased loan has already been originated by another party.

37. The Board concluded that loan origination fees and direct loan origination costs should be accounted for as components of a loan's acquisition cost and recognized as an adjustment to the yield of the related loan. The Board considered and rejected the argument that loan origination is a separate revenue-producing activity and concluded that originating loans is but one means of acquiring a loan. Revenue is not realized by acquisition of a loan; it is only realized by holding or selling it. Furthermore, the Board disagreed with those respondents who argued that originating a loan is a separate service to the borrower. The efforts of the lender to conclude that the borrower should be financially able to repay the loan and that the lender has satisfactory remedies in the event of default are for the benefit of the lender or subsequent investor rather than the borrower. The Board also rejected the argument that the fees represent a reimbursement for the costs the lender incurs in obtaining funds because the lending activity is not related to soliciting or obtaining funds to lend.

38. The Exposure Draft reflected the Board's tentative conclusions that certain origination costs should be deferred and recognized as an adjustment of yield over the life of the related loan. The Board limited the costs that should be deferred partly as a result of comments received from those respondents to the 1984 Invitation to Comment that asserted that they were unable to measure loan origination costs. The Exposure Draft proposed that costs to be deferred should be limited to those origination costs that are both incremental and direct to a specific lending transaction. Respondents to the Exposure Draft generally opposed deferral of only incremental direct costs. Respondents indicated that costs of origination, however defined, could be reliably measured, that deferral of only incremental direct costs treated costs of essentially similar activities differently, and that the way an enterprise carries out loan origination activities, for example, the way it compensates employees, should not determine the accounting for such costs. Based upon comments received, the Board was persuaded that the conclusions of the Exposure Draft should be modified.

39. The Board concluded that deferral of the costs of origination activities set forth in paragraph 6 for completed loans is appropriate whether the activities are performed by the lender's employees or by independent third parties. The Board views those specified activities as integral to the lending transaction. The Board acknowledges that the lender may perform activities other than those specified in paragraph 6 to originate a loan and therefore incurs costs related to lending that do not meet the definition set forth in paragraph 6.

40. The Board concluded that costs associated with loan origination that are incurred by the lender in transactions with independent third parties should be deferred. The Board recognizes that this decision permits the deferral of a fee paid to a third party for solicitation related to a completed loan whereas, if that solicitation were performed by the lender's employees, paragraph 7 would proscribe the deferral of those costs. The Board considered whether costs incurred in transactions with independent third parties should be deferred if those costs relate to activities other than those specified in paragraph 6. One approach was to defer all of those costs, because they represent a reliable measure of the lender's economic sacrifice that is incurred only if the lending transaction is completed. Another approach was to defer only the portion of those costs that relates to those specified origination activities and to charge the costs associated with other activities, such as solicitation, to expense. Under the latter approach, if the third party performed more than one activity for its fee, the lender would allocate the third party fee between specified origination activities and other activities. When origination activities are being performed by an independent third party, the Board believes that the lender is not in a position to determine the portion of time spent by the third party on each of the activities and therefore is unable to determine the amount of cost applicable to the origination activities. Because of that difficulty and because incremental direct costs incurred with an independent third party represent a reliable measure of the lender's economic sacrifice to acquire a specific loan, the Board concluded that the incremental direct costs of loan origination incurred in transactions with independent third parties should be deferred.

41. In requiring the deferral of incremental direct costs of loan origination incurred in transactions with independent third parties, the Board established certain conditions (refer to the definition of incremental direct costs in Appendix C) to have those costs qualify for deferral. Incremental direct costs of loan origination incurred with independent third parties must include only those costs that result directly from and are essential to the lending transaction and would not have been incurred by the lender had the lending transaction not occurred. The Board acknowledges that in some circumstances judgment will be necessary to conclude that a cost incurred with a third party is essential to the lending transaction and that the third party is, in fact, independent; however, the Board concluded that such judgments are both necessary and practicable.

42. The Board concluded that the costs associated with solicitation efforts by the lender's employees should be charged to expense as incurred because the nature of solicitation is such that it is impracticable to identify the extent of successful and unsuccessful solicitation efforts on a timely, reliable basis. The Board recognizes that commission-based compensation arrangements between a lender and its employees may be similar to arrangements a lender may have with independent third parties such as brokers. However, when origination activities are performed by the lender's employees, the Board believes that the lender can make reasonable estimates of the costs applicable to the activities specified in paragraph 6 based on the portion of time spent by employees. In making those cost allocations to a completed loan, the Board concluded that the lender should allocate the employee's total compensation, including payroll-related fringe benefits and amounts earned from solicitation, between origination

activities and other activities, including solicitation, and only that portion of total compensation that relates to activities set forth in paragraph 6 should be deferred for that completed loan. The Board acknowledges that such allocations will be judgmental, but it believes that lenders can make such judgments based on measures of the activities performed by employees.

43. The Board also considered respondents' suggestions to permit allocation of indirect costs, such as supervision, occupancy, depreciation, and other costs, to completed loans. The Board views those as recurring indirect costs and concluded that all of those costs should be charged to expense as incurred, including occupancy costs for facilities that are dedicated solely to loan origination.

44. Many financial institutions have recognized as revenue fees equal to the approximate costs of origination when a loan is made. The Board rejected that approach because it believes that revenue recognition should not be based on the timing and amount of cost recognition. Likewise, the Board concluded that the practice of accelerating the recognition of lease finance revenues to offset initial direct costs or other costs of direct financing leases should no longer be acceptable.

Commitment Fees

45. The Board concluded that a loan commitment may be either integral to lending or a separate customer service depending on the nature of the commitment. Paragraph 8 of this Statement requires commitment fees to be deferred except in limited circumstances and, if the loan commitment is exercised, recognized by the interest method over the life of the loan as an adjustment of yield or recognized in income on expiration of the commitment if the loan commitment expires unexercised.

46. The Board considered two principal factors in reaching its conclusions about whether a commitment is principally a separate service or is integral to lending. The first was whether the commitment provides the customer with a benefit that is objectively distinguishable from a commitment that is expected to result in a lending transaction. The Board could find little substantive difference between the activities involved in loan origination and those involved in loan commitment when the enterprise reasonably expects the commitment to be exercised. Accordingly, the Board concluded that the accounting for fees for both activities should be the same unless the likelihood the commitment will be exercised is remote.

47. The second factor was whether the commitment provides the customer with a benefit that is not principally derived from the use of borrowed funds. Some respondents suggested that a fee received for granting a commitment constitutes a separate revenue-generating activity that should result in fee recognition over the commitment period. Those respondents indicated that the commitment fee compensates the enterprise for a variety of risks assumed during the commitment period. Those risks may include a liquidity risk, credit risk, or interest rate risk. Other respondents suggested that a commitment fee usually has both service and yield

components and the accounting should reflect the substance of the fee. Some respondents, while noting that a commitment fee may have service and yield components, acknowledged that reliably measuring the separate components may be too difficult. As a result, they suggested that the commitment fee should be recognized over the combined commitment period and loan life. Recognition during the commitment period would be on a straight-line basis using a combined life approach; upon exercise, the remaining unamortized balance would be recognized under the interest method over the same period used for recognizing deferred origination fees and costs.

48. The Board rejected the suggestion of those respondents that the commitment fee be recognized over the commitment period or the combined commitment and loan period. The Board acknowledges that a fee received by an enterprise at the time a commitment is granted may be compensation to the enterprise for a variety of services provided and risks assumed. Those services and risks may include a guaranteed availability of funds and a guaranteed interest rate. However, to the extent that a commitment fee may compensate the enterprise for interest rate or credit risks assumed during the commitment period, the Board noted that the enterprise can suffer from those risks only if the loan is made. The related economic sacrifice is incurred by the lender over the term of the loan and not over the term of the commitment. Accordingly, the Board concluded that the lender should recognize the compensation related to those risks assumed over the period the enterprise incurs the economic sacrifice, that is, while the loan is outstanding. To the extent that a portion of the commitment fee represents a yield adjustment, recognition of the commitment fee over the combined commitment and loan period results in premature recognition of income. Further, even to the extent that a portion of the commitment fee is to compensate the enterprise for some service provided during the commitment period, the Board concluded that the separate components of a commitment fee cannot be identified and measured reliably enough to allow separate accounting recognition for each component part.

49. The Board concluded that if, at the inception of the commitment period, the likelihood of the commitment resulting in a loan is remote, the commitment fee should be recognized as service fee income over the commitment period. The Board decided that otherwise the fee should be deferred and, if the loan commitment is exercised, recognized by the interest method over the life of the loan as an adjustment of yield or, if the loan commitment expires unexercised, recognized in income upon expiration of the commitment.

50. The fees for some loan commitments are structured in a manner that precludes any part of the fee from being considered integral to lending because the amount of the commitment fee is based on the portion of a loan commitment that is not exercised. For example, a lending institution may grant its customer a commitment for a revolving line of credit, the fee for which is determined as a percentage of the unused line of credit. Since the percentage is applied only to the portion of the commitment that was not funded as a loan, the fee relates to the service of maintaining the availability of funds and is not considered to be principally integral to lending. Further, the level of fee for such commitments has historically been nominal in relation to the stated interest rate on any related borrowing. The Board concluded that if the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but

unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee should be recognized as service fee income as of the determination date.

Credit Card and Similar Fees

51. The Board retained the provision in the Exposure Draft that called for recognition of credit card fees on a straight-line basis over the period the fee entitles the cardholder to use the credit card. Some respondents suggested that credit card fees are not related to the lending process and should be excluded from the scope of the Statement. The Board did not accept that view. While the amount of fee collected from each individual borrower may not be of the magnitude of other commitment fees collected by the lender on other loan arrangements, the Board concluded that the substance is the same. A credit card fee represents a payment by the cardholder to obtain the ability to borrow from the lender under predefined conditions. Such borrowings take place at the option of the borrower. The Board noted that such arrangements provide opportunities to lend and concluded that the related fees represent commitment fees. The Board recognized that application of the interest method to the outstanding balances of a credit cardholder would be impracticable in most instances. Accordingly, this Statement requires the fee to be recognized on a straight-line basis over the period the fee entitles the cardholder to use the card. The Board agreed with those respondents who suggested that the conclusion regarding credit card fees be extended to fees collected in similar arrangements that involve an extension of credit by the card issuer, such as charge cards and cash cards. The Board views the substance of these transactions as similar and has included fees received from such arrangements in the definition of credit card fees for purposes of applying this Statement.

Refinancings and Restructurings

52. The Exposure Draft required that all refinanced or restructured loans be accounted for as continuations of the prior loans. The Exposure Draft reflected the Board's concern about the practicality of establishing effective criteria for differentiating between refinancings and restructuring that should be considered new loans and those that should be considered continuations of the prior loans. Respondents expressed the view that accounting for all refinanced or restructured loans as continuations of the prior loans would result in essentially identical loans having different effective yields and would not faithfully represent the substance of the transaction. Respondents acknowledged that establishing criteria that would be effective for all circumstances might not be possible but indicated that improvement could be achieved by permitting loans that can be demonstrated to possess terms that are comparable to new loans granted to comparable borrowers to be accounted for as new loans. The Board concluded that the lender should account for the loan as a new loan if the terms on the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing a loan with the lender; otherwise the fees and costs associated with the prior loan are carried forward as part of the investment in the new loan.

However, the Board also concluded that minor modifications to a loan agreement would not constitute a transaction that would result in a new loan and recognition of the prior loan's net fees or costs.

Amortization

53. The Board concluded that the interest method should be used to recognize fees and costs associated with originating and acquiring loans. The Board concluded that loan fees and costs and purchase premiums and discounts related to loans do not differ substantively and should be accounted for similarly. All are part of the net investment in the underlying asset, the loan. Using the interest method to recognize associated fees and costs, together with the loan's stated interest, appropriately reflects the effective interest on the loan.

54. When a loan's stated interest rate increases during the term of the loan, the periodic amortization calculated under the interest method early in the loan term would exceed the stated interest received. In such a case, an amount that would be recognized as income before it accrues under the contract would increase the net investment in the loan to an amount in excess of that at which the borrower could settle the obligation. The Board concluded that the recognition of interest income should not cause the net investment of a loan to exceed the amount at which the borrower could settle the obligation. Accordingly, paragraph 18(a) imposes a limit on the amount of periodic amortization that can be recognized. However, that limitation does not apply to the capitalization of costs incurred (such as direct loan origination costs and purchase premiums) that cause the investment in the loan to be in excess of the amount at which the borrower could settle the obligation. The Board concluded that the capitalization of costs incurred is different from increasing the net investment in a loan through accrual of interest income that is only contingently receivable.

55. In limiting the amount of interest income that can be recognized when a loan's stated interest rate increases during the term of the loan, paragraph 18(a) permits prepayment penalties to be considered only to the extent that such penalties are imposed on all prepayments occurring prior to maturity. Considering prepayment penalties has the effect of increasing the limit imposed on the recognition of interest income. Prohibiting consideration of penalties that are not imposed throughout the term of the loan is, in the Board's view, a simplified and practical way of assuring that the net investment in the loan is not increased through accrual of interest to an amount in excess of that at which the borrower could settle the obligation.

56. If a loan contract establishes an interest rate that decreases over the loan term, the Board concluded that the interest method should be applied to recognize the fees and costs and the stated interest payment as specified in paragraph 18(b). The Board views the high initial rates as being substantively the installment payment of a loan fee during the early life of the loan.

57. The Board also decided that the interest method should be applied to recognize fees and costs associated with variable rate loans. The Board noted that the effect on the amortization as

a result of subsequent changes in interest rates would not normally be significant and that the benefit of such subsequent calculations generally would not justify the additional cost. Therefore, paragraph 18(c) was added to simplify application of the interest method to those loans by eliminating the requirement to recalculate a new effective rate each time the index on the loan changes. However, the Board modified the provisions of the Exposure Draft to allow preparers the option of recalculating a new effective rate each time the index on the loan changes.

58. Respondents generally supported use of the interest method to recognize fees and costs and purchase premiums and discounts. However, most respondents disagreed with the provision of the Exposure Draft that precluded an entity from anticipating prepayments for purposes of applying the interest method. Respondents argued that the timing and amount of prepayments on loans such as mortgages can be reliably estimated and, therefore, prepayments should be anticipated for purposes of applying the interest method to recognize loan fees and costs. The Board acknowledges that in certain circumstances it may be possible to estimate reasonably an event beyond an enterprise's control, such as prepayments, if the population of loans is large and their characteristics are similar. The Board concluded that, in certain circumstances, anticipation of prepayments would be acceptable in applying the interest method. The Board concluded that an enterprise should be permitted but not required to anticipate prepayments of principal in applying the interest method to a large number of similar loans. The Board noted that loans grouped together should have sufficiently similar characteristics that prepayment experience of the loans can be expected to be similar in a variety of interest rate environments. The Board also noted that loans that are grouped together for purposes of applying paragraph 19 should have sufficiently similar levels of net fees or costs so that, in the event that an individual loan is sold, recalculation of that loan's carrying amount will be practicable. Paragraph 19 sets forth conditions that must exist for an enterprise to anticipate prepayments in applying the interest method. Absent a reasonably large number of loans with similar characteristics, the Board believes the reliability of reasonably projecting cash flows is diminished to an unacceptable level.

59. When the conditions of paragraph 19 are not met, the Board concluded that anticipation of prepayments is not appropriate and that recognition of fees and costs and purchase premiums or discounts should be in accordance with the repayment terms provided in the loan contract, with any unamortized amount recognized in income if and when a prepayment occurs.

Amendments to Other Pronouncements

60. The Board concluded that the activities involved in originating or acquiring leases are not substantively different from the activities involved in lending arrangements and, therefore, the costs involved in those activities should be determined similarly. In addition, nonrefundable fees and costs related to direct financing leases should be accounted for in a manner consistent with the accounting for lending activities.

Effective Date and Transition

61. The Exposure Draft would have been effective for fiscal years beginning after December 15, 1986 and would have required enterprises to adopt the provisions of the Statement by retroactively restating financial statements of prior years if practicable. If restatement of all years presented was not practicable, the provisions of the Statement were to be applied on a prospective basis to all lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1986.

62. The Exposure Draft included a notice to recipients specifically requesting comments on a transition approach that would have involved retroactive application only to transactions occurring within the last three years. Some respondents suggested that any retroactive application would be too costly and time-consuming. Those respondents suggested that the Statement be applied prospectively. Historically, most lenders have charged acquisition costs to expense and recognized all or a portion of origination and commitment fees at the date a loan was funded. Respondents suggested the information that would be necessary to determine the amounts that would be deferred if this Statement were applied retroactively is not available. The Board noted that applying this Statement prospectively to transactions occurring after the effective date will diminish the comparability of an enterprise's financial statements for periods before and after the effective date and that, due to the types of transactions addressed by this Statement, the lack of comparability may exist for long periods of time. However, the Board is persuaded that the costs of requiring such a determination retroactively would place an excessive burden on many entities. Therefore, the Board modified the transition provision of this Statement to encourage, but not require, retroactive restatement.

63. Some respondents commented that the accounting system changes that would be required as a result of the Exposure Draft would require time for implementation and urged that the effective date of the Statement be delayed for a number of years. The Board acknowledges that certain changes in accounting systems will be required as a result of the provisions of this Statement. As a result, the Board changed the effective date of the Statement so as to require adoption in fiscal years beginning after December 15, 1987.

Appendix B: EXAMPLES OF APPLICATION OF THIS STATEMENT

64. This appendix presents examples that illustrate the application of this Statement. The examples and estimates used are illustrative only and are not intended to modify or limit in any way the provisions of this Statement. All examples assume that principal and interest payments are made on the last day of the year.

Case 1—Amortization Based on Contractual Payment Terms

65. On January 1, 19X7, A Company originates a 10-year $100,000 loan with a 10 percent stated interest rate. The contract specifies equal annual payments of $16,275 through December 31, 19Y6. The contract also specifies that no penalty will be charged for prepayments of the loan. A Company charges a 3 percent ($3,000) nonrefundable fee to the borrower and incurs $1,000 in direct loan origination costs (attorney fees, appraisal, title insurance, wages and payroll-related fringe benefits of employees performing origination activities, outside broker's fee). The carrying amount of the loan is computed as follows:

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

66. A Company accounts for this loan using contractual payments to apply the interest method of amortization. In calculating the effective rate to apply the interest method, the discount rate necessary to equate 10 annual payments of $16,275 to the initial carrying amount of $98,000 is approximately 10.4736 percent. The amortization if no prepayment occurs is shown in Table 1.

Table 1—Amortization Based on Contractual Payment Terms

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(98,000)				$100,000		$98,000
1	16,275	$10,000	$ 264	$10,264	93,725	$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	16,275	8,682	257	8,939	79,230	1,217	78,013
4	16,275	7,923	248	8,171	70,878	969	69,909
5	16,275	7,088	234	7,322	61,691	735	60,956
6	16,275	6,169	215	6,384	51,585	520	51,065
7	16,275	5,159	189	5,348	40,469	331	40,138
8	16,275	4,047	157	4,204	28,241	174	28,067
9	16,275	2,824	116	2,940	14,790	58	14,732
10	16,275	1,485 [a]	58	1,543	0	0	0
Total amortization			$2,000				

Computations:

Column (1)—Contractual payments

Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)

Column (3)—Column (4) - Column (2)

Column (4)—Column (7) for prior year × the effective interest rate (10.4736%) [b]

Column (5)—Column (5) for prior year – (Column (1) - Column (2))

Column (6)—Initial net fees – amortization to date

Column (7)—Column (5) – Column (6)

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[a] $6 rounding adjustment.

[b] The effective interest rate is the discount rate that equates the present value of the future cash inflows to the initial net cash outflow of $98,000.

Case 2—Amortization Based on Contractual Payment Terms with Full Prepayment in Year 3

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

68. B Company accounts for this loan using contractual payments to apply the interest method of amortization. The amortization if the borrower prepays the remaining principal at the end of year 3 is shown in Table 2.

Table 2—Amortization Based on Contractual Payment Terms with Full Prepayment in Year 3

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(98,000)				$100,000		$98,000
1	16,275	$10,000	$ 264	$10,264	93,725	$1,736	91,989
2	16,275	9,373	262	9,635	86,823	1,474	85,349
3	95,505	8,682	1,474	10,156	0	0	0
	Total amortization		$2,000				

Computations:
Column (1)—Contractual payments + prepayments
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for prior year × the effective interest rate (10.4736%) plus in year 3 an adjustment of $1,217 representing the unamortized net fees recognized when the loan is paid in full.
Column (5)—Column (5) for prior year – (Column (1) – Column (2))
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

Case 3—Amortization Based on Estimated Prepayment Patterns

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

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

70. C Company chooses to account for this large number of loans using anticipated prepayment patterns to apply the interest method of amortization. C Company estimates a constant prepayment rate of 6 percent per year, which is consistent with C Company's prior experience with similar loans and C Company's expectation of ongoing experience. The amortization when prepayments occur as anticipated is shown in Table 3.

Table 3—Amortization Based on Estimated Prepayment Patterns

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(9,800,000)				$10,000,000		$9,800,000
1	2,227,454	$1,000,000	$ 35,141	$1,035,141	8,772,546	$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	1,880,619	760,018	28,724	788,742	6,479,577	104,189	6,375,388
4	1,719,716	647,958	25,453	673,411	5,407,819	78,736	5,329,083
5	1,566,144	540,782	22,111	562,893	4,382,457	56,625	4,325,832
6	1,419,028	438,246	18,677	456,923	3,401,675	37,948	3,363,727
7	1,277,230	340,168	15,131	355,299	2,464,613	22,817	2,441,796
8	1,138,934	246,461	11,458	257,919	1,572,140	11,359	1,560,781
9	1,000,180	157,214	7,646	164,860	729,174	3,713	725,461
10	802,091	72,917	3,713	76,630	0	0	0
Total amortization			$200,000				

Computations:
Column (1)—Contractual payments + 6% of Column (5) for the prior year (except in year 10)
Column (2)—Column (5) for prior year × the loan's stated interest rate (10%)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (10.5627%)
Column (5)—Column (5) for prior year – (Column (1) – Column (2))
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

Case 4—Amortization Based on Estimated Prepayment Patterns Adjusted for Change in Estimate

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

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

73. Table 4 illustrates the adjustment required by paragraph 19 of this Statement when an enterprise's actual prepayment experience differs from the amounts anticipated. The loans have actually prepaid at a rate of 6 percent in years 1 and 2 and 20 percent in year 3, and based on the new information at the end of year 3, D Company revises its estimate of prepayment experience

to anticipate that 10 percent of the loans will prepay in year 4 and 6 percent of the loans will prepay in remaining years. The carrying amount of the loans at the end of year 3 is adjusted to the amount that would have existed had the new effective yield been applied since January 1, 19X7. Included in amortization in year 3 is an adjustment for the difference in the prior effective yield and the new effective yield applied to amounts outstanding in years 1 and 2. Amortization in years 4-10 assumes the new estimates of prepayment experience occur as anticipated.

Table 4—Amortization Based on Estimated Prepayment Patterns Adjusted for a Change in Estimate

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(9,800,000)				$10,000,000		$9,800,000
1	2,227,454	$1,000,000	$ 35,141	$1,035,141	8,772,546	$164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	2,944,644	760,018	41,951	801,969	5,415,552	90,962	5,324,590
4	1,653,939	541,555	23,294	564,849	4,303,168	67,668	4,235,500
5	1,246,229	430,317	18,998	449,315	3,487,256	48,670	3,438,586
6	1,129,164	348,726	16,050	364,776	2,706,818	32,620	2,674,198
7	1,016,331	270,682	13,005	283,687	1,961,169	19,615	1,941,554
8	906,285	196,117	9,849	205,966	1,251,001	9,766	1,241,235
9	795,875	125,100	6,574	131,674	580,226	3,192	577,034
10	638,249	58,023	3,192	61,215	0	0	0
Total amortization			$200,000				

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

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[c]An adjustment would also be required if the level of prepayments realized was less than anticipated.

Case 5—Application of Paragraph 18(a)—When the Loan's Prepayment Penalty Is Effective throughout the Entire Term

74. E Company grants a 10-year $100,000 loan with an 8 percent stated interest rate in year 1 and 10 percent in years 2-10. E Company receives net fees of $1,000 related to this loan. The contract specifies that the borrower must pay a penalty equal to 1 percent of any principal

prepaid. Application of the effective yield to recognize an amount in excess of net fees is appropriate for a loan with an increasing stated interest rate only to the extent that the loan agreement provides for a prepayment penalty that is effective throughout the loan term.

Table 5—Application of Paragraph 18(a)—When the Loan's Prepayment Penalty Is Effective throughout the Entire Term

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees [d]	(7) Carrying Amount	(8) Settlement Amount
	$(99,000)				$100,000		$99,000	
1	14,903	$8,000	$1,710	$9,710	93,097	$(710)	93,807	$94,028
2	16,165	9,310	(108)	9,202	86,242	(602)	86,844	87,104
3	16,165	8,624	(106)	8,518	78,701	(496)	79,197	79,488
4	16,165	7,870	(102)	7,768	70,406	(394)	70,800	71,110
5	16,165	7,041	(97)	6,944	61,282	(297)	61,579	61,895
6	16,165	6,128	(88)	6,040	51,245	(209)	51,454	51,757
7	16,165	5,124	(78)	5,046	40,204	(131)	40,335	40,606
8	16,165	4,021	(65)	3,956	28,060	(66)	28,126	28,340
9	16,165	2,806	(47)	2,759	14,701	(19)	14,720	14,848
10	16,165	1,464 [e]	(19)	1,445	0	0	0	0
	Total amortization		$1,000					

Computations:

Column (1)—Contractual payments

Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in year 1, 10% in years 2-10)

Column (3)—Column (4) – Column (2)

Column (4)—Column (7) for the prior year × the effective interest rate (9.8085%)

Column (5)—Column (5) for prior year – (Column (1) – Column (2))

Column (6)—Initial net fees – amortization to date

Column (7)—Column (5) – Column (6)

Column (8)—Column (5) × 1.01 (to calculate the settlement amount including prepayment penalty)

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d Unamortized net fee and accrued interest.

e $6 rounding adjustment.

Case 6—Application of Paragraph 18(a)—With No Prepayment Penalty

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

76. The discount factor that equates the present value of the cash inflows in Column 1 with the initial cash outflow of $99,000 is 9.8085 percent. In year 1, recognition of interest income on the investment of $99,000 at a rate of 9.8085 percent would cause the investment to be

$93,807, or $710 greater than the amount at which the borrower could settle the obligation. Because the condition set forth in paragraph 18(a) is not met, recognition of an amount greater than the net fee is not permitted.

Table 6—Application of Paragraph 18(a)—With No Prepayment Penalty

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	($99,000)				$100,000		$99,000
1	14,903	$8,000	$1,000	$9,000	93,097	$0	93,097
2	16,165	9,310	0	9,310	86,242	0	86,242
3	16,165	8,624	0	8,624	78,701	0	78,701
4	16,165	7,870	0	7,870	70,406	0	70,406
5	16,165	7,041	0	7,041	61,282	0	61,282
6	16,165	6,128	0	6,128	51,245	0	51,245
7	16,165	5,124	0	5,124	40,204	0	40,204
8	16,165	4,021	0	4,021	28,060	0	28,060
9	16,165	2,806	0	2,806	14,701	0	14,701
10	16,165	1,464 [f]	0	1,464	0	0	0
Total amortization			$1,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in year 1, 10% in years 2-10)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (9.8085%) as limited by paragraph 18(a) of this section
Column (5)—Column (5) for prior year – (Column (1) – Column (2))
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

[f] $6 rounding adjustment.

Case 7—Application of Paragraph 18(b)

77. G Company grants a 10-year $100,000 mortgage. G Company receives net fees of $1,000 related to this loan. The contract provides for an interest rate of 12 percent in year 1, 11 percent in year 2, and 10 percent thereafter.

Table 7—Application of Paragraph 18(b)

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees [g]	(7) Carrying Amount
	$(99,000)				$100,000		$99,000
1	17,698	$12,000	$(1,259)	$10,741	94,302	$2,259	92,043
2	17,031	10,373	(388)	9,985	87,644	2,647	84,997
3	16,428	8,764	458	9,222	79,980	2,189	77,791
4	16,428	7,998	441	8,439	71,550	1,748	69,802
5	16,428	7,155	418	7,573	62,277	1,330	60,947
6	16,428	6,228	385	6,613	52,077	945	51,132
7	16,428	5,208	339	5,547	40,857	606	40,251
8	16,428	4,086	281	4,367	28,515	325	28,190
9	16,428	2,852	206	3,058	14,939	119	14,820
10	16,428	1,489 [h]	119	1,608	0	0	0
Total amortization			$1,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (12% in year 1, 11% for year 2, and 10% in years 3-10)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for the prior year × effective interest rate (10.8491%)
Column (5)—Column (5) for prior year – (Column (1) – Column (2))
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

[g] Unamortized net fee and deferred interest.
[h] $5 rounding adjustment.

Case 8—Application of Paragraph 18(c)—Amortization Based on Factor at Inception

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

Table 8—Application of Paragraph 18(c)—Amortization Based on Factor at Inception

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(97,000)				$100,000		$97,000
1	14,903	$8,000	$420	$8,420	93,097	$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,937	7,759	375	8,134	69,412	1,400	68,012
5	15,937	6,941	347	7,288	60,416	1,053	59,363
6	15,937	6,042	314	6,356	50,521	739	49,782
7	15,937	5,052	272	5,324	39,636	467	39,169
8	15,937	3,964	221	4,185	27,663	246	27,417
9	15,937	2,766	160	2,926	14,492	86	14,406
10	15,937	1,445 [i]	86	1,531	0	0	0
Total amortization			$3,000				

Computations:

Column (1)—Contractual payments

Column (2)—Column (5) for prior year × the loan's stated interest rate(8% in years 1-3, and 10% in years 4-10)

Column (3)—Calculated as if the index did not change—that is, the amount that would have been recognized for an 8%, 10-year $100,000 mortgage with no prepayments and a $3,000 net fee

Column (4)—Column (2) + Column (3)

Column (5)—Column (5) for prior year – (Column (1) – Column (2))

Column (6)—Initial net fees – amortization to date

Column (7)—Column (5) – Column (6)

[i] $4 rounding adjustment.

Case 9—Application of Paragraph 18(c)—Amortization Recalculated for Subsequent Changes in Factor

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

Table 9—Application of Paragraph 18(c)—Amortization Recalculated for Subsequent Changes in Factor

Year	(1) Cash (Out)Inflow	(2) Stated Interest	(3) Amortization	(4) Interest Income	(5) Remaining Principal	(6) Unamortized Net Fees	(7) Carrying Amount
	$(97,000)				$100,000		$97,000
1	14,903	$8,000	$ 420	$8,420	93,097	$2,580	90,517
2	14,903	7,448	410	7,858	85,642	2,170	83,472
3	14,903	6,851	395	7,246	77,590	1,775	75,815
4	15,937	7,759	358	8,117	69,412	1,417	67,995
5	15,937	6,941	340	7,281	60,416	1,077	59,339
6	15,937	6,042	311	6,353	50,521	766	49,755
7	15,937	5,052	275	5,327	39,636	491	39,145
8	15,937	3,964	227	4,191	27,663	264	27,399
9	15,937	2,766	168	2,934	14,492	96	14,396
10	15,937	1,445 [j]	96	1,541	0	0	0
	Total amortization		$3,000				

Computations:
Column (1)—Contractual payments
Column (2)—Column (5) for prior year × the loan's stated interest rate (8% in year 1-3, and 10% in years 4-10)
Column (3)—Column (4) – Column (2)
Column (4)—Column (7) for the prior year × the effective interest rate (8.6809%) for years 1-3 and Column (7) for the prior year × the effective interest rate (10.7068%) for years 4-10
Column (5)—Column (5) for prior year – (Column (1) – Column (2))
Column (6)—Initial net fees – amortization to date
Column (7)—Column (5) – Column (6)

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[j] $4 rounding adjustment.

Appendix C: GLOSSARY

80. This appendix defines certain terms that are used in this Statement.

Commitment fees

Fees charged for entering into an agreement that obligates the enterprise to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. For purposes of this Statement, the term *commitment fees* includes fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

Credit card fees

The periodic uniform fees that entitle cardholders to use credit cards. The amount of such fees generally is not dependent upon the level of credit available or frequency of usage. Typically the use of credit cards facilitates the cardholder's payment for the purchase of goods and services on a periodic, as-billed basis (usually monthly), involves the extension of credit, and, if payment is not made when billed, involves imposition of interest or finance charges. For purposes of this Statement, the term *credit card fees* includes fees received in similar arrangements, such as charge card and cash card fees.

Incremental direct costs

Costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred.

Origination fees

Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Footnotes

FAS91, Footnote 1--Terms defined in the glossary (Appendix C) are in **boldface type** the first time they appear in this Statement.

FAS91, Footnote 2--Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

FAS91, Footnote 3--The term *remote* is used here, consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

FAS91, Footnote 4--The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

FAS91, Footnote 5--The net investment in the original loan includes the unpaid loan principal, any remaining unamortized net fees or costs, any remaining unamortized purchase premium or discount, and any accrued interest receivable.

FAS91, Footnote 6--The "interest" method is also described in paragraph 16 of APB Opinion No. 12, *Omnibus Opinion--1967*, in the first sentence of paragraph 15 of APB Opinion No. 21, *Interest on Receivables and Payables*, and in paragraphs 235-239 of FASB Concepts Statement No. 6, *Elements of Financial Statements*.

FAS91, Footnote 7--A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

FAS91, Footnote 8--For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.