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Loans and investments

Partially updated September 2022

About the Loans and investments guide

PwC is pleased to offer our updated *Loans and investments* guide. This guide is intended to help our clients and other interested parties implement and apply the applicable accounting and reporting standards.

This guide discusses the accounting for loans and investments, including the recognition of interest income and impairment. This guide also discusses the accounting for loans and investments purchased with credit deterioration, modification or restructuring of a loan (including troubled debt restructuring before the adoption of ASU 2022-02 *Financial Instruments - Credit Losses (Topic 326)*, *Troubled Debt Restructurings and Vintage Disclosures*), loan foreclosures, and sales of real estate.

The FASB has issued two standards, as amended, that address the accounting for financial instruments, ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities* and ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. The FASB has subsequently issued amendments that clarify the guidance introduced by ASU 2016-01 and ASU 2016-13.

With the exception of ASU 2022-02, this guide assumes that ASU 2016-13 (and its subsequent amendments) has been adopted. Portions of this guide assume that ASU 2022-02, has been adopted. Although some significant aspects of the accounting for loans and investments have changed as a result of ASU 2016-01 and ASU 2016-13 (for example, the accounting for equity securities and the accounting for impairments of loans and securities), much of the accounting for these instruments remains the same.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification. It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation (CG)*
- *Equity method investments and joint ventures (EM)*
- *Derivatives and hedging (DH)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Foreign currency guide (FX)*
- *Insurance contracts (IG)*
- *Property, plant, equipment and other assets (PPE)*
- *Reference rate reform (REF)*
- *Revenue from contracts with customers (RR)*
- *Transfers and servicing of financial assets (TS)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in September 2022

LI 12, Presentation and disclosure

- **LI 12** was updated to reflect the impact of ASU 2022-03.

Revisions to guide made in May 2022

LI 3, Accounting for investments in debt securities

- **LI 3** was updated to reflect the impact of ASU 2022-02.

LI 4, Accounting for loans

- **LI 4** was updated to reflect the impact of ASU 2022-01 and ASU 2022-02.

LI 7, Current expected credit losses impairment model

- **LI 7** was updated to reflect the impact of ASU 2022-01 and ASU 2022-02.

LI 8, Impairment of available-for-sale debt securities

- **LI 8** was updated to reflect the impact of ASU 2022-01.

LI 10, Loan refinancing and restructuring - after adoption of ASU 2022-02

- **LI 10** was updated to reflect the impact of ASU 2022-02 which eliminated the accounting guidance for troubled debt restructurings (TDRs) for creditors.
- The accounting before the adoption of ASU 2022-02 for loan refinancing and restructuring including TDRs was moved to **LI 10A**.

LI 11, Accounting for foreclosures and sales of real estate

- **LI 11** was updated to reflect the impact of ASU 2022-02.

LI 12, Presentation and disclosure

- **LI 12** was updated to incorporate the disclosures required by ASU 2022-01 and the impact of ASU 2022-02.

LI 13, Effective date and transition

- **LI 13** was updated to discuss the effective date and transition requirements related to the adoption of ASU 2022-02.

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Chapter 1: Introduction

1.1 **Background on CECL**

After the financial crisis, many constituents criticized the accounting models for recognizing credit losses on financial assets because many of these models delay recognition until a loss is incurred. In an April 2009 report analyzing the causes of the global financial crisis, the Group of 20, consisting of the finance ministers and central bank governors of the major global economies, made several recommendations. Among other things, the report recommended that the accounting principles related to credit loss provisioning be improved to permit consideration of a broader range of credit information.

The Financial Crisis Advisory Group (FCAG) was established by the FASB and the IASB to advise the Boards on the standard-setting implications of the global financial crisis and potential changes to the regulatory environment. The FCAG noted in its July 2009 report that the financial crisis exposed weaknesses in financial reporting that included the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies, and other financial institutions. They recommended that the FASB and IASB explore an accounting model for impairment that uses more forward-looking information, such as an expected loss model or fair value model.

The FASB has issued two standards that address the accounting for financial instruments, ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, and ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. These standards started out as part of the FASB and IASB's joint project on the accounting for financial instruments, which was intended to address the FCAG report as well as simplify and harmonize the accounting for financial instruments under US GAAP and IFRS. During deliberations on these topics, however, the FASB and IASB reached several different decisions; therefore, convergence will not be achieved. Subsequent to the issuance of these standards, the FASB issued additional Accounting Standards Updates amending and clarifying the guidance based on feedback from constituents and discussions of the Transition Resource Group.

Refer to LI 13 for information on the effective dates for ASU 2016-01 and ASU 2016-13 and their related amendments.

The guidance reflected in this PwC guide assumes that ASU 2016-01, ASU 2016-13, ASU 2018-03, ASU 2018-19, ASU 2019-04, and ASU 2019-05 have been adopted. Although some significant aspects of the accounting for loans and investments have changed as a result of the aforementioned ASUs (for example, the accounting for equity securities and the accounting for impairments of loans and securities), other aspects of the accounting for these instruments remains the same.

1.2 **Changes to the recognition and measurement of financial assets**

Figure LI 1-1 summarizes the significant changes made to the recognition and measurement of financial assets by ASU 2016-01 and related codification improvements. There were no significant changes to the recognition and measurement guidance for investments in loans and debt securities, but as discussed later there were changes to the impairment models.

Figure LI 1-1**Changes to the recognition and measurement of financial assets**

Topic	Guidance	Observations
Accounting for equity investments with readily determinable fair values	All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) are generally measured at fair value through earnings. There is no longer an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.	The accounting model in ASU 2016-01 applies to all types of equity investments, including equity instruments that meet the definition of a security (as provided under US GAAP) and those that would not be considered securities (e.g., limited partnership interests). Equity investments included in the scope of the guidance may include investments in the equity of investment companies that hold nothing but debt securities, as ASU 2016-01 does not permit an investor to “look through” the investment to determine the appropriate recognition and measurement model.
Accounting for equity investments without readily determinable fair values	Under the guidance in ASU 2016-01, these investments can no longer be accounted for using the cost method. However, reporting entities (other than those following “specialized” accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, adjusted (to fair value) for subsequent observable price changes if certain criteria are met. Reporting entities that elect this measurement alternative will report changes in the carrying value of the equity investments in earnings.	If the measurement alternative is elected, the equity investment will be remeasured to fair value whenever there is an impairment or there are observable price changes in orderly transactions for the identical or similar investment of the same issuer.
Impairment of equity investments without readily determinable fair values – measurement alternative	A reporting entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates that an impairment exists, the reporting entity will need to estimate the fair value of the investment and recognize an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment in net income.	Although the FASB did allow a measurement alternative for equity investments without readily determinable fair values, they removed the concept of temporary impairment.

1.3 Changes to the accounting for impairments of financial assets

ASU 2016-13 introduces new accounting models related to how credit losses on financial instruments are determined. These new models apply to:

- Loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost
- Loan commitments and certain other off-balance sheet credit exposures
- Debt securities and other financial assets measured at fair value through other comprehensive income
- Beneficial interests in securitized financial assets

Figure LI 1-2 summarizes some of the significant changes in ASU 2016-13 and related codification improvements.

Figure LI 1-2

Changes to the accounting for impairments of financial assets

Topic	Guidance	Observations
Recognition of expected credit losses under current expected credit loss (CECL) impairment model	The CECL model requires a reporting entity to estimate credit losses expected over the “life” of an asset (or pool of assets). The estimate of expected credit losses should consider historical information, current information, and the reasonable and supportable forecasts of future events and circumstances, as well as estimates of prepayments.	The CECL model will apply to: (1) financial assets measured at amortized cost and (2) certain off-balance sheet credit exposures. Examples of instruments subject to the CECL model include loans, held-to-maturity (HTM) debt securities (including corporate bonds, mortgage backed securities, municipal bonds and other fixed income instruments), loan commitments (including lines of credit), financial guarantees accounted for under ASC 460, <i>Guarantees</i> , and net investments in leases, as well as reinsurance and trade receivables.
Initial recognition of expected credit losses (on assets not considered to be PCD)	The CECL model requires the recognition of expected credit losses upon initial recognition of a financial asset. With the exception of certain purchased assets with credit deterioration (PCD), this day-one recognition of the allowance for credit losses is recorded with an offset to net income.	Originated and purchased financial assets (not considered to be PCD) include compensation for credit risk in the yield or investment return of the assets. The recognition of the effective yield of the instrument (including compensation for credit risk) will occur over time through the application of the interest income models under GAAP. Since estimated credit losses will be recognized in net income on day one, this creates a mismatch in the timing of the

Topic	Guidance	Observations
Grouping of financial assets when applying the CECL model	Financial instruments with similar risk characteristics should be grouped together when estimating expected credit losses.	<p>recognition of expected credit losses and the recognition of the compensation for credit risk.</p> <p>Risk characteristics used as a basis for pooling may include past due status, collateral type, borrower's FICO score, internal and external credit ratings, maturity (term), industry of the borrower, subordination, origination vintage, geographical location of the borrower, or other factors.</p> <p>Reporting entities should carefully consider the attributes utilized to create pools of similar risk characteristics and consider what inputs drive the credit risk measurement used in credit loss modelling.</p>
Recoveries	Under CECL, expected recoveries of amounts previously written off and expected to be written off shall be included in the estimate of the allowance for credit loss. These amounts should not exceed the aggregate of amounts previously written off and expected to be written off. This may result in a "negative allowance," which when added to the amortized cost basis of the asset reflects the amount that an entity expects to collect.	<p>The impairment model applicable to available-for-sale investments prohibits the recognition of a "negative allowance".</p> <p>As of the content cutoff date of this publication, the FASB has not issued an accounting standards update regarding the applicability of the guidance on recoveries to PCD assets. Financial statements preparers and other users of this publication are therefore encouraged to monitor the status of this project and when the accounting standard update is issued, evaluate the effective date of the guidance and the implications on the accounting for PCD assets.</p>
Troubled debt restructuring (TDR)	Loans subject to a TDR will be assessed for impairment using the CECL model.	<p>In measuring an impairment on an instrument that has been restructured through a TDR, the value of certain concessions made by the creditor should be reflected in the allowance for credit losses.</p> <p>If a TDR is reasonably expected to occur, the expected life of a financial asset should consider any extensions that may result from the TDR.</p>
Impairment of available-for-sale (AFS) debt securities	The impairment model for AFS debt securities will require an estimate of expected credit losses only when the fair value is below the amortized cost of the asset. The credit-related impairment amount will be recognized in net income; the	<p>The AFS impairment model is no longer based on an impairment being "other-than-temporary."</p> <p>Unlike the CECL model, the impairment model for AFS debt securities does not permit pooling of</p>

Topic	Guidance	Observations
	<p>remaining impairment amount is recognized in OCI. Credit losses are recognized through the use of an allowance for credit losses account and subsequent improvements in expected credit losses are recognized as a reversal of the allowance account.</p>	<p>securities and requires an entity to use a discounted cash flow approach when estimating the expected credit losses.</p>
<p>Purchased assets with credit deterioration (PCD assets)</p>	<p>An investor will need to recognize an allowance for credit losses upon initial recognition of a PCD asset by estimating the expected credit losses. Unlike the CECL model for other financial assets, the initial estimate of expected credit losses should be recognized as an adjustment to the amortized cost basis of the related financial asset at acquisition (i.e., a balance sheet gross-up) rather than through net income.</p> <p>Subsequently, the accounting for PCD assets will follow the CECL model or AFS debt security impairment model (as appropriate) with all adjustments to the allowance for credit losses recognized in net income.</p>	<p>This guidance is intended to simplify the accounting for PCD assets from the purchased credit impaired (PCI) asset model in ASC 310-30 and also creates a model whereby the establishment of an initial allowance does not impact earnings. The PCD model is also meant to more closely align the accounting in periods subsequent to acquisition with the accounting for originated assets.</p>
<p>Beneficial interests subject to ASC 325-40</p>	<p>Beneficial interests that meet the definition of a PCD asset or have a significant difference between their expected cash flows and contractual cash flows at the date of initial recognition are subject to the PCD asset guidance.</p> <p>When expected cash flows change from projected cash flows, a reporting entity should first apply the CECL or AFS impairment model and then prospectively adjust the accretable yield if changes in expected cash flows not accounted for under those models.</p>	<p>Both favorable and adverse changes in cash flows will be recorded through changes in the allowance for credit losses and recognized in net income.</p>

1.4 Overview of ASU 2016-01 and ASU 2016-13 disclosures

Both the recognition and measurement and impairment standards include new disclosure requirements. See LI 12 for information on the required disclosures.

***Chapter 2:
Accounting for equity
investments—updated October
2021***

2.1 Chapter overview – equity investments

This chapter discusses the accounting for equity interests within the scope of ASC 321, *Investments – Equity Securities*. ASC 321 provides guidance for equity interests that meet the definition of an equity security, as well as other equity interests (such as investments in partnerships, unincorporated joint ventures, and limited liability companies) that are required to be accounted for like equity securities under ASC 321. The definition of an equity security also includes the right to acquire an ownership interest in an entity (e.g., warrants and forward purchase contracts) or dispose of an ownership interest in an entity (e.g., put options and forward sale contracts) at fixed or determinable prices. The term “equity interest,” as used in this chapter, refers to all equity instruments within the scope of ASC 321.

Equity interests issued by consolidated subsidiaries or equity method investees are outside the scope of this guide. For information on consolidation and the equity method of accounting, see PwC’s *Consolidation* guide.

Other equity interests outside the scope of ASC 321 include:

- Derivative instruments that are subject to the requirements of ASC 815, including those that have been separated from a host contract. If an equity interest is in the scope of ASC 321, the host instrument remains within the scope of ASC 321 after the embedded derivative has been separated.
- An exchange membership that has the characteristics specified in ASC 940-340-25-1(b) for an ownership interest in the exchange.
- Federal Home Loan Bank and Federal Reserve Bank stock. These equity interests should be accounted for at cost and evaluated for impairment in accordance with ASC 942-325-35-1 and ASC 942-325-35-3.

See LI 2.2.3 for information on specialized industries outside the scope of ASC 321.

Information on disclosures for equity investments within the scope of ASC 321 can be found in LI 12.

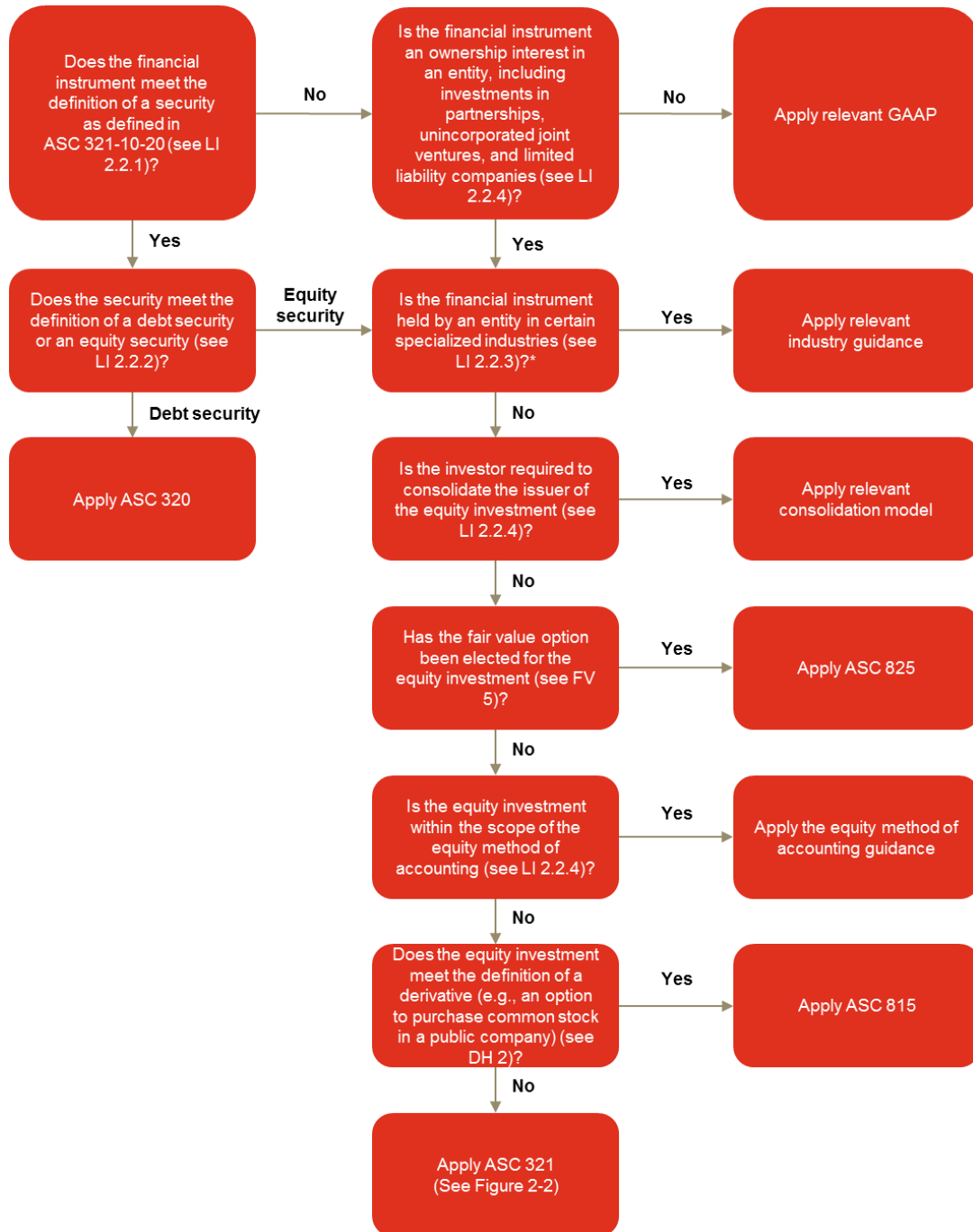
2.2 Analysis of equity interests

Figure LI 2-1 provides a framework for determining whether an investment in a financial instrument held by a for-profit reporting entity (other than those noted in LI 2.1) is within the scope of ASC 321.

Generally, a reporting entity considers whether consolidation, equity method, or derivative accounting applies before applying the recognition and measurement guidance in ASC 321.

Figure LI 2-1

Analysis of an equity interest held by for-profit reporting entities



*See LI 2.2.3 for information on specialized industries outside the scope of ASC 321.

2.2.1 Determining if an equity interest is a security

To determine the appropriate accounting treatment for an equity interest, a reporting entity should first determine whether the interest meets the definition of a security.

A security is defined in ASC 321 as follows.

Definition from ASC 321-10-20

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

The form of the instrument and the relevant jurisdiction should be considered when evaluating whether it meets the definition of a security under ASC 321. The definition in ASC 321 was based on the Uniform Commercial Code at the time the guidance was developed more than 20 years ago, but may not be consistent with the legal definition of a security today. As a result, the legal classification may not be conclusive for determining whether an instrument is a security as defined in ASC 321.

For information on equity interests that meet the definition of a security, see LI 2.2.2; for information on equity interests that do not meet the definition of a security, see LI 2.2.4.

2.2.2 Determining whether a security is a debt or equity security

After a reporting entity determines that an equity interest meets the definition of a security, it should then determine whether the security meets the definition of an equity or debt security. The accounting for debt securities is discussed in ASC 320, *Investments — Debt Securities* and LI 3.

Definition from ASC 321-10-20

Equity Security: Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

- a. Written equity options (because they represent obligations of the writer, not investments)
- b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
- c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

Securities that are legally equity interests may meet the definition of a debt security. For example, preferred stock that is mandatorily redeemable by the issuer or that can be redeemed at the option of the holder may be accounted for as a debt security. See LI 3 for information on the accounting for investments in debt securities. The definition of an equity security also includes the right to acquire an ownership interest in an entity (e.g., warrants and forward purchase contracts) or dispose of an

ownership interest in an entity (e.g., put options and forward sale contracts) at fixed or determinable prices. See LI 2.2.4.1 for additional guidance.

Question LI 2-1 discusses whether an equity security issued by a mutual fund holding only US government debt should be accounted for as an equity security or a debt security.

Question LI 2-1

Should an equity security issued by a mutual fund holding only US government debt securities be accounted for as an equity security or a debt security?

PwC response

It is an equity security and is subject to the guidance in ASC 321. As discussed in ASC 320-10-55-8 and ASC 321-10-55-6, an investor should not look through the form of its investment to the nature of the interests held by the investee to determine whether ASC 320 or ASC 321 applies.

If an equity interest meets the definition of a security, but not the definition of an equity security, it should assess whether the security meets the definition of a debt security. See LI 3 for information on debt securities. Generally, we believe that the determination of whether a security meets the definition of a debt security or an equity security should be reassessed each reporting period.

Example LI 2-1, Example LI 2-2, and Example LI 2-3 discuss whether a contingently redeemable preferred stock investment should be classified as an equity security or a debt security.

EXAMPLE LI 2-1

Assessment of classification of a contingently redeemable preferred stock investment before contingency has been resolved

On January 1, 20X1, a reporting entity purchases a preferred stock instrument with no maturity date. The preferred stock instrument has a contingent redemption feature such that if the issuer completes an initial public offering (“IPO”), the preferred stock instrument becomes redeemable at the investor’s option. If exercised, the redemption feature requires the issuer of the instrument to redeem the preferred stock for cash in an amount equal to its liquidation preference plus any unpaid dividends. Until such time that an IPO has been completed, the preferred stock instrument is not redeemable.

Should the reporting entity classify the preferred stock instrument as a debt or equity security at purchase?

Analysis

Upon purchase of the instrument, assuming an IPO has not yet been completed, the instrument should be considered an equity security and would be subject to the guidance in ASC 321. The definition of an equity security under ASC 321-10-20 states that preferred stock instruments that must be redeemed by the issuer or are redeemable at the investor’s option do not meet the definition of an equity security. While the preferred stock is contingently redeemable by the issuer, the redemption is only exercisable upon the successful completion of an IPO by the issuer, which is an event outside of the investor’s control. Upon purchase of the preferred stock, the instrument is neither mandatorily redeemable nor is it redeemable at the investor’s option. Therefore, the instrument would meet the

definition of an equity security under ASC 321-10-20, and the reporting entity should classify it as such.

EXAMPLE LI 2-2

Assessment of classification of a contingently redeemable preferred stock investment after contingency has been resolved

On January 1, 20X1, a reporting entity purchases a preferred stock instrument with no maturity date. The preferred stock instrument has a contingent redemption feature such that if the issuer completes an initial public offering, the preferred stock instrument becomes redeemable at the investor's option. If exercised, the redemption feature requires the issuer of the instrument to redeem the preferred stock for cash in an amount equal to its liquidation preference plus any unpaid dividends. On December 1, 20X5, the issuer completes an IPO.

On December 31, 20X5, should the reporting entity classify the preferred stock instrument as a debt or equity security?

Analysis

Following the completion of the IPO by the issuer, the reporting entity should reclassify the instrument to account for it as a debt security under ASC 320. Once the successful completion of the IPO has occurred, the redemption option is no longer contingently exercisable. The preferred stock instrument is now redeemable at any time at the reporting entity's option. ASC 320-10-20 states that the definition of a debt security includes preferred stock that is redeemable at the option of the investor. The preferred stock instrument in this example has become redeemable at the option of the investor and therefore meets the definition of a debt security. The reporting entity should account for the preferred stock under ASC 320 as long as it has the right to redeem the security.

EXAMPLE LI 2-3

Assessment of classification of a redeemable preferred stock investment where the redemption option expires

On January 1, 20X1, a reporting entity purchases a newly issued preferred stock instrument with no maturity date. The preferred stock instrument becomes redeemable at the investor's option five years after the issuance of the instrument (on January 1, 20X6). If exercised, the redemption feature requires the issuer of the instrument to redeem the preferred stock for cash in an amount equal to its liquidation preference plus any unpaid dividends. Once the preferred stock becomes redeemable, the investor has one year to exercise the redemption feature. After that one year, the preferred stock instrument is no longer redeemable (i.e., it is no longer redeemable as of January 2, 20X7).

On January 1, 20X1, should the reporting entity classify the preferred stock instrument as a debt or equity security? If the reporting entity still holds the instrument on January 2, 20X7 once the redemption option expires, should the reporting entity reassess the classification?

Analysis

The reporting entity should classify the preferred stock instrument as a debt security under ASC 320 when purchased on January 1, 20X1. While the preferred stock is not yet redeemable, there is no contingent event outside of the investor's control that would prevent the instrument from becoming redeemable. Since the preferred stock instrument becomes redeemable simply by the passage of time, the preferred stock would meet the definition of a debt security under ASC 321-10-20.

If the reporting entity chooses not to exercise the redemption option when it becomes exercisable and the one-year exercise period passes, beginning on January 2, 20X7, the reporting entity should then reclassify the security to an equity security and account for it under ASC 321. Once the exercise period has passed, the preferred stock instrument is no longer redeemable. Therefore, it no longer meets the definition of a debt security under ASC 320-10-20 and now meets the definition of an equity security under ASC 321-10-20.

2.2.3 *Entities within the scope of ASC 321*

The ASC 321 accounting model for equity interests applies to all entities other than those that apply industry-specific guidance requiring substantially all investments to be measured at fair value with subsequent changes in fair value recognized in net income or in the change in net assets. Examples of these specialized industries include:

- Brokers and dealers in securities
- Defined benefit pension plans and other postretirement plans
- Health and welfare plans accounted for under ASC 965
- Investment companies

Some entities that are similar to the entities exempted from the scope of ASC 321 do not qualify for the scope exception and must apply the provisions of ASC 321. Examples of these industries include:

- Cooperatives and mutual entities (such as credit unions and mutual insurance entities)
- Trusts that do not report substantially all of their securities at fair value

Further, the specialized industry guidance that formerly applied to an insurance company's investments in equity securities without readily determinable fair values has been superseded and no longer applies. As a result, these types of investments held by insurance companies are subject to ASC 321.

ASC 321 also applies to not-for-profit reporting entities. ASC 958-321 provides guidance on the accounting for investments in equity interests held by not-for-profit entities.

Question LI 2-2 discusses whether an investment company or broker-dealer can apply the measurement alternative for equity interests without readily determinable fair values.

Question LI 2-2

Can an investment company or broker-dealer apply the measurement alternative for equity interests without readily determinable fair values?

PwC response

No. Only entities in the scope of ASC 321 are able to apply the measurement alternative. Investment companies and broker-dealers are outside the scope of ASC 321.

2.2.4 Non-security equity interests within the scope of ASC 321

As noted in ASC 321-10-15-4, the scope of ASC 321 includes equity interests that meet the definition of an equity security, as well as certain other ownership interests in an entity.

ASC 321-10-15-4

The guidance in the Investments—Equity Securities Topic establishes standards of financial accounting and reporting for investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies as if those other ownership interests are equity securities.

An investor that holds an ownership interest should account for the interest using the guidance in ASC 321 provided the investor is not required to consolidate the issuer in accordance with the guidance in ASC 810 or account for the ownership interest using the equity method of accounting.

ASC 323-30-S99-1 provides guidance on the applicability of the equity method of accounting to limited partnership (LP) interests. ASC 323-30-35-3 provides guidance to help determine whether an equity investment in a limited liability corporation (LLC) should be considered similar to a partnership for purposes of applying this guidance.

ASC 323-30-S99-1

The SEC staff's position on the application of the equity method to investments in limited partnerships is that investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6. That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor.

ASC 323-30-35-3

An investment in a limited liability company that maintains a specific ownership account for each investor—similar to a partnership capital account structure—shall be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company shall be accounted for in accordance with the guidance in Topic 321 or the equity method.

For additional information on the use of the equity method of accounting, see EM.

Equity interests in LPs (and LLCs similar to a partnership) that do not result in consolidation and are not accounted for under the equity method may be eligible for a measurement alternative for equity interests without readily determinable fair values. See LI 2.3.2 for additional information on applying the measurement alternative.

2.2.4.1 *Purchased options and forward contracts*

The definition of an equity security subject to the guidance in ASC 321 includes certain gross physically-settled purchased options and forward contracts to acquire or dispose of an ownership interest. Gross physical settlement (or “physical settlement”) occurs when an entity settles a contract through the delivery of the underlying asset. Many physically-settled purchased options and forward contracts meet the definition of a derivative and should therefore be accounted for in accordance with ASC 815. However, entities with contracts that do not meet the net settlement criterion, or do not otherwise meet the definition of a derivative in ASC 815 but meet the definition of an equity security, need to apply the guidance in ASC 321. See DH 2.3.5 for information on the net settlement criterion.

In addition, ASC 815-10-15-141 describes certain option and forward contracts that are subject to ASC 321.

ASC 815-10-15-141

The guidance in the Certain Contracts on Debt and Equity Securities Subsections applies only to those forward contracts and purchased options having all of the following characteristics:

- a. The contract is entered into to purchase securities that will be accounted for under either Topic 320 or Topic 321.
- b. The contract’s terms require physical settlement of the contract by delivery of the securities.
- c. The contract is not a derivative instrument otherwise subject to this Subtopic.
- d. The contract, if a purchased option, has no intrinsic value at acquisition.

Recently issued guidance

In January 2020, the FASB issued ASU 2020-01, *Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)—Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*. When determining whether a forward contract or purchased option should be accounted for under ASC 321, the update clarifies that a reporting entity should not consider whether it will apply the equity method (or whether it will apply the fair value option to an investment that would otherwise apply the equity method) to the equity securities investment after the settlement of the forward contract or exercise of the purchased option. This guidance became effective for calendar year public business entities on January 1, 2021.

Subsequent to the adoption of ASU 2020-01 (see LI 13 for additional guidance on effective date and transition), ASC 815-10-15-141A provides guidance on applying ASC 815-10-15-141 to forward contracts and purchased options of equity securities that will be within the scope of ASC 323 upon purchase.

ASC 815-10-15-141A

For the purposes of applying paragraph 815-10-15-141(a) for forward contracts and purchased options, an entity shall not consider whether, upon the settlement of the forward contract or the exercise of the purchased option, individually or with existing investments, the underlying securities would be accounted for under either of the following:

- a. The equity method in accordance with Topic 323
- b. The fair value option in accordance with Topic 825 if those securities otherwise would have been accounted for under Topic 323

Question LI 2-3 discusses whether a gross physically-settled forward contract to purchase common stock issued by a public company at a fixed or determinable price is within the scope of ASC 321.

Question LI 2-3

Is a gross physically-settled forward contract to purchase common stock issued by a public company at a fixed or determinable price within the scope of ASC 321?

PwC response

Typically, no. A physically-settled forward contract to purchase common stock issued by a public company at a fixed or determinable price usually meets the definition of a derivative unless the number of shares to be delivered under the forward contract cannot be readily converted to cash (i.e., the number of shares to be delivered cannot be rapidly absorbed by the market). See DH 2.3 for information on the definition of a derivative. Forward contracts that do not meet the ASC 815 definition of a derivative are subject to the guidance in ASC 321.

Question LI 2-4 discusses whether a gross physically-settled forward contract to purchase a limited partnership interest subject to ASC 321 at a fixed or determinable price is within the scope of ASC 321.

Question LI 2-4

Is a gross physically-settled forward contract to purchase a limited partnership interest subject to ASC 321 at a fixed or determinable price within the scope of ASC 321?

PwC response

Typically, yes. A physically-settled forward contract to purchase a limited partnership interest at a fixed or determinable price would not typically meet the definition of a derivative (unless it provides for net share settlement) because many limited partnership interests cannot be readily converted to cash. In this case, it is not accounted for as a derivative, the forward contract should be accounted for as an equity security within the scope of ASC 321. ASU 2020-01 clarifies that a reporting entity should not consider whether it will apply the equity method (or whether it will apply the fair value option that would otherwise apply the equity method) to the equity securities investment after the settlement of the forward contract. This guidance became effective for calendar year public business entities on January 1, 2021. See LI 13 for additional information on the effective date and transition for ASU

2020-01. If the contract does not have a readily determinable fair value, it may be eligible for the measurement alternative discussed in LI 2.3.2.

Question LI 2-5 discusses whether a gross physically-settled option to purchase common stock issued by a private company at a fixed or determinable price is within the scope of ASC 321.

Question LI 2-5

Is a gross physically-settled option contract to purchase common stock issued by a private company at a fixed or determinable price within the scope of ASC 321?

PwC response

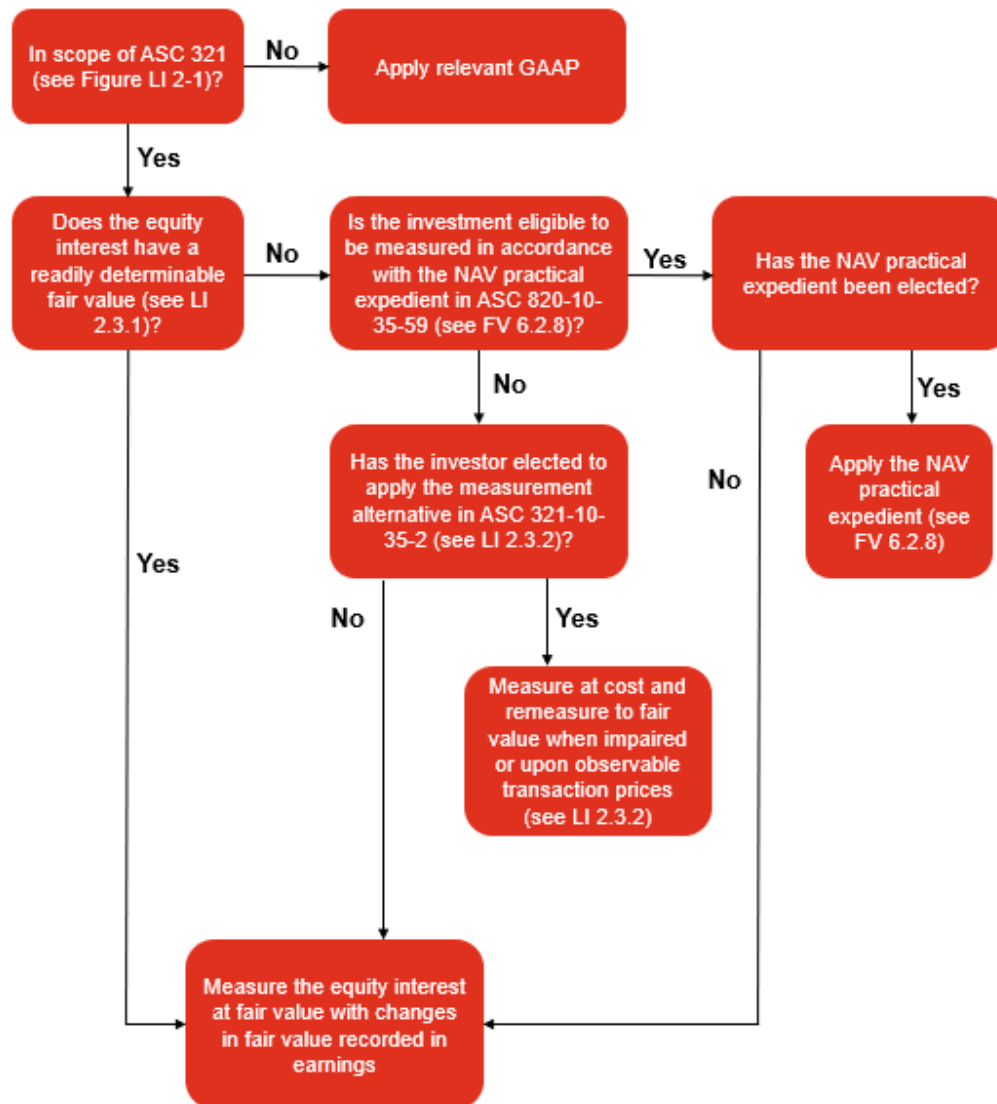
Typically, yes. A physically-settled option contract to purchase common stock issued by a private company at a fixed or determinable price does not usually meet the definition of a derivative (unless it provides for net share settlement) because the private company shares cannot be readily converted to cash. In that case, the option contract is considered an equity security within the scope of ASC 321. ASU 2020-01 clarifies that a reporting entity should not consider whether it will apply the equity method (or whether it will apply the fair value option that would otherwise apply the equity method) to the equity securities investment after the settlement of the forward contract. This guidance became effective for calendar year public business entities on January 1, 2021. See LI 13 for additional information on the effective date and transition for ASU 2020-01. If the contract does not have a readily determinable fair value, it may be eligible for the measurement alternative discussed in LI 2.3.2.

2.3 Accounting for equity interests

Figure LI 2-2 provides a framework for determining the accounting treatment for an equity interest within the scope of ASC 321.

Figure LI 2-2

Accounting for equity interests



2.3.1 Equity interests with readily determinable fair values

Equity interests with readily determinable fair values are carried at fair value with changes in value recorded in earnings. ASC 321 provides a definition of readily determinable fair value.

Definition from ASC 321-10-20

Readily Determinable Fair Value: An equity security has a readily determinable fair value if it meets any of the following conditions:

- a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.
- b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

We believe there is a rebuttable presumption that the primary exchange in a foreign country has a similar breadth and scope to the US markets. Trading volumes that provide liquidity and quoted market prices (even if such volumes do not compare to the volumes on US stock exchanges) are indicators that a primary exchange in a foreign country has a similar breadth and scope to the US markets.

2.3.1.1 *Readily determinable fair value of restricted stock*

Stock with a substantive restriction generally does not have a readily determinable fair value even when similar unrestricted shares are publicly traded. To be considered restricted stock, the restriction must be an attribute of the instrument itself and not a restriction on the current owner of the instrument. For example, securities pledged as collateral do not meet the definition of restricted stock regardless of whether the loan agreement prohibits sale or substitution of the securities. Voluntary restrictions on sales of stock also do not meet the definition of restricted stock.

Restricted stock with a restriction that terminates within one year of the reporting date has a readily determinable fair value based on the definition in ASC 321-10-20 (provided the unrestricted stock has a readily determinable fair value). See FV 4.8 for information on the measurement of restricted securities.

If an investor owns equity securities that are not subject to registration with the SEC, and the investor cannot require a registration statement to be filed, the securities should be considered unrestricted if and to the extent that the securities can be qualified for sale within one year under Rule 144 of Section 4 of the Securities Act of 1933, or similar rules of the SEC. Rule 144 specifies that, if certain conditions are met, a security may be sold to the public without an effective registration statement on file with the SEC, subject to a limitation on the number of shares that may be sold during a given time period.

If an investor can require that a registration statement covering the securities be filed, the securities should be considered unrestricted if it can reasonably be expected that a registration statement could become effective within one year from the date of the balance sheet, regardless of the investor's intent with respect to requiring the filing of a registration statement. Any portion of the security holding that

can be reasonably expected to qualify for sale within one year is not considered restricted and would be measured at fair value with subsequent changes in fair value recorded in net income.

Question LI 2-6 discusses whether an equity interest covered by a written call option is considered restricted stock.

Question LI 2-6

Is an equity interest covered by a written call option considered restricted stock?

PwC response

An equity interest covered by a written call option is not considered restricted stock as the written call option is not an attribute of the equity interest. For example, assume a reporting entity buys common stock for \$3 per share and sells a covered call option that is exercisable at \$7 per share. Until the covered call option expires, the reporting entity's policy is not to sell the security. The definition of restricted stock indicates that, if unrestricted stock is pledged as collateral, it does not become restricted stock. The same logic applies to voluntary limitations imposed when the covered call option is sold. An equity interest does not become restricted simply because a call option is voluntarily written against it.

2.3.2 Equity interests without a readily determinable fair value

ASC 321-10-35-2 provides a measurement alternative to the requirement to carry equity interests at fair value in accordance with ASC 820, *Fair value measurement*. The measurement alternative applies to certain equity interests without readily determinable fair values that are within the scope of ASC 321 and are otherwise required to be measured at fair value under ASC 321. It is not available for equity investments that qualify for the practical expedient within ASC 820-10-35-59, which allows the use of net asset value per share when certain conditions are met. See FV 6.2.6 for additional information on the practical expedient in ASC 820-10-35-59. The measurement alternative is also not available for equity interests for which the fair value option in ASC 825, *Financial Instruments*, has been elected or for reporting entities that do not apply ASC 321 because they apply certain specialized industry accounting practices (see LI 2.2.3). Application of the measurement alternative is optional and if elected, should be applied upon acquisition of an equity interest on an instrument-by-instrument basis.

ASC 321-10-35-2 provides guidance on the measurement alternative election.

ASC 321-10-35-2

An entity may elect to measure an equity security without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it shall measure the equity security at fair value as of the date that the observable transaction occurred. An election to measure an equity security in accordance with this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity shall continue to apply the measurement guidance in this paragraph until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily

determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph. If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), the entity may subsequently elect to measure the equity security at fair value. If an entity subsequently elects to measure an equity security at fair value, the entity shall measure all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer, at fair value. The election to measure those securities at fair value shall be irrevocable. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

ASC 825-10-50-8 clarifies that equity interests measured in accordance with the measurement alternative in ASC 321 are not required to be included within the fair value hierarchy.

Question LI 2-7 discusses whether a reporting entity can apply the measurement alternative to an equity interest without a readily determinable fair value if it has elected the fair value option under ASC 825 for that interest.

Question LI 2-7

Can a reporting entity apply the measurement alternative to an equity interest without a readily determinable fair value if it has elected the fair value option under ASC 825 for that interest?

PwC response

No. If the fair value option is elected for an equity interest, its fair value must be measured in accordance with the provisions of ASC 820.

2.3.2.1 *Election of the measurement alternative*

The election to apply the measurement alternative is made upon the purchase or acquisition of the investment. Subsequent information cannot be used in hindsight to determine if a reporting entity should elect the measurement alternative. A reporting entity should document their election.

If elected for an equity interest, the measurement alternative should continue to be applied thereafter, unless the equity interest no longer meets the measurement alternative's requirements or unless an entity chooses to discontinue use of the measurement alternative (as discussed in LI 2.3.2.6). If the measurement alternative is not elected, equity interests without readily determinable fair values should be reported at fair value in accordance with the provisions of ASC 820, with all subsequent changes in fair value recorded in net income.

2.3.2.2 *Recognition and measurement - measurement alternative*

When a reporting entity elects the measurement alternative in ASC 321, the equity interest is recorded at cost, less impairment. The carrying amount should be subsequently remeasured to its fair value in accordance with the provisions of ASC 820 when observable price changes (i.e., observable prices in orderly transactions for an identical or similar investment of the same issuer) occur as of the date the

transaction occurred or it is impaired. Any adjustments to the carrying amount are recorded in net income.

Question LI 2-8 discusses whether the costs to acquire an equity investment, that will be accounted for under the measurement alternative, can be capitalized as part of the carrying amount.

Question LI 2-8

Can the costs to acquire an equity investment that will be accounted for under the measurement alternative be capitalized as part of the carrying amount?

PwC response

ASC 321 does not address the initial measurement of equity investments accounted for under the measurement alternative. As a result, other applicable GAAP should be applied in determining the initial cost basis of the investment. However, it is explicit in ASC 820 that transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction. Therefore, once an equity investment accounted for under the measurement alternative is remeasured to fair value based on an orderly transaction of the same or similar investment from the same issuer or due to an impairment, any transaction costs capitalized upon initial measurement would effectively be written off.

Orderly transactions

ASC 321-10-20 defines an orderly transaction.

ASC 321-10-20

Orderly Transaction: A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Observable transactions

ASC 321-10-55-8 provides guidance on determining observable prices.

ASC 321-10-55-8

To identify observable price changes, an entity should consider relevant transactions that occurred on or before the balance sheet date that are known or can be reasonably known. To identify price changes that can be reasonably known, the entity should make a reasonable effort (that is without expending undue cost and effort) to identify any observable transactions that it may not be readily aware of. The entity need not conduct an exhaustive search for all observable price changes.

Although companies are not expected to perform an exhaustive search to identify observable prices under this exception, companies should have the necessary processes and controls in place to identify observable price changes in accordance with the guidance.

Figure LI 2-3 shows examples of transactions and whether or not they would qualify as observable transactions/prices consistent with ASC 321.

Figure LI 2-3

Examples of observable transactions/prices consistent with ASC 321

Transaction	Orderly and observable?
An investee entity issues the same or similar equity instrument to new or previously-existing equity owners in exchange for cash consideration.	Absent evidence that this is not an orderly transaction, the equity investment should be remeasured. A reporting entity should ensure that the remeasurement results in the investment being reported at fair value as defined by ASC 820.
An existing investor sells the same or similar equity instrument from the same issuer to a new or existing investor for cash consideration.	Absent evidence that this is not an orderly transaction, the equity investment should be remeasured. A reporting entity should ensure that the remeasurement results in the investment being reported at fair value as defined by ASC 820.
The equity investment of an investee is sold as part of a transaction between an existing investor and a new investor for cash. The transaction involves the sale of the same investment held by the reporting entity along with several other investments in other companies. The other investments have readily determinable fair values.	<p>Absent evidence that this is not an orderly transaction, this transaction should be considered and the equity investment should be remeasured.</p> <p>The observable price in this transaction would be calculated by subtracting the fair value of the other investments (which have readily determinable fair values) from the cash paid for the group of investments.</p> <p>A reporting entity should ensure that the remeasurement results in the investment being reported at fair value as defined by ASC 820.</p>
The equity investments of an investee are sold as part of a transaction between an existing investor and a new investor for cash. The transaction involves the sale of the same investment held by the reporting entity along with several other investments. The other investments do not have readily determinable fair values.	<p>This transaction, in isolation, would not be considered a remeasurement event unless it provided evidence of impairment.</p> <p>Unlike the example above, the transaction involves other investments that do not have readily determinable fair values. The transaction price of the investment held by the reporting entity would not be observable without separate observable transactions/prices for the other investments.</p>

Equity interests issued to employees as a form of compensation in exchange for services rendered as part of an approved long-term incentive compensation plan would not be considered an orderly transaction as it does not involve marketing activities that are usual and customary for sales of investments. In addition, it would likely not be considered an observable transaction/price because the value the reporting entity received in exchange for the equity instrument (the performance of services) is generally not observable. However, it may provide evidence of impairment.

Equity interests issued to non-employees may result in an observable transaction/price that would result in a remeasurement of the equity investment, or may provide evidence of impairment. The involvement of a third party could support a conclusion that the transaction is orderly but other factors may be considered, such as whether the price is considered observable. If the fair value of the services or goods exchanged are not readily determinable then it would be appropriate to conclude that this is not an observable transaction/price. However, it may provide evidence of impairment.

If the equity interest is remeasured or an impairment is recorded, the reporting entity should ensure that the remeasurement results in the investment being reported at fair value as defined by ASC 820.

Question LI 2-9 discusses whether identifying an orderly transaction in the same investment or similar investment of the same issuer that occurred during a prior reporting period, but the transaction was not identified until after the issuance of the financial statements for that period, would be considered an error.

Question LI 2-9

Assume a reporting entity identifies an orderly transaction in the same investment or similar investment of the same issuer that occurred during a prior reporting period but the transaction was not identified until after the issuance of the financial statements for that reporting period. Would this be considered an error?

PwC response

A reporting entity should have processes and internal controls over identifying transactions. These processes and controls should continually be re-evaluated based on changes in market conditions and practices. If the reporting entity made a reasonable effort to search for observable transactions but did not identify the transaction, then the subsequent discovery of a pre-balance sheet date transaction would not constitute an error. The reporting entity should record an adjustment to the carrying value in the period in which the transaction is identified. If a reporting entity concludes that the transaction should have been identified in a previous reporting period because processes and controls were insufficient, this should be evaluated as an error under ASC 250.

Question LI 2-10 and Question LI 2-11 discuss the accounting implications of identifying an orderly transaction in the same investment or similar investment of the same issuer after the balance sheet date but prior to the issuance of financial statements for that period.

Question LI 2-10

Assume a reporting entity identifies an orderly and observable transaction in the same investment or similar investment of the same issuer that occurred during the current reporting period, but the transaction is not identified until after the balance sheet date, yet prior to the financial statements being issued. Should the reporting entity adjust the carrying value of the equity interest to its fair value as of the date of the observable transaction in the financial statements that have not yet been issued?

PwC response

Yes, we believe a reporting entity should adjust the carrying value of that equity interest to its fair value because an orderly and observable transaction in the same or similar investment occurred prior to the balance sheet date and was identified before the financial statements were issued. ASC 321-10-35-2 states that a reporting entity should measure an equity interest at fair value as of the date the orderly transaction occurred. Since the orderly transaction occurred prior to the balance sheet date, the carrying value of that equity interest must be adjusted to reflect the remeasurement to fair value triggered by the observable transaction.

Question LI 2-11

Assume a reporting entity identifies an orderly and observable transaction in the same investment or similar investment of the same issuer that occurred after the balance sheet date but is identified prior to the financial statements being issued. Should the reporting entity adjust the carrying value of the equity interest to its fair value in the financial statements that have not yet been issued?

PwC response

ASC 321-10-35-2 states that the equity interest should be measured at fair value as of the date the orderly transaction occurs. As a result, the observable transaction would be a trigger to remeasure the equity investment to fair value in the subsequent reporting period.

However, an orderly transaction that occurs after the balance sheet date that indicates that the fair value of the equity interest is below the current carrying value could be an indication that an impairment existed as of the balance sheet date. If an impairment existed as of the balance sheet date, the reporting entity should measure the equity interest at its fair value as of the balance sheet date. Refer to LI 2.3.2.5 for further discussion on the impairment of equity interests using the measurement alternative.

The reporting entity should consider disclosing the impact from remeasuring the instrument to fair value under the subsequent events guidance.

Similar investments

ASC 321-10-55-9 provides guidance on identifying similar investments of the same issuer.

ASC 321-10-55-9

To identify whether a security issued by the same issuer is similar to the equity security held by the entity, the entity should consider the different rights and obligations of the securities. Differences in rights and obligations could include characteristics such as voting rights, distributions rights and preferences, and conversion features. The entity should adjust the observable price of a similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security measured in accordance with paragraph 321-10-35-2 to reflect the fair value of the security as of the date that the observable transaction for the similar security took place.

Application of the above guidance could be operationally challenging for reporting entities. In order to determine whether an equity interest issued by the same issuer is similar to an equity interest held by the reporting entity, a detailed understanding of the contractual terms of both equity interests must be

obtained. Even in circumstances when differences in rights and obligations are readily apparent, determining whether two equity interests are similar is highly judgmental.

ASC 321 provides limited guidance on how to determine if an instrument is similar. To identify whether an instrument issued by the same issuer is similar to the equity instrument held by the reporting entity, the entity should consider if there are different rights and obligations of the investments, which may include differences in liquidation preferences, distribution/dividend rights, conversion features, or voting rights.

The reporting entity should consider, among other things, the following questions in evaluating whether the instruments are similar:

- Would differences in rights and obligations have a significant impact on the valuation of an instrument?
- Would the adjustment from the observable transaction price to reflect the differences in rights and obligations require significant use of unobservable data?

The determination of whether an instrument is similar should be based on a holistic analysis. Individual factors may not be determinative. For example, the adjustment to compensate for the differences between two instruments may involve significant use of unobservable data, but if the adjustment would have an insignificant impact on the fair value of the instrument, this may indicate that the instruments are similar. In other situations, the impact on fair value of an identified difference may be significant, but if it is easy to calculate and does not require significant use of unobservable data, this may also indicate the instruments are similar.

Conclusions on whether or not instruments are similar may change over time based on changes to the investee's business and capital structure (e.g., a start-up versus an established company). Reporting entities should document the support of their conclusions.

Even if a reporting entity concludes that the observable transaction does not involve similar equity instruments, the transaction may be an indicator of impairment.

If a reporting entity concludes that the investments are similar, it should adjust the price of the similar investment as appropriate in order to arrive at a value that represents the fair value of the instrument held.

2.3.2.3 Remeasurement of purchased options and forward contracts

As discussed in LI 2.2.4.1, physically-settled purchased options and forward contracts to acquire or dispose of an ownership interest that do not meet the net settlement criterion, or do not otherwise meet the definition of a derivative under ASC 815 but meet the definition of an equity security, should apply ASC 321. See DH 2.3.5 for information on the net settlement criterion.

Under the measurement alternative, a change in the observable price or impairment of the forward contract or purchased option's underlying equity investment results in the remeasurement of the entire fair value of the forward contract or purchased option in accordance with ASC 815-10-35-6. As such, when remeasuring the forward contract or option, a reporting entity is required to update all inputs to the valuation and not just the input related to the change in the value of the underlying security.

ASC 815-10-35-6 requires that equity instruments that are subject to ASC 321 acquired under forward contracts should be recorded at their fair values at the settlement date. It also requires the same treatment for option contracts with no intrinsic value at acquisition. We generally believe this guidance should also be applied to option contracts that have intrinsic value at acquisition. As a result, a reporting entity applying the measurement alternative would measure the entire fair value of the equity security as of the settlement date of the forward contract or purchased option.

ASC 815-10-35-6

Changes in the fair value of forward contracts and purchased options on equity securities within the scope of this Subsection shall be recognized in earnings as they occur. Changes in observable price or impairment of forward contracts and purchased options on equity securities without readily determinable fair value within the scope of this Subsection measured in accordance with paragraph 321-10-35-2 shall be recognized in earnings as they occur. A change in observable price or impairment of the underlying securities of forward contracts and purchased options on equity securities shall result in a remeasurement of the entire fair value of the forward contracts and purchased options as of the date that the observable transaction took place. Equity securities within the scope of this Subsection purchased under a forward contract or by exercising an option shall be recorded at their fair values at the settlement date.

2.3.2.4 Remeasurement - foreign denominated equities

Foreign denominated equity investments that do not result in consolidation or the application of the equity method are considered non-monetary assets under ASC 830. If the equity investment is measured at fair value, the period end exchange rates should be utilized, as changes in exchange rates are considered part of changes in fair value. If the measurement alternative is applied to the equity investment, then the guidance in ASC 830-10-45-18 should be applied. Under that guidance, the historical rate at acquisition should be utilized until a remeasurement event occurs. In the period the carrying value is adjusted because of either an impairment or an observable price change, consistent with ASC 820, the fair value of the instrument should be reflected in the reported entity's functional currency based upon the spot rates in effect at the time of the remeasurement event. The resulting change in the carrying value, inclusive of the changes in value attributed to changes in exchange rates, would be recorded in earnings. The spot rate used at that point would become the "new" historical exchange rate until the carrying value is adjusted again as a result of an observable transaction or impairment.

2.3.2.5 Impairment of equity interests—measurement alternative

An ongoing assessment will need to be performed to determine whether an equity interest for which the measurement alternative has been elected has become impaired. The interest is impaired if based on a qualitative assessment of impairment indicators, the fair value of the equity interest is less than its carrying amount. If considered impaired, the difference between the carrying amount and fair value should be recorded in net income.

The impairment charge is a basis adjustment that reduces the carrying amount of the equity interest to its fair value. It is not a valuation allowance. The carrying amount of an equity interest should be remeasured to fair value even if the equity interest has previously been impaired if there is an observable price from an orderly transaction for identical or similar security from the same issuer or an additional impairment.

ASC 321 discusses impairment indicators that a reporting entity should consider. Other impairment indicators outside of those listed in ASC 321-10-35-3 should be considered if relevant.

Excerpt from ASC 321-10-35-3

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

In assessing an equity investment for impairment, the measurement alternative model does not include a significance threshold or the ability to avoid an impairment if a reporting entity believes the decline in fair value is temporary. ASC 321 does not recognize the concept of "other than temporary" as it relates to an impairment assessment.

The impairment model under ASC 321 is a one-step impairment model under which a reporting entity should compute the fair value of an equity investment in accordance with ASC 820 if it has reason to believe the investment's fair value is below the carrying value. If the equity investment's fair value is below the carrying value, the reporting entity must record an impairment for the difference.

Question LI 2-12 discusses whether changes in foreign currency exchange rates can result in an impairment of a foreign-denominated equity investment accounted for under the measurement alternative.

Question LI 2-12

Can changes in foreign currency exchange rates result in an impairment of a foreign-denominated equity investment accounted for under the measurement alternative?

PwC response

Yes. If a reporting entity has reason to believe the fair value of an equity investment accounted for under the measurement alternative is below the carrying value of the instrument, the entity must compute the fair value of the instrument. The entity would record an impairment if the fair value is below carrying value. Changes in spot rates affect the fair value of a foreign-denominated equity investment since, consistent with ASC 820, the fair value of an instrument is recorded in the reporting entity's functional currency. Accordingly, fluctuations in foreign currency exchange rates are an indicator that should be considered in conjunction with other indicators in the assessment of impairment.

Example LI 2-4 demonstrates the application of the impairment model for an equity security without a readily determinable fair value when a reporting entity has elected to apply the measurement alternative.

EXAMPLE LI 2-4

The measurement alternative impairment model

Investor Corp purchases preferred stock issued by Private Co, a private manufacturer of digital technology equipment, for \$100. Investor Corp has concluded that its investment meets the definition of an equity security and is therefore within the scope of ASC 321. The preferred stock does not have a readily determinable fair value and does not qualify for the practical expedient in ASC 820-10-35-59. Investor Corp elects to account for its investment in Private Co in accordance with the measurement alternative in ASC 321-10-35-2.

As a result of a significant technological advance by a competitor, Private Co's digital technology becomes obsolete; as a result, its ability to attract new business has been adversely impacted and its cash flow projections have been revised significantly downward.

How should Investor Corp assess the need for an impairment charge?

Analysis

To determine whether its equity interest in Private Co has been impaired, Investor Corp should first determine whether the deterioration in Private Co's business will have an adverse effect on the fair value of its investment in Private Co. Investor Corp would likely conclude that an impairment has occurred given the presence of the following impairment indicators:

- The significant deterioration in the ability to attract new business
- The obsolescence of Private Co's technology relative to the environment it operates in
- The downward revision to cash flow projections

Investor Corp would therefore need to estimate the fair value of the investment. If the estimated fair value is below its carrying amount, the investment is impaired and its carrying amount should be written down to the estimated fair value (determined in accordance with ASC 820) with the offset recorded in net income.

Example LI 2-5 demonstrates how to subsequently account for an equity interest without a readily determinable fair value that had an impairment in a prior period.

EXAMPLE LI 2-5

Adjustment arising from an observable price for a similar security of the same issuer

Investor Corp purchases preferred stock issued by Private Co, a private manufacturer of digital technology equipment, for \$100. Investor Corp has concluded that its investment meets the definition of an equity security and is therefore within the scope of ASC 321. The preferred stock does not have a readily determinable fair value and does not qualify for the practical expedient in ASC 820-10-35-59.

Investor Corp elects to account for its investment in Private Co in accordance with the measurement alternative in ASC 321-10-35-2.

As a result of a significant technological advance by a competitor, Private Co's digital technology becomes obsolete; as a result, its ability to attract new business has been adversely impacted and its cash flow projections have been revised downward. Investor Corp's assessment resulted in an impairment of \$20, resulting in a carrying value of \$80.

The following reporting period, Private Co issues additional shares of preferred stock to new investors. The preferred stock has the same terms as the preferred stock acquired by Investor Corp. Third-party investors that participated in the new round of financing acquired the preferred shares for \$85 per share.

How should Investor Corp account for its investment in Private Co?

Analysis

Since the additional round of financing is an observable price of an identical security, and assuming Investor Corp has concluded that the fair value of the security in accordance with ASC 820 is \$85, Investor Corp should remeasure its equity investment in Private Co to \$85 by recording the following journal entry.

Dr. Investment in Private Co equity interest	\$5	
Cr. Gain on equity interest		\$5

2.3.2.6 Discontinuance of the measurement alternative

Under ASC 321-10-35-2, a reporting entity can choose to discontinue the use of the measurement alternative and move to the fair value through current earnings model. While the initial election of the measurement alternative can be made on an investment-by-investment basis, the guidance stipulates that once the voluntary election is made, stopping use of the measurement alternative on one investment means that the measurement alternative can no longer be applied to any identical or similar investments from the same issuer. In addition, the measurement alternative cannot be applied to future purchases of the same or similar investments from the same issuer, even if the current position is liquidated between purchases. The election to stop applying the measurement alternative and apply fair value through current earnings is irrevocable.

Use of the measurement alternative should be discontinued if changes in facts and circumstances result in the equity interest no longer being eligible for the measurement alternative. For example, if an equity interest issued by a private company becomes exchange traded as a result of the issuer undergoing an IPO, the equity interest would no longer qualify for the measurement alternative and the equity instrument should be measured at fair value prospectively in accordance with ASC 820 beginning on the date of the remeasurement event (i.e., the IPO).

When a reporting entity moves from the measurement alternative to the fair value through earnings model (either voluntarily or because the investment now has a readily determinable fair value), the

entire difference between the investment's fair value and carrying value is recorded through current earnings.

2.3.2.7 Sale of equity instruments

When an equity instrument is transferred to another entity, it should first be determined whether or not the transfer qualifies as a sale under ASC 860 (see PwC's guide to *Transfers and servicing of financial instruments* for additional information on assessing whether a transfer should be recorded as a sale). If the transfer is a sale, it is generally recorded as a debit to cash (or trade date receivable) and a credit to equity instrument to remove the instrument at its fair value (or sales price). The sale of an equity security does not necessarily give rise to a gain or loss if all changes in the security's fair value are reported in earnings as they occur.

A sale of an equity instrument may constitute an observable transaction or an indicator of impairment that could require remeasurement of equity investments that continue to be held.

2.4 Accounting for changes in equity interests

An increase or decrease in the level of ownership of an investee's equity interests may cause a reporting entity to change its method of accounting for securities to or from the guidance in ASC 321.

In January 2020, the FASB issued ASU 2020-01, *Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)—Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*, which clarifies that observable transactions that result in a company applying or discontinuing the equity method of accounting for an investment should be considered for the purposes of applying the measurement alternative. This guidance became effective for calendar year public business entities on January 1, 2021. See LI 13 for additional information on the effective date and transition requirements for ASU 2020-01. See PwC's *Equity method investments and joint ventures* guide for additional information on the application of ASU 2020-01.

2.4.1 Increase in ownership in an equity interest

An increase in the level of ownership of an equity interest previously accounted for under ASC 321 may require the investor to adopt the equity method of accounting or consolidate the investee. See PwC's *Equity method investments and joint ventures* guide for information on applying the equity method and PwC's *Consolidation* guide for information on consolidating an investee. See FSP 10.4.3 for information on the presentation of an investment that qualifies for the equity method of accounting.

In January 2020, the FASB issued ASU 2020-01, *Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)—Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*, which clarifies that observable transactions that result in a company applying or discontinuing the equity method of accounting for an investment should be considered for the purposes of applying the measurement alternative. This guidance became effective for calendar year public business entities on January 1, 2021. See LI 13 for additional information on the effective date and transition requirements for ASU 2020-01. See PwC's *Equity method investments and joint ventures* guide for additional information on the application of ASU 2020-01.

2.4.2 Decrease in the level of ownership of an investee

A decrease in the level of ownership of an equity interest may require a reporting entity to deconsolidate an investee or to cease applying the equity method of accounting. The retained equity interests that are not accounted for as consolidated subsidiaries or equity method investees should apply the guidance in ASC 321. See EM 5.4.3 for information on accounting for equity interests that cease to qualify for the equity method of accounting when a reporting entity loses control of a subsidiary.

If the retained equity interests have a readily determinable fair value, they should be carried at fair value with changes in value recorded in net income. Any adjustment to the equity interest's initial carrying amount upon the application of ASC 321 (i.e., to adjust the investment's carrying amount to fair value) should be recognized in net income. If the retained equity interest does not have a readily determinable fair value, it may be eligible for the measurement alternative discussed in LI 2.3.2.

In January 2020, the FASB issued ASU 2020-01, *Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)—Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*, which clarifies that observable transactions that result in a company applying or discontinuing the equity method of accounting for an investment should be considered for the purposes of applying the measurement alternative. This guidance became effective for calendar year public business entities on January 1, 2021. See LI 13 for additional information on the effective date and transition requirements for ASU 2020-01. See PwC's *Equity method investments and joint ventures* guide for additional information on the application of ASU 2020-01.

***Chapter 3:
Accounting for investments in
debt securities—updated May
2022***

3.1 Chapter overview – debt securities

This chapter discusses the accounting for debt investments within the scope of ASC 320, *Investments – Debt Securities*.

There are various accounting considerations that may be relevant to a debt security on or after acquisition, including:

- Classification and measurement
- Estimated credit losses
- Interest income
- Presentation and disclosure

Many of these considerations are interrelated. For example, the decision to classify a debt security as held to maturity will mean that the current expected credit loss (CECL) model will need to be used to estimate and record expected credit losses. Conversely, a decision to classify a debt security as available for sale (AFS) will mean that the AFS debt security impairment model should be used to estimate and record credit losses.

In addition, the disclosures required for debt securities can vary based on the nature of the instrument and its measurement characteristics. For example, the required disclosures for held to maturity, available for sale, and trading securities are different.

Figure LI 3-1 identifies where additional information on debt securities can be found in other chapters of this guide.

Figure LI 3-1

Location of additional information on debt securities

Topic	Location
Recognizing interest income	LI 6
Impairment of debt securities held at amortized cost	LI 7
Impairment of debt securities classified as available for sale	LI 8
Disclosure requirements	LI 12

3.2 Scope of ASC 320

Figure LI 2-1 in LI 2.2 is a flowchart to help determine whether an investment held by a for-profit reporting entity is within the scope of ASC 320 or is within the scope of other guidance.

Investments outside the scope of ASC 320 include investments that are derivative instruments, in their entirety, subject to the requirements of ASC 815. Similarly, derivative instruments that have been separated from a host contract are outside the scope of ASC 320. However, if an investment in the

scope of ASC 320 contains an embedded derivative that is required to be separated, the host instrument remains within the scope of ASC 320.

3.2.1 *Entities within the scope of ASC 320*

ASC 320 is not applicable to entities that apply certain industry-specific guidance requiring substantially all debt securities to be measured at fair value with subsequent changes in fair value recognized in net income or in the change in net assets. Examples of these specialized industries include:

- Brokers and dealers in securities
- Defined benefit pension plans and other postretirement plans
- Investment companies
- Health and welfare plans accounted for under ASC 965

The following entities are not deemed to belong to specialized industries for the purposes of ASC 320 and so are included in the scope of ASC 320:

- Cooperatives and mutual entities (such as credit unions and mutual insurance entities)
- Trusts that do not report substantially all of their debt securities at fair value

3.2.2 *Instruments within the scope of ASC 320*

Entities within the scope of ASC 320 are required to apply its provisions to investments in all debt securities, including loans that meet the definition of a security.

Definition from ASC 320-10-20

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Trade receivables of commercial or industrial entities and loans receivable originated by banks or other financial institutions are common examples of instruments that may not meet the definition of a security in ASC 320-10-20. Therefore, these trade or loan receivable may not be within the scope of ASC 320.

The form of the instrument and the relevant jurisdiction should be considered when evaluating whether it meets the definition of a security under ASC 320. The definition in ASC 320 is based on the Uniform Commercial Code at the time the guidance was developed more than 20 years ago, but may not be consistent with the legal definition of a security today. As a result, the legal classification may not be conclusive for determining whether an instrument is in the scope of ASC 320.

Once a reporting entity determines that a debt instrument meets the definition of a security, it should then determine whether it is a debt or equity security.

ASC 320-10-20 defines a debt security.

Definition from ASC 320-10-20

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

- a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
- b. A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
- c. U.S. Treasury securities
- d. U.S. government agency securities
- e. Municipal securities
- f. Corporate bonds
- g. Convertible debt
- h. Commercial paper
- i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
- j. Interest-only and principal-only strips.

The term debt security excludes all of the following:

- a. Option contracts
- b. Financial futures contracts
- c. Forward contracts
- d. Lease contracts
- e. Receivables that do not meet the definition of security and, so, are not debt securities, for example:

1. Trade accounts receivable arising from sales on credit by industrial or commercial entities
2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.

A reporting entity should determine whether an investment meets the definition of a debt security without regard to the determination made by the issuer. For example, a preferred security issued in the form of equity, that has no maturity date and is redeemable at the option of an investor should be accounted for as a debt security regardless of how that instrument is classified by the issuer (i.e., liability, mezzanine equity, or permanent equity).

Although the legal form of an instrument should be considered when determining whether an investment meets the definition of a debt security, form does not always determine whether a security should be accounted for as a debt or an equity security. Instruments that are legally equity may still meet the ASC 320 definition of a debt security. As noted above, preferred stock that must be redeemed by the issuer or is redeemable at the option of the holder through the unilateral right of the individual investor to demand repayment is a debt security under ASC 320.

Question LI 3-1

Investor Corp owns 14% of the outstanding preferred shares of Issuer Corp. Issuer Corp has two classes of stock issued and outstanding: common and preferred. The preferred stock is not redeemable by Issuer Corp; however, after five years have passed, the preferred shareholders may, as a group, redeem the preferred stock for cash upon a two-thirds vote.

Should Investor Corp account for its preferred investment in Issuer Corp as an equity or debt security?

PwC response

Since Investor Corp only owns 14% of the preferred stock, it cannot trigger redemption of the preferred stock on its own (redemption requires a two-thirds vote by all holders). We believe the definition of a debt security includes instruments that the holder can choose to hold until maturity or demand repayment and ultimately receive payment from the issuer. Given that Investor Corp cannot unilaterally demand redemption of the preferred stock, it should account for its investment as an equity security. See LI 2 for additional information on accounting for equity securities.

Question LI 3-2

Are bank certificates of deposit (CDs) or guaranteed investment contracts (GICs) securities within the scope of ASC 320?

PwC response

It depends. If a CD or GIC meets the definition of a debt security, it is within the scope of ASC 320. Depending on the type, form, and characteristics of the CD or GIC, it may meet the definition of a debt security. This may more likely to be the case with a negotiable jumbo CD. In addition, notes collateralized by insurance company-issued GICs or funding agreements are often issued from special purpose vehicles to investors. These notes frequently meet the definition of a debt security.

Question LI 3-3

Are debt securities that are classified as cash equivalents (e.g., US Treasury bills with an original maturity of less than three months) within the scope of ASC 320?

PwC response

Yes. Debt securities classified as cash equivalents are within the scope of ASC 320. Upon acquisition, they should be classified as trading, available-for-sale, or held-to-maturity securities and accounted for according to that designation (see LI 3.3 for information on the classification of debt securities). Since trading and available-for-sale securities are measured at fair value, they are subject to the relevant disclosure requirements for recurring fair value measurements in ASC 820. See FSP 6.5 for information on cash equivalents.

3.2.2.1 Beneficial interests and other instruments

Many securitization transactions involve the transfer of financial assets to a limited-purpose entity through one or multiple steps. Beneficial interests are formed when a special purpose entity issues various interests in security form (hence the term “securitization”) to third parties. The interests entitle the third parties to the cash flows generated by the securitization entity’s underlying financial assets. ASC 860 defines beneficial interests.

Definition from ASC 860-10-20

Beneficial Interests: Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

- a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
- b. Premiums due to guarantors
- c. Commercial paper obligations
- d. Residual interests, whether in the form of debt or equity

Beneficial interests can take many different forms, ranging from debt securities to equity interests issued by a limited partnership or LLC. Examples of beneficial interests in securitizations include mortgage-backed securities, asset-backed securities, credit-linked notes, collateralized debt obligations, and interest-only (IO) or principal-only (PO) strips. The primary investors in beneficial interests in securitizations are insurance companies, banks, broker-dealers, hedge funds, pension funds, and other individuals or companies that maintain a significant investment or trading portfolio. Corporate treasury groups may also invest in beneficial interests. For example, many corporations invest in mortgage-backed securities issued by government-sponsored enterprises such as Freddie Mac or Fannie Mae.

Beneficial interests should be evaluated to determine whether they meet the definition of a derivative in ASC 815. Beneficial interests that are not derivatives in their entirety should also be evaluated to determine whether they contain embedded derivatives that should be accounted for separately. See

DH 4.4.6 for guidance on determining whether beneficial interests contain embedded derivatives that should be bifurcated from the host contract. ASC 815 provides an exception to derivative accounting for certain IO and PO strips, but the scope exception is limited to the most basic IO and PO instruments. See DH 3.2.12 for guidance on applying the scope exception for IO and PO instruments.

Certain beneficial interests in securitizations that are not derivatives within the scope of ASC 815 are accounted for like debt securities under ASC 320, as detailed in ASC 860-20-35-2.

ASC 860-20-35-2

Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of securities are included in the scope of that Topic. Therefore, all relevant provisions of that Topic (including the disclosure requirements) shall be applied. See related implementation guidance beginning in paragraph 860-20-55-33.

The term “substantially all” is not defined in ASC 860. However, based on other accounting literature, “substantially all” is generally interpreted in practice to mean 90% of the investment. Financial assets that can be contractually prepaid or otherwise settled in a way that would prevent the holder from recovering substantially all of its recorded investment often contain embedded derivatives that should be accounted for separately in accordance with the guidance in ASC 815. See DH 4 for additional information on embedded derivatives.

ASC 860-20-35-2 requires accounting consistent with ASC 320 even if the financial instrument is not within the scope of that Topic (e.g., non-certificated beneficial interests). Subsequent changes in the fair value of these financial assets should also be recognized in accordance with ASC 320 (through OCI for available-for-sale securities and through net income for trading securities). Because these securities can be contractually prepaid or settled in a manner in which the investor would not recover substantially all of its recorded investment, they may not be classified as held to maturity.

3.2.2.2 Structured notes

ASC 320-10-20 defines a structured note.

Definition from ASC 320-10-20

Structured Note: A debt instrument whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. Structured notes are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private entities. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.

Investments in structured notes are often required to be accounted for as debt securities. ASC 320-10-55-10 provides descriptions of various structured notes.

Some structured notes have contractual terms that cause them to be derivatives in their entirety. More commonly, structured notes contain embedded derivative features that require separate accounting. For example, a structured note that pays interest based on changes in the S&P 500 index contains an embedded derivative (the component of the contract that adjusts the interest payments based on changes in the S&P 500 index) that should be accounted for separately. The remaining host contract that pays principal and interest without such adjustment should be accounted for based on the guidance in ASC 320.

3.2.2.3 *Purchased options and forward contracts*

The guidance in ASC 320 applies to certain physically-settled purchased options or forward contracts to acquire or dispose of a debt security. Many physically-settled purchased option and forward contracts meet the definition of a derivative and should therefore be accounted for in accordance with ASC 815. However, contracts that do not meet the net settlement criterion, or do not otherwise meet the definition of a derivative in ASC 815, need to consider whether the guidance in ASC 320 applies.

ASC 815-10-15-141 describes the option and forward contracts subject to ASC 320. This guidance includes certain option and forward contracts to purchase debt securities. Therefore, these contracts are required to be designated at inception as either held to maturity, available for sale, or trading and measured in accordance with the guidance prescribed by ASC 320, as discussed further in LI 3.3.

ASC 815-10-15-141

The guidance in the Certain Contracts on Debt and Equity Securities Subsections applies only to those forward contracts and purchased options having all of the following characteristics:

- a. The contract is entered into to purchase securities that will be accounted for under either Topic 320 or Topic 321.
- b. The contract's terms require physical settlement of the contract by delivery of the securities.
- c. The contract is not a derivative instrument otherwise subject to this Subtopic.
- d. The contract, if a purchased option, has no intrinsic value at acquisition.

3.3 *Classification of debt securities*

The accounting and reporting requirements for debt securities are discussed in ASC 320. Debt securities should be classified into one of three categories at acquisition:

- Held to maturity
- Available for sale
- Trading

The classification of a debt security is important to the application of ASC 320 because the accounting treatment and related disclosures are different for each of the three categories. A reporting entity should document its classification of a debt security at acquisition. Classification as a held-to-maturity security should be reassessed each reporting period.

3.3.1 Classification: held-to-maturity debt securities

ASC 320-10-25-1(c) describes held-to-maturity securities.

Excerpt from ASC 320-10-25-1(c)

Held-to-maturity securities. Investments in debt securities shall be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.

The positive intent and ability to hold debt securities to maturity is different from not having an intent to sell. If a reporting entity's intention is uncertain, the security should not be classified as held to maturity. A reporting entity's intent and ability to hold a debt security to maturity is typically evidenced through written representation, as well as other evidence, such as historical experience, board and investment committee minutes, documented investment strategies, instructions to portfolio managers, future business plans, and projections of liquidity and capital adequacy. The intent and ability to hold a debt security to maturity should be reassessed at each reporting period.

The held-to-maturity classification is restrictive. ASC 320-10-25-4 and ASC 320-10-25-5 include specific circumstances and scenarios that preclude a reporting entity from classifying securities as held to maturity. For example, a security may not be classified as held to maturity if it can be contractually prepaid or otherwise settled in such a way that the holder will not recover substantially all of its recorded investment. Securities that a reporting entity may sell based on changes in interest rates, prepayment risk, foreign exchange rates, the entity's liquidity or funding sources/terms, or the availability of yield on other investments should also not be classified as held to maturity.

ASC 320-10-25-4

An entity shall not classify a debt security as held-to-maturity if the entity has the intent to hold the security for only an indefinite period. Consequently, a debt security shall not, for example, be classified as held-to-maturity if the entity anticipates that the security would be available to be sold in response to any of the following circumstances:

- a. Changes in market interest rates and related changes in the security's prepayment risk
- b. Needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims)
- c. Changes in the availability of and the yield on alternative investments
- d. Changes in funding sources and terms
- e. Changes in foreign currency risk.

ASC 320-10-25-5

Specific scenarios in which a debt security shall not be classified as held-to-maturity (or where sale or transfer of a held-to-maturity security will call into question an investor's stated intent to hold other debt securities to maturity in the future) are as follows:

- a. A security shall not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. The justification for using historical-cost-based measurement for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. However, that justification does not extend to receivables purchased at a substantial premium over the amount at which they can be prepaid, and it does not apply to instruments whose payments derive from prepayable receivables but have no principal balance. Therefore, a callable debt security purchased at a significant premium might be precluded from held-to-maturity classification under paragraph 860-20-35-2 if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. In addition, a mortgage-backed interest-only certificate shall not be classified as held-to-maturity. Paragraphs 860-20-35-3 through 35-6 provide further guidance on application of this paragraph. Note that a debt security that is purchased late enough in its life such that, even if it was prepaid, the holder would recover substantially all of its recorded investment, could be initially classified as held-to-maturity if the conditions of this paragraph and paragraph 320-10-25-1 are met. (A debt security that can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment may contain an embedded derivative. Therefore, such a security should be evaluated in accordance with Subtopic 815-15 to determine whether it contains an embedded derivative that needs to be accounted for separately.)
- b. A debt security that is available to be sold in response to changes in market interest rates, changes in the security's prepayment risk, the entity's need for liquidity, changes in foreign exchange risk, or other similar factors shall not be included in the held-to-maturity category because the possibility of a sale is indicative that the entity does not have a positive intent and ability to hold the security to maturity. A debt security that is considered available to be sold as part of an entity's asset-liability management activities shall not be classified as held-to-maturity. Similarly, an entity that maintains a dynamic hedging program in which changes in external factors require that certain securities be sold to maintain an effective hedge would not have the intent and ability to hold those securities to maturity.
- c. Securities that may need to be sold to implement tax-planning strategies (for example, to generate taxable gains to offset existing taxable losses—or vice versa—or in response to changes in the entity's anticipated future profitability—for example, if taxable losses were expected for the next several years) should be classified as available-for-sale, not held-to-maturity.
- d. The sale of a held-to-maturity security in advance of any deterioration in the creditworthiness of the issuer, perhaps based solely on industry statistics, will call into question an investor's stated intent to hold other debt securities to maturity in the future. The sale of a held-to-maturity security must be in response to an actual deterioration, not mere speculation. That deterioration shall be supported by evidence about the issuer's creditworthiness; however, the entity need not await an actual downgrading in the issuer's published credit rating or inclusion on a credit watch list.

- e. The sale of held-to-maturity securities to meet regulatory capital requirements will call into question an investor's stated intent to hold other debt securities to maturity in the future. An entity's ability and intent to hold securities to maturity would be called into question by the sale of held-to-maturity securities to realize gains to replenish regulatory capital that had been reduced by a provision for loan losses. Gains trading with held-to-maturity securities to meet an entity's capital requirements is inconsistent with the held-to-maturity notion.
- f. The exercise of a put option on a security classified as held-to-maturity will call into question an investor's stated intent to hold other debt securities to maturity in the future. Furthermore, a puttable debt security might be precluded from held-to-maturity classification pursuant to paragraph 860-20-35-2.
- g. Convertible debt securities shall not be classified as held-to-maturity. Classifying a security as held-to-maturity means that the entity is indifferent to future opportunities to profit from changes in the security's fair value and intends to accept the debt security's stipulated contractual cash flows, including the repayment of principal at maturity. Convertible debt securities generally bear a lower interest rate because the investor hopes to benefit from appreciation in value of the option embedded in the debt security. Given the unique opportunities for profit embedded in a convertible security, it generally would be contradictory to assert the positive intent and ability to hold a convertible debt security to maturity and forego the opportunity to exercise the conversion feature. The exercise of a conversion feature on a security classified as held-to-maturity will call into question an investor's stated intent to hold other debt securities to maturity in the future. (See Section 815-15-25 for additional guidance. If convertible debt is bifurcated into an equity option and a host debt instrument under the requirements of Subtopic 815-15, it generally still would be contradictory to assert the positive intent and ability to hold the debt host contract to maturity and forego the opportunity to exercise the conversion feature.)
- h. A documented policy to initially classify all debt securities as held-to-maturity but then automatically transfer every security to available-for-sale when it reaches a predetermined point before maturity (for example, every held-to-maturity security will be transferred to available-for-sale 24 months prior to its stated maturity) so that an entity has the flexibility to sell securities is not consistent with the held-to-maturity classification. Under the policy described, the entity does not intend to hold any security to maturity.
- i. An insurance entity or other regulated entity shall not classify securities as held-to-maturity and also indicate to regulators that those securities could be sold to meet liquidity needs in a defined interest rate scenario whose likelihood of occurrence is reasonably possible but not probable.

3.3.1.1 Tainting of held-to-maturity debt securities

Other than the specific circumstances described in ASC 320-10-25-6, ASC 320-10-25-14, and ASC 320-10-25-18, a reporting entity cannot periodically sell or transfer investments from the held-to-maturity category without calling into question:

- A reporting entity's previous assertions regarding the classification of those securities
- A reporting entity's assertions regarding the classification of other held-to-maturity securities

- A reporting entity's future assertions regarding the classification of securities until the reporting entity has reestablished the credibility of its classification policy

However, as a result of reference rate reform, ASC 848 provides an additional circumstance that allows for certain securities to be sold and or transferred without calling into question the reporting entity's previous assertions that it had the intent and ability to hold the securities to maturity. Pursuant to ASC 848-10-35-1, a reporting entity may make a one-time election to sell and/or transfer certain securities from the held-to-maturity portfolio that reference LIBOR, or another reference rate expected to be discontinued. Refer to REF 2 for further details.

Because a reporting entity's assertions relate to each investment in the held-to-maturity category, the sale of individual held-to-maturity securities will call into question a reporting entity's intent to hold all securities in the held-to-maturity category. The held-to-maturity category is purposely restrictive such that the use of amortized cost must be justified for each investment.

Securities should not be "compartmentalized" for the purpose of analyzing the impact of sales or transfers of held-to-maturity securities. That is, all types of securities classified as held to maturity should be considered. For example, a reporting entity should not separate treasury securities from corporate bonds in its held-to-maturity portfolio when evaluating the impact of a sale of a held-to-maturity treasury security on its intent to hold the remaining securities to maturity.

If a sale or transfer of a debt security results in a tainting event, all remaining held-to-maturity securities should be reclassified to available for sale. Securities should not be classified as held to maturity for some period of time following the tainting of the portfolio. This tainting period is intended as time for the reporting entity to reestablish its policies and procedures to ensure that it has both the intent and ability to hold securities to maturity. It also allows the reporting entity to demonstrate its reestablished intent and ability to hold securities to maturity. Practice has generally considered the taint period for sales or transfers of held-to-maturity securities that do not meet the limited exceptions in ASC 320 to be approximately two years.

Once the tainting period has passed, securities that the reporting entity (1) has the positive intent and ability to hold to maturity, and (2) that were acquired and classified as available for sale during the tainting period or were acquired prior to the tainting period and transferred to available for sale, can be transferred to the held-to-maturity category. For purposes of assessing a security's eligibility for the held-to-maturity category, there is no reason to differentiate between the securities originally classified as held to maturity before the tainting period, held-to-maturity securities purchased during the tainting period, or held-to-maturity securities purchased after the tainting period. Classification of these three types of securities as held to maturity is acceptable if they meet the criteria of held-to-maturity securities under ASC 320 and the reporting entity's intent is no longer in question. Securities designated as trading before, during, or after the tainting period cannot be reclassified as held to maturity unless the presumption in ASC 320 that such transfers out of the trading category should be rare can be overcome.

Question LI 3-4

Can a reporting entity classify a debt security as held to maturity if it may sell the security in the event that actual or expected interest rates or prepayments change?

PwC response

No. It is inconsistent to assert the intent to hold securities to maturity if those securities may be sold in response to actual or expected changes in market factors, such as interest rates or prepayment rates. Generally, sales under these conditions will call into question the reporting entity's intentions with respect to its remaining held-to-maturity portfolio.

Question LI 3-5

Certain states require life insurers to perform annual asset adequacy testing based on predefined interest rate scenarios including adverse interest rate shock changes. If an insurance company projects that a debt security will be liquidated prior to maturity under any one of the required asset adequacy scenarios, can that security be classified as held to maturity?

PwC response

No. Classification as held to maturity would be precluded based on the guidance in ASC 320-10-25-4 that states that sales made in response to changes in market interest rates are not consistent with the held-to-maturity classification.

3.3.1.2 Sale or reclassification of held-to-maturity securities

The intent to hold a security to maturity may change over time. ASC 320-10-25-6 identifies various circumstances that may justify the sale or transfer of a security classified as held to maturity without calling into question a reporting entity's intent to hold other debt securities to maturity in the future. Generally, these instances occur due to a change in circumstances that cause a reporting entity to change its intent.

ASC 320-10-25-6

The following changes in circumstances may cause the entity to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. The sale or transfer of a held-to-maturity security due to one of the following changes in circumstances shall not be considered inconsistent with its original classification:

- a. Evidence of a significant deterioration in the issuer's creditworthiness (for example, a downgrading of an issuer's published credit rating)
- b. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- c. A major business combination or major disposition (such as sale of a component of an entity) that necessitates the sale or transfer of held-to-maturity securities to maintain the entity's existing interest rate risk position or credit risk policy
- d. A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security

- e. A significant increase by the regulator in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities
- f. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes.

Additionally, ASC 848-10-35-1 permits a reporting entity to make a one-time election to sell and/or transfer certain debt securities classified as held-to-maturity that reference LIBOR, or another reference rate expected to be discontinued. Refer to REF 2 for further details.

A sale in response to a significant deterioration in the creditworthiness of the issuer must be in response to an actual credit deterioration that can be evidenced (e.g., by a rating agency downgrade or other observable event), rather than speculation, for it to be consistent with the original held-to-maturity classification. ASC 320 does not define what constitutes significant credit deterioration. However, in its deliberations, the FASB indicated that in evaluating credit deterioration, significance should be measured in relation to the individual security rather than in relation to the entire investment portfolio or the investor's financial position.

Question LI 3-6

A reporting entity has determined that its intent to hold a security to maturity has changed based on a tax law change that eliminates the exemption on the security's earned income. In response, the reporting entity sells a portion of its holdings in such security. How does this decision to sell a portion of its holdings impact its intent to hold the remaining portfolio of securities, which were impacted by the tax law change but not sold, to maturity?

PwC response

The sale of the securities would not be considered inconsistent with the original classification of held to maturity because the sale is permitted under the guidance in ASC 320-10-25-6(b). However, the sale of a portion, but not all, of its holdings in the security would call into question the reporting entity's intent to hold the remaining portfolio of securities impacted by the tax law to maturity. The reporting entity should consider whether the remaining securities should be classified as available for sale. Any decision to transfer such securities to available for sale must be made in the period of the tax law change to qualify as a change permitted under ASC 320-10-25-6.

The sale triggered by the tax law change is not likely to, by itself, taint the remaining portfolio of held-to-maturity securities (those not impacted by the tax law change) provided the reporting entity concludes that its intent to hold the portfolio to maturity has not changed.

Question LI 3-7

What constitutes a major business combination or major disposition that allows a reporting entity to sell or transfer held-to-maturity securities to maintain an interest rate risk position or credit risk policy that existed prior to the business combination?

PwC response

Because ASC 320 does not specify a quantitative threshold for a major business combination or

disposition, the significance of such is judgmental and requires analysis. The sale of a segment may be an example of a major disposition. Sales or purchases of financial instrument portfolios, such as loans or deposits, would generally not be considered a business combination or disposal of a business, even if the reporting entity is initiating or getting out of a line of business.

If held-to-maturity securities are sold or transferred in connection with a major business combination or major disposition to maintain the reporting entity's existing interest rate position or credit risk policy, the sale or transfer should occur concurrent with or shortly after the business combination. It should not be made in anticipation of or otherwise prior to the business combination.

Question LI 3-8

If a reporting entity sells held-to-maturity securities to fund an acquisition would it call into question its intent with respect to its remaining held-to-maturity portfolio?

PwC response

Yes. Sales of held-to-maturity securities to fund an acquisition is not one of the exceptions permitted in ASC 320-10-25-6 and would call into question a reporting entity's intent relative to its remaining portfolio.

Question LI 3-9

If a reporting entity is directed to sell certain investments by a regulatory agency, does the resultant sale of affected securities classified as held to maturity impact the classification of other held-to-maturity securities?

PwC response

Yes. The sale of held-to-maturity securities in this circumstance would not qualify for the exception related to changes in regulatory requirements, and therefore it may taint the remainder of the held-to-maturity portfolio. The exception related to changes in regulatory requirements pertains to a specific change in regulatory rules. A directive by a regulator in and of itself would not be considered a "change in statutory or regulatory requirements."

ASC 320 requires entities to reassess the appropriateness of the classification of its debt investments. If an entity no longer has the intent or ability to hold securities to maturity, continued classification as held to maturity is inappropriate. ASC 320-10-25-9 details the characteristics of events (in addition to those listed in ASC 320-10-25-6) that can cause a reporting entity to sell (or transfer) a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity.

Very few events are expected to meet these conditions.

ASC 320-10-25-9

In addition to the changes in circumstances listed in paragraph 320-10-25-6(a) through (f), certain other events may cause the entity to sell or transfer a held-to-maturity security without necessarily calling into question (tainting) its intent to hold other debt securities to maturity. Such events must

meet all of the following four conditions to avoid tainting its intent to hold other debt securities to maturity in the future:

- a. The event is isolated.
- b. The event is nonrecurring.
- c. The event is unusual for the reporting entity.
- d. The event could not have been reasonably anticipated.

In addition, under ASC 320-10-25-14, a sale of a held-to-maturity security would not taint the remaining portfolio if the security is sold close to its maturity date (e.g., three months or less). This is permitted because changes in market interest rates would not significantly impact the security's fair value. ASC 320-10-25-14 also allows a held-to-maturity security to be sold without tainting the remaining portfolio when a reporting entity has collected a substantial portion of the principal outstanding at acquisition (at least 85%). This can be due to prepayments or scheduled payments, comprising both principal and interest, that are payable in equal installments over the debt security's term.

ASC 320-10-25-14

Sales of debt securities that meet either of the following conditions may be considered as maturities for purposes of the classification of securities and the disclosure requirements under this Subtopic:

- a. The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable) that interest rate risk is substantially eliminated as a pricing factor. That is, the date of sale is so near the maturity or call date (for example, within three months) that changes in market interest rates would not have a significant effect on the security's fair value.
- b. The sale of a security occurs after the entity has already collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due either to prepayments on the debt security or to scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. For variable-rate securities, the scheduled payments need not be equal.

3.3.1.3 Classification: other scenarios relevant to HTM debt securities

ASC 320-10-25-18 includes specific scenarios when a debt security may be classified as held to maturity (or when sale or transfer of a held-to-maturity security will not call into question an investor's stated intent to hold other debt securities to maturity in the future).

ASC 320-10-25-18

Specific scenarios in which a debt security may be classified as held to maturity (or where sale or transfer of a held-to-maturity security will not call into question an investor's stated intent to hold other debt securities to maturity in the future) are as follows:

- a. Although its asset-liability management may encompass consideration of the maturity and repricing characteristics of all investments in debt securities, an entity may decide that it can

accomplish the necessary adjustments under its asset-liability management without having all of its debt securities available for disposition. In that case, the entity may choose to designate certain debt securities as unavailable to be sold to accomplish those ongoing adjustments deemed necessary under its asset-liability management, thereby enabling those debt securities to be accounted for at amortized cost on the basis of a positive intent and ability to hold them to maturity.

- b. The sale of one or more held-to-maturity securities if an entity chooses to downsize to comply with a significant increase in the industry's capital requirements would not call into question the classification of other held-to-maturity securities.
- c. In some circumstances it may not be possible to hold a security to its original stated maturity, such as when the security is called by the issuer before maturity. The issuer's exercise of the call option effectively accelerates the security's maturity and shall not be viewed as inconsistent with classification in the held-to-maturity category.
- d. A puttable debt security shall be classified as held-to-maturity only if the entity has the positive intent and ability to hold it to maturity.
- e. If a transfer of a held-to-maturity debt security is accounted for as a sale under Subtopic 860-20 and it is transferred for a reason other than those specified in paragraphs 320-10-25-6, 320-10-25-9, and 320-10-25-14, then the transfer would taint the held-to-maturity portfolio. However, if the transfer is accounted for as a secured borrowing, then the transfer would not taint the held-to-maturity portfolio. Transactions involving held-to-maturity securities that are not accounted for as sales under Subtopic 860-20 would not contradict an entity's stated intent to hold a security to maturity and, therefore, do not call into question the entity's intent to hold other debt securities to maturity. Examples of such transactions are as follows:
 1. Held-to-maturity securities pledged as collateral, provided that the transaction is not accounted for as a sale under Subtopic 860-20 and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral
 2. Held-to-maturity securities subject to a repurchase agreement or a securities lending agreement, provided that the transaction is accounted for as a secured borrowing under Subtopic 860-20 and the entity intends and expects to be able to repay the borrowing
 3. Beneficial interests classified as held-to-maturity that are desecuritized in a transaction that is not accounted for as a sale if the financial assets received in or that continue to be held after the desecuritization are held to maturity. Unless the debt instrument received or retained as a result of the transaction is held to maturity, the transaction would call into question the entity's intent to hold other debt securities to maturity. Desecuritizations are not specifically included within the scope of this paragraph. Nevertheless, that guidance is also appropriate for desecuritizations that are not accounted for as sales.

Question LI 3-10

Can a puttable debt security be classified as held to maturity?

PwC response

If the terms of a puttable debt security require an investor to surrender the security in exchange for cash upon exercise of its put option (as is typically the case), the puttable security may be classified as held to maturity only if the investor has the positive intent and ability to hold it to maturity (i.e., does not expect to exercise the put option prior to maturity). If a put option can be net cash-settled (i.e., the issuer simply pays the investor the difference between the face amount of the debt and the put price), exercise of the put option would not represent a contradiction to the investor's stated intent, as long as it continues to hold the debt instrument after the option is exercised. The cash-settled put option in this example is a freestanding financial instrument because the debt instrument continues to exist after the put option is exercised. Consideration should be given to whether the put option is required to be accounted for under the derivatives guidance in ASC 815.

Question LI 3-11

Can a callable debt security be classified as held to maturity?

PwC response

Yes. A callable debt security can be classified as held to maturity. The issuer's exercise of the call option is considered an effective acceleration of the security's maturity. Provided a reporting entity has the positive intent and ability to hold a callable debt security to maturity or until the issuer exercises its call option, it may classify the security as held to maturity. However, if a reporting entity intends to sell a callable debt security if the issuer does not exercise its call option, classification as held to maturity would be precluded.

Question LI 3-12

Does a reporting entity's acceptance of a tender offer for a held-to-maturity security call into question its intent and ability to hold securities to maturity?

PwC response

Yes. A tender offer is an offer by an issuer or another bidder to purchase its securities directly from investors. It is usually at a premium and for cash. The investor may choose whether to accept the offer. A tender offer is not the same as a callable debt security in which the investor is obligated to sell the security. An investor's acceptance of the tender offer is equivalent to a sale of the security, which will call into question the reporting entity's classification of the investment.

However, if the investor is required to sell the security due to a "squeeze out merger" (i.e., the investor is forced to tender the security), that disposition would not taint the reporting entity's held-to-maturity assertion.

Question LI 3-13

Can transferred debt securities subject to a repurchase agreement be accounted for as held-to-maturity securities if the reporting entity (transferor) concludes that the transfer and repurchase agreement should be accounted for as a secured financing based on the guidance in ASC 860?

PwC response

Yes. Debt securities subject to a repurchase agreement that are not accounted for as a sale of assets may be accounted for as held-to-maturity securities provided the reporting entity has the positive intent and ability to hold those securities to maturity. The ability to hold the securities to maturity is predicated upon the reporting entity's expectation that it can repay the borrowing, as discussed in ASC 320-10-25-18(e).

For accounting purposes, debt securities subject to repurchase agreements that are not accounted for as sales are considered to be collateral that is pledged to secure a loan (i.e., the proceeds received from the transfer of the securities). Refer to PwC's *Transfers and servicing of financial assets* guide for further information.

Question LI 3-14

Does an intercompany sale of held-to-maturity securities between subsidiaries call into question the held-to-maturity classification in the consolidated financial statements?

PwC response

No, an intercompany sale of a held-to-maturity security between subsidiaries does not call into question the held-to-maturity classification in the consolidated financial statements. However, if a subsidiary that has an intercompany sale of a held-to-maturity security (that qualifies as a sale under ASC 860) prepares stand-alone financial statements, the intercompany sale would call into question that subsidiary's intent or ability to hold other debt securities to maturity.

Convertible debt securities

Convertible debt securities are debt instruments that either require or permit the investor to convert the instrument into equity shares of the issuer. Investors typically accept a lower stated interest rate on convertible debt securities in exchange for the right to participate in the potential appreciation of the underlying equity shares. For purposes of ASC 320, a convertible debt security is a debt security. The conversion option should be evaluated under ASC 815 to determine if it is an embedded derivative that should be accounted for separate from the host debt instrument. See DH 4.2.1 for guidance on identifying embedded derivatives.

If a convertible debt security is separated into a conversion option and a host debt instrument by the investor based on the guidance in ASC 815, the host debt instrument should be accounted for under ASC 320. When the debt security is converted into equity shares, the shares must be measured in accordance with ASC 321 subsequent to the conversion. Refer to LI 2 for additional information.

Because a convertible debt security is often purchased with the intent to convert the security into equity shares, it should be carried on the balance sheet at fair value and not at amortized cost. Given

the unique opportunities for profit embedded in a convertible security in exchange for a lower interest rate, it is generally contradictory to assert the positive intent and ability to hold a convertible debt security to maturity and forego the opportunity to exercise the conversion feature. Therefore, a convertible debt security cannot be classified as held to maturity.

Question LI 3-15

If a reporting entity holds a convertible debt security in which it is required to separate the embedded conversion option from the debt host under ASC 815, can it elect to classify the host debt instrument as a held-to-maturity security?

PwC response

No. The exercise of the option by the reporting entity would require it to tender the host debt instrument upon exercise of the option. This would be inconsistent with the entity's assertion that it has the intent and ability to hold the convertible debt security to maturity.

3.3.2 *Classification: trading debt securities*

ASC 320-10-20 provides a definition of trading securities.

Definition from ASC 320-10-20

Trading Securities: Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.

ASC 320-10-25-1(a) provides that securities acquired with an intent to sell within hours or days must be classified as trading. However, the guidance does not preclude a security from being classified as trading if acquired with an intent to hold for a longer period. An entity that classifies debt securities as trading with the intent to hold the securities for a longer period would need to measure the securities at fair value, similar to the measurement it would use if it elected the fair value option under ASC 825. However, for securities measured at fair value under the fair value option, the additional disclosure requirements in ASC 825-10-50-28, 30 and 31 would need to be considered. Additionally, if an entity elects the fair value option for one or more investments, it may use terminology such as "securities carried at fair value" to describe these securities instead of the "trading" terminology in ASC 320.

Excerpt from ASC 320-10-25-1(a)

Trading securities. If a security is acquired with the intent of selling it within hours or days, the security shall be classified as trading. However, at acquisition an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading shall not be precluded simply because the entity does not intend to sell it in the near term.

The following factors should be considered when determining whether debt securities should be classified in the trading category:

- The business purpose of the transaction
- The reporting entity's trading strategy
- Management's intended exit strategy for the investment
- The reporting entity's historical trading activity

A reporting entity may use the trading category for securities that are expected to be held for longer periods. However, ASC 320 requires classification as a trading security to occur only at the acquisition date. Transfers to or from the trading category are expected to be rare. For example, we do not believe transfers to or from the trading category due to changes in investment strategies, achieving accounting results more closely matching economic hedging activities, or repositioning the portfolio due to anticipated changes in the economic outlook are permitted because these events are not considered rare.

3.3.3 Classification: available-for-sale debt securities

ASC 320-10-25-1(b) provides that investments that are not classified as held to maturity or trading securities are classified as available-for-sale securities.

Excerpt from ASC 320-10-25-1(b)

Available-for-sale securities. Investments in debt securities not classified as trading securities or as held-to-maturity securities shall be classified as available-for-sale securities.

A debt security cannot be classified as held to maturity if the reporting entity has the intent to hold the security for an indefinite period or may sell the security in response to the changes in economic conditions, as discussed in ASC 320-10-25-4. See LI 3.3.1 for information on held-to-maturity classification. A reporting entity should not transfer an available-for-sale security to the trading category simply because it intends to sell the security and/or because the passage of time has caused the maturity date to be within one year.

3.3.4 Classification of securitized mortgage loans

ASC 948-310-40-1 requires a reporting entity engaged in mortgage banking activities to classify beneficial interests in mortgage-backed securities (or other beneficial interests retained) resulting from a mortgage loan securitization using the guidance in ASC 320. The securitized debt instrument is a debt security under ASC 320 (and is no longer a mortgage loan).

Excerpt from ASC 948-310-40-1

After the securitization of a mortgage loan held for sale that meets paragraph 860-10-40-5's conditions for a sale, any mortgage-backed securities received by the transferor as proceeds shall be classified in accordance with the provisions of Topic 320.

A mortgage banking enterprise should classify any mortgage-backed securities received as proceeds that it commits to sell before or during the securitization process as trading, as discussed in ASC 948-310-35-3A.

ASC 948-310-35-3A

Paragraph 948-310-40-1 states that, after the securitization of a mortgage loan held for sale that meets paragraph 860-10-40-5's conditions for a sale, any mortgage-backed securities received by the transferor as proceeds shall be classified in accordance with the provisions of Topic 320. However, a mortgage banking entity shall classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. Paragraph 948-310-40-1 states that an entity is prohibited from reclassifying loans as investment securities unless the transfer of those loans meets paragraph 860-10-40-5's conditions for sale accounting.

Although the guidance requires that a transferor's beneficial interests be classified in accordance with ASC 320, certain beneficial interests cannot be classified as held to maturity as they can be contractually prepaid or otherwise settled in such a way that a holder would not recover substantially all of its recorded investment based on the guidance in ASC 320-10-25-5(a). Many reporting entities elect to classify beneficial interests as trading securities to avoid the complexity associated with evaluating them for potential embedded derivatives requiring bifurcation.

3.4 Accounting for debt securities

When a reporting entity acquires a debt security, it should be classified into one of three categories and recognized as an asset on the balance sheet. See LI 3.3 for information on classifying a debt security.

The accounting treatment and related disclosures depend on whether the security is classified as held to maturity, available for sale, or trading.

3.4.1 Held-to-maturity debt securities

Held-to-maturity debt securities are reported at amortized cost. This is due to the securities being held to collect contractual cash flows. As such, it would not be appropriate for an investor to recognize interim fluctuations in fair value through a fair value model since those fluctuations will not be realized by the investor.

Held-to-maturity securities are subject to an ongoing impairment evaluation under ASC 326-20, as discussed in LI 7. Interest income, which includes dividends on instruments that are accounted for as debt securities, such as preferred stock, and the amortization of any premiums and discounts, should be included in net income. ASC 320 does not address the methods of recognizing and measuring interest income each period. See LI 6 for information on recognizing interest income on held-to-maturity debt securities.

Held-to-maturity debt securities are considered monetary assets. The amount to be received at maturity is fixed and does not depend on future prices. Therefore, foreign currency transaction gains or losses are recognized in the income statement. See FX 4.8 for additional information on foreign currency denominated debt securities.

3.4.2 Trading debt securities

Debt securities classified as trading are reported at fair value, with unrealized gains and losses recorded in net income each period.

Debt securities classified as trading should be measured at fair value in the currency in which the debt securities are denominated and remeasured into the investor's functional currency using the spot exchange rate at the balance sheet date. See FX 4.8 for additional information on foreign currency denominated debt securities.

Generally, impairment testing is not necessary for trading debt securities because they are recorded at fair value; therefore, carrying value is always fair value. However, a reporting entity that separately presents interest income on trading securities would have to consider the impact of any impairments on interest income.

3.4.3 *Available-for-sale debt securities*

Debt securities classified as available for sale are reported at fair value and subject to impairment testing. Ignoring the impact of hedge accounting, other than impairment losses, unrealized gains and losses are reported, net of the related tax effect, in other comprehensive income (OCI). Upon sale, realized gains and losses are reported in net income.

There are two methods of accounting for an unrealized gain or loss on a security during the period in which it is sold.

- View A — First report the unrealized gain or loss as a component of other comprehensive income and then determine the reclassification adjustment
- View B — Determine the reclassification adjustment by reference to the unrealized gain reported in the previous reporting period

We believe that both View A and View B are acceptable alternatives under the provisions of ASC 320 and ASC 220, *Comprehensive Income*. A reporting entity should make a policy decision regarding the methodology it elects to follow. The policy should be applied consistently and disclosed in the financial statements, if material.

Interest income, including amortization of any premium or discount, should be included in net income. See LI 6 for information on recognizing interest income on available-for-sale debt securities.

Example LI 3-1 illustrates the accounting for the purchase and sale of an available-for-sale debt security.

EXAMPLE LI 3-1

Accounting for an available-for-sale debt security

ABC Corp acquires a debt security on 1/1/20X6 for \$100. Upon acquisition, ABC Corp documents its designation of that security as available for sale.

ABC Corp sells the security for \$150 on 2/1/20X7.

The following table summarizes the fair value of the security over the holding period.

Date	Fair value
1/1/20X6	\$100
12/31/20X6	\$130
2/1/20X7	\$150

How should ABC Corp record its (1) acquisition of the debt security, (2) subsequent changes in fair value, and (3) disposition of the debt security?

Analysis

To recognize the debt security upon acquisition, ABC Corp should record the following journal entry.

Dr. Debt security — cost basis	\$100	
Cr. Cash		\$100

In accordance with ASC 320, ABC Corp would measure the available-for-sale security at fair value on a quarterly basis and record any unrealized gains or losses in other comprehensive income. To recognize the change in the fair value of the debt security from 1/1/20X6 to 12/31/20X6, ABC Corp should record the following journal entry (note for simplicity purposes the effect of taxes has been ignored and a single journal entry is shown rather than four quarterly journal entries).

Dr. Debt security — unrealized gain	\$30	
Cr. Other comprehensive income		\$30

There are two methods of accounting for the unrealized gain on the security during the period from 12/31/20X6 to 2/1/20X7.

To recognize the unrealized gain of \$20 under View A, ABC Corp should record the following journal entry.

Dr. Debt security — unrealized gain	\$20	
Cr. Other comprehensive income		\$20

Under View B, no journal entry would be required because the \$20 unrealized gain is not recognized in other comprehensive income.

The accounting based on each view is illustrated in the following table (the effect of taxes has been ignored for simplicity).

	View A		View B	
	20X6	20X7	20X6	20X7
Other comprehensive income:				
Unrealized gain on securities	\$30	\$20	\$30	\$0
Less: reclassification adjustment for gains included in net income	—	(50)	—	(30)
Other comprehensive income	\$30	\$(30)	\$30	\$(30)

The journal entry to recognize the sale of the debt security on 2/1/20X7 will depend on the methodology used to record the unrealized holding gain from 12/31/20X6 to 2/1/20X7 (i.e., View A or View B).

Under View A, ABC Corp should record the following journal entry:

Dr. Cash	\$150	
Cr. Debt security — cost basis		\$100
Cr. Debt security — unrealized gain		\$50
Dr. Other comprehensive income	\$50	
Cr. Realized gain on sale of debt security	\$50	

Under View B, ABC Corp should record the following journal entry:

Dr. Cash	\$150	
Cr. Debt security — cost basis		\$100
Cr. Debt security — unrealized gain		\$30
Cr. Realized gain on sale of debt security		\$20
Dr. Other comprehensive income	\$30	
Cr. Realized gain on sale of debt security	\$30	

3.5 Transfers of debt securities between classification categories

For debt securities transferred between categories, an entity should:

- Account for the security through the date it is reclassified based on the accounting model applicable prior to its reclassification.
- On the date the security is reclassified, reverse (through earnings) any allowance for credit losses previously recorded on the debt security.
- Reclassify/transfer the debt security into the new category at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses). If a debt security is being reclassified from available for sale to held to maturity, the amortized cost basis is increased or decreased by the amount of any remaining unrealized holding gain or loss reported in accumulated other comprehensive income.
- Determine if an allowance for credit losses is necessary for a held-to-maturity debt security in accordance with ASC 326-20 or for an available-for-sale debt security in accordance with ASC 326-30.

When transferring a debt security from held to maturity to available for sale, an entity should report any unrealized gain or loss on the debt security at the date of transfer in AOCI, excluding the amount recorded in the allowance for credit losses determined in accordance with ASC 326-30. See LI 8 for further information. In addition, an entity should consider whether the transfer of the debt security calls into question the entity's intent and ability to hold securities that remain in the held-to-maturity category to maturity (i.e., would the transfer "taint" the held-to-maturity portfolio).

When transferring a debt security from available for sale to held to maturity, the held-to-maturity security's initial amortized cost basis will include the available-for-sale security's unrealized gains or losses deferred in AOCI. This could create a premium or discount associated with the held-to-maturity security upon transfer, which should be amortized as an adjustment to yield in accordance with ASC 310-20. In addition, an entity should continue to report the remaining unrealized gain or loss at the date of transfer in AOCI and amortize it over the remaining life of the held-to-maturity security as an adjustment to yield. The amortization of these unrealized gains or losses within AOCI may offset the effect on interest income of the amortization of the held-to-maturity security's premium or discount.

For debt securities transferred between categories, the income statement impact of amounts reversed or established associated with the valuation allowance and/or the allowance for credit losses should be presented gross.

Refer to ASC 320-10-35-10, ASC 320-10-35-10A, and ASC 320-10-35-10B for further information.

ASC 320-10-35-10

Transfers of a debt security from or into the trading category 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.

ASC 320-10-35-10A

For a debt security that is transferred into the available-for-sale category from the held-to-maturity category, an entity shall:

- a. Reverse in earnings any allowance for credit losses previously recorded on the held-to-maturity debt security at the transfer date
- b. Reclassify and transfer the debt security to the available-for-sale category at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses)
- c. Determine if an allowance for credit losses is necessary by following the guidance in Subtopic 326-30
- d. Report in other comprehensive income any unrealized gain or loss on the available-for-sale debt security at the date of transfer, excluding the amount recorded in the allowance for credit losses in accordance with paragraph (c)

- e. Consider whether the transfer of a debt security from the held-to-maturity category to the available-for-sale category calls into question the entity's intent and ability to hold securities that remain in the held-to-maturity category to maturity in accordance with paragraphs 320-10-35-8 through 35-9.

ASC 320-10-35-10B

For a debt security that is transferred into the held-to-maturity category from the available-for-sale category, an entity shall:

- a. Reverse in earnings any allowance for credit losses previously recorded on the available-for-sale debt security at the transfer date
- b. Reclassify and transfer the debt security to the held-to-maturity category at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses) plus or minus the amount of any remaining unrealized holding gain or loss reported in accumulated other comprehensive income
- c. Evaluate the debt security for an allowance for credit losses by following the guidance in Subtopic 326-20
- d. Continue to report the unrealized holding gain or loss at the date of the transfer in a separate component of shareholders' equity, such as accumulated other comprehensive income, but that gain or loss 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 transfer may create a premium or discount that, under amortized cost accounting, shall be amortized thereafter as an adjustment of yield in accordance with Subtopic 310-20 on receivables—nonrefundable fees and other costs.

3.6 Restructuring of a debt security – after adoption of ASU 2022-02

ASC 310-20-35-9 discusses the conditions for when a creditor should account for a modification of the terms of an existing debt instrument as a modification or as an extinguishment of the original debt instrument.

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or 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 and modifications of the original debt instrument are more than minor. 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. 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.

ASC 310-20-20 clarifies that the term “loan” includes loans accounted for as debt securities.

A new or restructured debt instrument is considered an extinguishment of the existing instrument and origination of a new instrument by the lender/investor when both of the following conditions are met:

- The terms of the new or restructured debt instrument are at least as favorable to the lender as the terms for comparable debt instruments to customers with similar creditworthiness.
- A modification is more than minor quantitatively or if facts and circumstances and other relevant considerations indicate that the modification is more than minor.

The terms of the new or restructured debt instrument are considered at least as favorable to the lender/issuer as the terms for comparable debt instruments to customers with similar creditworthiness when the new or restructured debt instrument is at or above a market rate of interest for the investor.

A modification is quantitatively more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original debt instrument. The guidance in ASC 470-50 (which is applicable to borrowers) should be used to calculate the present value of the cash flows for purposes of applying the 10% test. If the difference is less than 10%, the facts and circumstances and other relevant considerations may nevertheless indicate that the modification is more than minor.

To determine which facts and circumstances might help determine whether a modification is considered more than minor, a lender should consider the guidance in ASC 470-50 for borrowers. See FG 3 for additional information on accounting for debt modifications.

3.6A Restructuring of a debt security – before adoption of ASU 2022-02

A creditor may agree to modify the terms of a debt security either by restructuring its terms or by exchanging one debt instrument for another. When a creditor and a debtor agree to modify the terms of an existing debt instrument (or to exchange debt instruments) the creditor should evaluate whether the restructuring constitutes a troubled debt restructuring under the guidance in ASC 310-40. A restructuring of a debt instrument is considered a troubled debt restructuring if both of the following conditions are present:

- The lender has granted a concession
- The borrower is having financial difficulties

For additional guidance on troubled debt restructurings by creditors, see LI 10A.

For debt restructurings that are not considered troubled debt restructurings, a creditor must determine whether the modification or exchange should be accounted for as (a) the creation of a new

debt instrument and the extinguishment of the original debt instrument or (b) the modification of the original debt instrument.

ASC 310-20-35-9 discusses the conditions for when a creditor should account for a modification of the terms of an existing debt instrument as a modification or as an extinguishment of the original debt instrument.

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or restructuring, in which the refinancing or restructuring is not itself 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 and modifications of the original debt instrument are more than minor. 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. 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.

ASC 310-20-20 and ASC 310-20-15-4 clarify that the term "loan" includes loans accounted for as debt securities for the purposes of applying the guidance in ASC 310-20.

A new or restructured debt instrument is considered an extinguishment of the existing instrument and origination of a new instrument by the lender/investor when both of the following conditions are met:

- The terms of the new or restructured debt instrument are at least as favorable to the lender as the terms for comparable debt instruments to customers with similar creditworthiness.
- A modification is more than minor quantitatively or if facts and circumstances and other relevant considerations indicate that the modification is more than minor.

The terms of the new or restructured debt instrument are considered at least as favorable to the lender/issuer as the terms for comparable debt instruments to customers with similar creditworthiness when the new or restructured debt instrument is at or above a market rate of interest for the investor.

A modification is quantitatively more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original debt instrument. The guidance in ASC 470-50 (which is applicable to borrowers) should be used to calculate the present value of the cash flows for purposes of applying the 10% test. If the difference is less than 10%, the facts and circumstances and other relevant considerations may nevertheless indicate that the modification is more than minor.

To determine which facts and circumstances might help determine whether a modification is considered more than minor, a lender should consider the guidance in ASC 470-50 for borrowers. See FG 3 for additional information on accounting for debt modifications.

3.6.1 *Securities received in a restructuring – after adoption of ASU 2022-02*

ASC 320-10-15-6 and ASC 320-10-55-2 clarify that ASC 320 applies to all loans that meet the definition of a security. Therefore, if a loan is restructured such that it meets the definition of a security, it becomes subject to the guidance in ASC 320.

ASC 320-10-15-6

The guidance in this Topic applies to all loans that meet the definition of a security.

ASC 320-10-55-2

All of the following debt instruments are within the scope of this Topic if they meet the definition of a debt security :

- a. Loans restructured as securities. For example, any loan that was restructured involving a modification of terms would be subject to the provisions of this Topic if the debt instrument meets the definition of a security. See paragraph 310-20-40-10 for additional information.
- b. Beneficial interests in securitized financial assets that are in equity form but that meet the definition of a debt security. For example, some beneficial interests issued in the form of equity represent solely a right to receive a stream of future cash flows to be collected under preset terms and conditions (that is, a creditor relationship), while others, according to the terms of the special-purpose entity, must be redeemed by the issuing entity or must be redeemable at the option of the investor. Consequently, those beneficial interests would be within the scope of both this Topic and Subtopic 325-40 since they are required to be accounted for as debt securities.
- c. Certificates of deposit (CDs) or guaranteed investment contracts. For example, certain negotiable jumbo CDs and guaranteed investment contracts might meet the definition of security, which was modeled after the definition provided in the Uniform Commercial Code.

Redeemable convertible preferred stock. For example, convertible preferred stock that has mandatory redemption provisions or is redeemable at the option of the investor is considered a debt security and this Topic would apply.

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring. ASC 310-20-40-10 provides further guidance on how to account for the initial cost basis of a debt security of the original debtor received as part of a debt restructuring. The initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off. Subsequent to the restructuring, the security should be accounted for according to ASC 320. In accordance with ASC 310-20-40-11, a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring, and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to ASC 320.

For additional information on debt restructuring, see LI 10.

ASC 310-20-40-10

The initial cost basis of a debt security of the original debtor received as part of a debt restructuring shall be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan shall be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received shall be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security received shall be accounted for according to the provisions of Topic 320.

ASC 310-20-40-11

A security received in a restructuring in settlement of a claim for only the past-due interest on a loan shall be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security received shall be accounted for according to the provisions of Topic 320.

3.6.1A *Securities received in a restructuring— before adoption of ASU 2022-02*

ASC 320-10-15-6 and ASC 320-10-55-2 clarify that ASC 320 applies to all loans that meet the definition of a security. Therefore, if a loan is restructured such that it meets the definition of a security, it is subject to the guidance in ASC 320.

ASC 320-10-15-6

The guidance in this Topic applies to all loans that meet the definition of a security.

ASC 320-10-55-2

All of the following debt instruments are within the scope of this Topic if they meet the definition of a debt security:

- a. Loans restructured as securities. For example, any loan that was restructured in a troubled debt restructuring involving a modification of terms would be subject to the provisions of this Topic if the debt instrument meets the definition of a security. See paragraph 310-40-40-8A for additional information.
- b. Beneficial interests in securitized financial assets that are in equity form but that meet the definition of a debt security. For example, some beneficial interests issued in the form of equity represent solely a right to receive a stream of future cash flows to be collected under preset terms and conditions (that is, a creditor relationship), while others, according to the terms of the special-purpose entity, must be redeemed by the issuing entity or must be redeemable at the option of the investor. Consequently, those beneficial interests would be within the scope of both this Topic and Subtopic 325-40 since they are required to be accounted for as debt securities.
- c. Certificates of deposit (CDs) or guaranteed investment contracts. For example, certain negotiable jumbo CDs and guaranteed investment contracts might meet the definition of security, which was modeled after the definition provided in the Uniform Commercial Code.

- d. Redeemable convertible preferred stock. For example, convertible preferred stock that has mandatory redemption provisions or is redeemable at the option of the investor is considered a debt security and this Topic would apply.

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring. ASC 310-40-40-8A provides further guidance on how to account for the initial cost basis of a debt security of the original debtor received as part of a debt restructuring. The initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off. Subsequent to the restructuring, the security should be accounted for according to ASC 320. In accordance with ASC 310-40-40-9, a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring, and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to ASC 320.

ASC 310-40-40-8A

The initial cost basis of a debt security of the original debtor received as part of a debt restructuring shall be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan shall be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received shall be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security received shall be accounted for according to the provisions of Topic 320.

ASC 310-40-40-9

A security received in a restructuring in settlement of a claim for only the past-due interest on a loan shall be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security received shall be accounted for according to the provisions of Topic 320.

For additional information on debt restructuring, see LI 10A.

Chapter 4:
Accounting for loans—updated
May 2022

4.1 Chapter overview – loans

A loan receivable is recorded for loans that a reporting entity originates or purchases. Loans may be purchased individually, in pools, or as part of a business combination. A loan or portfolio of loans may also need to be recorded on the balance sheet as a result of applying the guidance in ASC 810, *Consolidation*. This chapter provides an overview of loan types and discusses the lender's accounting for originated and purchased loans, including:

- Classification of loans on the balance sheet as held for investment or held for sale
- Accounting for loan origination fees and costs

This chapter also discusses the accounting for loan commitments and mortgage-banking activities.

In March 2022, the FASB issued ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*, which eliminated the accounting guidance for troubled debt restructurings (TDRs) for creditors that have adopted ASU 2016-13. Guidance in this chapter has been updated to reflect the new ASU; impacted sections are denoted as before or after adoption of ASU 2022-02. This chapter also assumes an entity has adopted ASU 2022-01, *Derivatives and Hedging (Topic 815), Fair Value Hedging – Portfolio Layer Method*.

Figure LI 4-1 illustrates the primary sources of authoritative guidance on accounting for loans and the recognition of interest income.

Figure LI 4-1

Authoritative guidance on accounting for loans and recognition of interest income

ASC reference	Title	Location of discussion in guide
ASC 310-10	<i>Receivables – Overall</i>	LI 4.3 and LI 4.8
ASC 310-20	<i>Receivables – Nonrefundable Fees and Other Costs</i>	LI 4.4 and LI 6
ASC 310-20	<i>Receivables – Loan refinancing and restructuring</i>	LI 10 (after adoption of ASU 2022-02)
ASC 310-40	<i>Receivables – Troubled Debt Restructurings by Creditors</i>	LI 10A (before adoption of ASU 2022-02)
ASC 326	<i>Financial Instruments – Credit Losses</i>	LI 7 and LI 9
ASC 360-20	<i>Property, Plant, and Equipment – Real Estate Sales</i>	LI 11
ASC 948	<i>Financial Services – Mortgage Banking</i>	LI 4.3 and LI 4.9

4.2 Types of loans

ASC 310-20-20 provides the following definition of a loan.

Definition from ASC 310-20-20

Loan: A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable. This definition encompasses loans accounted for as debt securities.

Loans can be characterized in different ways. For example, loans can be described in terms of their credit characteristics (e.g., based on FICO bands, risk ratings), arrangement type (e.g., term, revolving, or demand loans), loan product type, or type of collateral. The following descriptions provide an overview of common types of loans.

See LI 4.6 for information on loan syndications.

4.2.1 Consumer loans

Loans used to fund household and personal expenditures are called consumer loans. Examples of consumer loans include credit cards, personal loans, and auto loans. Consumer loans can be either secured or unsecured.

4.2.1.1 Credit cards

Credit cards are a type of consumer loan. Credit card arrangements are short-term revolving lines of credit that are typically unsecured. The types of reporting entities involved in issuing credit cards ranges from direct card issuers (e.g., a bank) to card sponsors (e.g., airlines, hotels, retailers). Credit cards typically bear a higher rate of interest than other loans and may include some form of incentive for using the credit card (e.g., reward points).

4.2.2 Real estate loans (mortgages)

A real estate loan, or mortgage, is a loan collateralized by real estate property, such as a single-family home, multi-family home, or commercial property. The type of property determines the loan type.

4.2.2.1 Residential mortgage loans

Residential mortgage loans include mortgages secured by single family and certain multi-family homes (i.e., a home with four or fewer units). Residential mortgages include first lien, second lien, home equity lines of credit (HELOC), and reverse mortgages.

Certain residential mortgage loans may be partially insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans' Affairs (VA). Residential mortgage loans that are not insured by the FHA or guaranteed by the VA are often referred to as conventional loans.

Residential mortgage loans that meet the guidelines of a government-sponsored enterprise (GSE) are referred to as conforming loans. The loan amount must be less than the conforming loan limit, which can vary based on the location of the property securing the mortgage, and must meet certain other eligibility criteria. GSEs generally purchase conforming mortgage loans, securitize the loans into mortgage loan participation certificates by transferring the loans to a securitization trust, and guarantee the timely payment of interest and the collection of principal on the certificates issued by

the trust that are sold to investors. Loans that do not meet these guidelines are often referred to as non-conforming or jumbo loans.

4.2.2.2 Commercial real estate loans

Commercial real estate loans are collateralized by a commercial real estate property, such as a shopping mall, office building, hotel, or apartment building.

4.2.2.3 Multi-family loans

A multi-family loan is a loan obtained to purchase a building that is designed to house more than four families, such as an apartment building or condominium. Multi-family loans may also be referred to as commercial real estate loans.

4.2.3 Commercial and industrial loans

Commercial and industrial loans are often used for working capital purposes, purchases of inventory, or capital expenditures. They may be either secured or unsecured and vary from short-term revolving lines of credit to longer term arrangements.

4.2.4 Other loan types

Some of the other common types of loans include student loans, construction loans, and small business loans.

Student loans are used to pay for education costs, typically at the college or graduate/post-graduate levels.

Construction loans are typically structured as a variable-rate line of credit during the construction of a home or other building. Construction loans are often converted into fixed-term real estate loans upon completion of the construction or attainment of another specified milestone.

Small business loans are used to fund the operations of small businesses. These loans may be guaranteed by the Small Business Administration, a US government agency.

4.3 Classification and accounting for loans

Loan receivables may be classified as held for investment or held for sale, or accounted for under the fair value option (FVO) method of accounting. They may be accounted for under ASC 310 (nonmortgage loans, commonly referred to as “not held for sale) or under ASC 948-310 (mortgage loans, commonly referred to held for long term investment). The following sections discuss how to determine the appropriate classification and accounting for various loan types.

An entity may elect to apply the FVO to originated or purchased loans in accordance with ASC 825-10-15-4. The irrevocable election can be made on an instrument-by-instrument basis (i.e., only select loans will be reported at fair value) with changes in fair value recorded in earnings. As a result of the election, loans accounted for under the FVO will not be subject to an allowance for credit losses under the CECL impairment model as ASC 326-20-15-3 scopes out financial assets measured at fair value through earnings. See LI 7 for more information regarding the allowance for credit losses and FV 5 for more information on the FVO election.

4.3.1 **Classification and accounting: loans held for investment (HFI)**

When a reporting entity holds an originated or purchased loan for which it has the intent and ability to hold for the foreseeable future or to maturity or payoff, the loan should be classified as held-for-investment. If a reporting entity intends to sell a loan, the loan should be classified as held for sale (see LI 4.3.2). Management should make a positive assertion regarding its ability and intent to hold or sell loan receivables.

As discussed in ASC 310-10-35-47A and ASC 948-310-30-4, loans held for investment are reported on the balance sheet at their amortized cost basis. The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments. See LI 7 for information on determining the allowance for credit losses for a loan held for investment. See DH 6.5 for information on loans that are in an active portfolio layer method hedging relationship.

4.3.2 **Classification and accounting: loans held for sale (HFS)**

When a reporting entity originates or purchases a loan with the intent to sell the loan to another entity (e.g., a government-sponsored enterprise), the loan should be classified as held for sale. Management should make a positive assertion regarding its ability and intent to hold or sell loan receivables. Loans should be classified as held for sale once a decision has been made to sell the loans. It is possible to designate only a portion of a loan as held for sale.

If a reporting entity is unsuccessful in selling a loan classified as held for sale, it should remain in held for sale until the reporting entity decides not to sell the loan (and the intent and ability criteria for classifying the loan as HFI are met), at which point the loan should be transferred to the HFI portfolio.

Both mortgage and nonmortgage loans classified as held for sale should be carried at the lower of amortized cost basis or fair value. If the amortized cost basis of a loan exceeds fair value, a valuation allowance should be established for the difference. However, if the loan is hedged in an active portfolio layer method hedge, the loan's amortized cost basis (used in applying the lower of amortized cost or fair value model) should not reflect any basis adjustments associated with the portfolio layer method hedge. See DH 6.5 for information on portfolio layer method hedging relationships. The accounting for mortgage loans should be based on the guidance in ASC 948, *Mortgage Banking*, while the accounting for nonmortgage loans should be based on the guidance in ASC 310.

Question LI 4-1

Should a lender include a loan premium when measuring the lower of amortized cost basis or fair value of an HFS loan?

PwC response

Yes, with one exception. In accordance with ASC 310-10-20, unamortized loan premium is part of the amortized cost basis and should be considered when measuring the lower of amortized cost basis or fair value of an HFS loan. However, if the loan is hedged in an active portfolio layer method hedge, the loan's amortized cost basis (used in applying the lower of amortized cost or fair value model) should not reflect any basis adjustments associated with the portfolio layer method hedge. See DH 6.5 for information on portfolio layer method hedging relationships.

4.3.2.1 *Accounting for mortgage loans held for sale*

Mortgage loans that are classified as held for sale are accounted for in accordance with the guidance in ASC 948-310-35.

ASC 948-310-35-1

Mortgage loans held for sale shall be reported at the lower of amortized cost or fair value, determined as of the balance sheet date. If a mortgage loan has been the hedged item in a fair value hedge that is not a portfolio layer method hedge (as addressed in Topic 815), the loan's amortized cost basis used in lower-of-amortized-cost-or-fair value accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 815-25-35-1(b).

ASC 948-310-35-1A

If a mortgage loan that is held for sale is included in a closed portfolio hedged in an existing portfolio layer method hedge, the loan's amortized cost basis used in the lower-of-amortized-cost-basis-or-fair-value accounting shall not reflect the effect of the adjustments made pursuant to paragraph 815-25-35-1(c). If that portfolio layer method hedge is discontinued pursuant to paragraphs 815-25-40-7A through 40-8, the loan's amortized cost basis used in lower-of-amortized-basis-or-fair-value accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraphs 815-25-35-1(b) and 815-25-40-9 through 40-9A.

ASC 948-310-35-2

The amount by which amortized cost exceeds fair value shall be accounted for as a valuation allowance. Changes in the valuation allowances shall be included in the determination of net income of the period in which the change occurs. Purchase discounts on mortgage loans shall not be amortized as interest revenue during the period the loans or securities are held for sale.

ASC 948-310-35-6

Capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans (see paragraph 860-50-25-1), shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or fair value.

ASC 948 requires that the fair value of mortgage loans held for sale be determined by loan type. At a minimum, the fair value of residential and commercial mortgage loans should be determined separately. Either the aggregate or individual loan basis may be used to determine the lower of amortized cost or fair value for each loan type. However, the granularity of the analysis should not be inconsistent with the way the underlying loans are valued and ultimately sold by the reporting entity.

Because the net deferred fees or costs associated with a loan held for sale are deferred (i.e., not amortized or accreted in interest income) until the related loan is sold, they should be included in the amortized cost basis of an HFS mortgage loan when evaluating the need for a valuation allowance. See LI 4.4 for information on loan origination fees and costs.

4.3.3 *Loans: transfers between categories*

A reporting entity may decide to sell a loan classified as held for investment or to retain a loan previously classified as held for sale. The loan should be reclassified at the point the criteria for changing classification is met (e.g., when the reporting entity intends to sell loans that were originally classified as held for investment).

4.3.3.1 *Transfer from held for investment to held for sale*

As discussed in ASC 310-10-35-48A and ASC 948-310-35-2A, a loan classified as held for investment should be reclassified to held for sale if the reporting entity decides to sell the loan. On the date a loan is transferred into the held-for-sale category, any previously recorded allowance for credit losses is reversed in earnings and the loan is recorded at its amortized cost basis. Prior to the transfer, a reporting entity should apply its writeoff policy to the amortized cost basis. The amortized cost at the date of transfer should be reduced by any writeoffs recognized just prior to the transfer. If the amortized cost basis exceeds the loan's fair value at the date of transfer, the reporting entity should establish a valuation allowance equal to the difference between amortized cost basis and fair value. However, if the loan is hedged in an active portfolio layer method hedge, the loan's amortized cost basis (used in applying the lower of amortized cost or fair value model) should not reflect any basis adjustments associated with the portfolio layer method hedge. The previously recorded allowance for credit losses associated with the transferred loans (after applying the writeoff policy) should generally be released and an offsetting entry recorded to the provision. This will typically occur when the reporting entity determines its overall allowance for credit losses at the next reporting date. This could have the effect of reversing the pre-transfer held for investment allowance for credit losses through the provision and establishing a new held for sale valuation allowance through earnings in the same reporting period. For loans with credit deterioration, applying the writeoff policy should eliminate much of the pre-transfer allowance.

Question LI 4-2

If a bank has not made a final decision, but is considering the sale of one or more loans that have been previously designated as held for investment at origination, what should the bank consider in determining how those loans be classified in the bank's financial statements?

PwC response

The bank should consider the following factors to determine how to classify the loans it is considering selling:

- Is there a formal marketing strategy?
- Are there potential buyers?
- Have the loans to be sold been specifically identified?
- Has a potential sale been approved by the banks' Board of Directors or by those in management having authority over such decisions?

Positive answers to these questions may indicate that the bank has decided to sell the loans, and as a result they should be classified as held for sale. A bank should consider all relevant facts to determine the appropriate classification of loans.

4.3.3.2 ***Transfer from held for sale to held for investment***

A loan classified as held for sale should be reclassified to held for investment if a reporting entity no longer plans to sell it but will instead hold the loan as a long-term investment (i.e., it has the intent and ability to hold the investment for the foreseeable future or until its maturity or payoff).

As discussed in ASC 310-10-35-48B and ASC 948-310-35-5A, when a loan is reclassified to held for investment, any previously recorded valuation allowance is reversed in earnings and the loan recorded at its amortized cost basis. Upon transfer to held for investment, the reporting entity should calculate an allowance for credit losses using the CECL impairment model. See LI 7 for information on the CECL impairment model. Fair value hedge accounting basis adjustments on active portfolio layer method hedges should not be considered when measuring the allowance for credit losses.

If the basis of a loan transferred to held for investment had been adjusted due to the application of hedge accounting while it was classified as held for sale, such adjustment would be part of the loan's amortized cost basis upon transfer similar to any deferred fees or costs.

Example LI 4-1 illustrates a loan transfer from held for sale to held for long-term investment/not held for sale.

EXAMPLE LI 4-1

Transfer of loans from held for sale to held for investment

Bank Corp holds a loan with an amortized cost basis of \$100,000 and a fair value of \$80,000 in its loans held for sale portfolio. Since the fair value is \$20,000 lower than the amortized cost basis, Bank Corp has recognized a valuation allowance of \$20,000 on the loan.

On December 31, 20X7, Bank Corp makes the decision to hold the loan for long-term investment and transfers the loan to held for investment. Upon transfer, Bank Corp determined that it should record a \$10,000 allowance for credit losses associated with the transferred loan.

How should Bank Corp account for the transfer of the loan from held for sale to held for investment?

Analysis

Bank Corp would account for the transfer of the loan from held for sale to held for investment by recording the following journal entries.

Dr. Loans held for investment	\$100,000	
Dr. HFS valuation allowance	\$20,000	
Cr. Loans held-for-sale		\$100,000
Cr. Lower of cost or market adjustment on loans held for sale		\$20,000

To record the loan transfer and reverse the valuation allowance in net income

Dr. Provision for credit losses	\$10,000	
Cr. Allowance for credit losses		\$10,000
To record the allowance for credit losses associated with the loan on the transfer date		

4.4 *Loan origination fees and costs*

ASC 310-20 provides guidance on the recognition and measurement of nonrefundable fees and origination costs associated with all types of lending arrangements (e.g., consumer, mortgage, commercial, leases) other than those specifically scoped out in ASC 310-20-15-3 (e.g., fees and cost related to loans carried at fair value). Fees recognized as a result of arrangements that are outside the scope of ASC 310-20 should be accounted for under other applicable GAAP, for example, ASC 606, *Revenue*.

The table in ASC 310-20-15-4 outlines the types of instruments subject to the guidance in ASC 310-20.

ASC 310-20-15-4

The following table outlines the applicability of this Subtopic to various types of assets.

Types of Assets	Basis of Accounting	Applicability of This Subtopic
Loans or debt securities held in an investment portfolio	Historical or amortized cost ^(b)	Yes
Loans held for sale	Lower of cost or fair value ^(b)	Yes
Loans or debt securities held in trading accounts by certain financial institutions	Fair value, changes in fair value included in earnings	No
Loans or debt securities, available for sale ^(a)	Fair value, changes in fair value reported in OCI	Yes

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

b. Entities may choose, at specified election dates, to measure eligible items at fair value (the fair value option). See Section 825-10-15 for guidance on the scope of the Fair Value Option Subsections of the Financial Instruments Topic.

4.4.1 *Loan origination fees*

A reporting entity (the lender) may charge a borrower fees as part of its origination and lending activities. ASC 310-20-20 defines loan origination fees.

Definition from ASC 310-20-20

Loan Origination Fees: Origination fees consist of all of the following:

- 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 310-20-25-19)
- e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, 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.

See LI 4.7.1 for information on the accounting for fees paid for loan commitments. See LI 4.4.3 for information on the accounting for loan fees.

4.4.2 Loan origination costs

Costs incurred by a reporting entity as part of origination and lending activities should be evaluated under the guidance in ASC 310-20 to assess whether they represent direct loan origination costs or other lending related costs.

ASC 310-20-20 defines direct loan origination costs.

Definition from ASC 310-20-20

Direct Loan Origination Costs: Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:

- a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
- b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
 1. Evaluating the prospective borrower's financial condition
 2. Evaluating and recording guarantees, collateral, and other security arrangements

3. Negotiating loan terms
4. Preparing and processing loan documents
5. 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. See Section 310-20-55 for examples of items.

Commissions paid to originators, underwriting fees, and costs associated with the processing of loan documents and closing of the transaction are all examples of direct loan origination costs. As stated in the definition above, only the portion of employee salaries and benefits directly related to time spent performing activities directly related to the origination of the loan should be included in direct loan origination costs. ASC 310-20-55-11 through ASC-310-20-55-15 provide additional examples of direct loan origination costs.

See LI 4.4.3 for information on the accounting for direct loan origination costs.

All other lending-related costs should be expensed in the period incurred. Examples include the costs of advertising, occupancy and equipment, servicing of existing loans, unsuccessful loan origination efforts, and portions of employee salaries not directly related to the origination of a loan; these are not considered direct loan origination costs. In addition, as discussed in ASC 310-20-25-26 and ASC 310-20-25-27, fees paid for advisory services regarding loan origination activities, portfolio management, and investment consultations are not direct loan origination costs and should be expensed as incurred.

4.4.3 Accounting for loan origination fees and costs

Direct loan origination costs and loan origination fees should be offset and only the net amount is deferred. The accounting for the net fees or costs depends on whether the loan is classified as held for investment or held for sale.

The net deferred fees or costs associated with a loan held for sale are deferred until the related loan is sold (i.e., they are not amortized).

For loans for which the FVO has been elected, ASC 825-10-25-3 requires immediate recognition of related upfront costs and fees in the applicable expense or revenue account.

For loans held for investment, the net amount should be deferred and amortized over the life of the related loan using the interest method described in ASC 835, *Interest*. The objective of the interest method is to arrive at periodic interest income, net of fees and costs that reflects a constant effective yield on the net investment in the loan receivable. However, deferred net fees or costs should not be amortized during periods in which interest income on the loan is not being accrued because of concerns about the collection of principal and interest from the borrower (i.e., when the loan is put on nonaccrual status). See ASC 310-20-35-17.

4.4.3.1 *Loan origination fees or costs with demand debt*

ASC 310-20-35-22 provides guidance on the amortization of net fees or costs for loans that are payable at the lender's demand.

ASC 310-20-35-22

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 any of the following:

- a. The understanding between the borrower and lender
- b. 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.

Such estimates should be monitored regularly and revised as appropriate. If, contrary to expectation, a loan remains outstanding beyond the anticipated payment date, no adjustment is required.

4.4.3.2 *Origination fees/costs with revolving lines of credit*

ASC 310-20-35-23 through ASC 310-20-35-25 provide guidance on the amortization of net fees or costs associated with revolving lines of credit and similar arrangements.

ASC 310-20-35-23

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.

ASC 310-20-35-24

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.

ASC 310-20-35-25

If the borrower continues to have a contractual right to borrow under the revolving line of credit, net fees and costs associated with revolving lines of credit shall be amortized over the term of the revolver even if the revolver is unused for a period of time.

4.4.3.3 ***Credit card fees and costs***

As discussed in ASC 310-20-25-15 and ASC 310-20-35-5, periodic credit card fees charged to the cardholder should be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

Origination costs incurred by a credit card issuer should be deferred only if they meet the definition of direct loan origination costs. Direct loan origination costs should be netted against any credit card fees and recognized on a straight-line basis over the privilege period as described in ASC 310-20-25-17.

Excerpt from ASC 310-20-25-17

In situations where a significant fee is charged, the privilege period is the period that the fee entitles the cardholder to use the credit card. If there is no significant fee, the privilege period shall be one year. Significance for this purpose shall be evaluated based on the amount of the fee relative to the related costs.

All other costs that do not meet the definition of direct loan origination costs should be expensed as incurred. ASC 310-20-55-5 provides additional guidance on credit card solicitation costs.

ASC 310-20-55-5

In a typical credit card solicitation effort, an issuer engages an independent third party to solicit and obtain new customers. For a fee, the solicitor prepares and mails the promotional offer to a group of preselected consumers (for example, 1 million consumers). The expected response rate for new cardholders is generally 1 to 2 percent. Although only a small percentage of the total solicitation effort is expected to be successful, the portion of the solicitation performed by an independent third party that is allocable to successful efforts should not be deferred as direct loan origination costs under the definition of that term. Incremental direct costs to originate a loan are costs that the lender would not have incurred if that lending transaction had not occurred. In this example, the lender would have incurred all of the solicitation costs regardless of the number of credit cards issued. Accordingly, all costs in this example should be charged to expense.

If a reporting entity pays a third party to acquire individual credit card accounts, the amount paid should be netted against any related credit card fees and amortized on a straight-line basis over the privilege period.

4.4.3.4 ***Loan origination fees and costs with loans held for sale***

Loan origination fees and costs associated with loans held-for-sale should be deferred and included as part of the loan balance until the loan is sold.

4.5 ***Purchased loans***

When a loan or group of loans is purchased, the initial investment includes amounts paid to the seller plus any fees paid or less any fees received as part of the acquisition. The difference between the initial investment and the principal amount of the loan should be accounted for as a discount or premium

(see LI 6.4.1). All internal costs incurred when acquiring loans or committing to acquire loans should be expensed as incurred.

4.5.1 *Impairment of purchased loans*

To determine how to measure and account for the impairment of a purchased loan, a reporting entity must first determine whether the loan has experienced a more-than-insignificant deterioration in credit since origination. If it has, it would then be classified as a purchased financial asset with credit deterioration (PCD asset). See LI 9 for more information on PCD assets and the related accounting.

When a reporting entity purchases loans that have not experienced a more-than-insignificant deterioration in credit since origination and therefore do not meet the definition of a PCD asset, it should follow the guidance in the current expected credit loss (CECL) impairment model applicable to originated financial assets. See LI 7 for information on the application of the CECL impairment model.

ASC 326-20-30-15

An entity shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets in accordance with paragraphs 326-20-30-1 through 30-10 and 326-20-30-12. An entity shall not apply the guidance in paragraphs 326-20-30-13 through 30-14 for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination.

4.6 *Loan syndication*

A loan syndication involves multiple lenders; it is arranged by an agent bank that may also be a lender. Syndication arrangements may involve term debt, revolving debt, or a combination of both. ASC 310-20-20 provides a definition of a loan syndication.

Definition from ASC 310-20-20

Loan Syndication: A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend.

A loan syndication differs from a loan participation, in which a single lender enters into a lending arrangement with a borrower and subsequently transfers undivided interests in that loan to one or more other entities. In a participation, the borrower has a legal relationship only with the original lender. See TS 2.3.1.2 for additional information on loan participation transactions.

4.6.1 *Loan syndication fees*

ASC 310-20-25-19 provides guidance on recognizing syndication fees received for arranging the syndication.

ASC 310-20-25-19

The entity 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.

As the administrative agent, the lead bank may also receive an annual fee for servicing the loan. This fee should be recognized in income over the period for which it is earned.

4.7 Written loan commitments

Some commitments to originate loans are required to be evaluated as derivatives under the guidance in ASC 815. Whether the commitment is accounted for as a derivative depends on the type of loan that will be originated under the loan commitment and how the loan will be classified once it is originated. The following figure summarizes which loan commitments are accounted for as derivatives under the guidance in ASC 815. Refer to DH 3.2.11 for further information.

Figure LI 4-2 illustrates loan commitments that are accounted for as derivatives under ASC 815

Figure LI 4-2

Loan commitments that are accounted for as derivatives under ASC 815

	Originated loan will be held for sale	Originated loan will be held for investment
Mortgage loans	Derivative (ASC 815-10-15-71)	Not a derivative (ASC 815-10-15-69)
Non-mortgage loans	Not a derivative (ASC 815-10-15-69)	Not a derivative (ASC 815-10-15-69)

Loan commitments that are accounted for as derivatives are initially recorded at fair value with subsequent changes recognized in net income. See DH 3.2.11 for additional information on whether a loan commitment should be accounted for as a derivative instrument.

SAB Topic 5.DD, *Written Loan Commitments Recorded at Fair Value through Earnings*, provides interpretative Q&A related to the valuation of loan commitments recorded at fair value through net income.

4.7.1 Written loan commitments: commitment fees

Commitment fees are fees a lender charges for entering into an agreement under which it is obligated to fund or acquire a loan (or to satisfy an obligation of the other party under a specified condition). Commitment fees also include fees for letters of credit.

Commitment fees should be deferred. Any direct loan origination costs incurred by the reporting entity to make the commitment should be offset against the related commitment fee. If the direct loan

origination costs exceed the commitment fees, the lender should assess the likelihood of the commitment being exercised; if the likelihood that the commitment will be exercised is remote, any net costs should be expensed immediately.

ASC 310-20-35-3 provides subsequent measurement guidance for commitment fees.

ASC 310-20-35-3

Except as set forth in this paragraph, fees received for a commitment to originate or purchase a loan or group of loans shall be, 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 entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, 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. The term *remote* is used here, consistent with its use in Topic 450, to mean that the likelihood is slight that a loan commitment will be exercised before its expiration.
- 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.

If a loan commitment expires without the loan being made or if a loan is repaid before the estimated repayment date, any related unrecognized fees should be recognized as revenue or expense at that time.

4.8 Standby commitment to purchase loans

A standby commitment to purchase loans should be evaluated to determine whether it is a derivative within the scope of ASC 815. If it is, it should be accounted for using the guidance in ASC 815.

As discussed in ASC 310-10-25-6, if the settlement of a standby commitment to purchase a loan is not within the scope of ASC 815, is within a reasonable period of time, and if the reporting entity has the intent and ability to purchase the loan without selling assets, there is no separate accounting for the commitment. If the settlement date is not within a reasonable period, or the reporting entity does not have the intent and ability to accept delivery without selling assets, the standby commitment should be accounted for as a written put option. Subsequent accounting should follow the guidance in ASC 310-10-35-46.

If a commitment to purchase loans is a guarantee within the scope of ASC 460, *Guarantees*, it should be accounted for using the guidance in ASC 460. See FG 2 for information on guarantees.

4.9 *Mortgage banking activities*

A mortgage banking entity uses its own funds (or funds borrowed from a warehouse lender) to originate (or purchase) mortgages that it then sells to an investor. A mortgage bank may be a standalone institution or a division of a larger financial institution.

ASC 948 provides guidance on mortgage banking related topics.

4.9.1 *Loan pipeline*

A mortgage banking entity's loan pipeline consists of loan applications that have been received, but that have not yet closed. Pipeline loans are either "floating" or "locked."

- A floating pipeline loan is one for which an interest rate has not been set by the borrower.
- A locked pipeline loan is one for which the potential borrower has set the interest rate for the loan by entering into an interest rate lock commitment (IRLC) in advance of closing the loan with the mortgage banker. The commitment period for a single-family mortgage loan is typically 30 to 60 days. The IRLC binds the mortgage banker to lend funds to the potential borrower at a set interest rate during the commitment period regardless of changes in market interest rates.

The mortgage banker bears the interest rate risk on locked pipeline loans; the borrower bears the interest rate risk on floating pipeline loans.

An IRLC that relates to a mortgage loan expected to be classified as held for sale should be accounted for as a derivative under ASC 815.

4.9.2 *Sale of mortgage loans to an affiliated entity*

ASC 948-310-30 provides measurement guidance for mortgage loan transactions with affiliates.

ASC 948-310-30-1

The carrying amount of mortgage loans to be sold to an affiliated entity shall be adjusted to the lower of amortized cost basis or fair value of the loans as of the date management decides that a sale to an affiliated entity will occur. The date shall be determined based on, at a minimum, formal approval by an authorized representative of the purchaser, issuance of a commitment to purchase the loans, and acceptance of the commitment by the selling entity. The amount of any adjustment shall be charged to income.

ASC 948-310-30-2

If a particular class of mortgage loans or all loans are originated exclusively for an affiliated entity, the originator is acting as an agent of the affiliated entity, and the loan transfers shall be accounted for at the originator's acquisition cost. Such an agency relationship, however, would not exist in the case of right of first refusal contracts or similar types of agreements or commitments if the originator retains all the risks associated with ownership of the loan.

A transfer of financial assets from one subsidiary to another with a common parent should be accounted for as a sale in the transferor subsidiary's separate financial statements if both of the following requirements are met:

- All of the sale conditions in ASC 860 are met
- The transferee's assets and liabilities are not consolidated into the transferor's separate-company financial statements

When loans that are originated exclusively for an affiliated entity (when the originator is acting as an agent of the affiliated entity), ASC 948 requires that loan transfers be accounted for at the originator's acquisition cost.

4.10 Acquisition, development, and construction arrangements

Reporting entities may enter into acquisition, development, and construction (ADC) lending arrangements in which they have virtually the same risks and potential rewards as those of owners or venturers as a result of participating in the projects expected residual profit. Due to the unique nature of these arrangements, lenders will need to determine whether the arrangement should be accounted for as a loan or as a real estate investment (i.e., joint venture) once it has been determined that an entity would not be consolidated under the guidance in ASC 810, *Consolidation*. If a lender is expected to receive more than 50% of the expected residual profit, the lender should account for the arrangement as a real estate investment subject to ASC 970 (the profit-sharing agreement may be separate from the mortgage contract). If a lender is expected to receive 50% or less of the expected residual profit, further consideration is needed to determine how to account for the arrangement. More specifically, if at least one of the characteristics identified in ASC 310-10-25-20(b) through ASC 310-10-25-20(e) are identified or there is a qualifying personal guarantee by the borrower and/or third party, the arrangement should be accounted for as a loan. Otherwise, the arrangement should be accounted for as a real estate investment. When determining the extent of participation in the expected residual profits, lenders should take into account (1) the contractual interest and fees and whether they are at market, (2) the agreed portion of profit to be shared upon a sale, if any, (e.g., 20%, 50%, 90%), and (3) the sharing of any future cash flows from the project after completion (e.g., gross rent).

Definition from ASC 310-10-20

Expected residual profit: The amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by a lender.

ASC 310-10-25-20

Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an acquisition, development, and construction arrangement are similar to those associated with a loan:

- a. The lender participates in less than a majority of the expected residual profit.
- b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower

of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally shall be valued at no higher than cost.

- c. The lender has either of the following:
 - 1. Recourse to substantial tangible, saleable assets of the borrower, with a determinable sales value, other than the acquisition, development, and construction project that are not pledged as collateral under other loans
 - 2. An irrevocable letter of credit from a creditworthy, independent third party provided by the borrower to the lender for a substantial amount of the loan over the entire term of the loan.
- d. A take-out commitment for the full amount of the lender's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.
- e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Generally, the existence of a guarantee alone rarely provides a basis for concluding that the arrangement should be accounted for as a loan. However, it may provide a basis for concluding the arrangement is a loan when the expected residual profit share is 50% or less and none of the characteristics in ASC 310-10-25-20(b) through ASC 310-10-25-20(e) are identified, but a guarantee is present in the arrangement. In order to determine if loan classification is appropriate, lenders should determine the ability of the guarantor to perform, the practicality of enforcing the guarantee in the applicable jurisdiction, and if there is a demonstrated intent to enforce the guarantee. Some examples of a qualifying guarantee would be liquid assets placed in escrow, pledged marketable securities, and irrevocable letters of credit from an independent credit-worthy third party. The credit worthiness of the guarantor may be taken into consideration absent any other indicators of the ability to perform. However, emphasis should be placed on the guarantor's liquidity and net worth and whether any other guarantees by the guarantor exist for other projects.

In addition to the guidance above, additional considerations may be needed in order to determine whether the arrangement should be accounted for as a real estate investment or as a loan. ASC 310-10-25-19 provides guidance when determining whether the characteristics of the arrangement would imply a real estate investment.

ASC 310-10-25-19

In an acquisition, development, and construction arrangement in which the lender participates in expected residual profit, in addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of the arrangement are similar to those associated with an investment in real estate or joint venture:

- a. The lender agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The lender funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The lender funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The lender's only security is the acquisition, development, and construction project. The lender has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- e. In order for the lender to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

ASC 310-20-35-20 provides guidance when determining whether the characteristics of the arrangement would imply a loan. If the arrangement is accounted for as a loan, interest and fees should be recognized as income, subject to recoverability. If the arrangement is accounted for as a real estate investment, lenders should apply the accounting in ASC 970-323 and ASC 835-20. Additional considerations are included in ASC 970-835-35-1 on when the recognition of interest income would not be appropriate.

The accounting treatment for an ADC arrangement should be periodically reassessed. An arrangement originally classified as a real estate investment could subsequently be accounted for as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50% of the expected residual profit. Conversely, if the lender assumes further risks and rewards, its percentage of profit participation may increase to over 50%. Any change in the classification of the arrangement should be applied prospectively.

If the lender's interest in expected residual profits of the project are sold, the accounting treatment will be dependent on whether the arrangement was accounted for as (1) a loan or (2) an investment in real estate or a joint venture. First, it should be determined if the transfer qualifies as a sale under ASC 860. Assuming the requirements for sale accounting are met, if the arrangement was accounted for as a loan, the proceeds from the sale of the expected residual profits should be recognized prospectively as additional interest income over the remaining term of the loan since the expected residual profit is considered additional compensation to the lender in accordance with ASC 310-10-40-4. No immediate income would be recognized on the date of sale if it is accounted for as a loan. For arrangements accounted for as a real estate investment, the guidance in ASC 860 should be applied for transfers that qualify as sales.

Furthermore, ASC 310-10-S99-1 addresses certain reporting requirements for lenders in situations where nonrecourse mortgage loans may in essence be equity investments in the borrower's project. If

the lender is determined to be in-substance an equity participant, the SEC may require the lender to include audited financial information related to the underlying investment in its public filings.

***Chapter 5:
Investments in life insurance
contracts and captive
insurance***

5.1 Investments in life insurance contracts

The following sections describe some of the more common types of life insurance contracts and discuss a reporting entity's accounting for its investment in these contracts.

5.1.1 Key-person life insurance

A reporting entity may purchase a life insurance policy to fund deferred compensation or post-retirement benefit arrangements, protect against the loss of key persons, or fund an obligation to redeem an ownership interest upon death. These types of insurance policies are referred to as corporate-owned life insurance (COLI), bank-owned life insurance (BOLI), and key-person life insurance. A life insurance contract provides an accumulated contract value that increases over time and an additional return upon the death of the insured. There are several types of life insurance that provide different levels of participation in investment performance, including whole life, universal life, and variable life insurance policies.

Death benefits are typically exempt from taxes. In addition, the accumulation of value is often tax deferred until withdrawal, which can give life insurance investments an economic advantage over more traditional debt and equity investments. Unless the conditions in ASC 210-20-45 are met, a reporting entity should not offset a deferred compensation liability and an investment in the life insurance contract even when the policy is purchased in contemplation of funding employee benefits.

5.1.1.1 Accounting for key-person life insurance

An investment in life insurance should be reported at the amount that could be realized under the contract at the balance sheet date, which includes the cash surrender value and any additional amounts realizable as discussed in ASC 325-30 less an allowance for credit losses. Insurance contracts are outside the scope of the embedded derivative guidance in ASC 815; therefore, embedded derivative features should not be accounted for separately. The change in cash surrender value during the period and the premium paid determine the expense or income to be recognized in the period.

Some life insurance policies adjust the realizable amount if certain conditions apply. For example, a BOLI contract may have a different surrender value if there is a change in control or a tax net operating loss is incurred. Also the cash surrender value may be adjusted in early years for the tax effects of insurance company acquisition costs. If it is probable that contractual terms will limit the amount that could be realized under the life insurance contract, these contractual limitations should be considered when determining the realizable amounts.

Reporting entities often purchase group life insurance policies that cover a number of individual employees. The amount realizable under the contract may differ depending on whether an individual policy or the entire group contract is surrendered. When determining the realizable amount at the balance sheet date, reporting entities should assume that policies will be surrendered on an individual policy basis, rather than as a group of policies. See ASC 325-30-55 for an illustration of the calculation of the cash surrender value of a group policy.

Discounting cash surrender value

Under ASC 325-30, amounts recoverable by the policyholder beyond one year from the surrender of the policy should be discounted. If the policyholder continues to participate in changes of the cash

surrender value, the participation amounts should be projected and discounted using the rates that would have accrued if no surrender notice had been given. If the participation will be the same as before the surrender notice, no adjustment for discounting will be necessary. If the participation after the surrender notice is limited such as only in immunized or “safer” investments, discounting will be required.

5.1.2 Life settlement contracts

A life settlement contract is the sale of an existing life insurance policy to a third-party for more than its cash surrender value, but less than its net death benefit. A policy owner may choose to sell his or her life insurance policy because they no longer need or want their policy, wish to purchase a different kind of life insurance, or the premium payments are no longer affordable. The policy owner receives a cash payment, while the purchaser of the policy assumes the obligation to pay all future premium payments required to keep the policy in force and receives the death benefit upon the death of the insured. ASC 325-30-20 provides a definition of a life settlement contract.

Definition from ASC 325-30-20

Life Settlement Contract: A life settlement contract is a contract between the owner of a life insurance policy (the policy owner) and a third-party investor (investor), and has all of the following characteristics:

- a. The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).
- b. The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.
- c. The contract pays the face value of the life insurance policy to an investor when the insured dies.

5.1.2.1 Accounting for life settlement contracts

The accounting for investments in life settlement contracts differs from the accounting by the original purchasers of life insurance. ASC 325-30-25 states that a third-party investor should account for its investments in life settlement contracts using either the investment method or fair-value method. The policy election is irrevocable and is made on an instrument-by-instrument basis upon purchase.

Investment method

Based on a cost accumulation model, the investment method requires the life settlement contract to be initially recognized at the transaction price plus initial direct external costs paid to acquire the life settlement contract (e.g., broker fees, medical expenses) less expected credit losses. Continuing costs, such as premiums paid and any direct external costs to keep the policy in force, are capitalized.

An investor should test the life settlement contract for impairment if information or events indicate that the expected proceeds of the insurance policy will be less than the carrying amount of the investment plus anticipated undiscounted future premiums and capitalizable direct external costs. A factor that would trigger an impairment assessment would be a change in the expected mortality of the insured. A change in the creditworthiness of the issuer of the underlying insurance policy will change

the allowance for credit losses. A change in interest rates would not require an investment in a life settlement contract to be tested for impairment. If an impairment loss is recognized, the investment should be written down to fair value. Any subsequent premiums would continue to be capitalized and added to the new basis and the contract would continue to be subject to impairment testing.

No investment income is recognized while the policy is in force. When the insured dies, the difference between the carrying amount of the life settlement contract and the proceeds of its underlying life insurance policy is recognized in net income.

Fair-value method

The fair-value method recognizes the initial investment in a life settlement contract at its transaction price, without regard to initial direct external costs, which are expensed as incurred. At each subsequent reporting period, the investment is remeasured at fair value and changes in fair value are recognized in net income.

5.1.3 Overview of split-dollar life insurance

Split-dollar life insurance is an arrangement between an employer and an employee to share the cost and benefits of a life insurance policy on the employee. The employer pays all or most of the policy premiums in exchange for an interest in the policy cash value and death benefit. The two most common forms of split-dollar arrangements are collateral assignment and endorsement. The ownership and control of the life insurance policy determines the type of arrangement.

In a collateral assignment split-dollar arrangement, the employee (or employee's estate or trust) owns and controls the policy. The employer is reimbursed for premiums paid from the death benefits or cash surrender proceeds. A portion of the value of the insurance policy is assigned by the employee to the employer, which secures the employer's right to be repaid for the premiums it paid on the policy.

In an endorsement arrangement, the employer owns and controls the insurance policy. The employer enters into a separate agreement to split the policy benefits between the employer and employee and endorses a portion of the death benefits to the employee. Upon death of the employee, the employee's beneficiary typically receives the designated portion of the death benefits directly from the insurance entity and the employer receives the remainder.

5.1.3.1 Accounting for split-dollar life insurance

Under a collateral assignment arrangement, the cumulative premiums that an employer paid will be reimbursed from the death benefits or cash surrender proceeds. The employer does not control the surrender decision. ASC 325-30 does not allow a life insurance asset to exceed cash surrender value less an allowance for credit losses and also requires discounting if access to proceeds will be longer than a year. If the employer does not control the surrender decision, the employer should record an asset equal to the lesser of the following amounts:

- The cash surrender value, discounted only if restrictions exist as to the timing of cash receipts
- The net present value of the cumulative premiums paid by the reporting entity discounted over the life expectancy of the insured

This is based on the premise that surrender is not within the control of the employer and it is uncertain whether the employer will be reimbursed for cumulative premiums paid upon death or upon surrender. Premiums paid in excess of the asset should be treated as an expense in the income statement.

If the employer is able to unilaterally control the surrender decision, the employer may record an asset equal to the lesser of the following:

- The cash surrender value, discounted only if restrictions exist as to the timing of cash receipts
- The cumulative premiums paid

This is based on the premise that the employer can surrender the policy at its discretion and be reimbursed for cumulative premiums paid. This would also be appropriate under an endorsement arrangement as the employer owns the insurance policy and would be able to terminate the insurance policy at its discretion.

If the employee is a shareholder and the collateral assignment agreement does not require the insurance company to reimburse the employer directly, but requires the shareholder to reimburse the employer for its cumulative premiums paid, then, in essence, a secured loan has been provided to the shareholder. The secured loan may require treatment as a deduction from equity in the employer's financial statements.

5.2 Captive insurance arrangements

Traditional risk management includes commercial insurance (under occurrence-based, claims-made, or retrospectively-rated policies) and self-insurance. Another alternative involves the use of a captive insurance company. Broadly, a captive insurance company is an entity created and controlled by a parent for the purpose of providing insurance for that parent.

A policy issued by a 100% owned captive insurance company to its parent or sister subsidiaries does not relieve the consolidated company of any liability (i.e., self-insurance at the consolidated entity level), except for the degree to which the captive itself obtains excess or catastrophic insurance coverage from an outside insurance company.

Companies that insure through these types of entities should determine the appropriate manner of accounting for the investment.

5.2.1 Majority-owned investment in captive

Consolidation is appropriate for majority-owned captives whereby all intercompany transactions are eliminated. ASC 810-10-15-10 requires the consolidation of all majority-owned subsidiaries unless control does not rest with the majority owners. Consolidation of captives may also be required under the variable interest entity (VIE) model, described in ASC 810-10. See CG 2 for further information.

When parent only or separate subsidiary statements are prepared, the insured must consider whether the economic substance of the captive is sufficient to transfer the risk of loss from itself to the captive. If it is not, the insured is in effect "uninsured," and the contract would be accounted for as a deposit in accordance with ASC 340-30.

Single-owner captive insurance companies that do not write unrelated risks do not change the accounting result of recording liabilities under ASC 450-20 on a consolidated basis. The captive is consolidated and all transactions within the group are eliminated. Companies, including insurance companies, cannot recognize a claim liability until it has been incurred.

5.2.2 *Protected cell rent-a-captive arrangements*

Protected cell rent-a-captive arrangements are a variation of the captive model. In a rent-a-captive structure, an insurance company establishes a rent-a-captive company and typically owns 100% of the captive company's voting common stock. The captive company "rents" its capital, surplus, and license to multiple insureds and usually provides administrative services, reinsurance, and/or a "fronting" company (i.e., an arrangement between two or more insurance companies whereby one company issues a policy and then cedes all risk to the other company). The experience of an individual insured "renting" arrangement is protected from the other insureds "renting" arrangements through a "protected cell" contract. This contract creates a legal segregation of the accounts of each insured from the liabilities of every other insured and those of the rent-a-captive itself. Typically, investment risk on assets transferred by an individual insured to the rent-a-captive and underwriting risk related to business assumed by the rent-a-captive are transferred back to the individual insured through various mechanisms. In such situations, the insured should record the amount invested in the rent-a-captive as an asset, classified in accordance with its legal nature, and record losses incurred and a related liability for any underwriting risk retained. The asset should be valued based on the terms of the contract, and considering the embedded derivative requirements of ASC 815 as appropriate. It may be appropriate for the insured to consolidate its protected cell under the "silo" provisions in ASC 810-10-25-57; however, this only applies when the protected cell captive is itself a VIE. See CG 2 for guidance on "silos" and the variable interest model.

5.2.3 *Partial ownership in a captive or industry association*

An entity may participate in an industry captive or other captive with multiple owners formed to pool risks and potential reinsurance pricing power. Payments to the captive entity have two components: (1) an investment component helping fund the equity of the entity and (2) an insurance premium component paid in return for insurance coverage for the period. Generally, in this type of structure, the entity has rights indicating significant influence over the captive's operations. If so, the equity method is appropriate for the capital infusion component. This may result in offsetting some of the benefit of the entity's claim reimbursement under the insurance component and also recognition of the shared part of other members' losses. See CG 3 and CG 4 for further information. Accounting for investments in common stock involves significant judgment.

Companies insured under these types of arrangements must determine whether the economic substance of the captive is sufficient to transfer risk of loss from the insured to the captive. If the insured determines that risk is transferred, the accounting for the insurance contract will be the same as if the coverage was provided by an independent insurer. If the economic substance is not sufficient to transfer risk of loss, the provider is in effect uninsured and deposit accounting would be appropriate.

If the insurance policy issued by the captive is claims-made or retrospectively rated, see PPE 8 for additional considerations. Additional guidance applicable to health care organizations that utilize captive insurance arrangements is provided at ARM 9592.823.

5.2.4 Captive accounting principles

Separately prepared captive company financial statements should comply with the GAAP requirements specific to the insurance industry (see ASC 944, *Insurance*). The guidance on discounting of loss reserves of captive insurance companies is consistent with discounting by other insurance companies (see IG 4.3.3).

If a non-insurance entity has a wholly-owned captive subsidiary, all related party transactions, including the insurance transactions, will be eliminated upon consolidation, and self-insured liabilities will be reported in the consolidated balance sheet. Although ASC 810-10-25-15 generally requires specialized industry accounting of subsidiaries to be continued by the parent upon consolidation, this only applies to transactions that do not eliminate in consolidation. Judgment needs to be applied when the captive is not wholly owned. This could result in differences between the accounting reflected in the captive's stand-alone financial statements and that reflected in the parent entity's consolidated financial statements, given that the captive would apply specialized industry accounting. For example, with regard to discounting of reserves, the non-insurance enterprise would apply the discounting guidance in ASC 450-20-S99-1 (SAB Topic 5.Y) while the insurance entity would apply the guidance in ASC 944-20-S99-1 (SAB Topic 5.N). With regard to balance sheet classifications, insurance companies generally do not report classified balance sheets, unlike non-financial services companies.

5.2.5 Capital contributions to captive entities

A captive insurance subsidiary may engage in lending transactions with its parent under formal agreements. Such agreements may result in the recognition of an asset (note receivable) in the captive's stand-alone financial statements prepared in accordance with US GAAP. An important factor in making the determination of whether the note receivable should be recognized as an asset or as a component of equity is the source of the funds that are lent. When the captive has sufficient internally generated cash flows to support lending and the note is of a form that generates a return to the investor and a maturity date, it may be appropriate for the transaction to be accounted for as a debt instrument. However, if the amount loaned, or any portion thereof, represents the "lending" of contributed capital, that portion of the transaction should be presented as a reduction of capital, not as a debt investment. When presented as a reduction in equity, "interest" should be recognized as a capital contribution upon receipt. It would not be appropriate to accrue a capital contribution unless the accrued interest receivable is also presented in equity.

Lending of contributed capital presented as a reduction of capital is derived from ASC 505-10-45-2, which states that, when an enterprise receives a note rather than cash as a contribution to equity, the note receivable should generally be reported as a reduction of shareholders' equity, except in very limited circumstances. See FG 4.5 for additional information. The substance of the transaction, rather than its timing or legal form, should be considered when determining the appropriate accounting. For example, the accounting result should be the same whether the captive receives capital in the form of a note or physically receives cash as a capital contribution but then returns that cash to the parent in the form of a note, because there is no substantive difference in these transactions.

The ultimate determination of whether a note receivable should be treated as an asset or a return of capital is highly judgmental, and should consider all relevant facts and circumstances. FG 4.5.2.1 lists other factors that should be considered in making the determination.

In circumstances when a captive insurance company receives premium payments that exceed the liability it assumes at the time the contract is executed, the difference between the cash received and the liability assumed generally would not be accounted for in the captive's stand-alone financial statements as a capital contribution. The captive would consider the provisions of ASC 944 in determining how to account for the contract. When such excess exists, the captive should consider whether it is possible that the risk transfer criteria of ASC 944-20-15-40 through ASC 944-20-15-54 are not met and that deposit accounting should be followed. If the transaction represents a deposit, no premiums or loss expense would be recognized at inception or throughout the term of the contract, and the deposit accounting guidance in ASC 340-30 would instead be applicable. If the transaction does qualify for insurance accounting, the captive cannot record an immediate gain when it enters into the contract; any gain must be deferred and amortized over the settlement period of the contract. There is no specific guidance in ASC 944 for an insurer or assuming company accounting for coverage of past incurred events (the only guidance in ASC 944 on retroactive coverage relates to the ceding company accounting), as no service has been provided at inception of the contract immediate gain recognition is not appropriate.

For accounting purposes, such transactions are generally not deemed to be merely a "transfer" of an asset or a liability. Rather, the distinguishing feature for accounting purpose is the existence of an insurance contract between related parties. Because ASC 850, *Related Party Disclosures*, does not require imputation of arms-length terms in related party transactions, in most circumstances the insurer should not impute a capital contribution for the difference between the liability assumed and the cash received in its separate company financial statements. Robust disclosure of the related party transaction should be included in the footnotes to the financial statements as required by ASC 850.

Chapter 6:
Interest income—updated
June 2021

6.1 Chapter overview – interest income

Interest income is earned by a creditor, investor, or lender as compensation for providing financing to a borrower or issuer and assuming the credit risk that he or she may not be repaid. Financing can take many forms, including loans, bonds, notes receivable, and depository accounts. Interest income may be in the form of interest or coupon payments made to the lender from the borrower, the difference between the amount invested (or lent) and the amount repaid at maturity, or both.

For financial institutions, interest income is one of the more important measures to users of the financial statements. It is a metric often used to measure and assess a financial institution's financial performance, future prospects, and financial health. It is generally not, however, subject to ASC 606, *Revenue from Contracts with Customers*.

This chapter discusses the recognition and measurement of interest income.

6.2 Interest income overview

To determine the appropriate interest income recognition model, a reporting entity must first consider the nature of the financial instrument, any industry-specific guidance, and the accounting model being applied to the instrument. Many instruments are subject to the interest income guidance in ASC 310, *Receivables*. Although the guidance is written referencing receivables, debt securities also fall in the scope of ASC 310.

Excerpt from ASC 310-20-15-2

The guidance in this Subtopic explicitly includes the following transactions:

- b. 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)

6.3 Types of interest rates

An interest rate is economically composed of different components designed to compensate lenders (investors) for their investment. The base component is a risk-free rate, or the amount a lender would charge if there was no possibility of default. Another component is a credit spread, which compensates the lender for the possibility that the borrower may default and fail to repay its loan. The interest rate demanded by the market may also include components for the liquidity risk of the instrument, other market considerations, and contractual features, such as prepayment options. In practice, the individual elements that compose the interest rate demanded by the market may be difficult to quantify.

Interest, in its simplest form, is calculated by applying a contractually-specified rate of return to the principal (par) amount of a receivable (investment) that has specified payment dates and a stated maturity date. The amount of interest earned can be impacted by other factors, such as whether a receivable was acquired at an amount less than its principal amount (a discount) or more than its principal amount (a premium).

Figure LI 6-1 describes some of the more common types of interest rates.

Figure LI 6-1
Types of interest rates

Interest type	Description
Fixed-rate interest	Interest rates set at issuance of the financial asset that do not change over time
Variable-rate interest	Interest rates that change over time, most often based on a published interest rate index, such as the London InterBank Offered Rate (LIBOR), Secured Overnight Financing Rate (SOFR) or a prime rate
Zero coupon	<p>A zero-coupon bond is purchased for an amount lower than its face value, with the face value repaid at maturity.</p> <p>There is no stated interest rate and the issuer does not make periodic interest payments. When the bond reaches maturity, its investor receives the face (or par) value. Although there are no regularly scheduled interest payments, interest is earned over time as the difference between the bond's purchase price and its par value.</p>
Paid-in-kind (PIK)	Interest on a financial asset paid by the issuance of a new bond as compensation for interest due, which in turn has its own stated terms, including interest, principal, and maturity.

Interest can be simple or compounded. Simple interest is computed on the amount of the principal only; compound interest is computed on principal and on any interest earned that has not been paid.

When the terms of a financial asset involve returns that vary in timing or amounts, the financial asset should be evaluated to determine if there are any freestanding or embedded derivatives that should be accounted for separately. See PwC's *Derivative instruments and hedging activities* guide (DH 4) for guidance on the evaluation of embedded features.

6.3.1 **Imputed interest**

When an entity originates a note that is non-interest bearing or has a stated interest rate that is not a market rate of interest, it may be required to impute interest based on the guidance in ASC 835-30. ASC 835-30-15-3 lists the transactions not subject to the requirement to impute interest.

ASC 835-30-15-3, post ASU 2020-10, Codification Improvements

With the exception of guidance in paragraphs 835-30-45-1A through 45-3 addressing the presentation of discount and premium in the financial statements, which is applicable in all circumstances, and the guidance in paragraphs 835-30-55-2 through 55-3 regarding the application of the interest method, the guidance in this Subtopic does not apply to the following:

- a. Payables arising from transactions with suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year
- b. Amounts that do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved; for example, deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage exploration in the extractive industries (see paragraph 932-835-25-2)
- c. Amounts intended to provide security for one party to an agreement (for example, security deposits, retainages on contracts)
- d. The customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money
- e. Transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements)
- f. Transactions between parent and subsidiary entities and between subsidiaries of a common parent
- g. The application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service, for example, a warranty for product performance
- h. Receivables, contract assets, and contract liabilities in contracts with customers, see paragraphs 606-10-32-15 through 32-20 for guidance on identifying a significant financing component in a contract with a customer

Question LI 6-1 and Question LI 6-2 discuss the application of ASC 835-30 to certain types of instruments.

Question LI 6-1

Does the imputed interest guidance in ASC 835-30 apply to loans payable on demand with no stated maturity date?

PwC response

No. ASC 835-30-15-2 states that the guidance applies to receivables that represent contractual rights to receive money on fixed or determinable dates. A loan payable on demand with no stated maturity date is not payable on a fixed or determinable date.

Question LI 6-2

Does the imputed interest guidance in ASC 835-30 apply to a long-term note that is non-interest bearing in the first year that bears a market rate of interest rate after the first year?

PwC response

Yes. See Example LI 6-2 for an example of how to apply the interest method to an instrument with an increasing interest rate.

6.3.1.1 *Receipt of note for non-cash consideration*

As noted in ASC 835-30-15-3(h), the imputed interest guidance in ASC 835-30 generally does not apply to receivables, contract assets, and contract liabilities in contracts with customers subject to ASC 606. ASC 606 provides guidance on the recognition of revenue from contracts with customers. ASC 606-10-32-15 through ASC 606-10-32-20 address the identification, measurement, and recognition of a significant financing component in contracts with customers. See RR 4.4 for additional guidance on significant financing components in contracts with customers.

For transactions not involving revenue from contracts with customers subject to ASC 606, ASC 835-30-25-7 through ASC 835-30-25-11 provide guidance on the initial recognition for notes received for property, goods, or services.

ASC 835-30-25-7

A note exchanged for property, goods, or service represents the following two elements, which may or may not be stipulated in the note:

- a. The principal amount, equivalent to the bargained exchange price of the property, goods, or service as established between the supplier and the purchaser
- b. An interest factor to compensate the supplier over the life of the note for the use of funds that would have been received in a cash transaction at the time of the exchange.

ASC 835-30-25-8

Notes exchanged for property, goods, or services are valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction.

ASC 835-30-25-9

The difference between the face amount and the present value upon issuance is shown as either discount or premium.

ASC 835-30-25-10

In circumstances where interest is not stated, the stated amount is unreasonable, or the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the fair value of the note at the date of the transaction, the note, the sales price, and the cost of the property, goods, or service exchanged for the note shall be recorded at the fair value of the property, goods, or service or at an amount that reasonably approximates the fair value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium shall be accounted for as an element of interest over the life of the note.

ASC 835-30-25-11

In the absence of established exchange prices for the related property, goods, or service or evidence of the fair value of the note (as described in paragraph 835-30-25-2), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable shall be determined by discounting all future payments on the notes using an imputed rate of interest. This determination shall be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates shall be ignored.

If an established exchange price is not determinable and the note has no ready market, the reporting entity should impute an interest rate to determine the present value of the note. The rate should be equivalent to a rate that would be recorded in a market transaction with similar terms with the counterparty. This requires analyzing the economic substance of the transaction, rather than simply the form of the note.

6.3.1.2 *Receipt of note for cash*

When a debtor issues a note to an unrelated lender in exchange for cash and no other rights or privileges are exchanged, the note is assumed to have a present value at issuance equal to the amount of cash exchanged (assuming the transaction did not involve other elements). Because the total amount of interest recognized over the term of a cash loan is equal to the difference between cash exchanged at inception and the total amount that the borrower will repay over the term of the loan, any difference between cash exchanged at inception and the present value of cash flows repaid over the term of the loan is shown as a premium or discount to the original issuance. In these circumstances, the discount or premium on the note shall be amortized into interest income over the life of the note to arrive at a constant effective yield when applied to the outstanding amount of the note at the beginning of each period (i.e., the interest method) in accordance with ASC 835-20-35-2. See LI 6.5.

If a company issues or receives a note in exchange for only cash with no interest rate or a stated interest rate that appears to be other than a market rate of interest for similar transactions, the situation should be investigated to determine if additional rights or privileges were exchanged. In such cases, ASC 835-30-25-6 requires that the rights or privileges be given accounting recognition, which creates a discount or premium on the note. ASC 835-30-25-6 includes an example.

ASC 835-30-25-6

A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, an entity may lend a supplier cash that is to be repaid five years hence with no stated interest. Such a non-interest-bearing loan may be partial consideration under a purchase contract for supplier products at lower than the prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the contract term. The note discount shall be amortized as interest income over the five-year life of the note, as required by Section 835-30-35.

Additional examples of unstated rights or privileges that may accompany cash loans include:

- A supplier contracts with a purchaser for cash sales of product for more than the prevailing market price and, simultaneously, lends the purchaser funds at a low interest rate.
- A supplier performs a purchaser's warehousing for no additional charge in exchange for a non-interest-bearing loan from the purchaser.
- A company provides a service to another company at no charge in exchange for funds borrowed at a low interest rate.

In these circumstances, any discount or premium on the note would be accreted or amortized as interest income or expense using the interest method, as discussed in LI 6.5.

6.4 *Interest income – determining the effective interest rate*

The objective of determining an effective interest rate is to identify the economic rate of return of a financial asset based on the concepts of accrual accounting. The difference between the purchase price of an investment and the amount due at maturity (or principal payments received over the instrument's term) coupled with any coupon interest paid over the investment's life determine the investor's rate of return on its investment. US GAAP requires the amortization of premiums and discounts (including certain deferred origination costs and fees) to be recognized through interest income. This results in the recognition of interest income based on the effective rate of return on the financial instrument.

The ASC Master Glossary provides a definition of the effective interest rate.

Definition from the ASC Master Glossary

Effective interest rate: The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

The following sections describe some of the items that cause an adjustment to the contractual interest rate to arrive at the effective interest rate.

6.4.1 *Impact of discounts and premiums on effective interest rate*

As discussed in LI 6.3, the market interest rate of a financial instrument depends on a number of factors, including the risk-free interest rate, credit risk, and liquidity. When an asset does not provide a coupon equal to the rate demanded by market participants, a loan or security may be issued at a discount or premium. Normally, the market price of a debt instrument is equal to the present value of its future cash flows discounted at the rate of return demanded by market participants.

Discounts and premiums are the difference between the amount paid upon acquisition of a financial asset and the amount repayable at its maturity (or in scheduled principal payments made over its life). Discounts occur when a financial asset is purchased for an amount less than the par amount of an instrument and are typically seen when the coupon on the investment is less than the market yield for that instrument. Premiums arise when a financial asset is purchased for an amount greater than the par amount of an instrument and are typically seen when the coupon on the instrument is higher than the market yield for that instrument.

The difference between the purchase price of an investment and the amount to be repaid at maturity (the premium or discount) coupled with any coupon interest received over the instrument's life determine the investor's yield on its investment. If a debt instrument is originated or purchased at a discount, the effective interest rate on the instrument will be higher than the stated rate. Conversely, if a debt instrument is originated or purchased at a premium, the effective rate is lower than the stated rate.

6.4.1.1 *Accounting for discounts on loans held for sale*

Nonmortgage and mortgage loans held for sale are carried at the lower of cost or fair value. In accordance with ASC 948-310-35-2, purchase discounts on mortgage loans should not be amortized as interest income during the period the loan or security is classified as held for sale.

Refer to LI 4.3.3 for guidance on how to transfer a loan into or out of the held for sale classification.

6.4.2 *Effective interest rate: loan origination fees and costs*

As discussed in LI 4.4, certain loan origination fees and costs are deferred and amortized over the life of the related loan; these deferred loan fees and costs should be considered when determining the effective interest rate of a loan. Deferred loan fees or costs create a discount or premium to the stated loan amount. For example, if a bank lends \$1,000,000 to a borrower and incurs \$50,000 of net deferred costs associated with originating that loan, the initial amortized cost basis of the loan is \$1,050,000.

In accordance with ASC 310-20-15-3(c), reporting entities that account for receivables and debt instruments at fair value with changes in fair value recorded in net income should not defer fee recognition. See LI 6.9 for information on interest income recognition for those reporting entities.

See LI 6.6 for information on prepayment fees and LI 4.6.1 for information on loan syndication fees. ASC 310-10-25-13 provides guidance on the accounting for delinquency fees.

6.5 *Interest method*

The ASC Master Glossary provides the following definition of the interest method.

Definition from the ASC Master Glossary

Interest method: The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.

While the definition in the ASC Master Glossary focuses on debt, the concept is also applicable to loans, receivables, and debt securities.

For loans, receivables, and debt securities that are not prepayable by the issuer, the interest method is generally applied over the contractual life of the asset for purposes of recognizing accretion and amortization associated with premiums, discounts, and deferred origination fees and costs.

Example LI 6-1 illustrates the basic application of the interest method.

EXAMPLE LI 6-1

Application of the interest method

Investor Corp pays \$4,650,000 for a bond with the following terms.

Par amount	\$5,000,000
Coupon rate	6% paid annually
Years to maturity	10 years

Since Investor Corp pays \$4,650,000 for a bond with a par amount of \$5,000,000, it acquires the bond at a discount of \$350,000.

What is the effective interest rate of the bond? How should Investor Corp record interest income on its investment?

Analysis

The effective interest rate is determined by solving for the rate needed for the present value of the bond's future cash flows to equal the initial amortized cost basis of the bond.

The schedule of cash flows is shown below. There is a cash outflow at the date the bond is purchased equal to the purchase price. The annual cash inflow relates to the 6% coupon payments on the par amount of the bond ($6\% \times \$5,000,000 = \$300,000$). The bond is repaid at maturity.

Period	Cash inflow (outflow) amount
Purchase date	(\$4,650,000)
Year 1	300,000
Year 2	300,000
Year 3	300,000
Year 4	300,000
Year 5	300,000
Year 6	300,000
Year 7	300,000
Year 8	300,000
Year 9	300,000
Year 10	5,300,000

The interest rate needed for the present value of these cash flows to equal the initial amortized cost basis of \$4,650,000 is approximately 6.996%.

Investor Corp would record interest income each period by applying the effective interest rate of 6.996% to the carrying value of the bond (for example, in period 2, $6.996\% \times \$4,675,336 = \$327,109$) as shown in the following table. This table also illustrates the impact of using the effective interest rate (rather than the coupon rate) to determine the periodic interest income.

Period	Cash inflow (outflow)	Coupon payment	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
0	(\$4,650,000)	—	—	—	\$350,000	\$4,650,000
1	300,000	\$300,000	\$25,336	\$325,336	324,664	4,675,336
2	300,000	300,000	27,109	327,109	297,555	4,702,445
3	300,000	300,000	29,006	329,006	268,549	4,731,451
4	300,000	300,000	31,035	331,035	237,514	4,762,486
5	300,000	300,000	33,206	333,206	204,308	4,795,692
6	300,000	300,000	35,530	335,530	168,778	4,831,222

Period	Cash inflow (outflow)	Coupon payment	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
7	300,000	300,000	38,016	338,016	130,672	4,869,238
8	300,000	300,000	40,675	340,675	90,087	4,909,913
9	300,000	300,000	43,521	343,521	46,566	4,953,434
10	5,300,000	300,000	46,566	346,566	—	—

6.5.1 *Applying the interest method when cash flows change*

The application of the interest method may be relatively straightforward for a financial asset that has static terms and involves cash flows that are fixed in terms of their timing and amount. However, there can be significant complexity in applying the interest method when the timing or amounts of cash flows are not fixed. These instruments include:

- Instruments that allow the borrower to prepay the principal of the loan/security
- Investments in asset backed securities when prepayments from assets underlying the investments are passed through to investors, which are treated as prepayments on the securities
- Variable-rate instruments

Over time, different approaches to address the complexity have been developed. In many cases, the use of a specific method is required by the accounting literature. In other cases, a policy election among the alternatives is permitted. The three main approaches are prospective, catch-up, and retrospective.

Figure LI 6-2 discusses each of the approaches, which are designed to address situations in which the timing or amount of cash flows is different than the amount anticipated when the initial effective interest rate was calculated.

Figure LI 6-2
Interest method approaches to changes in estimates

Method	Description
Prospective approach	A new effective interest rate is computed based on the current cost basis of the instrument and remaining cash flows. Changes in cash flows from previous estimates are included in future interest income on a prospective basis.
Catch-up approach	The cost basis is adjusted to the present value of the revised estimated cash flows discounted at the original effective interest rate. Using this

Method	Description
	approach, the impact of the change in cash flows is recorded in the current period.
Retrospective approach	A new effective interest rate is computed based on the original cost basis, actual cash flows to date, and the revised estimate of remaining cash flows. The new effective interest rate is then used to adjust the cost basis to the present value of the revised estimated cash flows, discounted at the new effective interest rate. Using this approach, the impact of the change in cash flows is recorded in the current period.

While a current period adjustment is recorded under both the catch-up and retrospective approaches, the key distinction relates to the effective interest rate. In a catch-up approach, cash flows are updated to reflect current estimates, but the rate used to discount those cash flows remains the original effective interest rate. Under the retrospective approach, the effective interest rate is changed to reflect the actual cash flows received to date and the revised estimate of future cash flows.

6.5.1.1 *Applying the interest method to changing rates*

ASC 310 provides guidance on accounting for a loan in which the stated interest rate changes over time based on a defined schedule.

ASC 310-20-35-18(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 (See Section 310-20-55). Accordingly, a limit is imposed 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 capitalization of costs incurred is different from increasing the net investment in a loan through accrual of interest income that is only contingently receivable.

ASC 310-20-35-18(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 (See Section 310-20-55).

For an interest rate that contractually increases over the life of an asset, the stated interest may be lower than the effective interest income recognized. As discussed in ASC 310-20-35-18(a), a reporting entity is precluded from accruing interest at an effective rate that results in a net investment in the asset greater than the amount at which the borrower could settle its obligation. When this occurs, the reporting entity is limited in the amount of interest income that can be recorded.

Conversely, for an interest rate that contractually declines over time, the stated interest will be greater than the effective interest. In this circumstance, the interest method should be applied. Cash-based interest received as interest payments in excess of interest recognized should be deferred as an adjustment to the amortized cost basis of the instrument.

Example LI 6-2 illustrates the recognition of interest on an instrument that has an interest rate that increases.

EXAMPLE LI 6-2

Interest recognition on an instrument with an increasing interest rate

Finance Co pays \$950,000 for a bond with a par value of \$1,000,000. Other than the purchase discount of \$50,000, there are no items that impact the amortized cost basis of the bond. As a result, Finance Co records the bond at \$950,000.

The bond's annual interest rate increases over its life as shown in the following table. The bond has a five-year term, but can be prepaid at face value at the issuer's option at par plus accrued interest.

Period	Interest rate
Year 1	2%
Year 2	3%
Year 3	4%
Year 4	5%
Year 5	6%

What is the effective interest rate of the bond? How should Finance Co record interest income on its investment?

Analysis

The effective interest rate needed for the present value of the bond's cash flows to equal the initial carrying amount of \$950,000 is approximately 5.058%. However, using this effective interest rate would result in the bond's carrying amount exceeding the amount that could be prepaid by the borrower during the third year:

Period	Cash in / (out)flow	Coupon payment	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
0	(950,000)				50,000	950,000
1	20,000	(20,000)	28,052	48,052	21,948	978,052
2	30,000	(30,000)	19,471	49,471	2,476	997,524
3	40,000	(40,000)	10,456	50,456	(7,980)	1,007,980

As a result, the amortization schedule is updated in period 3 to only amortize the remaining unamortized discount (\$2,476) as opposed to the full amount of amortization that otherwise would have been recorded based on the effective interest rate of approximately 5.058%. Once the discount is fully amortized, the effective interest rate becomes the stated rate. This is shown in the following table.

Period	Cash inflow (outflow)	Coupon payment	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
0	(\$950,000)	—	—	—	\$50,000	\$950,000
1	20,000	\$20,000	\$28,052	\$48,052	21,948	978,052
2	30,000	30,000	19,471	49,471	2,476	997,524
3	40,000	40,000	2,476	42,476	—	1,000,000
4	50,000	50,000	—	50,000	—	1,000,000
5	1,060,000	60,000	—	60,000	—	—

Note that the \$50,000 discount has been fully recognized by the end of the third year. As a result of the limitation in ASC 310-20-35-18(a), interest income in years 3 through 5 are different than what they would have otherwise been.

6.5.1.2 *Applying the interest method to variable rate instruments*

ASC 310-20-35 provides guidance on calculating the effective interest rate on a variable rate instrument. For the purposes of amortizing premiums or discounts, the determination of whether to use the variable rate at inception or as it changes over the life of the instrument is an accounting policy election. If a reporting entity chooses to use the variable rate as it changes over the life of the instrument, subsequent changes should be accounted for using a prospective approach.

ASC 310-20-35-18(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. (See Section 310-20-55.) A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of (a) and (b).

ASC 310-20-35-19

The preceding paragraph provides that when a loan's stated interest rate varies based on future changes in an independent factor, the lender shall calculate a constant effective yield by using the independent factor in effect at the inception of the loan or the factor as it changes over the life of the loan. In applying the guidance in (c) in the preceding paragraph, the lender may not change from one alternative to the other during the life of the loan. The lender must select one of the two alternatives and apply the method consistently throughout the life of the loan.

ASC 310-20-35-20

In a period in which the independent factor on a variable rate loan changes, the constant effective yield is recalculated not from the inception of the loan but from the time of the change. See Example 9 (paragraph 310-20-55-43) for an illustration.

Financial assets with provisions that can cause the timing or amount of cash flows to change should be evaluated to determine whether the provisions are derivatives that should be separately accounted for under the guidance in ASC 815. See DH 4 for information on the evaluation of embedded derivatives.

Example LI 6-3 and Example LI 6-4 demonstrate the application of the interest method to an instrument with an interest rate that varies based on an interest rate index.

EXAMPLE LI 6-3**Interest recognition on an instrument with a variable rate – policy of using rate in effect at inception**

Finance Co pays \$950,000 for a bond with a par value of \$1,000,000. Other than the purchase discount of \$50,000 there are no items that impact the amortized cost basis of the bond; therefore, Finance Co records the bond at \$950,000.

The bond's annual interest rate is based on an interest rate index plus a 2% fixed spread. The bond has a five-year term. Interest is paid annually and full payment of principal is due at maturity.

Finance Co has elected a policy of using the rate in effect at inception of a financial asset for purposes of determining the asset's effective interest rate.

Through the life of the bond, the interest rate index and total coupon amount resets as shown in the following table.

Period	Interest rate index	Coupon
Year 1	2%	4%
Year 2	1.5%	3.5%
Year 3	3%	5%
Year 4	4%	6%
Year 5	4%	6%

How should Finance Co amortize the discount over the life of the bond?

Analysis

Since Finance Co has chosen an accounting policy to determine the effective rate using the interest rate in effect at inception of the bond, amortization of the discount should be determined assuming a 4% coupon rate (i.e., it should be assumed the rate will not change over the life of the bond). The effective interest rate needed for the present value of the bond's cash flows (based on the 4% coupon in effect at inception) to equal the initial carrying amount of \$950,000 is approximately 5.16%.

The following table shows how the discount should be amortized using this accounting policy.

Period	Assumed cash in/(out) flow (1)	Interest income (2)	Unamortized discount	Ending carrying amount
0	(950,000)	—	50,000	950,000
1	40,000	49,020	40,980	959,020
2	40,000	49,485	31,495	968,505
3	40,000	49,975	21,520	978,480
4	40,000	50,489	11,031	988,969
5	1,040,000	51,031	—	—

(1) The Assumed cash in/(out)flow column represents the cash flows used for the purposes of calculating the accretion of the discount and are based on the variable index at inception/acquisition plus the fixed spread (i.e., 4% assumed coupon payments each year and payment of par at maturity).

(2) The Interest income column represents the interest that would have been recorded in each period if the variable index never changed from inception/acquisition. Actual interest income will be different as rates change each period.

The discount amortization would not change in subsequent periods when the coupon on the instrument changes, however the total interest income would change with changes in the variable

interest rate. For example, in the second year, interest income would be \$44,485 (\$5,000 less than \$49,485) since interest rates declined by 0.5% (from 4% to 3.5%).

EXAMPLE LI 6-4

Interest recognition on an instrument with a variable rate – policy of updating the rate

Assume the same facts as Example LI 6-3 except that Finance Co elects an accounting policy to change its effective interest rate calculation when the variable rate changes.

How should Finance Co amortize the discount over the life of the bond?

Analysis

In the first year, the calculation of the effective interest rate, and in turn the amortization of the discount, would be based on the 4% rate in effect at the inception of the bond as shown in Example LI 6-3.

In subsequent years, Finance Co would update its effective interest rate on a prospective basis, using the updated coupon on the bond. For example, in year 2, Finance Co would calculate the effective interest rate needed for the present value of the bond's cash flows (based on the 3.5% coupon in effect in year 2) to equal the then-carrying amount of \$959,020 (the carrying amount at the end of year 1/beginning of year 2); that rate is approximately 4.65%.

This revised effective interest rate would be applied to the carrying amount of the bond at the end of year 1/beginning of year 2 (\$959,020) resulting in interest income of \$44,558 (\$35,000 coupon + \$9,558 amortization of discount) for year 2.

6.5.1.3 Applying interest method to borrower prepayment options

In most cases, the effective interest rate on an instrument should be calculated using the contractual life of an asset. In some cases (e.g., beneficial interests accounted for under ASC 325-40 and certain callable debt securities acquired at a premium), the guidance requires that the effective interest rate not be calculated using the contractual life of the instrument.

When the contractual life is used to amortize premiums and discounts, prepayments impact unamortized amounts as they occur. However, ASC 310-20-35 permits the use of an estimated life when certain criteria are met.

ASC 310-20-35-26

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 entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the entity anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the entity 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.

ASC 310-20-35-29

If loan-by-loan accounting is used, net fees and costs shall be amortized over the contract life and adjusted based on actual prepayments.

The use of the contractual term results in a reporting entity amortizing premiums or discounts over the contractual life of the financial asset. To maintain the effective interest rate, an adjustment needs to be made as prepayments occur. In the period a prepayment occurs, in accordance with ASC 310-20-35-16, the carrying amount of the financial asset should be adjusted such that the new carrying amount equals the present value of the updated cash flows (subsequent to the prepayment) discounted at the original effective interest rate. This will result in accelerated recognition of a portion of the unamortized premium or discount in interest income.

Example LI 6-5 illustrates the accounting for interest on a prepayable instrument under the contractual method.

EXAMPLE LI 6-5

Interest recognition on a prepayable instrument – prepayments are accounted for when they occur

Bank Corp originates a loan with the following terms.

Principal amount (due in full at maturity)	\$100,000
Origination fees paid by the borrower	\$3,000
Origination costs incurred by Bank Corp	\$1,000
Coupon rate	5% paid annually
Term	5 years
Prepayment feature	The borrower can prepay the loan at any time without penalty.

Assume that the loan origination fees and costs meet the requirements in ASC 310-20 to be deferred as part of the carrying amount of the loan; therefore, the carrying amount of the loan is \$98,000 (\$100,000 principal - \$3,000 loan origination fees + \$1,000 loan origination costs).

Bank Corp calculates the effective interest rate on the loan by determining the present value of the loan's cash flows (assuming the loan remains outstanding for its entire contractual term) to equal the initial carrying amount of \$98,000; this rate is approximately 5.47%.

Bank Corp calculates the following interest income and amortization using this effective interest rate.

Period	Cash inflow (outflow)	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
0	(\$98,000)	—	—	\$2,000	\$98,000
1	5,000	359	5,359	1,641	98,359
2	5,000	378	5,378	1,263	98,737
3	5,000	399	5,399	864	99,136
4	5,000	421	5,421	444	99,556
5	\$105,000	\$444	\$5,444	—	—

At the end of the period 2, the borrower prepays \$20,000 of principal.

How should Bank Corp account for the principal repayment?

Analysis

Bank Corp should first determine the new carrying amount of the loan by calculating the present value of the new contractual payments using the initial effective rate of 5.47%. The new contractual payments are \$4,000 of interest payments ($5\% \times \$80,000$ remaining loan balance) and an \$80,000 principal payment at maturity. Using this calculation, the new carrying amount of the loan is \$78,990.

After Bank Corp recognizes the prepayment, the carrying amount of the loan absent an adjustment would be \$78,737 (\$98,737 loan carrying amount at the end of period 2 - \$20,000 prepayment). Bank Corp should record an adjustment to the carrying amount of the loan of \$253 to adjust the loan value to \$78,990 ($\$78,990 - \$78,737 = \253).

Bank Corp would record the following journal entries.

Dr. Cash	\$20,000	
Cr. Loan asset balance		\$20,000

To record the prepayment made by the borrower

Dr. Loan asset balance	\$253	
Cr. Interest income		\$253

To adjust the loan balance to the present value of the remaining contractual cash flows

Bank Corp would also recompute its amortization schedule prospectively (i.e., it would not adjust the interest income and accretion amounts recorded in prior periods). Due to adjusting the loan balance to reflect the present value of the remaining contractual cash flows, the effective interest rate would remain 5.47%.

Period	Cash inflow (outflow)	Accretion of discount	Interest income	Unamortized discount	Ending carrying amount
0	(\$98,000)	—	—	\$2,000	\$98,000
1	5,000	359	5,359	1,641	98,359
2	25,000 ¹	631	5,631 ²	1,010	78,990
3	4,000 ³	319	4,319 ⁴	691	79,309
4	4,000	337	4,337	355	79,645
5	\$84,000	\$355	\$4,355	—	—

¹ \$20,000 prepayment + \$5,000 interest payment

² Interest income of \$5,378 originally recognized in year 2 plus \$253 adjustment.

³ New loan asset balance of \$80,000 (\$100,000 - \$20,000 prepayment) x 5% coupon rate.

⁴ Product of the carrying amount of \$78,990 and the original effective interest rate of 5.47%.

Estimating prepayments when determining the effective interest rate

As discussed in ASC 310-20-35-26, when a reporting entity holds a large number of similar loans, investments in debt securities, or other receivables for which prepayments are probable, and the timing and amount of prepayments can be reasonably estimated, the reporting entity may elect to consider estimates of future principal prepayments in the calculation of the effective interest rate.

For certain callable debt securities purchased at a premium, if the entity does not elect to apply the guidance in ASC 310-20-35-26, it must amortize the premium to the next call date. Refer to the Premium amortization on purchased callable debt securities section below for further discussion.

ASC 310-20 provides implementation guidance to assist in determining whether instruments are similar for the purposes of meeting the requirements to aggregate the assets and estimate prepayments when determining the effective interest rate.

ASC 310-20-35-27

Loans grouped together shall have sufficiently similar characteristics that prepayment experience of the loans can be expected to be similar in a variety of interest rate environments. Loans that are grouped together for purposes of applying the preceding paragraph shall 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.

ASC 310-20-35-30

There are a number of characteristics to be considered in determining whether the lender holds a large number of similar loans for purposes of estimating prepayments in accordance with paragraph 310-20-35-26. The objective is to evaluate all characteristics that would affect the ability of the lender to estimate the behavior of a group of loans. The following are examples of some characteristics that shall be considered when aggregating loans:

- a. Loan type
- b. Loan size
- c. Nature and location of collateral
- d. Coupon interest rate
- e. Maturity
- f. Period of origination
- g. Prepayment history of the loans (if seasoned)
- h. Level of net fees or costs
- i. Prepayment penalties
- j. Interest rate type (fixed or variable)
- k. Expected prepayment performance in varying interest rate scenarios

When calculating the effective interest rate considering estimated prepayments, the pool of instruments becomes the unit of account, but only for the purposes of calculating interest income. For purposes of applying other measurement guidance, such as the calculation of fair value or the measurement of impairment, the unit of account will likely be different. For example, when calculating impairment under the current expected credit loss (CECL) impairment model, the guidance requires instruments to be aggregated if they are based on similar credit risk characteristics. As a result, aggregation of instruments for purposes of calculating estimated credit losses under the CECL impairment model is likely to be based on different criteria than those used to aggregate loans when determining interest income.

Question LI 6-3 discusses the potential application of ASC 310-20-35-26 to callable corporate bonds.

Question LI 6-3

Investor Corp invests in callable corporate bonds. Can Investor Corp estimate prepayments for purposes of applying the interest method?

PwC response

It depends. If Investor Corp can demonstrate the following then estimating prepayments may be permissible.

- Its corporate bonds can be grouped into homogenous pools
- It is probable that the bonds will experience prepayments (the issuers will exercise their call options)
- The prepayments can be reasonably estimated

See below for further discussion of callable debt securities purchased at a premium.

Question LI 6-4 addresses whether an entity is required to apply the guidance in 310-20-35-26.

Question LI 6-4

If a reporting entity meets the requirements in ASC 310-20-35-26 to consider estimates of future principal prepayments in the calculation of the effective interest rate, is it required to do so?

PwC response

No. As discussed in ASC 310-20-35-28, whether to consider future prepayments is an election available to a reporting entity for portfolios that meet the stated criteria. It is not required. However, the election is a policy decision and should be applied consistently. See below for further discussion of callable debt securities purchased at a premium.

ASC 310-20-35-28

For loans that do qualify under paragraph 310-20-35-26, a lender may use either method for different loans and select the most appropriate method for a group of loans based on the characteristics of those loans. (For example, homogeneous mortgage loans might be aggregated while construction loans are accounted for separately.) However, once a lender has selected the appropriate method of accounting for a loan or a group of loans, a lender must continue to use the method throughout the life of the loan or group of loans.

Question LI 6-5 addresses whether the criteria used to create a pool can be changed when applying ASC 310-20-35-26.

Question LI 6-5

Once a loan pool has been established for a group of similar loans for purposes of applying the guidance in ASC 310-20-35-26 to estimate prepayments when determining the effective interest rate, may the characteristics that were used to identify the pool be changed?

PwC response

No. Once a pool of loans has been established, the characteristics used to identify that pool may not be changed (for the purposes of calculating interesting income). Therefore, the loan pool becomes the unit of account going forward for the purposes of determining interest income, and as a result, the characteristics considered in aggregating similar loans into a pool may not be changed. However, future loan pools may be aggregated using a different set of characteristics.

As discussed in ASC 310-20-35-26, a reporting entity should periodically reevaluate its estimation of prepayments including when actual cash flows differ from estimated cash flows and estimates of future prepayments might change.

Excerpt from ASC 310-20-35-26

If the entity anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the entity 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.

Example LI 6-6 illustrates the accounting for interest on a prepayable instrument if prepayments are estimated in accordance with ASC 310-20-35-26.

EXAMPLE LI 6-6

Interest recognition on prepayable instruments – prepayments are estimated

The content in this example is from Example 4 in ASC 310-20-55-26 through ASC 310-20-55-32 and includes the calculations from that example.

Bank Corp originates 1,000 loans with the following terms:

Loan principal amount	Each loan has a principal amount of \$10,000, resulting in principal of the loan pool of \$10,000,000
Contractual payment terms	Equal annual payments
Aggregate origination fees paid by the borrowers on loan pool	\$300,000
Aggregate origination costs incurred by Bank Corp on loan pool	\$100,000
Coupon rate	10% paid annually
Term	10 years
Prepayment feature	The borrower can prepay the loan at any time without penalty. When prepayments occur, the amortization schedule of the loan resets.

Assume the loan origination fees and costs meet the requirements in ASC 310-20 to be deferred as part of the carrying amount of the loan; therefore, the carrying amount of the loan pool is \$9,800,000 (\$10,000,000 principal - \$300,000 loan origination fees + \$100,000 loan origination costs).

Bank Corp concludes that the loans have similar characteristics, prepayments are probable, and it can reasonably estimate payment timing. Based on Bank Corp's estimates, it is expected that the loans will prepay at a constant annual rate of 6%.

Bank Corp calculates the effective interest rate on the loan pool by determining the present value of the cash flows (assuming a prepayment rate of 6%) to equal the initial carrying amount of \$9,800,000; this rate is approximately 10.5627%. Bank Corp calculates the following interest income and amortization schedule using this effective interest rate.

Period	Cash inflow (outflow)	Stated Interest	Accretion of discount	Interest income	Unamortized net fees	Ending carrying amount
0	(\$9,800,000)	—	—	—	\$200,000	\$9,800,000
1	2,227,454	1,000,000	35,141	1,035,141	164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	132,913	7,467,265
3	1,880,619	760,018	28,724	788,742	104,189	6,375,388
4	1,719,716	647,958	25,453	673,411	78,736	5,329,083
5	1,566,144	540,782	22,111	562,893	56,625	4,325,832
6	1,419,028	438,246	18,677	456,923	37,948	3,363,727
7	1,277,230	340,168	15,131	355,299	22,817	2,441,796
8	1,138,934	246,461	11,458	257,919	11,359	1,560,781
9	1,000,180	157,214	7,646	164,860	3,713	725,461
10	802,091	72,917	3,713	76,630	—	—

At the end of period 3, Bank Corp has experienced 6% prepayments in periods 1 and 2, and 20% in period 3. In addition, based on new information at the end of period 3, Bank Corp revises its estimate of prepayments to 10% beginning in period 4 and 6% in the remaining years.

How should Bank Corp account for the change in estimated principal repayments?

Analysis

Bank Corp should recalculate the effective interest rate on the loan pool by determining the rate needed for the present value of the loan pool cash flows (from inception of the loans (period 0) using

the actual prepayments in periods 1 – 3 and the revised prepayments estimate in periods 4 – 10) to equal the original carrying amount of the loan pool (\$9,800,000). This rate is approximately 10.6083%.

Pursuant to ASC 310-20-35-26, a reporting entity that elects to anticipate prepayments would be required to recalculate the effective yield to reflect the actual prepayments to date and to anticipate future payments (i.e., it is required to use the retrospective method). Therefore, Bank Corp would recognize an adjustment to the carrying amount of the loans of \$8,876, which represents the cumulative effect applicable to periods 1 and 2 of the revised effective interest rate of 10.6083% as compared to the original effective interest rate of 10.5627%. Bank Corp would use the revised effective interest rate of 10.6083% beginning in period 3.

Period	Cash inflow (outflow)	Stated interest	Amortization	Interest income	Unamortized net fees	Ending carrying amount
0	(\$9,800,000)	—	—	—	\$200,000	\$9,800,000
1	2,227,454	1,000,000	35,141	1,035,141	164,859	8,607,687
2	2,049,623	877,255	31,946	909,201	132,913	7,467,265
3	2,944,644	760,018	41,951 ¹	801,969	90,962	5,324,590
4	1,653,939	541,555	23,294	564,849	67,668	4,235,500
5	1,246,229	430,317	18,998	449,315	48,670	3,438,586
6	1,129,164	348,726	16,050	364,776	32,620	2,674,198
7	1,016,331	270,682	13,005	283,687	19,615	1,941,554
8	906,285	196,117	9,849	205,966	9,766	1,241,235
9	795,875	125,100	6,574	131,674	3,192	577,034
10	\$638,249	\$58,023	\$3,192	\$61,215	—	—

¹ Amortization of \$33,074 using the revised effective interest rate of 10.6083% + adjustment to the carrying amount of \$8,876 relating to the difference in amortization for years 1 and 2 between the original and revised effective interest rates.

Premium amortization on purchased callable debt securities

Premiums and discounts on loans, investments in debt securities, and receivables are generally amortized to maturity date. If the entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may elect to consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method.

One exception relates to callable debt securities purchased at a premium with explicit, noncontingent call features that are callable at fixed prices on preset dates. This guidance only relates to debt securities. Refer to LI 3.2.2 for the definition of debt securities.

Callable debt securities whose coupon rate exceeds market yields often trade at a premium in the market. Similar to other types of receivables, an entity may elect to consider expected prepayments on debt securities in its calculation of the effective interest rate if it holds a large number of similar loans for which prepayments are probable and their timing and amount can be reasonably estimated. However, if this election is not made, ASC 310-20-35-33 requires premiums on certain individual callable debt securities (i.e., the amount of the amortized cost basis that exceeds the amount payable by the issuer at the next call date) to be amortized to the next call date. Conversely, discounts on individual callable debt securities are amortized to the maturity date unless the election in ASC 310-20-35-26 is made on a portfolio of debt securities.

The remainder of this section assumes an entity has adopted ASU 2020-08, *Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs*. For public business entities, this guidance became effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. Public business entities cannot early adopt this guidance. For all other entities, this guidance is effective for fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022. Early adoption for entities that are not public business entities is permitted for fiscal periods beginning after December 15, 2020, including interim periods within those fiscal years. This guidance should be adopted prospectively by resetting the effective yield to the extent that the amortized cost basis of an existing individual callable debt security within its scope exceeds the amount repayable by the issuer at the next earliest call date, unless the guidance in ASC 310-20-35-26 is applied to consider estimated prepayments.

ASC 310-20-35-33

For each reporting period, to the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the next call date, the excess (that is, the premium) shall be amortized to the next call date, unless the guidance in paragraph 310-20-35-26 is applied to consider estimated prepayments. For purposes of this guidance, the next call date is the first date when a call option at a specified price becomes exercisable. Once that date has passed, the next call date is when the next call option at a specified price becomes exercisable, if applicable. If there is no remaining premium or if there are no further call dates, the entity shall reset the effective yield using the payment terms of the debt security. Securities within the scope of this paragraph are those that have explicit, noncontingent call options that are callable at fixed prices and on preset dates at prices less than the amortized cost basis of the security. Whether a security is subject to this paragraph may change depending on the amortized cost basis of the security and the terms of the next call option.

The term “next call date” is important in evaluating whether a debt security with explicit, noncontingent call features that is callable at fixed prices on preset dates is subject to the guidance in ASC 310-20-35-33 and in order to apply this guidance. Debt securities may have call features that are only exercisable on certain dates. However, call features in debt securities are often exercisable over a period of time as opposed to a single date. For the purposes of this guidance, the “next call date” is the first date when a call feature at a specified price that is not currently exercisable becomes exercisable. For example, if evaluating the next call date on 1/1/20X1 of a debt security callable at a price of \$102 from 7/1/20X1 through 12/31/20X1, the next call date would be 7/1/20X1. Once 7/1/20X1 has passed,

the next call date would be based on a different call option within the debt security that is exercisable at a different price subsequent to the 7/1/20X1 through 12/31/20X1 call period (if applicable).

Certain debt securities may fall outside the scope of this guidance, even if the debt security is purchased at a premium. For example, certain asset backed securities may not have explicit, noncontingent call features that are only exercisable on certain dates. Another example is a debt security for which the price at the next call date is greater than the amortized cost basis of the debt security. As a result, it would not be subject to ASC 310-20-35-33. Some debt securities that have multiple call features may not initially be subject to this guidance but may subsequently become subject if the call feature associated with the then next call date is at a price less than the amortized cost basis of the debt security. Example LI 6-8 illustrates a debt security that becomes subject to the guidance at a later date.

Assuming a debt security is subject to the guidance in ASC 310-20-35-33, the security's effective yield should be adjusted prospectively if a call feature is not exercised. Question LI 6-6 addresses a situation when an issuer does not exercise its call option on a callable debt security purchased at a premium.

Question LI 6-6

For debt securities subject to ASC 310-20-35-33, how should an entity calculate the effective yield on a callable debt security purchased at a premium if the issuer does not exercise the call option at the next call date?

PwC response

If a callable debt security purchased at a premium is not called at its next call date, the holder should reset the effective yield using the amortized cost basis and the remaining payment terms of the security as of that date, which may require consideration of the debt security's next call date. If the entity has fully amortized the premium of the debt security as a result of applying this guidance, the amortized cost basis would equal par value. Going forward, the effective yield of the security would equal its coupon rate.

Conversely, if the entity has been amortizing the premium on a debt security to an amount greater than par value (which would occur if, for example, a security was purchased at a \$5 premium and the original next call was at a \$3 premium), the amortized cost basis would be higher than par value at that date. In this scenario, the entity would reset the effective yield using the amortized cost basis at that date and the remaining payment terms (including any future call options). For example, if the security was callable at par two years later, the remaining premium would be amortized over the next two years.

Example LI 6-7 illustrates the amortization of a premium on a debt security within the scope of ASC 310-20-35-33 with multiple call features.

EXAMPLE LI 6-7

Amortization of a callable debt security's premium

Bank Corp purchases a noncontingent callable debt security on 1/1/20X1 with the following terms.

Principal amount:	\$100,000
Annual coupon rate:	15%
Maturity:	12/31/20X5
Purchase price:	\$110,000

The issuer has the right to call the debt security as outlined in the call schedule below.

Call date/period	Call price (per thousand dollar debt security)
1/1 – 12/31/20X1	N/A
1/1 – 12/31/20X2	105
1/1 – 12/31/20X3	103
1/1 – 12/31/20X4	102
1/1 – 12/31/20X5	100

How would Bank Corp amortize the debt security's premium assuming the issuer never exercises the call option and the debt security remains outstanding through maturity?

Analysis

On 1/1/20X1, the date of purchase, Bank Corp determines that the debt security's amortized cost basis of \$110,000 exceeds the price (\$105,000) of the call feature on the next call date (1/1/20X2). Bank Corp begins amortizing the premium such that the debt security will have an amortized cost basis of \$105,000 on 12/31/20X1. This results in an effective interest rate of 9.09%.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
1/1/20X1	\$(110,000)	\$10,000	N/A	\$110,000
12/31/20X1	\$15,000	\$5,000	\$10,000	\$105,000

On 1/1/20X2, the next call date is 1/1/20X3 when the debt security is callable at \$103,000. Bank Corp resets the bond's effective yield to 12.38% such that the debt security will have an amortized cost basis of \$103,000 on 1/1/20X3.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
12/31/20X2	\$15,000	\$3,000	\$13,000	\$103,000

On 1/1/20X3, the debt security's amortized cost basis of \$103,000 exceeds the call price of \$102,000 on the next call date of 1/1/20X4. Bank Corp resets the bond's effective yield to 13.59% such that the debt security will have an amortized cost basis of \$102,000 as of 1/1/20X4.

On 1/1/20X4, the debt security's amortized cost basis of \$102,000 exceeds the call price of \$100,000 on the next call date of 1/1/20X5. Bank Corp again resets the debt security's effective yield to 12.75% such that the debt security will have an amortized cost basis of \$100,000 as of 1/1/20X5. On 12/31/20X4, the debt security's premium has been fully amortized.

The calculations of interest income and the debt security's amortized cost basis from years 20X3 through 20X5 are illustrated as follows.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
12/31/20X3	\$15,000	\$2,000	\$14,000	\$102,000
12/31/20X4	\$15,000	0	\$13,000	\$100,000
12/31/20X5	\$115,000	0	\$15,000	0

Example LI 6-8 illustrates the amortization of a premium on a debt security with multiple call features, but the debt security is not initially subject to the guidance in ASC 310-20-35-33 because its amortized cost basis is less than the amount the call can be exercised for at the next call date.

EXAMPLE LI 6-8

Amortization of a callable debt security's premium

Bank Corp purchases a noncontingent callable debt security on 1/1/20X1 with the following terms.

Principal amount:	\$100,000
Annual coupon rate:	15%
Maturity:	12/31/20X5
Purchase price:	\$106,000

The issuer has the right to call the debt security on any date beginning with the first call date outlined in the call schedule below.

Call date/period	Call price (per thousand dollar debt security)
1/1 - 12/31/20X1	N/A
1/1 - 12/31/20X2	110
1/1 - 12/31/20X5	102

How would Bank Corp amortize the debt security's premium assuming the issuer never exercises the call option and the debt security remains outstanding through maturity?

Analysis

On 1/1/20X1, the date of purchase, Bank Corp determines that the debt security's amortized cost basis of \$106,000 is less than the call price of \$110,000 of the call feature on the next call date (1/1/20X2). As such, the debt security is not subject to ASC 310-20-35-33 and Bank Corp begins amortizing the premium over the contractual maturity using the debt security's effective interest rate of 13.28%.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
1/1/20X1	\$(106,00)	\$6,000	N/A	\$106,000
12/31/20X1	\$15,000	\$5,079	\$14,079	\$105,079

On 1/1/20X2, the debt security's amortized cost basis of \$105,079 exceeds the call price of \$102,000 on the next call date (1/1/20X3). The debt security is now subject to ASC 310-20-35-33, Bank Corp resets the debt security's effective yield to 11.34% such that the debt security will have an amortized cost basis of \$102,000 on 1/1/20X3.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
12/31/20X2	\$15,000	\$2,000	\$11,921	\$102,000

On 1/1/20X3, the debt security's amortized cost basis is \$102,000 and there are no additional call features at a different price. As a result, the debt security is no longer subject to ASC 310-20-35-33. Bank Corp resets the debt security's effective yield to 14.14% and begins amortizing the remaining premium to contractual maturity.

The calculations of interest income and the debt security's amortized cost basis for years 20X3 through 20X5 are illustrated as follows.

Period	Cash inflow/(outflow)	Unamortized premium	Interest income	Ending amortized cost basis
12/31/20X3	\$15,000	\$1,419	\$14,419	\$101,419
12/31/20X4	\$15,000	\$756	\$14,337	\$100,756
12/31/20X5	\$115,000	0	\$14,244	0

6.6 Accounting for prepayment fees

Prepayment options are usually exercised by borrowers when financing is no longer needed or when financing at a lower rate is available. As a result, prepayments are more common during periods in which interest rates have declined. Sometimes the terms of a loan or debt instrument require the borrower to pay a penalty for prepayment. Prepayment penalties serve as a deterrent to repaying outstanding debt.

ASC 310 addresses the accounting for prepayment penalties.

ASC 310-10-25-12

Prepayment penalties shall not be recognized in income until loans or trade receivables, if applicable, are prepaid, except that the existence of prepayment penalties may affect the accounting resulting from the application of paragraph 310-20-35-18(a).

ASC 310-20-35-18(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. (See Section 310-20-55.)

Accordingly, a limit is imposed 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 capitalization of costs incurred is different from increasing the net investment in a loan through accrual of interest income that is only contingently receivable.

6.6.1 Recording a prepayment penalty in interest income

In the guidance regarding when a refinanced loan should be accounted for as a modification or new loan (i.e., extinguishment), ASC 310-20-35-9 states that "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." Although this guidance is not directly applicable, this accounting treatment could be used for loans that are paid off without being refinanced by a new loan by analogy. In addition, Example 2 in ASC 310-20-55-23 through ASC 310-20-55-25, indicates that unamortized net fees should be

recognized in interest income when a loan is prepaid and not refinanced. Under this approach, prepayment fees are viewed as compensation for interest income to which the investor would otherwise have been entitled. Accordingly, prepayment fees should be included in interest income even though the loan has been extinguished.

Alternatively, some believe because the loan no longer exists, prepayment penalties should not be reported in interest income, but rather should be recognized in another income statement line item, such as other income.

We believe that either view is acceptable but represents an accounting policy that should be applied consistently.

6.7 Recognition of interest income on beneficial interests

Beneficial interests can take many different forms, ranging from debt securities to equity interests issued by a limited partnership, LLC, or other entity. Securitization transactions may result in beneficial interests such as mortgage-backed securities, asset-backed securities, credit-linked notes, collateralized debt obligations, and interest-only (IO) or principal-only (PO) strips.

ASC 325-40 provides guidance on the accounting for interest income and impairment models for certain beneficial interests. The guidance applies to beneficial interests classified as held-to-maturity, available-for-sale, or trading. ASC 325-40 includes in its scope entities that account for financial assets at fair value with changes in fair value recorded in earnings. Refer to LI 14 for further information on accounting for beneficial interests that are within the scope of ASC 325-40, including guidance on the accounting for interest income.

6.8 Recognition of interest income on structured notes

ASC 320-10-35-40 through ASC 325-10-35-42 provide guidance on interest recognition for certain structured notes. This guidance applies to instruments that are not accounted for as derivatives and in which the “structured payments” are not bifurcated and separately accounted for as derivatives under the guidance in ASC 815. The guidance also does not apply to instruments classified as trading.

The guidance requires the use of the retrospective interest method.

ASC 320-10-35-40

Entities shall use the retrospective interest method for recognizing income on structured note securities that are classified as available-for-sale or held-to-maturity debt securities and that meet any of the following conditions:

- a. Either the contractual principal amount of the note to be paid at maturity or the original investment amount is at risk (for other than failure of the borrower to pay the contractual amounts due). Examples include principal-indexed notes that base principal repayment on movements in the Standard & Poor's S&P 500 Index or notes that base principal repayment on the occurrence of certain events or circumstances.

- b. The note's return on investment is subject to variability (other than due to credit rating changes of the borrower) because of either of the following:
1. There is no stated coupon rate or the stated coupon is not fixed or prespecified, and the variation in the return on investment or coupon rate is not a constant percentage of, or in the same direction as, changes in market-based interest rates or interest rate index, for example, the London Interbank Offered Rate (LIBOR) or the U.S. Treasury Bill Index.
 2. The variable or fixed coupon rate is below market rates of interest for traditional notes of comparable maturity and a portion of the potential yield (for example, upside potential for principal) is based on the occurrence of future events or circumstances. (Examples of instruments that meet this condition include inverse floating-rate notes, dual-index floating notes, and equity-linked bear notes.)
- c. The contractual maturity of the bond is based on a specific index or on the occurrence of specific events or circumstances outside the control of the parties to the transaction, excluding the passage of time or events that result in normal covenant violations. Examples of instruments that meet this condition include index amortizing notes and notes that base contractual maturity on the price of oil.

ASC 320-10-35-41

Under the retrospective interest method, the income recognized for a reporting period would be measured as the difference between the amortized cost of the security at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period. The amortized cost would be calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimated future cash flow streams to the initial investment. If the effective yield is negative (that is, the sum of the newly estimated undiscounted cash flows is less than the security's amortized cost), the amortized cost would be calculated using a zero percent effective yield. Example 1 (see paragraph 320-10-55-16) illustrates the application of the retrospective interest method.

ASC 320-10-35-42

For purposes of determining the effective yield at which income will be recognized, all estimates of future cash flows shall be based on quoted forward market rates or prices in active markets, when available; otherwise, they shall be based on current spot rates or prices as of the reporting date.

An example of an instrument subject to this guidance is an inflation-linked bond in which the contractual principal is indexed to an inflation rate. See ASC 320-10-55-10 for a description of structured notes that may also be subject to this guidance.

ASC 320-10-55-11 and ASC 320-10-55-12 provide a description of the procedures required to calculate the interest income on a retrospective basis.

ASC 320-10-55-11

Paragraph 320-10-35-40 requires the retrospective interest method to recognize income on certain securities. The amortized cost amount is calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimates of future cash flow streams to the initial investment. If the effective yield is negative, the amortized cost amount should be calculated using a zero percent effective yield. Thus, the following procedures would be required for each reporting period:

- a. Calculate the effective yield that equates all past actual cash flows and current estimates of future cash flows to the initial investment amount.
- b. Using the rate calculated in (a), or zero percent if negative, calculate the present value of the estimated future cash flows. That amount represents the amortized cost at the end of the period.
- c. Adjust the amortized cost balance to the amount calculated in (b) with the offsetting amount recognized as income for the period.

ASC 320-10-55-12

The preadjusted amortized cost balance should represent the amortized cost balance at the beginning of the period less any cash received on the investment during the period.

See ASC 320-10-55-16 through ASC 320-10-55-19 for an illustrative example of the application of this guidance.

6.9 Instruments reported at fair value through earnings

For various reasons, loans, receivables, and investments may be reported at fair value with changes in fair value reported in earnings. This treatment may be required as a result of the accounting guidance for the instrument (e.g., debt securities held for trading purposes) or mandated by industry-specific guidance (e.g., broker-dealers and investment companies). In other cases, instruments may be reported at fair value with changes in fair value reported in current earnings because the reporting entity has elected the fair value option for the instrument.

Some of the interest income guidance specifically scopes out instruments reported at fair value with changes in fair value reported in current earnings and some specifically includes such instruments. As a result, reporting entities that carry instruments at fair value with changes in fair value reported in current earnings should consider whether industry-specific and/or instrument-specific guidance addresses their specific fact pattern.

6.9.1 Considerations relating to the fair value option

For instruments measured under the fair value option (FVO), ASC 825-10 indicates that it does not establish requirements for recognizing and measuring dividend income, interest income, or interest expense but that the reporting entity's policy in these areas should be disclosed. Accordingly, ASC 825-10 allows for discretion in how to report interest income and expense for items under the FVO.

We believe reporting entities may apply one of the following models for reporting interest income related to financial assets accounted for at fair value with changes in fair value recorded in earnings when there is not specific guidance:

- Present the entire change in fair value of the FVO item, including the component related to accrued interest, in a single line item in the income statement.
- Separate the interest income from the full change in fair value of the FVO item and present that amount in interest income. The remainder of the change in fair value should be presented in a separate line item in the income statement.

If existing US GAAP prescribes a method of calculating interest income for identical instruments not carried at fair value, we generally believe the same model should be applied to instruments carried at fair value. The allocation of the change in fair value to interest income/expense should be based on an appropriate and acceptable method under US GAAP. Reporting entities should select a policy for income statement presentation that is appropriate for their individual facts and circumstances, disclose the policy in the notes to financial statements, and follow it consistently.

ASC 825 generally requires immediate recognition of upfront costs and fees related to items that are reported at fair value through current earnings. For example, if the FVO is elected for a loan receivable, the reporting entity should not defer loan origination fees or costs related to that loan. Immediate recognition of income and expense items that would be deferred absent election of the FVO might significantly change both the recognition pattern and the presentation of income or expense in the income statement. For example, loan origination fees and costs associated with originated loans that are not measured using the FVO are capitalized as a net basis adjustment and either amortized to interest income or recognized as part of the gain/loss on the sale of the loan. When an originated loan is measured using the FVO, the costs and fees are recognized in current earnings in the applicable expense or revenue accounts (e.g., salaries, legal fees, fee revenue).

6.10 Non-accrual loans

Although not specifically prescribed in US GAAP for non-PCD assets, the accrual of interest income is generally suspended when the collection of interest is less than probable or the collection of any portion of the loan's principal is doubtful (i.e., a non-performing loan). Note the non-accrual guidance for PCD assets is different than for non-PCD assets.

Although GAAP does not address how a creditor should recognize, measure, or display interest income on an impaired loan (except for purchased financial assets with credit deterioration), ASC 310-10-35-53A allows a creditor to use existing methods of recognizing interest income on impaired loans, including cash basis, modified cost recovery, or some combination of both. When applying these methods, a reporting entity should also consider changes in the allowance for credit losses related to the passage of time.

6.10.1 Cash-basis method

Under the cash-basis method, interest payments received by the creditor are recorded as interest income provided the amount does not exceed the amount that would have been earned at the asset's original effective interest rate. The amount of interest income recognizable in any one period is usually

limited to the lesser of the amount of interest that is actually received or the product of the recorded investment in the asset and the asset's effective interest rate.

6.10.2 *Modified cost recovery method*

Under the modified cost recovery method (often referred to simply as the cost recovery method), any interest or principal received is recorded as a direct reduction of the recorded investment in the loan.

Many financial institutions apply this method when collection of the recorded balance of the financial asset is doubtful. As a result of the application of this method, an investment may be recorded at an amount less than the present value of the projected cash flows on the loan.

6.10.3 *Non-accrual loans: returning to accrual status*

US GAAP does not prescribe when a non-PCD financial asset should be moved from non-accrual to accrual status, or when a cash basis or modified cost recovery method should revert back to the interest method of income recognition. However, banking regulatory agencies have issued guidance relating to accrual and non-accrual designation that many institutions follow.

***Chapter 7:
Current expected credit losses
impairment model—updated
May 2022***

7.1 CECL chapter overview

In response to the financial crisis of 2008, the FASB was tasked with revisiting the accounting model for impairments of financial assets, resulting in the issuance of ASU 2016-13, *Financial Instruments — Credit Losses* (codified in ASC 326). ASU 2016-13 requires the use of the current expected credit losses (CECL) impairment model for a broad scope of financial instruments, including financial assets measured at amortized cost (which includes loans, held-to-maturity debt securities and trade receivables), net investments in leases, and certain off-balance sheet credit exposures. The CECL model requires the immediate recognition of estimated expected credit losses over the life of the financial instrument. The estimate of expected credit losses considers not only historical information, but also current and future economic conditions and events.

The FASB has issued a number of ASUs amending the guidance introduced by ASU 2016-13. In March 2022, the FASB issued ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*, which eliminated the accounting guidance for troubled debt restructurings (TDRs) for creditors that have adopted ASU 2016-13. Guidance in this chapter has been updated to reflect the new ASU. Impacted sections are denoted as before or after adoption of ASU 2022-02.

This chapter discusses the CECL impairment model. Figure LI 7-1 shows where additional information can be found on the application of the CECL model to specific types of assets and troubled debt restructurings. This chapter also assumes an entity has adopted ASU 2022-01, *Derivatives and Hedging (Topic 815), Fair Value Hedging – Portfolio Layer Method*.

Figure LI 7-1

Location of additional information on the CECL impairment model

Topic	Guide chapter
PCD assets	LI 9
Troubled debt restructurings	LI 10A (before adoption of ASU 2022-02)
Beneficial interests subject to ASC 325-40	LI 14

7.2 Instruments subject to the CECL model

The CECL model applies to a broad range of financial instruments, including financial assets measured at amortized cost (which includes loans, held-to-maturity debt securities and trade receivables), net investments in leases, and certain off-balance sheet credit exposures. Given the broad scope of the new guidance, both financial services and non-financial service entities will be affected.

ASC 326-20-15-2 provides information on the scope of the CECL guidance.

ASC 326-20-15-2

The guidance in this Subtopic applies to the following items:

- a. Financial assets measured at amortized cost basis, including the following:

1. Financing receivables
 2. Held-to-maturity debt securities
 3. Receivables that result from revenue transactions within the scope of Topic 605 on revenue recognition, Topic 606 on revenue from contracts with customers, and Topic 610 on other income
 4. Subparagraph superseded by Accounting Standards Update No. 2019-04.
 5. Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860.
- b. Net investments in leases recognized by a lessor in accordance with Topic 842 on leases.
 - c. Off-balance-sheet credit exposures not accounted for as insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815 on derivatives and hedging.
 - d. Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance.

Other financial instruments subject to CECL may not be included within this list. For example, receivables subject to CECL may be generated from sales of retired equipment, sales of scrap metal or by-products from manufacturing processes, or refunds due from vendors. Typically, these receivables are short term in duration and payment is expected to be received in under one year. Other examples include loans to officers or employees, store credit card arrangements, and tax refunds for which the taxing authority has issued a legally enforceable instrument for the settlement.

ASC 326-20-20 provides the definition of a financial asset.

ASC 326-20-20

Financial Asset: Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- a. Receive cash or another financial instrument from a second entity
- b. Exchange other financial instruments on potentially favorable terms with the second entity.

Other guidance may require an asset to be assessed for credit losses under ASC 326. For example, in the revenue standard, ASC 606-10-45-3 requires contract assets to be assessed for credit losses under ASC 326-20.

ASC 606-10-45-3

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

The CECL model does not apply to financial assets carried at fair value with changes in fair value reported in net income. It does not apply to loans held for sale carried at the lower of amortized cost or fair value because changes in credit risk are included in the change in fair value recognized in net income. Available-for-sale (AFS) debt securities, which can be sold prior to their maturity at fair value, are also not subject to the CECL model. See LI 8 for information on the AFS debt security impairment model. Loans and receivables between entities under common control are also outside the scope of the CECL model. This scope exception applies to all reporting entities and includes parent-only financial statements. Loans and receivables between related parties that are not under common control do not fall within this scope exception.

ASC 326-20-15-3 provides a list of items that are outside the scope of the CECL model.

ASC 326-20-15-3

The guidance in this Subtopic does not apply to the following items:

- a. Financial assets measured at fair value through net income
- b. Available-for-sale debt securities
- c. Loans made to participants by defined contribution employee benefit plans
- d. Policy loan receivables of an insurance entity
- e. Promises to give (pledges receivable) of a not-for-profit entity
- f. Loans and receivables between entities under common control.
- g. Receivables arising from operating leases accounted for in accordance with Topic 842.

Question LI 7-1

Should the CECL impairment model only be applied to recognized financial instruments?

PwC response

No. The CECL impairment model should be applied to measure the expected credit losses of certain unrecognized financial instruments, such as certain financial guarantee obligations (guarantee

contracts not accounted for as derivatives or insurance contracts) and certain unfunded loan commitments (commitments for which the lender does not have the unconditional right to cancel the commitment).

See LI 7.5 for further information on the application of CECL to off-balance sheet credit exposures.

Question LI 7-2

Are tax receivables within the scope of the CECL impairment model?

PwC response

Typically, no. Most receivables from tax authorities are not considered financial assets since they arise from an imposition of an obligation by law or regulation and do not represent a contractual right to receive cash. However, if a tax receivable is considered a financial asset, it would be within the scope of ASC 326-20. For example, assume a company has a tax refund due from a state, but the state wants to defer settlement. As a result, the state issues an installment note payable to the entity requiring payments over a period of time. The note receivable would be a financial asset subject to CECL.

Deferred tax assets are not considered financial assets and are not subject to CECL.

Question LI 7-3

If an employer has the right to receive payment on an employee loan, even if that employee's employment is terminated, but is expected to forgive the loan as part of a compensation agreement if the borrower remains employed, is the loan in the scope of the CECL impairment model?

PwC response

It depends. Certain loans to employees are considered in substance options and subject to other accounting standards. For example, a non-recourse loan to an employee secured by stock of the employer is considered an unexercised stock option, as described in ASC 718-10-25-3. However, if the loan to the employee is reported as a loan at amortized cost, it would be within the scope of ASC 326-20.

In estimating credit losses, the employer would include amounts it does not expect to collect due to credit risk (for example, amounts not collected from a terminated employee who defaults on the loan). However, we believe an employer would not include amounts it expects to forgive as part of a compensation arrangement once an employee meets the conditions for forgiveness (e.g., continued employment for a specified time) as an expected credit loss. Forgiveness as a result of employee service or performance should be accounted for under the employee compensation guidance, similar to a bonus arrangement earned over time.

7.3 Principles of the CECL model

Reporting entities should record lifetime expected credit losses for financial instruments within the scope of the CECL model through the allowance for credit losses account. As a result, the financial statements will generally reflect the net amount expected to be collected on the financial instrument. The allowance is measured and recorded upon the initial recognition of the in-scope financial

instrument, regardless of whether it is originated or purchased or acquired in a business combination. Recording an impairment as an adjustment to the basis of the instrument is only permitted in certain circumstances, such as when the asset is written off (see LI 7.3.6.3).

ASC 326-20-30-1 defines the allowance for credit losses.

Excerpt from ASC 326-20-30-1

The allowance for credit losses is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset.

At each reporting period, a reporting entity should update its estimate and adjust the allowance for credit losses accordingly. Increases in the allowance are recorded through net income as credit loss expense. Decreases in the allowance are recorded through net income as a reversal of credit loss expense.

7.3.1 Portfolio layer method

The portfolio layer method introduced by ASU 2022-01 permits reporting entities to designate the portion of a closed portfolio of financial assets, beneficial interests secured by financial assets, or a combination of the two, that is not expected to be prepaid during the hedge period as the hedged item in a fair value hedge of interest rate risk. Although the portfolio layer method (originally referred to as the last-of-layer model) was designed considering prepayable mortgage loans or mortgage-backed securities, it may be applicable to other assets as well. The guidance allows an entity to essentially ignore prepayment risk in the hedge relationship even when prepayable assets are present in the closed portfolio. It does so by permitting designation of the portion of the pool not expected to be prepaid, defaulted, or sold as the hedged item.

Fair value hedge accounting basis adjustments on active portfolio layer method hedges should not be considered when measuring the allowance for credit losses. An active portfolio layer method hedge is an existing hedge relationship designated under the portfolio layer method hedging strategy in ASC 815 (after adoption of ASU 2022-01). However, basis adjustments associated with dedesignated portfolio layer method hedges should be considered when measuring the allowance for credit losses.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as

an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

ASC 815-25-35-11

This Subtopic implicitly affects the measurement of credit losses under Subtopic 326-20 on financial instruments measured at amortized cost by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted amortized cost basis in a hedged loan. Paragraph 326-20-55-9 requires that, when the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. That paragraph states that the adjustment under fair value hedge accounting for changes in fair value attributable to the hedged risk under this Subtopic shall be considered to be an adjustment of the loan's amortized cost basis. As discussed in that paragraph, the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Because paragraph 815-25-35-10 requires that the loan's amortized cost basis be adjusted for hedge accounting before the requirements of Subtopic 326-20 are applied, this Subtopic implicitly supports using the new effective rate and the adjusted amortized cost basis. A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not adjust the amortized cost basis of the individual assets or individual beneficial interest included in the closed portfolio. An entity may not apply this guidance by analogy to other components of amortized cost basis.

ASC 815-25-35-12

This guidance applies to all entities applying Subtopic 326-20 to financial assets that are hedged items in a fair value hedge, regardless of whether those entities have delayed amortizing to earnings the adjustments of the loan's amortized cost basis arising from fair value hedge accounting until the hedging relationship is dedesignated. The guidance on recalculating the effective rate is not intended to be applied to all other circumstances that result in an adjustment of a loan's amortized cost basis and is not intended to be applied to the individual assets or individual beneficial interest in an existing portfolio layer method hedge closed portfolio.

7.3.2 CECL application to amortized cost basis of financial assets

ASC 326-20-30-5 requires a reporting entity to determine the allowance for credit losses for an instrument based on the amortized cost of the financial asset, including accrued interest, discounts, deferred origination fees or costs, foreign exchange adjustments, and fair value hedge accounting adjustments (except for fair value hedge accounting adjustments from active portfolio layer method hedges as noted in ASC 815-25-35-10).

ASC 326-20-20 defines the amortized cost basis.

ASC 326-20-20

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

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

Question LI 7-4

An entity may have a receivable subject to CECL that has had losses allocated to it as a result of applying the equity method of accounting to a separate equity investment in the borrower. Is the estimate of expected credit losses calculated before or after allocating equity method losses?

PwC response

The allowance for credit losses is estimated after allocating the equity method losses under ASC 323. Equity method losses are allocated first because the losses adjust the investment's amortized cost basis. ASC 326-20-30-4 and ASC 326-20-30-5 require the allowance for credit losses to reflect the expected credit losses related to a financial asset's amortized cost basis.

7.3.3 Unit of account for applying the CECL model

ASC 326-20-30-2 requires a reporting entity to measure expected credit losses on a collective (pool) basis when similar risk characteristics exist. If a financial instrument does not share similar risk characteristics with other assets subject to CECL, expected credit losses may be measured on an individual asset basis.

ASC 326-20-30-2

An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

If a financial asset is assessed on an individual basis for expected credit losses, it should not be included in a pool of assets, as doing so would result in double counting the allowance for credit losses related to that asset.

The unit of account for purposes of determining the allowance for credit losses under the CECL impairment model may be different from the unit of account applied for other purposes, such as when calculating interest income. See LI 6 for more details on calculating interest income.

7.3.3.1 **Similar risk characteristic for CECL pooling requirement**

ASC 326-20-55-5 provides a list of risk characteristics that can be used to pool assets. An entity is permitted to consider one risk characteristic or a combination of risk characteristics when evaluating its pooling. When determining risk characteristics to include in its pooling assessment, reporting entities should consider which attributes are used for credit risk management and credit loss modelling.

ASC 326-20-55-5

In evaluating financial assets on a collective (pool) basis, an entity should aggregate financial assets on the basis of similar risk characteristics, which may include any one or a combination of the following (the following list is not intended to be all inclusive):

- a. Internal or external (third-party) credit score or credit ratings
- b. Risk ratings or classification
- c. Financial asset type
- d. Collateral type
- e. Size
- f. Effective interest rate
- g. Term
- h. Geographical location
- i. Industry of the borrower
- j. Vintage
- k. Historical or expected credit loss patterns
- l. Reasonable and supportable forecast periods.

Figure LI 7-2 provides examples of common risk characteristics that may be used in an entity's pooling assessment.

Figure LI 7-2
Examples of risk characteristics

Risk characteristic	Description
Collateral type	Collateral type can be based on asset class, such as financial assets collateralized by commercial real estate, residential real estate, inventory, or cash. It can also be more detailed, such as subdividing commercial real estate into multifamily apartment buildings, warehouses, or condominiums.
Credit rating/scores	External or internal credit rating/scores. External are those issued by credit ratings agencies, such as Moody's or S&P. Internally developed risk ratings are more typically used in commercial lending and for debt securities. Other credit indicators, such as credit default or bond spreads, may also be utilized. For certain assets, the counterparty's FICO score may be used as a risk characteristic.
Asset to value ratio	The ratio of the outstanding financial asset balance to the fair value of any underlying collateral
Duration	The duration of the financial assets
Industry	The primary industry in which the borrower or issuer operates
Geographical location	Location of the borrower or issuer
Origination vintage	Year of origination of an asset. For purchased assets, vintage would be the issuance or origination date. Vintage may indicate specific risk characteristics based on the underwriting standards that were in effect at the time the financial asset was originated.
Payment structure	Payment structure can be differentiated between interest only, principal amortization, amortizing with a balloon payment, paid in kind, and capitalized interest. Different payment structures may have different credit risks depending on the nature of the asset.

7.3.3.2 *Reassessing pools when applying the CECL model*

For purposes of applying the CECL model, financial instruments are initially pooled, as applicable, at origination or acquisition. The pools established are not static and should be reassessed each reporting period. When an instrument no longer shares similar risk characteristics to other instruments in the pool, it should be removed from the pool and put into another pool of instruments with similar risk characteristics. If there are no pools with similar risk characteristics to that of the financial instrument, an entity should individually evaluate the instrument for impairment.

Question LI 7-5

Investor Corp invests in debt securities classified as HTM. Investor Corp's portfolio has similar maturity dates and has several bonds issued by companies in similar industries. Is Investor Corp required to pool its HTM debt securities for purposes of measuring its allowance for credit losses?

PwC response

It depends. Financial instruments subject to the CECL impairment model must be pooled with other financial instruments if they share similar risk characteristics. Given that the securities have similar maturity dates and may have similar industry exposure, Investor Corp should consider whether they should be grouped in one or more pools for measuring the allowance for credit losses. Investor Corp would also need to consider other relevant risk factors (e.g., credit ratings) when determining whether these securities should be pooled at a more granular level.

7.3.4 *CECL measurement methodology – after adoption of ASU 2022-02*

ASC 326-20-30-3 does not require reporting entities to use a specific method to calculate the allowance for credit losses, instead, various methods can be used, including discounted cash flow (DCF), loss-rate, roll-rate, and probability-of-default/loss given default, among others.

ASC 326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

The selection of a model to estimate the allowance for credit losses will depend on the reporting entity's facts and circumstances, including the complexity and significance of the financial instruments being evaluated, as well as other relevant considerations.

Although ASC 326-20 does not require the use of a DCF, we believe there are certain circumstances when a DCF would be the appropriate method for determining the allowance for credit losses. For example, we believe a DCF would be the appropriate method when an entity has elected to keep its purchased credit impaired (PCI) pools together when transitioning from the ASC 310-30 accounting guidance to the purchased credit deteriorated (PCD) accounting guidance under CECL. See LI 13 for further information.

For loans with borrowers experiencing financial difficulty that are modified, there is no requirement to use a DCF approach to estimate credit losses. Entities are not permitted to include certain concessions related to the present value impact of extending the timing of cash flows and reductions of future interest payments as a credit loss. See LI 7.3.4.2 for addition information on calculating credit losses using a DCF approach. An entity should generally apply the same credit loss methodology for modified loans as it uses for similar loans that were not modified.

7.3.4A ***CECL measurement methodology – before adoption of ASU 2022-02***

ASC 326-20-30-3 does not require reporting entities to use a specific method to calculate the allowance for credit losses; instead, various methods can be used, including discounted cash flow (DCF), loss-rate, roll-rate, probability-of-default/loss given default, among others.

ASC 326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

The selection of a model to estimate the allowance for credit losses will depend on the reporting entity's facts and circumstances, including the complexity and significance of the financial instruments being evaluated, as well as other relevant considerations.

Although ASC 326-20 does not require the use of a DCF, we believe there are certain circumstances when a DCF would be the appropriate method for determining the allowance for credit losses. These circumstances include, but are not limited to:

- When the impacts of certain types of concessions can only be measured through a DCF method, such as interest rate concessions related to TDRs and reasonably expected TDRs. See LI 10A.3.1.2 for further information.
- When an entity has elected to keep its purchased credit impaired (PCI) pools together when transitioning from the ASC 310-30 accounting guidance to the PCD accounting guidance under CECL. See LI 13 for further information.

7.3.4.1 ***Measuring CECL allowance using a method other than a DCF***

ASC 326-20 does not require a reporting entity to use a DCF method to calculate its allowance for credit losses. ASC 326-20-30-5 states that a reporting entity that does not use a DCF method should use a method that appropriately reflects the estimate of expected credit losses relative to an asset's amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges as noted in ASC 815-25-35-10) as of the reporting date.

ASC 326-20-30-5

If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on

a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following:

- a. Amortized cost basis, excluding applicable accrued interest, premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance).
- b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge.
- c. Applicable accrued interest. See paragraph 326-20-30-5A for guidance on excluding accrued interest from the calculation of the allowance for credit losses.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

See LI 7.3.4.3 for information on developing an estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring certain components of the amortized cost basis.

Question LI 7-6

When using a method other than a DCF method, such as a probability-of-default method, can an entity discount selected inputs or expected cash flows or discount cash flows to a date other than the reporting date?

PwC response

No. This topic was discussed during the November 1, 2018 TRG meeting (TRG Memo 14: Cover Memo and TRG Memo 18: Summary of Issues Discussed and Next Steps).

The FASB staff noted that the effect of discounting would have to be measured as of the reporting date, not another date, such as the default date. At its November 7, 2018 meeting, the FASB agreed that ASC 326-20 prohibits discounting inputs to a date other than the reporting date. Note that loss given default data used for other purposes may use different conventions (including discounting recoveries

back to the default date) and therefore may need to be adjusted to be used in an estimation of credit losses under ASC 326-20.

Using discounting in an estimate of credit losses will generally require discounting all estimated cash flows (principal and interest) in accordance with ASC 326-20-30-4 (see LI 7.3.4.2 (after adoption of ASU 2022-02) or LI 7.3.4.2A (before adoption of ASU 2022-02)). We do not believe it would be appropriate to estimate expected credit losses by discounting amounts of principal not expected to be collected to the reporting date.

In some situations, an estimate of the fair value of collateral (which may be an important consideration in determining estimated credit losses) will require the expected future cash flows of the collateral to be discounted. We believe this is appropriate and would not be the same as discounting only certain inputs.

Question LI 7-7

Is multiplying an annual historical loss rate by the remaining contractual term of a financial asset and applying this to the amortized cost basis of an asset (or pool of assets) an acceptable method to estimate allowances for credit losses under CECL?

PwC response

Solely using an annual historical loss rate to estimate an allowance for credit losses may not be appropriate under CECL. The use of an annual historical loss rate may not appropriately reflect management's expectation of current economic conditions or its forecasts of economic conditions. Instead, historical loss data should be used as one of many factors to estimate a CECL allowance.

Question LI 7-8

Is the WARM method an acceptable method to estimate allowances for credit losses under CECL?

PwC response

The WARM method is one of many methods that may be used to estimate the allowance for credit losses for less complex pools of financial assets under ASC 326-20. This method is discussed in a FASB staff Q&A document available on the FASB's website.

The WARM method simplifies the quantitative calculation of estimated expected credit losses by using an average annual charge-off rate that is determined using historical loss information. In order to calculate estimated expected credit losses at the balance sheet date, the WARM method requires an entity to multiply the annual charge-off rate by the estimated amortized cost basis of a pool of financial assets over the pool's remaining contractual term, adjusted for prepayments.

Generally, the WARM method's quantitative calculation will not, by itself, be sufficient. Qualitative adjustments will generally be necessary in order to compensate for the method's simplifying assumptions. For example, the average charge-off rate may not appropriately reflect management's expectation of current economic conditions or its forecasts of economic conditions. In addition, there may be other challenges, such as a lack of historical loss data, losses with no predictive patterns, current pools that significantly differ from historical pools, a low number of loans in a pool, or changes

in the economic environment. The FASB staff's Q&A acknowledges that a qualitative adjustment may be needed to reflect these considerations.

Additional considerations may be required when using the WARM method. For products with loss profiles that suggest losses do not occur in the same pattern for each year of an asset's life, adjustments to consider seasonality and other such factors may be required. Additional adjustments may be required if historic loss information is gathered from an "open" pool (and in the case of the FASB staff's Q&A, a growing pool) of loans because a credit loss estimate should only consider existing assets as they "run-off." There may be other factors or considerations that should be considered depending on the nature and type of the assets.

For entities that are considering using the WARM method, the complexity of estimating and supporting the method's qualitative adjustments may outweigh the benefits of using the simplified quantitative approach.

7.3.4.2 Using a DCF method to estimate expected credit losses – after adoption of ASU 2022-02

ASC 326-20 does not require a reporting entity to use a DCF method to calculate its allowance for credit losses. ASC 326-20-30-4 requires entities electing to use a DCF method to (1) calculate the present value of the financial asset's expected cash flows using its effective interest rate and (2) calculate the allowance for credit losses as the difference between the asset's amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges) and the present value of expected cash flows.

ASC 326-20-30-4

If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's **effective interest rate**. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If a financial asset is modified and is considered to be a continuation of the original asset, an entity shall use the post-modification contractual interest rate to derive the effective interest rate when using a discounted cash flow method. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge. If the financial asset's contractual interest rate varies based on subsequent 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, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

A reporting entity's method of estimating the expected cash flows used in forecasting credit losses should be consistent with the FASB's intent that such cash flows represent the cash flows that an entity expects to collect after a careful assessment of available information. See LI 7.3.6 for further information on developing a forecast of expected credit losses.

The effective interest rate for discounting when using a DCF in the CECL model

Financial instruments accounted for under the CECL model are permitted to use a DCF method to calculate the allowance for credit losses. ASC 326-20-30-4 states that when using a DCF method, an entity should discount expected cash flows at the financial asset's effective interest rate. The effective interest rate is defined in ASC 326-20-20.

ASC 326-20-20

Effective interest rate: The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

When an effective interest rate is used to discount expected cash flows on fixed or floating rate instruments, the discount rate will generally not include expectations of prepayments (unless an entity is applying the guidance in ASC 310-20-35-26 (see LI 6.5.1.3)). Prepayments are, however, required by ASC 326-20-30-6 to be considered in expected cash flows used to estimate credit losses on these instruments. As a result ASC 326-20-30-4A provides entities with an accounting policy election to adjust the effective interest rate used to discount expected cash flows for the consideration of timing (and changes in timing) of expected prepayments of financial instruments within the scope of ASC 326-20.

ASC 326-20-30-4A

As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments.

Entities need to calculate future cash flows, including future interest (or coupon) payments, in order to determine the effective interest rate. To estimate future interest payments on variable rate instruments, a company can elect to use either projections of future interest rate environments or use the current rate. ASC 326-20-30-4 further requires variable rate instruments to use the same interest rate projections used to forecast expected cash flows for the purposes of determining the effective interest rate used in discounting to calculate the allowance for credit losses. If an entity using a DCF model elects to project future interest rate environments to estimate credit losses for variable rate instruments, it is required to adjust the effective interest rate used in discounting cash flows to consider the timing (and changes in timing) of expected cash flows resulting from prepayments. The elections within ASC 326-20-30-4 and ASC 326-20-30-4A are applicable only to adjusting the effective interest rate for the purposes of estimating credit losses. Interest income is required to be recognized using an effective interest rate in accordance with other GAAP (for example ASC 310-20 for loans, which was not amended by these provisions of ASC 326-20).

When a reporting entity uses a DCF model to estimate expected credit losses on loans with borrowers experiencing financial difficulty that have been restructured:

- the estimated cash flows should be based on the post-modification contractual terms, and
- the discount rate shall be based on the post-modification effective interest rate.

An entity is prohibited from using the pre-modification effective interest rate as a discount rate as this would be applying a TDR measurement principle that was superseded by ASU 2022-02.

7.3.4.2A *Using a DCF method to estimate expected credit losses – before adoption of ASU 2022-02*

ASC 326-20 does not require a reporting entity to use a DCF method to calculate its allowance for credit losses. ASC 326-20-30-4 requires entities electing to use a DCF method to (1) calculate the present value of the financial asset's expected cash flows at its effective interest rate and (2) calculate the allowance for credit losses as the difference between the asset's amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges) and the present value of expected cash flows.

ASC 326-20-30-4

If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge. If the financial asset's contractual interest rate varies based on subsequent 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, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

A reporting entity's method of estimating the expected cash flows used in forecasting credit losses should be consistent with the FASB's intent that such cash flows represent the cash flows that an entity expects to collect after a careful assessment of available information. See LI 7.3.6A for further information on developing a forecast of expected credit losses.

The effective interest rate for discounting when using a DCF in the CECL model

Financial instruments accounted for under the CECL model are permitted to use a DCF method to calculate the allowance for credit losses. ASC 326-20-30-4 states that, when using a DCF method, an entity should discount expected cash flows at the financial asset's effective interest rate. The effective interest rate is defined in ASC 326-20-20.

ASC 326-20-20

Effective interest rate: The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

When an unadjusted effective interest rate is used to discount expected cash flows on fixed or floating rate instruments, the discount rate will generally not include expectations of prepayments (unless an entity is applying the guidance in ASC 310-20-35-26 (see LI 6.5.1.3)). However, in estimating credit losses, an entity is required by ASC 326-20-30-6 to consider the impact of prepayments in its expected cash flows on these instruments. As a result, ASC 326-20-30-4A provides entities with an accounting policy election to adjust the effective interest rate used to discount expected cash flows for the consideration of timing (and changes in timing) of expected prepayments of financial instruments within the scope of ASC 326-20.

ASC 326-20-30-4A

As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments. However, if the asset is restructured in a troubled debt restructuring, the effective interest rate used to discount expected cash flows shall not be adjusted because of subsequent changes in expected timing of cash flows.

Entities need to calculate future cash flows, including future interest (or coupon) payments, in order to determine the effective interest rate. To estimate future interest payments on variable rate instruments, a company can elect to use either projections of future interest rate environments or use the current rate. ASC 326-20-30-4 further requires variable rate instruments to use the same interest rate projections used to forecast expected cash flows for the purposes of determining the effective interest rate used in discounting to calculate the allowance for credit losses. If an entity using a DCF model elects to project future interest rate environments when using a DCF to estimate credit losses for variable rate instruments, it is required to adjust the effective interest rate used in discounting cash flows to consider the timing (and changes in timing) of expected cash flows resulting from prepayments. The elections within ASC 326-20-30-4 and ASC 326-20-30-4A are only applicable to adjusting the effective interest rate for the purposes of estimating credit losses. Interest income is required to be recognized using an effective interest rate in accordance with other GAAP (for example ASC 310-20 for loans, which was not amended by these provisions of ASC 326-20).

7.3.4.3 Amortized cost basis and measurement in a CECL model

When a reporting entity measures the allowance for credit losses using a DCF approach, the allowance will reflect the difference between the amortized cost (except for fair value hedge accounting adjustments from active portfolio layer method hedges) of the financial asset and the present value of the expected cash flows of the financial asset. Under this methodology, the discount rate used to discount estimated cash flows for the purposes of calculating an allowance for credit losses will be based on the effective interest rate of the instrument. As a result, this methodology explicitly considers elements that impact the amortized cost basis of the asset.

When a reporting entity uses a measurement technique other than a DCF approach, the allowance should reflect the reporting entity's expected credit losses of the amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges). Therefore, non-DCF methods should incorporate the impact of accrued interest, premiums, and discounts into the estimate of expected credit losses. ASC 326-20-30-5 allows an entity to measure the estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring certain components of the amortized cost basis as follows:

- Amortized cost basis, excluding applicable accrued interest, premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance)
- Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments (except for fair value hedge accounting adjustments from active portfolio layer method hedges)
- Applicable accrued interest. ASC 326-20-30-5A provides guidance on when it would be appropriate to exclude accrued interest from the calculation of the allowance for credit losses

Note that for any entities that have adopted ASU 2022-01, utilizing a portfolio layer method hedge, fair value hedge accounting adjustments on active portfolio layer method hedges should not be considered when measuring the allowance for credit losses. Refer to DH 6.5.

Question LI 7-9

Should an entity record an allowance for credit losses on unearned future interest coupons/payments when using a method other than a DCF method to estimate expected credit losses?

PwC response

No. An entity should not consider future interest coupons/payments (not associated with unamortized discounts/premiums) that have not yet been accrued if using a method other than a DCF to estimate expected credit losses. This issue was discussed at the June 11, 2018 meeting of the TRG (TRG Memo 8: Capitalized Interest and TRG Memo 13: Summary of Issues Discussed and Next Steps).

Certain instruments permit or require interest payments to be deferred (capitalized) and paid at a later date. In some cases, this deferred interest may effectively become part of the loan's par or principal amount. Accrued interest coupons/payments (whether capitalized or paid on a recurring basis) only become legally due after the passage of time.

For a financial asset issued at par with expected future interest coupons/payments still to accrue (and potentially capitalized), the amount due upon default is the par amount and accrued interest to date. The borrower is not obligated to repay the lender unearned interest coupons/payments or any amount greater than the outstanding principal plus any accrued interest to date. This is different from a discount, when the lender is legally entitled to par or principal upon a borrower's default. An entity should therefore not consider future expected interest coupons/payments not associated with unamortized discounts/premiums (e.g., estimated future capitalized interest) when estimating expected credit losses.

Estimating credit losses when there are premiums and discounts

When an entity assesses a financial asset for expected credit losses through a method other than a DCF method, it should consider whether any unamortized premium or discount (except for fair value hedge accounting adjustments from active portfolio layer method hedges) would also be affected by an expectation of future defaults. However, the FASB agreed as part of the June 11, 2018 TRG meeting that an entity does not need to consider the timing of credit losses when determining the impact of

premiums and discounts on the measurement of the allowance for credit losses (see TRG Memo 8: Capitalized Interest and TRG Memo 13: Summary of Issues Discussed and Next Steps).

Although ASC 326-20-30-5 requires the estimate to be based on a financial asset's amortized cost (except for fair value hedge accounting adjustments from active portfolio layer method hedges), it also states that when an entity expects to accrete a discount into interest income, the discount cannot be used to offset the entity's expectation of credit losses (i.e., a discount on a financial instrument subject to CECL cannot be used to avoid recognizing an allowance).

Question LI 7-10

If an HTM debt security is purchased at a discount, should the discount offset the measurement of credit losses at acquisition date?

PwC response

No. Despite the fact that the security was acquired at fair value (which includes consideration of credit risk), the CECL impairment model requires day one recognition of expected credit losses. The discount should not offset the initial estimate of expected credit losses.

Accrued interest in a non-DCF model used to measure credit losses

When an entity assesses a financial asset for expected credit losses through a method other than a DCF approach, it should consider whether any accrued interest could be affected by an expectation of future defaults.

For financial assets within the scope of ASC 326-20, the literature provides the following additional guidance:

- A reporting entity can elect to develop expected credit losses on its accrued interest receivable balances separate from other components of the amortized cost basis.
- A reporting entity can make an accounting policy election to not measure an allowance for credit losses on accrued interest if an entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be made at the class of financing receivable or the major security-type level and should be disclosed, including the time period the entity considers timely. This guidance should not be applied by analogy to other components of the amortized cost basis.

ASC 326-20 does not define what is considered a "timely manner." This could differ between entities, portfolios, and industry practices. We believe that writing off accrued interest amounts once such amounts are greater than 90 days past due may be consistent with current practice for some assets in certain industries following guidance issued by the US banking regulatory agencies. Entities should apply judgment and consider the specific facts and circumstances of their portfolio when determining what time period is considered timely.

- A reporting entity can make an accounting policy election to write off accrued interest by reversing interest income or recognize the write off as a credit loss expense (or a combination of both). This accounting policy election should be made at the class of financing receivable or the major

security-type level. This election cannot be applied by analogy to other components of the amortized cost basis. This accounting policy is required to be disclosed and any reversal of interest income should be disclosed by portfolio segment or major security type.

This guidance is discussed in ASC 326-20-30-5 (see LI 7.3.4.1), ASC 326-20-30-5A, and ASC 326-20-35-8A.

ASC 326-20-30-5

If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following:

- a. Amortized cost basis, excluding applicable accrued interest, premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance).
- b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge.
- c. Applicable accrued interest. See paragraph 326-20-30-5A for guidance on excluding accrued interest from the calculation of the allowance for credit losses.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

ASC 326-20-30-5A

An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an allowance for credit losses for accrued interest receivables if the

entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-35-8A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

ASC 326-20-35-8A

An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, to write off accrued interest receivables by reversing interest income or recognizing credit loss expense or a combination of both. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-30-5A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

See LI 12 for information regarding the presentation and disclosure requirements related to these elections.

Question LI 7-11

Is a reporting entity permitted to record an initial allowance for credit losses (or subsequent adjustments) as a reduction of interest income, and not as a credit loss expense, if the reporting entity has made the election in ASC 326-20-35-8A to writeoff accrued interest receivable as a reduction of interest income?

PwC response

No. When establishing an allowance for credit losses (or recording subsequent adjustments not associated with writeoffs), the allowance for credit losses should be recorded as a credit loss expense (or a reversal of credit loss expense) pursuant to ASC 326-20-35-1. As such, any allowance recorded against accrued interest receivable should be reported as a credit loss expense (or reversal of credit loss expense).

ASC 326-20-35-8A allows for an accounting policy choice when writing off accrued interest receivable, but it is only applicable to writeoffs. If a reporting entity has made an accounting policy election to record writeoffs as a reduction of interest income and has established an allowance for credit losses related to the accrued interest receivable, we believe there are two acceptable views on how the writeoff may be recorded:

- Writeoff the allowance for credit losses (related to the accrued interest) against the accrued interest receivable. This may result in a balance sheet only impact if the amount written off was equal to the allowance. If the accrued interest receivable balance exceeds the allowance established, the writeoff of that excess would be recorded as a reduction of interest income.
- Reverse the allowance for credit losses (related to the accrued interest) as a recovery of a credit loss expense and writeoff the accrued interest receivable balance by reducing interest income. This view would result in a “gross” impact to the income statement (decreasing credit loss expense and decreasing interest income).

A reporting entity should elect an accounting policy at the appropriate class of financing receivable or the major security type, disclose it, and apply it consistently.

7.3.5 **CECL – determining the life of a financial instrument – after adoption of ASU 2022-02**

ASC 326-20-30-6 provides guidance on determining the life to be used for financial instruments for purposes of estimating credit losses.

ASC 326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless the following applies:

- a. Subparagraph superseded by Accounting Standards Update No. 2022-02.
- b. The extension or renewal options (excluding those that are accounted for as derivatives in accordance with Topic 815) are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

Under ASC 326-20, a reporting entity estimates expected credit losses over the life of the financial instrument at each reporting period. The life over which an entity should estimate expected credit losses should consider prepayments, but not expected extensions, renewals, or modifications unless the extension or renewal options (excluding those that are separately accounted for as derivatives in accordance with ASC 815) are explicitly stated in the contract and are not unconditionally under the control of the lender. Contractual extensions or renewals that are not unconditionally within the lender's control should be considered regardless of whether or not they are contingent on conditions outside the borrower's control.

In order to eliminate differences between modifications of receivables made to borrowers experiencing financial difficulty and those who are not, ASU 2022-02 removed the guidance in ASC 326-20-30-6 that requires entities to consider reasonably expected renewals, modifications, and extensions associated with reasonably expected TDRs. We understand that the removal of this guidance is not designed to require entities to ignore their expected credit loss management strategy in estimating credit losses and record an estimate of credit loss they do not expect to occur. The basis for conclusions of ASU 2022-02 notes that historical loss data does not need to be adjusted for the impact of expected renewals, modifications, or extensions undertaken as part of restructuring loans with borrowers experiencing financial difficulty.

See LI 7.6.2 for information regarding determining the life of a net investment in a lease for the purposes of applying ASC 326. See LI 7.5 for information on the life of off-balance sheet credit exposures, including lines of credit.

Question LI 7-12

How should an entity estimate the life of a credit card receivable for the purposes of estimating expected credit losses?

PwC response

The June 12, 2017 TRG meeting included a discussion of how to estimate the life of a credit card receivable. The TRG discussed how future credit card activity (i.e., future draws on the unused line of credit) should be considered when determining how future payments are applied to the outstanding balance (see TRG Memo 5: Estimated life of a credit card receivable, TRG Memo 5a: Estimated life of a credit card receivable, TRG Memo 6: Summary of Issues Discussed and Next Steps, and TRG Memo 6b: Estimated life of a credit card receivable). The TRG considered two views: (1) apply estimated future payments to the current outstanding balance (or components of the balance) first (a FIFO approach), or (2) forecast future draws and apply estimated future payments based on how the Credit Card Accountability Responsibility and Disclosure Act of 2009 would require estimated future payments to be applied based upon estimated future balances (and components of such balances). Both of these views would be applied to the current outstanding balance if the undrawn line of credit associated with the credit card agreements is unconditionally cancellable by the creditor.

At the same meeting, questions were raised regarding how future payments on a credit card receivable should be estimated. TRG members noted that future payments could either (1) be estimated at an “account level” (i.e., all payments expected to be received from an individual borrower), which may include payments related to future draws, or (2) estimate only the portion of future payments relating to the outstanding balance as of the measurement date.

At its October 4, 2017 meeting, the FASB decided that any combination of these methodologies for applying and determining future payments is acceptable. The FASB noted that the CECL model provides for flexibility in the type of methodology used to estimate expected credit losses. As a result, various methodologies can be used to estimate the life of a credit card receivable, which is influenced by the determination of how payments are applied. The Board noted that the chosen methodologies should be applied consistently over time and represent a faithful estimate of expected credit losses for financial assets.

We believe the guidance provided by the FASB on credit cards may be useful in other situations, such as in determining the life of account receivables from customers who are buying goods or services on a recurring basis.

7.3.5A *CECL – determining the life of a financial instrument – before adoption of ASU 2022-02*

ASC 326-20-30-6 provides guidance on determining the life to be used for financial instruments for purposes of estimating credit losses.

ASC 326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless either of the following applies:

- a. The entity has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

- b. The extension or renewal options (excluding those that are accounted for as derivatives in accordance with Topic 815) are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

Under ASC 326-20 a reporting entity estimates expected credit losses over the life of the financial instrument at each reporting period. The life over which an entity should estimate expected credit losses should consider prepayments, but not expected extensions, renewals, or modifications unless (1) the entity has a reasonable expectation that it will execute a troubled debt restructuring (TDR) or (2) the extension or renewal options (excluding those that are separately accounted for as derivatives in accordance with ASC 815) are explicitly stated in the contract and are not unconditionally under the control of the lender. Contractual extensions or renewals that are not unconditionally within the lender's control should be considered regardless of whether or not they are contingent on conditions outside the borrower's control. See LI 10A for further information on TDRs and reasonably expected TDRs.

See LI 7.6.2 for information regarding determining the life of a net investment in a lease for the purposes of applying ASC 326. See LI 7.5 for information on the life of off-balance sheet credit exposures, including lines of credit.

Question LI 7-12A

How should an entity estimate the life of a credit card receivable for the purposes of estimating expected credit losses?

PwC response

The June 12, 2017 TRG meeting included a discussion of how to estimate the life of a credit card receivable. The TRG discussed how future credit card activity (i.e., future draws on the unused line of credit) should be considered when determining how future payments are applied to the outstanding balance (see TRG Memo 5: Estimated life of a credit card receivable, TRG Memo 5a: Estimated life of a credit card receivable, TRG Memo 6: Summary of Issues Discussed and Next Steps, and TRG Memo 6b: Estimated life of a credit card receivable). The TRG considered two views: (1) apply estimated future payments to the current outstanding balance (or components of the balance) first (a FIFO approach), or (2) forecast future draws and apply estimated future payments based on how the Credit Card Accountability Responsibility and Disclosure Act of 2009 would require estimated future payments to be applied based upon estimated future balances (and components of such balances). Both of these views would be applied to the current outstanding balance if the undrawn line of credit associated with the credit card agreements is unconditionally cancellable by the creditor.

At the same meeting, questions were raised regarding how future payments on a credit card receivable should be estimated. TRG members noted that future payments could either (1) be estimated at an "account level" (i.e., all payments expected to be received from an individual borrower), which may include payments related to future draws, or (2) estimate only the portion of future payments relating to the outstanding balance as of the measurement date.

At its October 4, 2017 meeting, the FASB decided that any combination of these methodologies for applying and determining future payments is acceptable. The FASB noted that the CECL model provides for flexibility in the type of methodology used to estimate expected credit losses. As a result, various methodologies can be used to estimate the life of a credit card receivable, which is influenced

by the determination of how payments are applied. The Board noted that the chosen methodologies should be applied consistently over time and represent a faithful estimate of expected credit losses for financial assets.

We believe the guidance provided by the FASB on credit cards may be useful in other situations, such as in determining the life of account receivables from customers who are buying goods or services on a frequent and recurring basis.

7.3.5.1 CECL - forecasts past the life of financial assets – after adoption of ASU 2022-02

When developing an allowance for credit losses over the life of the financial instrument, reasonable and supportable information beyond the contractual term should be considered to the extent that it is relevant. See LI 7.3.6.1 for information on estimating credit losses and the consideration of reasonable and supportable information. The issue of considering reasonable and supportable information beyond the contractual term was discussed at the November 1, 2018 TRG meeting (see TRG Memo 15: Contractual term and TRG Memo 18: Summary of Issues Discussed and Next Steps).

Assume, for example, a bank originates a one-year loan to finance a commercial real estate development project anticipated to be completed in three years. The project's developed assets are the primary source of collateral and expected source of repayment for the loan. In this situation, the borrower will most likely need to refinance the loan with the originating bank or obtain financing from another lender upon the maturity of the one-year loan. Another lender would likely consider future economic forecasts in deciding whether to refinance the loan.

ASC 326-20-30-6 indicates that when estimating credit losses, an entity should not consider modifications, renewals, or extensions unless the renewal and extension options are explicitly stated in the contract and not within the control of the lender. Based on this guidance, we believe that unless the entity has explicit contractual renewals or extensions not within the control of the lender, the reporting entity should model the borrower's ability to obtain refinancing from another lender who does not have an outstanding loan to the borrower. The ability of the borrower to refinance this loan will likely be based on a lender's forecast of economic conditions over the life of the project. Based on the guidance in ASC 326-20-30-7, we believe the lender should incorporate this information into the expected credit losses model, as the ability to refinance directly impacts the collectibility of cash flows of the one-year loan.

If an entity has explicit contractual renewal or extension options not within the control of the lender, the estimate of expected credit losses should consider the impact of the extension or renewal.

Question LI 7-13

How should an entity estimate the life of a demand loan for the purposes of estimating credit losses?

PwC response

Demand loans are loans that generally require repayment upon request of the lender. Since repayment can be required at any time, the life of the loan is considered to be the amount of time the borrower has to repay the loan once the lender demands repayment. For example, if a borrower has 30 days to repay a loan when requested by the lender, the life of the loan would be considered 30 days for the purposes of estimating expected credit losses.

As a result, when an entity is determining its CECL allowance on demand loans, it should consider the borrower's ability to repay the loan if payment was demanded on the current date. Some factors an entity should consider when determining the allowance include historical data, current economic conditions, and future economic conditions. Additionally, an entity may need to consider information beyond the life of the loan in order to determine the allowance for credit losses. An entity can accomplish this through modelling the borrower's ability to obtain refinancing from another lender who does not have an outstanding loan to the borrower. The ability of the borrower to refinance this loan will likely be based on a lender's forecast of economic conditions beyond the life of the loan, as defined in ASC 326-20.

7.3.5.1A CECL - forecasts past the life of financial assets – before adoption of ASU 2022-02

When developing an allowance for credit losses over the life of the financial instrument, reasonable and supportable information beyond the contractual term should be considered to the extent that it is relevant. See LI 7.3.6.1A for information on estimating credit losses and the consideration of reasonable and supportable information. The issue of considering reasonable and supportable information beyond the contractual term was discussed at the November 1, 2018 TRG meeting (see TRG Memo 15: Contractual term and TRG Memo 18: Summary of Issues Discussed and Next Steps).

Assume, for example, a bank originates a one-year loan to finance a commercial real estate development project anticipated to be completed in three years. The project's developed assets are the primary source of collateral and expected source of repayment for the loan. In this situation, the borrower will most likely need to refinance the loan with the originating bank or obtain financing from another lender upon the maturity of the one-year loan. Another lender would likely consider future economic forecasts in deciding whether to refinance the loan.

ASC 326-20-30-6 indicates that in estimating credit losses, an entity should not consider modifications, renewals, or extensions unless, at an individual loan level, it has a reasonable expectation of a TDR or the renewal and extension options are explicitly stated in the contract and not within the control of the lender. Based on this guidance, we believe that unless the entity has a reasonable expectation of a TDR or explicit contractual renewals or extensions not within the control of the lender, the reporting entity should model the borrower's ability to obtain refinancing from another lender who does not have an outstanding loan to the borrower. The ability of the borrower to refinance this loan will likely be based on a lender's forecast of economic conditions over the life of the project. Based on the guidance in ASC 326-20-30-7, we believe the lender should incorporate this information into the expected credit losses model, as the ability to refinance directly impacts the collectibility of cash flows of the one-year loan.

If an entity has a reasonable expectation that it will execute a TDR with the borrower or explicit contractual renewal or extension options not within the control of the lender, the estimate of expected credit losses should consider the impact of the TDR (including any expected concessions and extension of term), extension, or renewal.

See LI 10A.3.1.2 for information on reasonably expected TDRs.

Question LI 7-13A

How should an entity estimate the life of a demand loan for the purposes of estimating credit losses?

PwC response

Demand loans are loans that generally require repayment upon request of the lender. Since repayment can be required at any time, the life of the loan is considered to be the amount of time the borrower has to repay the loan once the lender demands repayment. For example, if a borrower has 30 days to repay a loan when requested by the lender, the life of the loan would be considered 30 days for the purposes of estimating expected credit losses.

As a result, when an entity is determining its CECL allowance on demand loans, it should consider the borrower's ability to repay the loan if payment was demanded on the current date. Some factors an entity should consider when determining the allowance include historical data, current economic conditions, and future economic conditions. Additionally, an entity may need to consider information beyond the life of the loan in order to determine the allowance for credit losses. An entity can accomplish this through modelling the borrower's ability to obtain refinancing from another lender who does not have an outstanding loan to the borrower. The ability of the borrower to refinance this loan will likely be based on a lender's forecast of economic conditions beyond the life of the loan, as defined in ASC 326-20.

In the event the lender has a reasonable expectation that they will execute a TDR with the borrower, the impact of the TDR (including its impact to the term of the loan) should be considered. See LI 10A for further information on TDRs and reasonably expected TDRs.

7.3.5.2 *CECL - impact of prepayments and call features – after adoption of ASU 2022-02*

In estimating credit losses, ASC 326-20 requires consideration of prepayments. When estimating prepayments, a reporting entity should consider all relevant data. There are many factors that may impact anticipated borrower prepayment behavior. All else being equal, if interest rates decline, borrowers/issuers of instruments will have an incentive to refinance their loans, potentially resulting in prepayment activity that will accelerate amounts expected to be received. For certain asset classes, borrower behavior may also be relevant. For example, a residential mortgage loan or residential mortgage-backed held-to-maturity (HTM) debt security may have an expected life different than its contractual maturity because the assets may be expected to be paid off prior to their contractual maturity due to borrowers having the option to prepay their loans. Borrowers may prepay loans because they are moving to a new home as opposed to taking advantage of lower interest rates. Rising interest rates or deteriorating economic conditions may result in fewer prepayments.

Question LI 7-14

Investor Corp invests in callable corporate bonds that it appropriately classifies as HTM. The contractual maturity of the bonds ranges between 7 and 10 years and are callable in 3 to 4 years. Should Investor Corp consider the call features when determining an allowance for credit losses on its corporate bond portfolio?

PwC response

Yes. For purposes of determining the allowance for credit losses under the CECL impairment model, Investor Corp should consider the call features when evaluating the expected credit losses of its corporate bonds.

Question LI 7-15

Should the loan modification guidance in ASC 310-20 be used to determine whether an “internal refinancing” represents a prepayment under CECL?

PwC response

It is common for certain types of loans to be refinanced with lenders before their maturity, whether through a contractual modification or through the origination of a new loan, the proceeds of which are used to repay the existing loan. These are sometimes referred to as “internal refinancings.” To the extent these events are considered prepayments, they must be considered in the estimate of expected credit losses under CECL, as they would shorten the expected life of the instrument. The “internal refinancing” would not extend the life of the instrument beyond its contractual maturity.

This issue was discussed at the June 11, 2018 TRG meeting (TRG Memo 12: Refinancing and loan prepayments and TRG Memo 13: Summary of Issues Discussed and Next Steps). The credit losses standard does not provide specific guidance on what constitutes a prepayment. The FASB clarified that an entity is not required to use the loan modification guidance in ASC 310-20-35-9 through ASC 310-20-35-12 to determine if a refinancing with the same lender constitutes a prepayment for the purposes of estimating expected credit losses, but an entity is not precluded from using this guidance if it provides an appropriate basis for determining prepayments given its specific facts and circumstances.

We believe entities should apply a reasonable, rational, and consistent methodology to determine if internal refinancings would be considered prepayments for the purposes of determining expected credit losses.

See LI 7.3.5.3 for further information on the impact of refinancings and restructurings on the life of a financial asset for the purposes of determining the allowance for credit losses.

7.3.5A.2 CECL - impact of prepayments and call features – before adoption of ASU 2022-02

In estimating credit losses, ASC 326-20 requires consideration of prepayments. When estimating prepayments, a reporting entity should consider all relevant data. There are many factors that may impact anticipated borrower prepayment behavior. All else being equal, if interest rates decline, borrowers/issuers of instruments will have an incentive to refinance their loans, potentially resulting in prepayment activity that will accelerate amounts expected to be received. For certain asset classes, borrower behavior may also be relevant. For example, a residential mortgage loan or residential mortgage-backed HTM debt security may have an expected life different than its contractual maturity because the assets may be expected to be paid off prior to their contractual maturity due to borrowers having the option to prepay their loans. Borrowers may prepay loans because they are moving to a new home as opposed to taking advantage of lower interest rates. Rising interest rates or deteriorating economic conditions may result in fewer prepayments.

Question LI 7-14A

Investor Corp invests in callable corporate bonds that it appropriately classifies as HTM. The contractual maturity of the bonds ranges between 7 and 10 years and are callable in 3 to 4 years. Should Investor Corp consider the call features when determining an allowance for credit losses on its corporate bond portfolio?

PwC response

Yes. For purposes of determining the allowance for credit losses under the CECL impairment model, Investor Corp should consider the call features when evaluating the expected credit losses of its corporate bonds.

Question LI 7-15A

Should the loan modification guidance in ASC 310-20 be used to determine whether an “internal refinancing” represents a prepayment under CECL?

PwC response

It is common for certain types of loans to be refinanced with lenders before their maturity, whether through a contractual modification or through the origination of a new loan, the proceeds of which are used to repay the existing loan. These are sometimes referred to as “internal refinancings.” To the extent these events are considered prepayments, they must be considered in the estimate of expected credit losses under CECL, as they would shorten the expected life of the instrument. Unless the “internal refinancing” would be considered a TDR, it would not extend the life of the instrument beyond its contractual maturity.

This issue was discussed at the June 11, 2018 TRG meeting (TRG Memo 12: Refinancing and loan prepayments and TRG Memo 13: Summary of Issues Discussed and Next Steps). The credit losses standard does not provide specific guidance on what constitutes a prepayment. The FASB clarified that an entity is not required to use the loan modification guidance in ASC 310-20-35-9 through ASC 310-20-35-12 to determine if a refinancing with the same lender constitutes a prepayment for the purposes of estimating expected credit losses, but an entity is not precluded from using this guidance if it provides an appropriate basis for determining prepayments given its specific facts and circumstances.

We believe entities should apply a reasonable, rational, and consistent methodology to determine if internal refinancings would be considered prepayments for the purposes of determining expected credit losses.

See LI 7.3.5.3A for further information on the impact of refinancings and restructurings on the life of a financial asset for the purposes of determining the allowance for credit losses.

7.3.5.3 *CECL - impact of refinancing and restructurings – after adoption of ASU 2022-02*

Lenders and debtors may mutually agree to modify their arrangements as a part of their respective business strategies. These modifications may be done in conjunction with declining interest rates in a competitive lending environment, or to extend the maturity of a debt arrangement based on a favorable profile of the debtor. For example, a borrower may approach a lender and request a

reduction in the interest rate of a loan (or an extension of the maturity) in lieu of prepaying the loan and refinancing with another lending institution. Borrowers and lenders also may agree to renew maturing lending agreements based on the continuation of a positive credit relationship. In other instances, modifications, extensions, and refinancings are agreed to by the borrower and the lender as a result of the borrower's financial difficulty in an attempt by the creditor to maximize its recovery.

When determining the expected life and contractual amount for purposes of calculating expected credit losses, a reporting entity should not consider expectations of modifications of instruments unless the loan has been restructured. The reporting entity should only consider renewals or extensions if these renewals or extensions are explicitly stated in the original or modified contract and are not unconditionally cancellable by the lender.

Example LI 7-1 illustrates the application of the CECL impairment model to a modification with a borrower that is not experiencing financial difficulty. Although this example illustrates the application of the guidance to a bank lending relationship, these concepts apply to all restructured financial instruments within the scope of the CECL impairment model.

EXAMPLE LI 7-1

Impact of a refinancing on the life of the asset for purposes of estimating credit losses

Bank Corp originates an interest-only loan to Borrower Corp with the following terms.

Principal amount	\$1,000,000
Coupon rate	4.5% paid annually
Payment terms	Interest-only loan; principal repaid at maturity
Term	3 years
Collateral	Real estate

Borrower Corp holds several depository accounts with Bank Corp and utilizes several non-lending service offerings of Bank Corp.

Borrower Corp has made voluntary principal payments and has never been late on an interest payment. Close to the maturity date of the loan, Borrower Corp requests an extension of the original maturity date and an advance of additional funds. Borrower Corp is not in financial difficulty. No extension or renewal options are explicitly stated within the original contract outside of those that are unconditionally cancellable by (within the control of) Bank Corp.

Should Bank Corp consider the potential restructuring in its estimation of expected credit losses?

Analysis

No. Since there are no extension or renewal options explicitly stated within the original contract outside of those that are unconditionally cancellable by/within the control of Bank Corp, Bank Corp should base its estimate of expected credit losses on the term of the current loan. However, Bank Corp

may consider additional information obtained during its diligence of Borrower Corp before approving the modification (e.g., changes in real estate value, Borrower Corp credit risk) in its credit loss estimate. Such information may be relevant to consider for the specific loan as well as a data point for estimates of credit losses on similar assets.

After the modification is complete, Bank Corp's estimate of expected credit losses would be based on the terms of the modified loan.

7.3.5A.3 CECL - impact of refinancing and restructurings – before adoption of ASU 2022-02

Lenders and debtors may mutually agree to modify their arrangements as a part of their respective business strategies. These modifications may be done in conjunction with declining interest rates in a competitive lending environment, or to extend the maturity of a debt arrangement based on a favorable profile of the debtor. For example, a borrower may approach a lender and request a reduction in the interest rate of a loan (or an extension of the maturity) in lieu of prepaying the loan and refinancing with another lending institution. Borrowers and lenders also may agree to renew maturing lending agreements based on the continuation of a positive credit relationship.

In other instances, modifications, extensions, and refinancings are agreed to by the borrower and the lender as a result of the borrower's financial difficulty in an attempt by the creditor to maximize its recovery. These restructurings may be accounted for and disclosed as troubled debt restructurings.

When determining the expected life and contractual amount for purposes of calculating expected credit losses, a reporting entity should not consider expectations of modifications of instruments unless there is a reasonable expectation that a loan will be restructured through a TDR or if the loan has been restructured. See LI 10A for further information on TDRs and reasonably expected TDRs. The reporting entity should only consider other renewals or extensions if these renewals or extensions are explicitly stated in the original or modified contract and are not unconditionally cancellable by the lender.

Example LI 7-1A illustrates the application of the CECL impairment model to a modification that is not a troubled debt restructuring. Example LI 7-2A illustrates the application of the CECL impairment model to a modification that is a troubled debt restructuring. Although these examples illustrate the application of the guidance to a bank lending relationship, these concepts apply to all restructured financial instruments within the scope of the CECL impairment model.

EXAMPLE LI 7-1A

Impact of a refinancing on the life of the asset for purposes of estimating credit losses

Bank Corp originates an interest-only loan to Borrower Corp with the following terms.

Principal amount	\$1,000,000
Coupon rate	4.5% paid annually
Payment terms	Interest-only loan; principal repaid at maturity
Term	3 years
Collateral	Real estate

Borrower Corp holds several depository accounts with Bank Corp and utilizes several non-lending service offerings of Bank Corp.

Borrower Corp has made voluntary principal payments and has never been late on an interest payment. Close to the maturity date of the loan, Borrower Corp requests an extension of the original maturity date and an advance of additional funds. Borrower Corp is not in financial difficulty. No extension or renewal options are explicitly stated within the original contract outside of those that are unconditionally cancellable by (within the control of) Bank Corp.

Should Bank Corp consider the potential restructuring in its estimation of expected credit losses?

Analysis

No. Since the potential modification is not a troubled debt restructuring and there are no extension or renewal options explicitly stated within the original contract outside of those that are unconditionally cancellable by/within the control of Bank Corp, Bank Corp should base its estimate of expected credit losses on the term of the current loan. However, Bank Corp may consider additional information obtained during its diligence of Borrower Corp before approving the modification (e.g., changes in real estate value, Borrower Corp credit risk) in its credit loss estimate. Such information may be relevant to consider for the specific loan as well as a data point for estimates of credit losses on similar assets.

After the modification is complete, Bank Corp's estimate of expected credit losses would be based on the terms of the modified loan.

EXAMPLE LI 7-2A

Impact of a troubled debt restructuring on the life of the asset for purposes of estimating credit losses

Bank Corp originates a loan to Borrower Corp with the following terms.

Principal amount	\$1,000,000
Coupon rate	4% paid annually
Term	1 year

The current loan originated from a renewal of a previous loan. Bank Corp has an ongoing relationship with Borrower Corp and has renewed its loan to Borrower Corp in each of the preceding three years. None of the previous renewals were considered a troubled debt restructuring.

During the current year, Borrower Corp has had a significant decline in revenue. Although Borrower Corp is currently in compliance with the contractual terms and payment requirements of its loan, Bank Corp forecasts that Borrower Corp may not be able to repay the loan at maturity and concludes that Borrower Corp is experiencing financial difficulties. Bank Corp is in the process of negotiating a loan modification with Borrower Corp that would convert the loan into a five-year amortizing loan with a fixed interest rate of 3.5%, which would be below current market rates.

Should Bank Corp consider the potential restructuring in its estimation of expected credit losses?

Analysis

Yes. Since Borrower Corp is experiencing financial difficulties and the terms of the modification are indicative of a concession, the anticipated modification is reasonably expected to be a troubled debt restructuring. As a result, the life of the loan utilized for modelling expected credit losses should include the terms of the modified loan. See LI 10A for information regarding the impact on the allowance estimate as a result of a reasonably expected TDR.

7.3.6 Estimating lifetime expected credit losses – after adoption of ASU 2022-02

ASC 326-20 requires an entity to estimate lifetime expected credit losses (after consideration of prepayments and certain contractually provided extension options). In doing so, an entity is not required to develop economic forecasts over the asset's life if such estimates are not reasonable and supportable, but instead, may use a combination of economic forecasts and reversion to historical loss information in arriving at its estimate. The estimate should consider all relevant data that is reasonably available to an entity at the balance sheet date without undue cost and effort.

An entity will need to support the reasonableness of the expected credit losses estimate in its entirety. The length of the forecast period will be a judgment that should “work together” with all other judgments that contribute to the credit losses estimate (e.g., forecasting methodologies, reversion methodology, historical data used to “revert to”). Each component of an estimate for credit losses must be evaluated in contemplation of each other and in the context of the estimate as a whole. The overall estimate of lifetime expected credit losses is a significant judgment and needs to be reasonable.

ASC 326-20-30-7 through ASC 326-20-30-10 provides information on estimating lifetime expected credit losses.

ASC 326-20-30-7

When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue

cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

ASC 326-20-30-8

Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

ASC 326-20-30-9

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

ASC 326-20-30-10

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

7.3.6A Estimating lifetime expected credit losses – before adoption of ASU 2022-02

ASC 326-20 requires an entity to estimate lifetime expected credit losses (after consideration of prepayments, certain contractually provided extension options, and reasonably expected TDRs). In doing so, an entity is not required to develop economic forecasts over the asset's life if such estimates are not reasonable and supportable, but instead, may use a combination of economic forecasts and reversion to historical loss information in arriving at its estimate. The estimate should consider all relevant data that is reasonably available to an entity at the balance sheet date without undue cost and effort.

An entity will need to support the reasonableness of the expected credit losses estimate in its entirety. The length of the forecast period will be a judgment that should “work together” with all other judgments that contribute to the credit losses estimate (e.g., forecasting methodologies, reversion methodology, historical data used to “revert to”). Each component of an estimate for credit losses must be evaluated in contemplation of each other and in the context of the estimate as a whole. The overall estimate of lifetime expected credit losses is a significant judgment and needs to be reasonable.

ASC 326-20-30-7 through ASC 326-20-30-10 provides information on estimating lifetime expected credit losses.

ASC 326-20-30-7

When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

ASC 326-20-30-8

Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

ASC 326-20-30-9

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the

group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

ASC 326-20-30-10

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

7.3.6.1 *CECL - determining reasonable and supportable forecast - after adoption of ASU 2022-02*

ASC 326-20-30-9 requires an entity that uses historical data to adjust this data for current conditions and reasonable and supportable forecasts to estimate expected credit losses over the life of an instrument. The term "reasonable and supportable forecasts" is not defined in ASC 326-20. As a result, reporting entities will need to develop their own perspectives and policies when interpreting this term. For the purposes of this section, the term "reasonable and supportable forecast" considers both the current conditions and reasonable and supportable forecasts discussed in ASC 326-20-30-9.

ASC 326-20 also does not include prescriptive guidance on the length of the reasonable and supportable forecast period or how this should be developed, and it does not require an entity to develop a specific statistical confidence level to support the forecast period. An entity is, however, required to support its selection of the forecast period (as well as its expected credit losses estimate in its entirety). While not required, an entity may consider the accuracy of historical forecasts to support its decision regarding the establishment of the reasonable and supportable forecast period. The determination of what is reasonable and supportable should be based on the reporting entity's facts and circumstances, including the availability of and access to information.

The selection of a reasonable and supportable period is not an accounting policy decision, but is one component of an accounting estimate. The length of the period is judgmental and should be based in part on the availability of data on which to base a forecast of economic conditions and credit losses. The process should be applied consistently and in a systematic manner. Changes in factors such as

macroeconomic conditions could cause the reasonable and supportable period to change. The factors considered and judgments applied should be documented.

An entity should consider the appropriateness of the reasonable and supportable forecast period, as well as all other judgments applied in its credit loss estimate at each reporting date. An entity will also need to consider changes in the supporting information that could indicate a change in the reasonable and supportable forecast period. For example, a change in the source of the supporting information or period covered by the supporting information could result in an entity changing the length of the reasonable and supportable forecast period.

An entity's process for determining the reasonable and supportable period should also be applied consistently, in a systematic manner, and be documented consistent with the guidance in SEC Staff Accounting Bulletin No. 119 (SAB 119). SAB 119 amends Topic 6 of the Staff Accounting Bulletin Series, to add Section M, *Financial Reporting Release No. 28 - Accounting for Loan Losses by Registrants Engaged in Lending Activities Subject to FASB ASC Topic 326*. An entity is expected to support its determination of a reasonable and supportable forecast period and document the factors considered and judgments applied. An entity should develop processes and related controls to support its ongoing evaluation of the reasonable and supportable period.

For the period beyond which management is able to develop a reasonable and supportable forecast, ASC 326-20 states that an entity should revert to unadjusted historical loss information either at an individual input level or at the overall estimate level. See LI 7.3.6.2 for further information on reverting to historical information.

Question LI 7-16

When developing an entity's reasonable and supportable forecast of expected credit losses, is probability weighting of multiple economic scenarios required?

PwC response

No. The CECL model does not require an entity to probability weight multiple economic scenarios to develop its reasonable and supportable forecast of expected credit losses, but it is not precluded by ASC 326-20. CECL provides flexibility in the method used by an entity to estimate expected credit losses.

While an entity could meet the objectives of CECL by using a single economic scenario, some entities may determine it appropriate to probability weight multiple scenarios in order to capture elements such as nonlinearity of credit risk. Management should apply judgment to determine the appropriate estimation method to be applied based on the entity's and the portfolio's facts and circumstances, and be able to support both its reasonable and supportable forecast and its credit losses estimate as a whole.

Question LI 7-17

Can an entity assert that no reasonable and supportable forecast can be made and rely solely on historical data?

PwC response

No. CECL requires an entity to use historical data adjusted for current conditions and reasonable and supportable forecasts to estimate expected credit losses over the life of an instrument. Only for the period beyond which an entity is able to develop a reasonable and supportable forecast can an entity revert to unadjusted historical loss information. While some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, it is not acceptable for an entity to assert it cannot develop a forecast and use only historical loss information.

Question LI 7-18

Can an entity have different reasonable and supportable forecast periods for different portfolios?

PwC response

Yes. The length of the reasonable and supportable forecast period is a judgment based on an entity's ability to forecast economic conditions and expected losses. The reasonable and supportable forecast period may differ between products if, for example, the factors that drive estimated credit losses, the availability of forecasted information, or the period of time covered by that information are different.

In evaluating the information selected to develop its forecast for portfolios, an entity should consider the period of time covered by the information available. An entity should ensure the information used, including the economic assumptions, are relevant to the portfolio being assessed. For example, the US unemployment rate may not be relevant to a portfolio of loans based in Europe, or the home price index may be a key assumption for only some assets. Since different economic forecasts may be relevant for different assets, there may be circumstances when the length of the forecast period that is reasonable and supportable may differ among entities or among asset portfolios within an entity.

An entity should consider whether the assumptions underlying its economic forecasts for its various asset portfolios are consistent with one another when appropriate, and reflect a common view of future economic conditions, especially when different sources are used for different assumptions.

Use of historical data to estimate credit losses

A reporting entity may begin the process of measuring expected credit losses by analyzing its historical loss experience for financial assets with risk characteristics similar to the assets being measured. However, as discussed in ASC 326-20-30-8, this information must be adjusted, as necessary, to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated and due to differences in the composition of the current portfolio.

ASC 326-20-30-7 requires a reporting entity to evaluate both internally generated data and reasonably accessible external data for purposes of estimating credit losses. However, it also states a reporting entity may determine that using its internally generated data is sufficient.

Sometimes, a reporting entity may lack historical credit loss experience. For example, a startup institution would have no historical operations from which to develop loss patterns; similarly, an institution may not have relevant loss experience when entering into a new line of business or lending product. When a reporting entity does not have relevant internal historical data, it may look to

external data. For example, it may consider rating agency reports to develop its loss expectations related to certain debt instruments, or it can obtain external information for losses on loan and financing lease receivables from call report information filed by regulated banks with regulatory bodies. However, as noted in ASC 326-20-30-7, a reporting entity is not required to search all possible information that is not reasonably available without undue cost and effort.

When estimating expected credit losses, a reporting entity should evaluate how historical data differs from current and future economic conditions. In evaluating conditions that may merit an adjustment to the historical data used to measure expected credit losses, a reporting entity should consider the risk factors relevant to the assets being measured. These may include data that is borrower specific, specific to a group of pooled assets, at a macro-economic level, or some combination of these. Examples of factors that may be considered, include:

- Unemployment rates
- Sources of income available to debt issuers
- Collateral valuations
- Underwriting policies and procedures of a reporting entity, such as underwriting standards and exception tolerance, “out of area” lending policies and collection and recovery practices
- Payment status or payment structure
- Regulatory and legal environment
- Local and macro-economic and business conditions
- Conditions of market segments in conjunction with the analysis of financial asset concentrations

ASC 326-20-55-4 provides further examples of factors that may be considered.

Excerpt from ASC 326-20-55-4

To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility. Examples of factors an entity may consider include any of the following, depending on the nature of the asset (not all of these may be relevant to every situation, and other factors not on the list may be relevant):

- a. The borrower’s financial condition, credit rating, credit score, asset quality, or business prospects
- b. The borrower’s ability to make scheduled interest or principal payments
- c. The remaining payment terms of the financial asset(s)
- d. The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)
- e. The nature and volume of the entity’s financial asset(s)

- f. The volume and severity of past due financial asset(s) and the volume and severity of adversely classified or rated financial asset(s)
- g. The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been utilized
- h. The entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, writeoff, and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- i. The quality of the entity's credit review system
- j. The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- k. The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as:
 - 1. Regulatory, legal, or technological environment to which the entity has exposure
 - 2. Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
 - 3. Changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments.

Determining the relevant factors and the amount of adjustments required will require judgment. To the extent an entity's quantitative models and historical data do not reflect current conditions or an entity's reasonable and supportable forecasts, such factors should be included through qualitative adjustments such that the estimate in total is reasonable. Over time, the impact of the changes identified may begin to be reflected in the loss history of the portfolio, which may impact the amount of adjustment required. Refer to LI 7.3.6.5 for further information on qualitative factors.

ASU 2022-02 removed the guidance in ASC 326-20-30-6 that requires entities to consider reasonably expected renewals, modifications, and extensions associated with reasonably expected TDRs. The basis for conclusions of ASU 2022-02 notes that entities are not required to remove from or adjust historical loss data for the impact of expected renewals, modifications, or extensions undertaken as part of restructuring loans with borrowers experiencing financial difficulty. If an entity expects that its future loss mitigation efforts will be different than those in the past, it should consider making appropriate adjustments to its loss estimates. For example, if an entity discontinued certain loan modification programs offered to troubled borrowers in the past, this would need to be considered.

Amortized cost basis and historical data

Reporting entities are expected to apply judgment to determine the appropriate historical data set to use when calculating the allowance for credit losses under the CECL model. Reporting entities may need to analyze historical data to determine whether it should be adjusted to be consistent with the notion of calculating the allowance for credit losses based on an amortized cost amount (except for fair value hedge accounting adjustments from active portfolio layer method hedges). For example, if a reporting entity's historical loss rates are based on amortized cost amounts that have been charged off,

such historical data would have included any unamortized premiums and discounts that existed at the time of writeoff. Alternatively, a reporting entity's historical loss rates may be based on losses of principal amounts, and therefore did not include any unamortized premiums or discounts that may have existed. Refer to LI 7.3.4.3 for further information on the interaction of CECL with the amortized cost basis of financial instruments.

Consideration of collateral and credit enhancements

A reporting entity should consider sources of repayment associated with a financial asset when determining its credit losses forecast under the CECL impairment model, including collection against the collateral and certain embedded credit enhancements, such as guarantees or insurance.

Collateral

Although collateralization mitigates the risk of credit losses, the existence of collateral does not remove the requirement to record current expected credit losses, even when the current fair value of the collateral exceeds the amortized cost of the financial asset (unless the instrument qualifies for one of the practical expedients discussed in LI 7.4). This is because the collateral value may decline in the future, exposing the lender to losses in the event of default by the borrower. In addition, the collateral may be illiquid, such as real estate, automobiles, business inventory, equipment, and other assets. In addition, ASC 326-20-30-10 highlights the fact that the existence of collateral, on its own, does not eliminate the need for an allowance for credit losses.

In considering collateral value, a reporting entity should consider factors such as perfection of the lien, lien positioning, and potential changes in the value of the collateral.

In addition, if a financial asset is collateralized, and the reporting entity determines that foreclosure of the collateral is probable, the entity must measure expected credit losses based on the difference between the fair value of the collateral and the amortized cost basis of the asset. Refer to LI 7.3.6.6 for further information.

Credit enhancements

A reporting entity may obtain credit enhancements, such as guarantees or insurance, contemporaneous with or separate from acquiring or originating a financial asset or off-balance sheet credit exposure. As discussed in ASC 326-20-30-12, only credit enhancements embedded in an asset at origination or purchase can be considered when determining expected credit losses.

ASC 326-20-30-12

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

For an arrangement to be considered in an expected credit loss estimate, it must “travel with” the underlying instrument in the event of sale. Separate, freestanding contracts (such as credit default swaps or insurance) should not be combined with the underlying financial asset or portfolio for purposes of measuring expected credit losses. The Codification Master Glossary provides information on the definition of a freestanding financial instrument.

Definition from ASC Master Glossary

Freestanding Financial Instrument: A financial instrument that meets either of the following conditions:

- a. It is entered into separately and apart from any of the entity’s other financial instruments or equity transactions.
- b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Example LI 7-3 illustrates the consideration of mortgage insurance in the estimate of credit losses.

EXAMPLE LI 7-3

Consideration of mortgage insurance in the estimate of credit losses

Finance Co originates mortgage loans to individuals in the northeastern US. After originating the loans, Finance Co separately enters into a mortgage insurance contract. The mortgage insurance is specific to Finance Co and is not assignable. In the event a mortgage loan subject to the insurance coverage is sold, the insurance coverage on that loan terminates.

Should Finance Co consider the mortgage insurance when it estimates its expected credit losses on the insured loans?

Analysis

No. Since the mortgage insurance has been acquired through a transaction separate from the origination of the loan, and does not transfer with the underlying loan agreement, it should not be considered when determining expected credit losses.

Other considerations when developing the forecast of credit losses

Actual economic conditions may turn out differently than those included in an entity’s forecast as there may be unforeseen events (e.g., fiscal or monetary policy actions). The further out in the forecasted period, the more likely it is that circumstances may be different than what was forecasted. As a result, the accuracy of the forecasted economic conditions may not be an effective indicator of the quality of an entity’s forecasting process, including their judgment in selecting the length of the reasonable and supportable forecast period. However, significantly missing near-term forecasts may be an indicator of a deficient forecasting process.

Assumptions for key economic conditions within an entity are expected to be consistent across relevant estimates. Therefore, an entity should consider the assumptions of future economic

conditions used in other forecasted estimates within an entity if they are relevant to the credit loss estimate (e.g., projections used in determining fair value, assessing goodwill impairment, or used in business planning and budgeting). An entity should be able to explain any differences between the assumptions and provide appropriate supporting documentation.

A reporting entity should consider quantitative and qualitative data that relates to both the environment in which the reporting entity and borrower operate as well as data specific to the borrower. Reporting entities should not ignore available information that is relevant to the estimated collectibility of amounts related to the financial asset. Further, the CECL model requires an entity to estimate and recognize an allowance for credit losses for a financial instrument, even when the expected risk of credit loss is remote.

Question LI 7-19

Is an entity required to perform “backtesting” of historical reasonable and supportable forecast periods?

PwC response

No. While the CECL standard does not require it, backtesting of elements of the credit losses estimate may be useful.

There is an important distinction between backtesting a forecast of future economic conditions and backtesting elements of the estimate of expected credit losses. An entity’s comparison of its expected credit loss estimate against actual experienced losses may not be of great value due to the estimation uncertainty involved in the estimate. However, we believe there are various components of the entity’s expected credit losses estimation process that may lend themselves to an evaluation utilizing backtesting, such as to assess a model’s responsiveness to changing economic forecasts or its correlation between economic conditions and credit losses.

7.3.6.1A CECL - determining reasonable and supportable forecast - before adoption of ASU 2022-02

ASC 326-20-30-9 requires an entity that uses historical data to adjust this data for current conditions and reasonable and supportable forecasts to estimate expected credit losses over the life of an instrument. The term “reasonable and supportable forecasts” is not defined in ASC 326-20. As a result, reporting entities will need to develop their own perspectives and policies when interpreting this term. For the purposes of this section, the term “reasonable and supportable forecast” considers both the current conditions and reasonable and supportable forecasts discussed in ASC 326-20-30-9.

ASC 326-20 also does not include prescriptive guidance on the length of the reasonable and supportable forecast period or how this should be developed, and it does not require an entity to develop a specific statistical confidence level to support the forecast period. An entity is, however, required to support its selection of the forecast period (as well as its expected credit losses estimate in its entirety). While not required, an entity may consider the accuracy of historical forecasts to support its decision regarding the establishment of the reasonable and supportable forecast period. The determination of what is reasonable and supportable should be based on the reporting entity’s facts and circumstances, including the availability of and access to information.

The selection of a reasonable and supportable period is not an accounting policy decision, but is one component of an accounting estimate. The length of the period is judgmental and should be based in part on the availability of data on which to base a forecast of economic conditions and credit losses. The process should be applied consistently and in a systematic manner. Changes in factors such as macroeconomic conditions could cause the reasonable and supportable period to change. The factors considered and judgments applied should be documented.

An entity should consider the appropriateness of the reasonable and supportable forecast period, as well as all other judgments applied in its credit loss estimate at each reporting date. An entity will also need to consider changes in the supporting information that could indicate a change in the reasonable and supportable forecast period. For example, a change in the source of the supporting information or period covered by the supporting information could result in an entity changing the length of the reasonable and supportable forecast period.

An entity's process for determining the reasonable and supportable period should also be applied consistently, in a systematic manner, and be documented consistent with the guidance in SEC Staff Accounting Bulletin No. 119 (SAB 119). SAB 119 amends Topic 6 of the Staff Accounting Bulletin Series, to add Section M, *Financial Reporting Release No. 28 - Accounting for Loan Losses by Registrants Engaged in Lending Activities Subject to FASB ASC Topic 326*. An entity is expected to support its determination of a reasonable and supportable forecast period and document the factors considered and judgments applied. An entity should develop processes and related controls to support its ongoing evaluation of the reasonable and supportable period.

For the period beyond which management is able to develop a reasonable and supportable forecast, ASC 326-20 states that an entity should revert to unadjusted historical loss information either at an individual input level or at the overall estimate level. See LI 7.3.6.2 for further information on reverting to historical information.

Question LI 7-16A

When developing an entity's reasonable and supportable forecast of expected credit losses, is probability weighting of multiple economic scenarios required?

PwC response

No. The CECL model does not require an entity to probability weight multiple economic scenarios to develop its reasonable and supportable forecast of expected credit losses, but it is not precluded by ASC 326-20. CECL provides flexibility in the method used by an entity to estimate expected credit losses.

While an entity could meet the objectives of CECL by using a single economic scenario, some entities may determine it appropriate to probability weight multiple scenarios in order to capture elements such as nonlinearity of credit risk. Management should apply judgment to determine the appropriate estimation method to be applied based on the entity's and the portfolio's facts and circumstances, and be able to support both its reasonable and supportable forecast and its credit losses estimate as a whole.

Question LI 7-17A

Can an entity assert that no reasonable and supportable forecast can be made and rely solely on historical data?

PwC response

No. CECL requires an entity to use historical data adjusted for current conditions and reasonable and supportable forecasts to estimate expected credit losses over the life of an instrument. Only for the period beyond which an entity is able to develop a reasonable and supportable forecast can an entity revert to unadjusted historical loss information. While some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, it is not acceptable for an entity to assert it cannot develop a forecast and use only historical loss information.

Question LI 7-18A

Can an entity have different reasonable and supportable forecast periods for different portfolios?

PwC response

Yes. The length of the reasonable and supportable forecast period is a judgment based on an entity's ability to forecast economic conditions and expected losses. The reasonable and supportable forecast period may differ between products if, for example, the factors that drive estimated credit losses, the availability of forecasted information, or the period of time covered by that information are different.

In evaluating the information selected to develop its forecast for portfolios, an entity should consider the period of time covered by the information available. An entity should ensure the information used, including the economic assumptions, are relevant to the portfolio being assessed. For example, the US unemployment rate may not be relevant to a portfolio of loans based in Europe, or the home price index may be a key assumption for only some assets. Since different economic forecasts may be relevant for different assets, there may be circumstances when the length of the forecast period that is reasonable and supportable may differ among entities or among asset portfolios within an entity.

An entity should consider whether the assumptions underlying its economic forecasts for its various asset portfolios are consistent with one another when appropriate, and reflect a common view of future economic conditions, especially when different sources are used for different assumptions.

Use of historical data to estimate credit losses

A reporting entity may begin the process of measuring expected credit losses by analyzing its historical loss experience for financial assets with risk characteristics similar to the assets being measured. However, as discussed in ASC 326-20-30-8, this information must be adjusted, as necessary, to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated and due to differences in the composition of the current portfolio.

ASC 326-20-30-7 requires a reporting entity to evaluate both internally generated data and reasonably accessible external data for purposes of estimating credit losses. However, it also states a reporting entity may determine that using its internally generated data is sufficient.

Sometimes, a reporting entity may lack historical credit loss experience. For example, a startup institution would have no historical operations from which to develop loss patterns; similarly, an institution may not have relevant loss experience when entering into a new line of business or lending product. When a reporting entity does not have relevant internal historical data, it may look to external data. For example, it may consider rating agency reports to develop its loss expectations related to certain debt instruments, or it can obtain external information for losses on loan and financing lease receivables from call report information filed by regulated banks with regulatory bodies. However, as noted in ASC 326-20-30-7, a reporting entity is not required to search all possible information that is not reasonably available without undue cost and effort.

When estimating expected credit losses, a reporting entity should evaluate how historical data differs from current and future economic conditions. In evaluating conditions that may merit an adjustment to the historical data used to measure expected credit losses, a reporting entity should consider the risk factors relevant to the assets being measured. These may include data that is borrower specific, specific to a group of pooled assets, at a macro-economic level, or some combination of these. Examples of factors that may be considered, include:

- Unemployment rates
- Sources of income available to debt issuers
- Collateral valuations
- Underwriting policies and procedures of a reporting entity, such as underwriting standards and exception tolerance, “out of area” lending policies and collection and recovery practices
- Payment status or payment structure
- Regulatory and legal environment
- Local and macro-economic and business conditions
- Conditions of market segments in conjunction with the analysis of financial asset concentrations

ASC 326-20-55-4 provides further examples of factors that may be considered.

Excerpt from ASC 326-20-55-4

To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility. Examples of factors an entity may consider include any of the following, depending on the nature of the asset (not all of these may be relevant to every situation, and other factors not on the list may be relevant):

- l. The borrower’s financial condition, credit rating, credit score, asset quality, or business prospects
- m. The borrower’s ability to make scheduled interest or principal payments
- n. The remaining payment terms of the financial asset(s)
- o. The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)

- p. The nature and volume of the entity's financial asset(s)
- q. The volume and severity of past due financial asset(s) and the volume and severity of adversely classified or rated financial asset(s)
- r. The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been utilized
- s. The entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, writeoff, and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- t. The quality of the entity's credit review system
- u. The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- v. The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as:
 1. Regulatory, legal, or technological environment to which the entity has exposure
 2. Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
 3. Changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments.

Determining the relevant factors and the amount of adjustments required will require judgment. To the extent an entity's quantitative models and historical data do not reflect current conditions or an entity's reasonable and supportable forecasts, such factors should be included through qualitative adjustments such that the estimate in total is reasonable. Over time, the impact of the changes identified may begin to be reflected in the loss history of the portfolio, which may impact the amount of adjustment required. Refer to LI 7.3.6.5 for further information on qualitative factors.

If an entity expects that its future loss mitigation efforts will be different than those in the past, it should consider making appropriate adjustments to its loss estimates. For example, if an entity discontinued certain loan modification programs offered to troubled borrowers in the past, this would need to be considered.

Amortized cost basis and historical data

Reporting entities are expected to apply judgment to determine the appropriate historical data set to use when calculating the allowance for credit losses under the CECL model. Reporting entities may need to analyze historical data to determine whether it should be adjusted to be consistent with the notion of calculating the allowance for credit losses based on an amortized cost amount (except for fair value hedge accounting adjustments from active portfolio layer method hedges). For example, if a reporting entity's historical loss rates are based on amortized cost amounts that have been charged off, such historical data would have included any unamortized premiums and discounts that existed at the time of writeoff. Alternatively, a reporting entity's historical loss rates may be based on losses of

principal amounts, and therefore did not include any unamortized premiums or discounts that may have existed. Refer to LI 7.3.4.3 for further information on the interaction of CECL with the amortized cost basis of financial instruments.

Consideration of collateral and credit enhancements

A reporting entity should consider sources of repayment associated with a financial asset when determining its credit losses forecast under the CECL impairment model, including collection against the collateral and certain embedded credit enhancements, such as guarantees or insurance.

Collateral

Although collateralization mitigates the risk of credit losses, the existence of collateral does not remove the requirement to record current expected credit losses, even when the current fair value of the collateral exceeds the amortized cost of the financial asset (unless the instrument qualifies for one of the practical expedients discussed in LI 7.4). This is because the collateral value may decline in the future, exposing the lender to losses in the event of default by the borrower. In addition, the collateral may be illiquid, such as real estate, automobiles, business inventory, equipment, and other assets. In addition, ASC 326-20-30-10 highlights the fact that the existence of collateral, on its own, does not eliminate the need for an allowance for credit losses.

In considering collateral value, a reporting entity should consider factors such as perfection of the lien, lien positioning, and potential changes in the value of the collateral.

In addition, if a financial asset is collateralized, and the reporting entity determines that foreclosure of the collateral is probable, the entity must measure expected credit losses based on the difference between the fair value of the collateral and the amortized cost basis of the asset. Refer to LI 7.3.6.6 for further information.

Credit enhancements

A reporting entity may obtain credit enhancements, such as guarantees or insurance, contemporaneous with or separate from acquiring or originating a financial asset or off-balance sheet credit exposure. As discussed in ASC 326-20-30-12, only credit enhancements embedded in an asset at origination or purchase can be considered when determining expected credit losses.

ASC 326-20-30-12

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

For an arrangement to be considered in an expected credit loss estimate, it must “travel with” the underlying instrument in the event of sale. Separate, freestanding contracts (such as credit default swaps or insurance) should not be combined with the underlying financial asset or portfolio for purposes of measuring expected credit losses. The Codification Master Glossary provides information on the definition of a freestanding financial instrument.

Definition from ASC Master Glossary

Freestanding Financial Instrument: A financial instrument that meets either of the following conditions:

- a. It is entered into separately and apart from any of the entity’s other financial instruments or equity transactions.
- b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Example LI 7-3A illustrates the consideration of mortgage insurance in the estimate of credit losses.

EXAMPLE LI 7-3A

Consideration of mortgage insurance in the estimate of credit losses

Finance Co originates mortgage loans to individuals in the northeastern US. After originating the loans, Finance Co separately enters into a mortgage insurance contract. The mortgage insurance is specific to Finance Co and is not assignable. In the event a mortgage loan subject to the insurance coverage is sold, the insurance coverage on that loan terminates.

Should Finance Co consider the mortgage insurance when it estimates its expected credit losses on the insured loans?

Analysis

No. Since the mortgage insurance has been acquired through a transaction separate from the origination of the loan, and does not transfer with the underlying loan agreement, it should not be considered when determining expected credit losses.

Other considerations when developing the forecast of credit losses

Actual economic conditions may turn out differently than those included in an entity’s forecast as there may be unforeseen events (e.g., fiscal or monetary policy actions). The further out in the forecasted period, the more likely it is that circumstances may be different than what was forecasted. As a result, the accuracy of the forecasted economic conditions may not be an effective indicator of the quality of an entity’s forecasting process, including their judgment in selecting the length of the reasonable and supportable forecast period. However, significantly missing near-term forecasts may be an indicator of a deficient forecasting process.

Assumptions for key economic conditions within an entity are expected to be consistent across relevant estimates. Therefore, an entity should consider the assumptions of future economic

conditions used in other forecasted estimates within an entity if they are relevant to the credit loss estimate (e.g., projections used in determining fair value, assessing goodwill impairment, or used in business planning and budgeting). An entity should be able to explain any differences between the assumptions and provide appropriate supporting documentation.

A reporting entity should consider quantitative and qualitative data that relates to both the environment in which the reporting entity and borrower operate as well as data specific to the borrower. Reporting entities should not ignore available information that is relevant to the estimated collectibility of amounts related to the financial asset. Further, the CECL model requires an entity to estimate and recognize an allowance for credit losses for a financial instrument, even when the expected risk of credit loss is remote.

Question LI 7-19A

Is an entity required to perform “backtesting” of historical reasonable and supportable forecast periods?

PwC response

No. While the CECL standard does not require it, backtesting of elements of the credit losses estimate may be useful.

There is an important distinction between backtesting a forecast of future economic conditions and backtesting elements of the estimate of expected credit losses. An entity’s comparison of its expected credit loss estimate against actual experienced losses may not be of great value due to the estimation uncertainty involved in the estimate. However, we believe there are various components of the entity’s expected credit losses estimation process that may lend themselves to an evaluation utilizing backtesting, such as to assess a model’s responsiveness to changing economic forecasts or its correlation between economic conditions and credit losses.

7.3.6.2 Historical loss data reversion in estimating credit loss

For periods beyond which a reporting entity is able to make reasonable and supportable forecasts of expected credit losses, ASC 326-20-30-9 requires a reporting entity to revert to its unadjusted historical loss information.

ASC 326-20-30-9 provides entities with flexibility in selecting a reversion methodology. Reversion methods include immediately reverting to unadjusted historical information, the use of straight-line, or another rational method. Entities should ensure they can support that the method selected is rational. The reversion technique should be evaluated in conjunction with all other judgments made in an entity’s estimate and in the context of the estimate as a whole. This is an ongoing evaluation that should be supported by an entity’s processes and related controls.

ASC 326-20 also provides entities with flexibility when selecting the unadjusted historical information it reverts to after the reasonable and supportable period. In applying ASC 326-20-30-9, the historical data for reversion that an entity selects may, in part, be influenced by its view of what economic conditions may look like in the future in order to arrive at its best estimate of expected credit losses.

In determining the historical loss information to be used, a reporting entity should consider a number of factors, including:

- The historical period over which the historical loss data should be derived
- The data points to be included in the computation of the historical loss information
- The reporting entity's historical experience and expectation regarding loss curves

The determination of the period historical loss information to be used in the estimate of expected credit losses is judgmental and may vary based on a reporting entity's specific facts and circumstances. However, a reporting entity must consider the remaining life of the financial asset or pool of financial assets when selecting the historical loss information to be used in accordance with ASC 326-20-30-8.

When using the reversion guidance discussed in ASC 326-20, the historical loss information used in the reversion period cannot be adjusted for existing economic conditions or expectations of future economic conditions. Historic loss information should be adjusted for differences in current asset-specific risk characteristics (e.g., underwriting or loan terms). However, the guidance does not preclude an entity from adjusting data used in reversion if that reversion is part of the reasonable and supportable forecast (and not in connection with the reversion guidance specifically discussed in ASC 326-20). For example, an entity may believe that economic data will revert to levels similar to historic levels and as such include such forecasts as part of their reasonable and supportable forecasts. Refer to LI 7.3.6.1 (after adoption of ASU 2022-02) or LI 7.3.6.1A (before adoption of ASU 2022-02) for further information on the reasonable and supportable forecasts in estimating expected credit losses.

7.3.6.3 Writeoffs of financial assets

ASC 326-20-35-8 requires reporting entities to writeoff individual financial assets (or a portion thereof) in the period in which a determination is made that the financial asset (or portion) is uncollectible. This generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted. Factors an entity may consider include (1) significant changes in the borrower's financial position such that they can no longer pay the obligation or (2) an assessment that the proceeds from collateral will not be sufficient to repay the loan. However, the term "uncollectible" is not defined and continues to require the application of judgment. Certain regulatory agencies have provided guidance to financial institutions with respect to when writeoffs are appropriate or required.

ASC 326-20-35-8

Writeoffs of financial assets, which may be full or partial writeoffs, shall be deducted from the allowance. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible.

7.3.6.4 Considering recoveries in the estimate of credit losses

ASC 326-20-30-1 requires entities to consider recoveries when estimating the allowance for credit losses on an individual asset or pool of financial assets. The amount of expected recoveries on previously written off and expected to be written off financial assets considered in the allowance should not exceed the aggregate of amounts previously written off and expected to be written off by the entity.

ASC 326-20-30-1

The allowance for credit losses is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. Expected recoveries of amounts previously written off and expected to be written off shall be included in the valuation account and shall not exceed the aggregate of amounts previously written off and expected to be written off by an entity. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

The inclusion of estimated recoveries can result in a “negative allowance” on an individual financial asset or on a pool of financial assets whereby the allowance is added to the amortized cost basis of a financial asset to present the net amount expected to be collected.

We believe the types of expected recoveries that should be considered in an entity's expected credit loss calculation include estimates of:

- cash received from the borrower,
- proceeds from liquidation of any collateral that would be available in the event of a default,
- amounts received from the sale of defaulted financial assets (if selling such defaulted financial assets is a component of a company's credit loss mitigation strategy), and
- recoveries through the operation of credit enhancements that are not considered freestanding contracts.

Expected recoveries should not include proceeds from sales of performing financial assets that are not part of a strategy to mitigate losses on defaulted assets.

Expected recoveries on PCD assets

It is important to note that the guidance for recoveries and negative allowances is different for PCD assets than non-PCD assets. Companies should consider these differences in establishing and maintaining policies, procedures, and controls related to their allowance estimates.

See LI 9 for further information on purchased credit deteriorated assets.

7.3.6.5 CECL - qualitative factors

An entity should develop an estimate of credit losses based upon historical information, current conditions, and reasonable and supportable forecasts. To the extent an entity's quantitative models and historical data do not reflect current conditions or an entity's reasonable and supportable forecasts, such factors should be included through qualitative adjustments such that the estimate in total is reasonable. Documentation of an entity's estimate, including supporting qualitative adjustments, is a critical element of internal controls over financial reporting.

In developing an estimate of credit losses, an entity should consider the guidance from SEC Staff Accounting Bulletin No. 119.

7.3.6.6 ***Collateralized assets when foreclosure is probable***

Regardless of an entity's initial measurement method for the allowance for credit losses for a collateralized asset, ASC 326-20-35-4 requires the estimate of expected credit losses to be based on the fair value of the collateral when the entity determines foreclosure is probable. This requirement also applies to collateralized loans with borrowers experiencing financial difficulty that have been restructured. In these cases, the estimate of expected credit losses would be the difference between the fair value of the collateral (less costs to sell, if applicable) and the amortized cost basis of the asset (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges). This prevents the reporting of a credit loss being delayed until actual foreclosure. If repayment is dependent upon the sale of the collateral when foreclosure of a collateralized asset is probable, the fair value used to measure the allowance should be adjusted for the costs to sell.

ASC 326-20-35-4

Regardless of the initial measurement method, an entity shall measure expected credit losses based on the fair value of the collateral at the reporting date when the entity determines that foreclosure is probable. The entity shall adjust the fair value of the collateral for the estimated costs to sell if it intends to sell rather than operate the collateral. When an entity determines that foreclosure is probable, the entity shall remeasure the financial asset at the fair value of the collateral at the reporting date (less costs to sell, if applicable) so that the reporting of a credit loss is not delayed until actual foreclosure. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses. An allowance for credit losses that is added to the amortized cost basis of the financial asset(s) shall not exceed amounts previously written off.

ASC 326-20-35-4 also clarifies that the potential for a negative allowance discussed in LI 7.3.6.4 also exists for collateral-dependent assets when the guidance requires the measurement of credit losses to be based on the fair value of collateral (i.e., when foreclosure is probable).

For example, an entity may have determined foreclosure was probable and recorded a writeoff based upon the fair value of the collateral because they deemed amounts in excess of the fair value of the collateral (less costs to sell, if applicable) uncollectible. However, in a subsequent period, if the fair value of the collateral increased, the guidance would require the recovery to be recorded (to the extent it did not exceed amounts previously written off) and it may create a negative allowance (an allowance that when added to the amortized cost basis of the asset results in the net amount expected to be collected).

An entity should reassess its estimate of credit losses at each reporting date. This would include reassessing whether foreclosure is probable. If foreclosure is no longer probable, an entity should apply another technique for estimating credit losses, including the collateral-dependent practical expedient, as long as the borrower meets the criteria to apply the election. The collateral-dependent practical expedient can be applied to a financial asset if (1) the borrower is experiencing financial difficulty, and (2) repayment is expected to be provided substantially through the sale or operation of the collateral. See LI 7.4.1 for further information on the collateral-dependent practical expedient.

Costs to sell

“Costs to sell” is not a defined term within ASC 326. As a result, we believe that the guidance from ASC 360 should be applied. ASC 360 states that costs to sell are incremental direct costs to transact a sale and represent the costs that result directly from and are essential to a sale transaction. Costs to sell would not have been incurred by the entity had the decision to sell not been made.

Costs to sell may vary depending on the nature of the collateral, but generally include legal fees, brokerage commissions, and closing costs that must be incurred before legal title to the collateral can be transferred. Costs to sell generally exclude holding costs, such as insurance, property taxes, security, and utilities while the collateral is held for sale.

7.3.6.7 Possibility of zero nonpayment risk

CECL requires an entity to estimate and recognize an allowance for credit losses for a financial instrument, even when the expected risk of credit loss is remote. However, ASC 326-20-30-10 does not require an entity to measure expected credit losses on an instrument, or a pool of instruments, if historical information adjusted for current conditions and reasonable and supportable forecasts result in zero expected credit losses in all scenarios. In these situations, the risk of default may be greater than zero, but the amount of the expected loss is zero.

ASC 326-20-55-49 and ASC 326-20-55-50 uses US Treasuries as an example of an asset that may result in an expectation that the risk of non-payment of the amortized cost basis (i.e., the loss given default) is zero given that they are explicitly guaranteed by a high-quality sovereign entity and have a long history with no credit losses. However, the FASB did not provide a list of other assets that may qualify for zero expected credit losses. The example in the standard sets a high bar for zero expected credit losses “exception” and these situations are not expected to occur frequently.

ASC 326-20-55-49

Entity J invests in U.S. Treasury securities with the intent to hold them to collect contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.

ASC 326-20-55-50

Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J’s management still believes that there is a possibility of default, even if that risk is remote. However, Entity J considers the guidance in paragraph 326-20-30-10 and concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity’s currency is routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its

U.S. Treasury securities at the end of the reporting period. The qualitative factors considered by Entity J in this Example are not an all-inclusive list of conditions that must be met in order to apply the guidance in paragraph 326-20-30-10.

Entities will need to apply judgment and consider the specific facts and circumstances to determine if a zero-loss estimate is supportable for a specific asset or pool of assets. An entity will need to support that it expects the non-payment of the instruments' amortized cost basis to be zero, even if the borrower defaults.

Typically, corporate bonds would not qualify for zero expected credit losses as even highly rated bonds have some risk of loss, regardless of the specific corporate borrower having no history or expectation of default and nonpayment.

Based on the current facts and circumstances, we believe Ginnie Mae, Fannie Mae (FNMA) and Freddie Mac (FHLMC) guaranteed pass-through mortgage-backed securities would qualify for zero expected credit losses under CECL. The factors considered in reaching this conclusion include the long history of zero credit losses, the explicit guarantee by the US government (although limited for FNMA and FHLMC securities) and yields that, while not risk-free, generally trade based on market views of prepayment and liquidity risk (not credit risk).

The existence of collateral, in and of itself, does not support an assumption of zero loss of the amortized cost basis. For financial assets secured by collateral, unless applying the collateral maintenance practical expedient, collateral-dependent practical expedient, or when foreclosure is probable, an entity cannot assume a zero expected credit loss solely because the current value of the collateral exceeds the amortized cost basis. An entity should consider potential future changes in collateral value and historical loss experience for financial assets that were secured by similar collateral. For instruments with collateral maintenance provisions, an entity could consider applying the collateral maintenance practical expedient (if the requirements are met). See LI 7.4 for information on practical expedients.

For other financial assets, an entity should consider the instrument's relevant facts and circumstances in estimating the expected credit loss. The following are some qualitative factors that an entity could consider in determining if a zero-credit loss expectation is supportable:

- Term and structure of the instrument
- Credit rating by rating agencies
- Historic experience of downgrades
- Historic credit losses (adjusted for current conditions and reasonable and supportable forecasts), including during periods of stress (e.g., the financial crisis)
- Explicit guarantees by a high credit quality sovereign entity or agency
- Interest rate or rate of return (and whether it is recognized as a risk-free rate or if any differences from the risk-free-rate relate to non-credit related risk)

- If the issuer is a sovereign entity, its ability to print its own currency and whether the currency is considered a “reserve currency” (i.e., currency is routinely held by central banks, used in international commerce, and commonly viewed as a reserve currency)
- The country’s political uncertainty and budgetary concerns

These factors are not all inclusive, nor is one single factor considered conclusive. A combination of factors needs to be considered and judgment applied to determine if an entity’s expectation of non-payment of the instrument’s amortized cost basis is zero.

An entity should continually update its analysis of assets that may qualify for zero expected credit losses and revisit conclusions considering changes in current conditions and reasonable and supportable forecasts of future conditions (e.g., heightened government budgetary concerns). If facts or circumstances change, assets that previously qualified for zero loss treatment may no longer qualify.

7.4 *CECL-related practical expedients*

The CECL model provides practical expedients to simplify the estimate of credit losses on certain financial assets supported by collateral. These practical expedients relate to collateral-dependent assets and assets with collateral maintenance provisions.

7.4.1 *Collateral-dependent CECL practical expedient*

ASC 326-20-35-5 permits an entity to elect a practical expedient for its collateral-dependent assets, whereby estimated credit losses are based on the fair value of the collateral (less costs to sell, if applicable). The practical expedient can be applied to a financial asset if (1) the borrower is experiencing financial difficulty, and (2) repayment is expected to be provided substantially through the sale or operation of the collateral. However, if it is probable that an entity will foreclose on the collateral, the use of the fair value of the collateral to calculate the allowance for credit loss is required (see LI 7.3.6.6).

If applied, the estimate of expected credit losses is equal to the difference between the fair value of the collateral as of the balance sheet date and the amortized cost basis of the asset (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges). If repayment is dependent on the sale of the collateral under the collateral-dependent practical expedient, the fair value used to measure the allowance should be adjusted for the costs to sell. Refer to LI 7.3.6.6 for information on costs to sell.

ASC 326-20-35-5

An entity may use, as a practical expedient, the fair value of the collateral at the reporting date when recording the net carrying amount of the asset and determining the allowance for credit losses for a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity’s assessment as of the reporting date (collateral-dependent financial asset). If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell. However, the entity shall not incorporate in the net carrying amount of the financial asset the estimated costs to sell the collateral if repayment or satisfaction of the financial asset depends only

on the operation, rather than on the sale, of the collateral. When the fair value (less costs to sell, if applicable) of the collateral at the reporting date exceeds the amortized cost basis of the financial asset, an entity shall adjust the allowance for credit losses to present the net amount expected to be collected on the financial asset equal to the fair value (less costs to sell, if applicable) of the collateral as long as the allowance that is added to the amortized cost basis of the financial asset(s) does not exceed amounts previously written off. If the fair value of the collateral is less than the amortized cost basis of the financial asset for which the practical expedient has been elected, an entity shall recognize an allowance for credit losses on the collateral-dependent financial asset, which is measured as the difference between the fair value of the collateral, less costs to sell (if applicable), at the reporting date and the amortized cost basis of the financial asset. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

ASC 326-20-35-5 clarifies that the potential for a negative allowance also exists for collateral-dependent assets when the guidance requires the measurement of credit losses to be based on the fair value of collateral (i.e., when the collateral-dependent practical expedient is elected). For example, an entity may have elected the collateral-dependent practical expedient and recorded a write off based upon the fair value of the collateral because they deemed amounts in excess of the fair value of the collateral (less costs to sell, if applicable) uncollectible. However, in a subsequent period the fair value of the collateral increased. In these instances, the guidance would require this recovery to be recorded (to the extent it did not exceed amounts previously written off) and it may create a negative allowance (an allowance which when added to the amortized cost basis of the asset results in the net amount expected to be collected).

An entity should reassess its estimate of credit losses at each reporting date. This includes reassessing whether the collateralized asset continues to qualify for the practical expedient. If the entity no longer qualifies for the collateral-dependent practical expedient, an entity is required to estimate its credit losses using another technique. If foreclosure becomes probable, an entity is required to use the fair value of collateral to estimate expected credit losses (see LI 7.3.6.6).

Example LI 7-4 illustrates application of the collateral-dependent financial asset practical expedient.

EXAMPLE LI 7-4

Measurement of impairment on a collateral-dependent financial asset

Bank Corp originates a construction loan to Developer LLC for purposes of constructing a condominium. Developer LLC holds no assets other than the construction in progress and has no guarantor support. Bank Corp's loan is collateralized with a first lien position on the underlying real estate and construction in progress.

In the current period, there has been a significant downturn in real estate values, including the condominium market in Developer LLC's region. Developer LLC has told Bank Corp that the expected pre-sales of condominium units are significantly below expectations. As a result, at the reporting date, Bank Corp does not believe Developer LLC will be able to repay the loan. Bank Corp determines it will substantially recover its investment through the sale of the real estate, but it is not probable that Bank Corp will foreclose.

The amortized cost of the loan is \$1,000,000, and the entity (which obtained a certified external appraisal) estimates the as-is value of the property at \$600,000. Estimated costs to sell the property are \$80,000.

Can Bank Corp elect to measure its expected credit losses associated with this loan using the collateral-dependent financial asset practical expedient?

Analysis

Yes. Bank Corp expects that due to Developer LLC's financial difficulty, repayment of the loan will be through the sale of the collateral. As a result, Bank Corp can elect to measure impairment using the collateral-dependent financial asset practical expedient.

If Bank Corp elects to use the practical expedient, the impairment would be calculated as follows.

Amortized cost of the loan		\$1,000,000
Fair value of the collateral	600,000	
Estimated costs to sell	(80,000)	
		520,000
Impairment		\$480,000

7.4.2 ***Collateral maintenance CECL practical expedient***

ASC 326-20-35-6 provides a practical expedient for assets secured by collateral when the amount of collateral is continually adjusted as a result of changes in the fair value of the collateral. In these arrangements, a reporting entity may estimate the expected credit losses by comparing the fair value of the collateral as of the balance sheet date to the asset's amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges). In situations when the fair

value of the collateral is equal to or greater than the amortized cost, a reporting entity may determine that there are no expected credit losses.

ASC 326-20-35-6

For certain financial assets, the borrower may be contractually required to continually adjust the amount of the collateral securing the financial asset(s) as a result of fair value changes in the collateral. In those situations, if an entity reasonably expects the borrower to continue to replenish the collateral to meet the requirements of the contract, an entity may use, as a practical expedient, a method that compares the amortized cost basis with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity reasonably expects the borrower to continue to replenish the collateral as necessary to meet the requirements of the contract. If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset and the entity reasonably expects the borrower to continue to replenish the collateral as necessary to meet the requirements of the contract, the entity shall estimate expected credit losses for the unsecured amount of the amortized cost basis. The allowance for credit losses on the financial asset is limited to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

To evaluate whether the use of the practical expedient is appropriate, an entity should consider where the collateral is held, the legal terms of the arrangement, how often the collateral is replenished, whether the entity expects the borrower to continually replenish the collateral, and the liquidity of the collateral.

To qualify for the practical expedient, we believe the collateral should be highly liquid. Additionally, the collateral maintenance practical expedient guidance requires the borrower to continually replenish the collateral but does not provide a definition of “continually replenish.” We believe arrangements that require daily replenishments would qualify for the practical expedient. However, the less frequently the collateral is adjusted, the more challenging it will be to assert that the collateral is continually replenished. Further, when demonstrating that the borrower is able to continually replenish the collateral, the creditor need only demonstrate a reasonable expectation that a borrower is able to continually replenish the collateral. The creditor does not have to prove it is probable or consider remote scenarios.

Question LI 7-20

Some arrangements provide for “tolerance bands” that must be “breached” before the collateral is adjusted. For example, repurchase agreements may not provide for adjustments until the fair value of the collateral has dropped below 98% of the amount advanced (or exceeds 102% of the amount advanced). Can the collateral maintenance practical expedient be applied to agreements with tolerance bands?

PwC response

It depends. The practical expedient can be applied in situations that provide for adjustments to the amount of collateral securing the financial assets if the terms of the agreements provide for narrow tolerance bands and highly liquid collateral. For example, we believe certain repurchase agreements with highly liquid collateral that have tolerance bands of 98% to 102% would be eligible to apply the practical expedient. We believe agreements that do not have narrow tolerance bands would not be able to apply the practical expedient.

Example LI 7-5 illustrates application of the practical expedient related to financial assets with collateral maintenance requirements.

EXAMPLE LI 7-5

Application of collateral maintenance practical expedient requirements

Lender Corp enters into a reverse repurchase arrangement with Counterparty Corp, under which Counterparty Corp sells securities to Lender Corp with the requirement to repurchase them back at a specified date for a specified price. To mitigate credit risk, Lender Corp requires Counterparty Corp to post collateral, with daily valuation requirements and collateral maintenance requirements intended to ensure Counterparty Corp maintains the fair value of the collateral at an amount equal to or in excess of the amortized cost of the reverse repurchase asset.

How should Lender Corp consider the collateralized relationship of its arrangement with Counterparty Corp in estimating expected credit losses?

Analysis

Although Lender Corp appears to have a well-collateralized arrangement, it should consider the following:

- The nature of the collateral. For example, does the collateral consist of US treasuries, or does it consist of illiquid financial assets.
- The sufficiency of systems and controls over the data used to determine the collateral to value ratios for the collateral maintenance requirements
- Whether Counterparty Corp is expected to continue to be able to post collateral over the life of the contract

Considering these points, if Lender Corp can assert that it has access to liquid and marketable collateral and believes it has proper recourse to Counterparty Corp’s accounts, the relationship could

be viewed as having a collateral maintenance arrangement that would permit the use of the practical expedient.

Figure LI 7-3 demonstrates how to calculate an allowance using the collateral maintenance practical expedient:

Figure LI 7-3

Calculating an allowance using the collateral maintenance practical expedient

Scenario	Application
<p>At the reporting date, the fair value of the collateral is equal to or greater than the amortized cost basis (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges).</p>	<p>Assuming the asset qualified for the collateral maintenance practical expedient, since the fair value of the collateral at the reporting date is equal to or greater than the amortized cost basis (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges), the allowance is \$0 as long as the creditor is able to demonstrate a reasonable expectation that the borrower is able to continually replenish the collateral.</p> <p>Unlike what would usually be required in applying the CECL model, the creditor does not need to consider the possibility of the collateral falling in value after the reporting date. Under the expedient, a creditor is allowed to only consider the reporting period fair value of the collateral. As a result, credit losses are capped at the difference between the amortized cost basis (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges) and the current fair value of the collateral.</p>
<p>At the reporting date, the fair value of the collateral is \$98, and the amortized cost basis (excluding any fair value hedge accounting adjustments from active portfolio layer method hedges) is \$100.</p>	<p>Assuming the asset qualifies for the collateral maintenance practical expedient (including the demonstration that the creditor has a reasonable expectation that the borrower is able to continually replenish the collateral), the financial asset should be evaluated as two separate components:</p> <ol style="list-style-type: none"> <li data-bbox="753 1360 1463 1598">1. With respect to the uncollateralized portion of the loan, the maximum credit loss is \$2. The entity should evaluate the credit loss under the expected credit losses guidance to determine the allowance. The allowance is only measured at \$2 if both the probability of default and the loss given default are 100% (in which case it may be difficult to support an assertion the borrower is able to replenish the collateral). <li data-bbox="753 1619 1382 1675">2. The collateralized portion of the loan (\$98) has an allowance of \$0.

7.5 *Application of CECL to off-balance sheet exposures*

CECL applies to off-balance sheet credit exposures not accounted for as insurance, such as unfunded revolving lines of credit, financial guarantees written that are not accounted for as derivatives, other unfunded loan commitments, and other similar instruments. Because off-balance sheet exposures are often legally binding agreements to extend credit under certain terms and conditions, they can expose an entity to credit losses.

The expected credit losses liability for off-balance sheet credit exposures should be estimated over the contractual period in which the entity is exposed to credit risk, unless that obligation is unconditionally cancellable by the issuer. The estimate of credit losses should consider the likelihood that funding will occur and if funded, the related estimate of expected credit losses.

The expected credit loss estimate for off-balance sheet credit exposures is recorded as a liability on the balance sheet (separate from any allowance for credit losses associated with recognized financial assets) with changes in the estimate reported as credit loss expense in the statement of net income each reporting period.

Question LI 7-21

Should an entity measure the expected credit loss liability on off balance sheet credit exposures on a pool basis?

PwC response

Yes. Similar to financial assets, when similar risk characteristics exist between off balance sheet credit exposures, the expected credit loss estimate should be measured on a collective (pool) basis. In a scenario when the off-balance sheet exposure does not share risk characteristics with other exposures, the expected credit losses should be measured on an individual basis using information available for that type of commitment.

Question LI 7-22

Is a forward commitment to purchase a loan that will subsequently be classified as held for investment within the scope of the CECL impairment model?

PwC response

It depends. Similar to a loan commitment, a forward commitment to purchase a loan (including a loan that is deemed to be a PCD asset) represents an off-balance sheet credit exposure in the scope of ASC 326 if the forward commitment is (1) not accounted for as a derivative and (2) is not unconditionally cancellable by the purchaser.

7.5.1 *Credit losses on unfunded commitments*

Unfunded commitments, such as a loan commitment, require a reporting entity to extend credit to a counterparty under certain specified terms and conditions. Because they are often legally binding agreements to extend credit, loan commitments can expose an entity to credit losses.

For unfunded loan commitments, a reporting entity should first determine whether the commitment can be unconditionally (i.e., unilaterally and irrevocably) cancelled by the issuer. If this is the case, then as discussed in ASC 326-20-30-11, the potential exposure of the unused or undrawn portion of the commitment would not be included in an entity's estimate of expected credit losses. When the issuer does not have the unconditional right to cancel the commitment, an estimate of credit losses is required for the unfunded portion. The estimate of credit losses would include a determination of the likelihood that funding will occur, and if funded, the related expected credit losses under the CECL model. The estimate of expected credit loss for an unfunded commitment would be recorded as a liability.

ASC 326-20-30-11

In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures. For that period of exposure, the estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life. If an entity uses a discounted cash flow method to estimate expected credit losses on off-balance-sheet credit exposures, the discount rate used should be consistent with the guidance in Section 310-20-35.

Loan commitments can be either revolving (in which the amount of the overall commitment is re-established upon repayment of previously drawn amounts) or non-revolving (in which the amount of the overall commitment is not re-established upon repayment of previously drawn amounts). For revolving commitments, the estimate of expected credit losses is more complex, as the provider of the commitment will need to consider the probability of multiple future draws and repayments. See Question LI 7-12 for an example of these complexities.

Once a commitment has been funded, a reporting entity should apply the CECL impairment model as it would for any other recognized financial asset. See LI 7.3.

When an unfunded commitment becomes funded, the expected credit loss for the liability would be reclassified as the allowance for the funded loan. An entity should also reassess whether the amount of the allowance is appropriate. The initial estimate of expected credit losses for the unfunded commitment would have considered the probability of the commitment not being funded. This same consideration is not relevant when determining the expected credit loss estimate for a funded loan and therefore, there could be a change in the estimate.

Question LI 7-23

Is a loan commitment acquired as part of a business combination within the scope of the CECL impairment model?

PwC response

Yes. As discussed above, unfunded commitments, such as a loan commitment that cannot be unconditionally (i.e., unilaterally and irrevocably) cancelled by the issuer, are in scope of the CECL impairment model. This is true regardless of whether the loan commitment was originated or acquired (including in a business combination). An estimate of credit losses would be required for the unfunded portion of the loan commitment (as well as for any funded component). As noted in LI 9.2, the PCD asset guidance is not applicable to acquired unfunded loan commitments.

As a result of the application of ASC 805, *Business combinations*, the acquirer will generally recognize identifiable assets acquired and liabilities assumed at fair value. This will generally include loan commitments. Certain loan commitments do not require the borrower to make ongoing payments at a market rate to the lender for the right to borrow under the loan commitment and, as a result, the application of ASC 805 will result in the recognition of a liability for the acquired loan commitment. Similar to the guidance in ASC 460-10-25-2 for guarantees, the expected credit losses for these commitments should be measured and accounted for in addition to and separately from the liability recognized for the acquired loan commitment. The initial recognition of the liability for the estimate of expected credit losses on the loan commitment (as well as subsequent changes in the estimate) are recognized in earnings as a credit loss expense. The liability recognized for the acquired loan agreement should be accounted for in accordance with the guidance in ASC 310-20 similar to a commitment fee.

7.5.2 Credit losses related to financial guarantees

Financial guarantees in the scope of ASC 460, *Guarantees*, are in the scope of the CECL impairment model in ASC 326-20. Financial guarantees may be in the scope of ASC 460 if they are not required to be accounted for as derivatives under the guidance in ASC 815, *Derivatives and Hedging*. Insurance companies that issue financial guarantee contracts must assess whether they are within the scope of ASC 944, *Insurance*, before considering whether ASC 460 is applicable.

ASC 460-10-55-2 provides examples of financial guarantee contracts that may be in the scope of ASC 460.

ASC 460-10-55-2**Financial Guarantees**

The following are examples of contracts of the type described in paragraph 460-10-15-4(a):

- a. A financial standby letter of credit
- b. A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
- c. A guarantee of the market price of the common stock of the guaranteed party
- d. A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity
- e. A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

Under ASC 460, a reporting entity must recognize a liability for the fair value of the obligation associated with a guarantee and record an associated asset (e.g., either cash or receivable depending on the contractual terms). In addition, the CECL model considers the credit risk of financial guarantees to be off-balance sheet exposures (e.g., unfunded commitments). Therefore, as described in ASC 460-10-30-5, a reporting entity should record both a guarantee obligation and an allowance for credit losses (calculated using the CECL impairment model) for financial guarantees in the scope of ASC 326. See FG 2.6 for information on the initial recognition and measurement of a guarantee obligation.

The measurement of an allowance under CECL is calculated independent from and is not influenced by the establishment of a guarantee obligation under ASC 460. In other words, an allowance under CECL is recorded in addition to the guarantee obligation under ASC 460.

7.6 Application of CECL to leasing

The CECL impairment model is applicable to lessors for certain types of leases. ASC 326-20 applies to net investments in leases associated with sales-type leases and direct financing leases. The FASB recognized that these receivables include both financial and non-financial elements, but concluded that the application of a single impairment model to the recognized lease asset would be preferable to assessing different components of a single asset under different impairment models.

ASC 326-20 requires an allowance for credit losses to be recognized on the date that a sales-type lease or direct financing lease receivable is recognized, either through origination or acquisition. The guidance requires an entity's estimate of expected credit losses to include a measure of the expected risk of credit loss even if that risk is remote. It also requires that the measurement of credit losses be on a collective (pool) basis when individual assets share similar risk characteristics.

For leases that are originated, the initial measurement of the allowance for credit losses will be recorded through earnings. For leases that will be accounted for as sales-type or direct financing leases acquired either through a business combination or an asset purchase, we believe an entity should assess whether the acquired leases would be considered purchased credit deteriorated (PCD) assets. To the extent a lease is not considered to be a PCD asset, the initial measurement of the allowance for credit losses would be reported in current earnings (similar to an originated lease). If a lease is considered a PCD asset, the initial measurement of the allowance for credit losses will create a basis adjustment to the amortized cost basis of the net investment in the lease. This is commonly referred to as a "gross up" as the initial entry to establish the allowance adjusts the carrying value of the asset. Refer to LI 9 for further information on PCD assets.

7.6.1 Unit of measurement for leases under CECL

As discussed in LI 7.3.3, the CECL model requires the measurement of credit losses to be on a collective (pool) basis when individual assets share similar risk characteristics. The implementation guidance provides some examples of factors that could be used to identify assets that share similar risk characteristics. Many of these factors (e.g., credit rating of the lessee, remaining term of the lease) will be relevant when considering if leases share similar characteristics.

The nature of the leased asset will likely be a key consideration in determining whether leases share similar characteristics. The value of the leased asset can impact the estimate of expected credit losses in two ways; (1) with respect to serving as collateral against rental payments and (2) based on its

residual value. The volatility of the value of a leased asset, whether the value of the assets is correlated amongst the leases, and other similar considerations will also be relevant. For example, it may not be appropriate to create a single portfolio of auto leases that includes some leases of small cars and others for large pickups and SUVs as those assets would not be expected to have similar risks with respect to their residual values.

At the June 11, 2018 TRG meeting, the FASB staff shared their perspectives that all cash flows from expected disposals of leased assets, including those that result in a gain, should be included in an estimate of expected credit losses for a pool of lease receivables (see TRG Memo 7: Cover Memo and TRG Memo 13: Summary of Issues Discussed and Next Steps) to the extent they reduce losses. Including expected gains serves to reduce credit losses within the pool (“offsetting” losses such as lessee default or declines in the residual value of other assets).

Some noted that using expected gains on the disposition of leased assets to offset credit losses effectively includes that gain in earnings (by reducing credit losses) before it is realized. In their conclusion, the FASB staff noted that the guidance requires the net investment in lease (including the residual value of the asset) to be evaluated as a single unit and that a pool-level assessment does not preclude including cash flows associated with the disposition of the asset.

To the extent that a pool includes leases with substantial expected gains on the disposal of the leased assets and substantial losses on the disposition of other leased assets, this may indicate that the leases do not share similar risk characteristics. As a result, the leases may need to be assessed as part of other pools of leases or be assessed individually for credit losses if they no longer share common risk characteristics with other leases.

The existence of a residual value guarantee (that is considered part of the unit of the account of the lease) and the credit risk of the provider of that guarantee (whether it is the lessee or a third party) may also be key factors in evaluating whether leases share similar risks characteristics.

7.6.2 *Determining life of the lease when estimating credit losses*

As stated in ASC 326-20-30-6A, when determining the life over which to estimate expected credit losses on a net investment in a lease subject to CECL, entities should determine lease term solely based upon the guidance in ASC 842. For example, if the lease term is determined to be 10 years under ASC 842, then 10 years should be used as the life under the CECL guidance.

ASC 326-20-30-6A

For net investment in leases recognized by a lessor in accordance with Topic 842, instead of applying the guidance in paragraph 326-20-30-6, an entity shall use the lease term as the contractual term.

This will result in a different conclusion for leases than for other financial assets subject to CECL. For example, if an entity is a lessor for a 10-year lease (sales type or direct financing) and the lessee has the right to extend the lease for another 2 years, ASC 842 would treat the lease as a 10-year lease unless it is reasonably certain the lessee would exercise their option. Assuming the lessor is not reasonably certain of the exercise of the extension option, it would be considered a 10-year lease under ASC 842. For the purposes of estimating credit losses, it should also be assumed to be a 10-year credit exposure. If this contract was a 10-year loan for which the borrower had the right to extend the maturity date for 2 years, the term used for modeling credit losses would be 12 years and consider the probability the

borrower did not extend (alternatively it could be thought of as a 10-year loan with a chance that it could become a 12-year loan).

7.6.3 *Estimating lifetime expected credit losses for a lease*

In developing the CECL model, the FASB consciously allowed for a variety of acceptable techniques to estimate credit losses. Entities can utilize DCF models, undiscounted approaches, such as loss rate or probability of default/loss given default models, or other models. See LI 7.3.4 for further information on measurement methodologies. With respect to sales-type and direct financing leases that have financial and non-financial components, entities should consider a number of factors in their analysis when estimating lifetime expected credit losses in addition to those discussed in LI 7.3.6

7.6.3.1 *Rental payments when applying the CECL model*

The rental payments component of the net investment in leases could be thought of similar to a collateralized loan with an amortizing principal balance. This component consists of contractually specified payments on specified dates and if the lessee defaults, the lessor has the ability to repossess the leased asset similar to a lender's ability to foreclose on collateral for a loan. In this context, consideration should be given to the probability that the lessee will default and the loss given default considering amounts that may be collected from the lessee as well as the ability to obtain the leased asset.

In some instances, the fair value of the leased asset may be forecasted to decline at a different pace than the amortized cost basis of the net investment in the lease. This could impact credit modeling at inception if it is forecasted that at different points in the life of the lease, the degree to which the rental payments are collateralized changes. For example, if the fair value of the leased asset declines in the early years of a lease faster than the amortized cost basis of the net investment, different losses may be realized depending on when a default is estimated to occur. This should be considered in an entity's estimate of credit losses, and may be captured in an entity's historic loss information, which may serve as a starting point for estimating credit losses.

7.6.3.2 *Considering residual value of leased assets in the CECL model*

Obtaining the asset at the maturity of the lease is dependent on the lease reaching its maturity. To the extent the lessee defaults, the loss incurred by the lessor is dependent on the fair value of the leased asset when repossessed as opposed to at maturity. However, the residual value of the asset is a component of the net investment in lease balance. As a result, lessors will need to update their estimates of the residual value of the leased asset when applying ASC 326-20.

As discussed in more detail in LI 7.6.1, during the June 11, 2018 TRG meeting, the FASB staff shared their perspectives that all cash flows from expected disposals of leased assets, including those that result in a gain, should be included in an estimate of expected credit losses for a pool of lease receivables (see TRG Memo 7: Cover Memo and TRG Memo 13: Summary of Issues Discussed and Next Steps) to the extent that they reduce losses. Including expected gains serves to reduce credit losses within the pool ("offsetting" losses such as lessee default or declines in the residual value of other assets). In their conclusion, the FASB staff noted that the guidance requires the net investment in lease (including the residual value of the asset) to be evaluated as a single unit and that a pool-level assessment does not preclude including cash flows associated with the disposition of the asset.

7.6.3.3 *Residual value guarantees in the CECL model*

The leasing guidance requires certain residual value guarantees to be considered in determining the lease classification and the measurement of the initial recognition of the net investment in the lease. In these cases, we believe that it should be considered in the assessment of credit losses.

This may result in considering the impact of residual value guarantees when seemingly similar credit insurance arrangements would not be considered. ASC 326-20 indicates that credit insurance arrangements that are considered freestanding contracts would not be considered in determining the allowance for credit losses. However, we believe that guidance was written in the context of loan accounting, in which freestanding credit insurance agreements are not considered in the determination of the initial carrying value of the loan as they are not part of the same unit of account. If under the leasing guidance, the unit of account of the lease includes the residual value guarantee, we believe the unit of account for the purposes of determining credit losses should include the residual value guarantee as well.

In considering the impact of any residual value guarantee, the degree to which the estimated fair value of the residual asset is below the guaranteed amount, as well as the credit risk of the guarantee provider, will be key inputs into modelling the impact of such guarantees.

7.6.3.4 *Lease writeoffs and recoveries in the CECL model*

Estimated credit losses on sales-type and direct financing lease receivables are reflected through an allowance for credit losses account, which is separately reported in the financial statements as a deduction from the amortized cost basis of the asset. The CECL model requires assessments of allowance amounts to determine whether they should be written off against the amortized cost basis of the receivables. Receivables (and allowance accounts) are written off either in full or in part when such amounts are deemed uncollectible.

For leases, each component of a lease receivable (financial or non-financial) could cause a writeoff. Companies may need to establish policies and procedures to determine when receivables (and allowance balances) should be written off.

Further, ASC 326-20 requires entities to consider recoveries when estimating the allowance for credit losses on an individual or pool of financial assets. The amount of expected recoveries on previously written off and expected to be written off financial assets considered in the allowance should not exceed the aggregate of amounts previously written off and expected to be written off by the entity. See LI 7.3.6.4 for further information.

7.6.4 *Applying the CECL model to collateral-dependent leases*

The credit loss guidance provides a practical expedient under which an allowance can be measured based upon the difference between the fair value of collateral and the amortized cost basis when the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the collateral (see LI 7.4.1). If collection would be achieved through the sale of the collateral, costs to sell must also be considered. This method of calculating an allowance is required when foreclosure is deemed probable. See LI 7.3.6.6 for further information.

The collateral-dependent practical expedient and the requirement to use collateral value when foreclosure is probable are elements that are integral to the CECL model. As a result, we believe that

the collateral-dependent practical expedient could be used for leases and the requirement to use collateral value when “foreclosure” is probable should also be applied to leases.

We do not believe that this guidance should be applied in situations when the lessee has performed (and is expected to perform) on its obligations to make payments and the leased asset is returned to the lessor at the expiration of the lease in accordance with the lease’s contractual provisions. However, if the lessee is experiencing financial difficulty and repayment is expected to be provided substantially through the operation or sale of the leased asset following repossession, we believe that the collateral-dependent practical expedient can be applied. In addition, if it is probable that the lessee will default and the lessor will repossess the leased asset, we believe that the fair value of the leased asset (less costs to sell, if applicable) must be used in the determination of the allowance.

7.6.5 Sale of lease receivables under the CECL model

In some cases, a lessor may sell the receivable associated with future rental payments but retain ownership of the leased asset. ASC 860 is the applicable guidance for determining whether that transfer would be accounted for as a sale resulting in derecognition of the receivable. In instances when the transfer of the receivable is accounted for as a sale, and the asset remaining relates to the unguaranteed residual value, the leasing guidance states that the lessor should begin applying ASC 360, *Property, Plant and Equipment*, to determine whether the unguaranteed residual asset is impaired. As a result, the CECL model would no longer be applicable.

We do not believe that this guidance should be extended to address situations when the lessor has not transferred receivables and simply as a result of a lessee making payments, the net investment of the lease consists principally of the estimated residual value of the leased asset. In these situations, we believe it is appropriate to continue applying the credit loss model in ASC 326 until the leased asset is obtained.

7.7 Application of CECL to trade receivables

Typically, trade receivables are short term in duration as payment is generally expected to be received within one year. For the accounting associated with the initial recognition and presentation of trade receivables and contract assets, refer to PwC’s *Revenue from contracts with customers* guide.

CECL is the model that must be used to measure impairment on financial assets measured at amortized cost, which includes trade receivables. Therefore, estimates of expected credit losses on trade receivables over their life will be required to be recorded at inception, based on historical information, current conditions, and reasonable and supportable forecasts.

While the probability criterion for initial receivable recognition under ASC 606 considers a customer’s ability and intent to repay, probable repayment under ASC 606 does not imply a credit-risk free receivable, nor does consideration of such collectability remove an entity’s requirement to apply the CECL model. There will be an expectation of losses when a portfolio of similar receivables is considered on a pooled basis. An entity’s estimate of expected credit losses should include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses.

7.7.1 Unit of measurement for assessing trade receivable in CECL

As discussed in LI 7.3.3, ASC 326-20-30-2 requires a reporting entity to use a pooled approach to estimate expected credit losses for financial assets with similar risk characteristics. If a financial asset does not share similar risk characteristics with other financial assets held by the reporting entity, the allowance for credit losses should be determined on an individual basis. Similar risk characteristics for trade receivables may include customer credit rating, trade receivable aging category (e.g., 30-90 days past due), industry, geographical location of the customer, product line, and other factors that may influence the likelihood of the customer not being able to pay for the goods or services.

7.7.2 Applying CECL to trade receivables

As discussed in LI 7.3.4 (after adoption of ASU 2022-02) or LI 7.3.4A (before adoption of ASU 2022-02), ASC 326-20-30-3 does not require reporting entities to use a specific method to calculate the allowance for credit losses; instead, it allows entities to use various methods, including methods that utilize an aging matrix.

Prior to the adoption of ASU 2016-13, many non-financial services companies used provision matrices for trade receivables in which historical loss percentages are applied to the respective aging categories. Under the CECL model, these companies are required to use a forward-looking methodology that incorporates lifetime expected credit losses. While the provision matrices may still be used under CECL, historical loss data will need to be combined with current conditions and reasonable and supportable forecasts of future losses to determine estimated credit losses. The most visible impact of CECL may be that receivables that are either current or not yet due, will have an allowance for expected credit losses.

When using a provision matrix under CECL, a reporting entity should segregate customer accounts into pools with similar risk characteristics, such as by product type, industry, and/or geographic region, and delinquency status. Loss rates are then calculated for each pool based on historical experience and adjusted for any changes in current and future economic conditions or differences in the attributes of the current portfolio. The model generally includes assumptions about (1) the migration of receivables from current to loss, and (2) cure rates associated with receivables that go from delinquent to current. The determination of the actual loss rate may be driven by actual writeoff experience as a percentage of the total receivable balance. When using this approach, reporting entities should be aware of modelling anomalies, such as customers that consistently fall in a particular delinquency category (e.g., a customer that consistently pays at 90 days), large writeoff or recovery activity from a particular customer or type of customer, and the method with which a reporting entity pools assets for purposes of the model.

7.7.3 Lifetime expected credit losses on trade receivables

As discussed in LI 7.3.6 (after adoption of ASU 2022-02) or LI 7.3.6A (before adoption of ASU 2022-02), once reporting entities adopt the expected credit loss model, determining what data is relevant in estimating expected credit losses will become a critical part of the allowance assessment. Under the CECL model, reporting entities can leverage historical loss data, but CECL also requires forward looking information and forecasts to be considered in determining credit loss estimates.

Most reporting entities have access to historical loss data that they have been using to estimate an allowance for doubtful accounts under the incurred loss model. This data allows reporting entities to estimate the percentage of uncollectible accounts or the amount of bad debt expense, typically as a

percentage of accounts receivable, sales, or a combination of these metrics. Reporting entities may aggregate this data and analyze how it trends over time. Reporting entities can utilize historical data to understand and identify factors that resulted in historical credit losses and incorporate those factors into their analysis of future expected credit losses.

Reporting entities may use historical loss data, adjusted for current conditions and reasonable and supportable forecasts in conjunction with an accounts receivable aging matrix, to form a view of the relative size of credit losses to be expected under the CECL impairment model. For example, data may indicate that as a customer moves from the 60- to 90-day delinquency category to the 90- to 120-day delinquency category, the expected credit losses increase. A reporting entity may use this analysis to identify customers on which it will perform further credit analysis, such as customers who have particularly large uncollectable accounts or who have receivables that have been aged for a long period of time. Reporting entities may have also performed an analysis to determine whether there were significant changes in the credit ratings of their customers, as decreases in the credit ratings of customers may indicate a deterioration in credit quality. This analysis will be important in the CECL model, as the results of the analysis may lead a reporting entity to increase its expectation of credit losses.

Understanding the relationship between the reporting entity, the industry, and the customer base is an important starting point in assessing which factors may impact the assessment of expected credit losses. Understanding customer demographics, payment terms offered in the normal course of business to customers, and industry-specific factors that could impact the reporting entity's receivables is critical to forming the basis of the expected credit loss analysis.

In addition, under an expected loss model, reporting entities are required to consider available external data in their analyses. These external data points include macroeconomic factors, such as economic growth trends. Companies will need to assess the degree of correlation between these data points and the reporting entity's loss experience and loss forecasts to determine the impact macro (and micro) economic factors have on loss experience. Judgment will be required to determine how historical loss information, as well as the macroeconomic factors that were present when the historical losses took place (as compared to those that may exist today and in the future), should be incorporated into current period credit loss estimates.

Question LI 7-24

Should a reporting entity consider factors unrelated to credit that could impact the expected cash flows of a receivable (e.g., product returns, cash discounts, volume rebates, discounts for early payment) when calculating its allowance for credit losses?

PwC response

No. When developing its allowance for credit losses, a reporting entity should ensure that factors unrelated to credit that may impact expectations of cash flows are excluded. Items that impact the amount of cash to be received that are unrelated to expected credit losses should be accounted for using other GAAP (e.g., revenue guidance).

7.7.4 Application of the CECL model to contract assets

ASC 606-10-20 defines a contract asset as an entity's conditional right to consideration in exchange for goods or services. The conditional right is based on something other than the passage of time, such

as future performance. Once the conditional right has been fulfilled and an unconditional right to consideration exists, the contract asset becomes a trade receivable. While contract assets are not financial assets, ASC 606-10-45-3 requires these assets to be evaluated for credit losses under ASC 326-20. Therefore, estimates of expected credit losses on contract assets over their life will be required to be recorded at inception and on an ongoing basis, based on historical information, current conditions, and reasonable and supportable forecasts. See BCG 2.5.2 for further details on the application of CECL to contract assets.

7.8 Application of CECL to insurance receivables

Figure LI 7-4 illustrates common insurance-related assets and whether they are in the scope of CECL.

Figure LI 7-4

Common insurance-related balances included/excluded from CECL

In CECL scope	Excluded from CECL scope
<input type="checkbox"/> Reinsurance and insurance recoverables billed and unbilled	<input type="checkbox"/> Ceded unearned premium (prepaid reinsurance)
<input type="checkbox"/> Premiums receivable and other contract holder receivables	<input type="checkbox"/> Policy loans
<input type="checkbox"/> Funds withheld assets	<input type="checkbox"/> Reinsurance recoverables between entities under common control
<input type="checkbox"/> Premium receivable (host contract) in modified coinsurance	<input type="checkbox"/> Market risk benefits (MRB) reinsurance recoverables
<input type="checkbox"/> Financial guarantees purchased	<input type="checkbox"/> Prepaid insurance expense
<input type="checkbox"/> Structured settlements purchased	

As discussed in LI 7.2, reinsurance recoverables are within the scope of the CECL model. The insurance company estimates a reinsurance receivable, which represents all amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, and for long duration contracts, future policy benefits.

For reinsurance contracts, an insurance company should consider factors such as the reinsurer's ability to pay and collateral arrangements in determining its expected losses. In accordance with ASC 326-20-30-2, when similar risk characteristics exist, expected credit losses should be measured on a pooled basis. The criteria for pooling may be met when reinsurance counterparties have one or a combination of the following characteristics in common; (1) credit ratings, (2) geographic concentrations, (3) size of the business, and (4) types of agreements written.

Insurance receivables that arise due to salvage and subrogation rights ("the rights") should also be evaluated for impairment under CECL. The rights are not separate financial assets, but instead are rights/potential cash inflows of an insurance contract that consider both estimated claim payments and expected recoveries from an existing insurance contract. During the life of the insurance contract, multiple claim payments may be made, all of which could generate the rights. When the insurer receives payment in satisfaction of the rights (e.g., in the form of cash, a financial asset, or some other asset), it would reduce the rights' component of the claim liability and account for the newly obtained

asset. Assets received that are financial assets subsequently measured at amortized cost are within the scope of CECL upon initial recognition.

Question LI 7-25

Once an insurance company determines it should book a reinsurance receivable (based on the terms of the contract), should it consider the effect of contractual coverage disputes when calculating its allowance for credit losses?

PwC response

No. Since the process for deciding whether or not to record a reinsurance receivable considers contractual coverage, the allowance for credit losses should not include risks related to contractual coverage disputes. The allowance for credit losses should also not include the consideration of other contract administration risks. Refer to ASC 326-20-55-82 for further information.

Question LI 7-26

What factors should an entity consider in estimating the expected credit losses of reinsurance recoverables?

PwC response

As required by ASC 326-20-30-7, an entity should consider available information about past events, current conditions, and reasonable and supportable forecasts to assess the collectability of cash flows to develop an estimate of the allowance for credit losses of reinsurance recoverables. Factors to consider include:

- Expected term of the exposure under the contract, including termination clauses. Reinsurance arrangements may have no stated termination date and remain in force until all claims from the reinsured policies have been paid or the agreement is commuted or terminated by mutual agreement.
- Historical losses of similar reinsurers
- Funds withheld, trust accounts, letters of credit (that are not freestanding), and other collateral provisions. The presence of these embedded provisions should be evaluated similar to collateral and credit enhancement provisions as described in ASC 326-20-30-10 and ASC 326-20-30-12, which notes that “an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.”
- Geographic and coverage type concentration of the reinsurer
- Credit rating, financial health, and regulatory oversight of the reinsurer
- Ability and history of government program administrator to fund or assess members to keep program viable and political environment for legislative change

An entity must also decide the appropriate level of aggregation at which to measure the expected credit losses by either grouping reinsurance recoverables on a collective pool basis or assessing on an individual basis. Some of the factors to consider when determining the appropriate level of aggregation include:

- External credit rating of the reinsurer. This is because reinsurance recoverables from reinsurers with different credit ratings would generally not be considered to have similar counterparty credit risk characteristics.
- Whether the reinsurer is involved in reinsurance agreements globally or they are contained to a specific geographic region
- Size of the reinsurer, which may be indicative of its financial strength
- The types of reinsurance agreements written by the reinsurer

Question LI 7-27

How should an entity consider cancellation provisions and remaining unearned premium reserves for an insurance contract when estimating the expected credit losses of premiums receivable?

PwC response

The premium receivable asset is required to be evaluated for credit losses in accordance with ASC 326. In certain instances, an insurance entity will record written premiums and a premium receivable from the policyholder as of the effective date of the insurance contract to reflect the entire amount of premium due under the contract for the period of coverage. The insurance entity will also record an unearned premium reserve liability for the portion of the written premium that has not yet been earned. This generally results in no income being recorded as of the effective date of the contract but an equivalent premium receivable asset and unearned premium reserve liability being recorded.

Most insurance policies allow the insurance company to unilaterally cancel the policy if the policyholder fails to pay the contractual premium due. The insurance policy will generally allow for a 30- to 60-day legal grace period for the policyholder to pay the premium before the coverage is cancelled and the insurance entity is no longer under any obligation to perform. If a policy is cancelled, any remaining premium receivable balance and unearned premium liability would be written off, limiting the insurance company's exposure to the unpaid earned premium that had already been recognized in earnings prior to the cancellation date.

We believe that when measuring expected credit losses related to premium receivables, an insurer should consider the contractual provisions that allow them to cancel the policy following a legal grace period if the policyholder fails to pay the contractual premium. These cancellation provisions can reduce the exposure to credit losses as the write off of any premium balances, including the premium receivable and unearned premium reserve upon cancellation, does not represent a credit loss that needs to be captured in the CECL calculation. If laws and regulations state that coverage must be provided for the remaining term despite a delinquency or default by the policyholder, we believe that an insurer should consider credit losses on the entire premium receivable without consideration of the unearned premium.

7.9 **CECL - subsequent events and the allowance for credit losses**

Under ASC 855, *Subsequent Events*, there are two types of subsequent events:

- Recognized subsequent events that require adjustments to amounts recorded in the financial statements to be issued
- Nonrecognized subsequent events that are considered for disclosure

Events or transactions related to the estimate for credit losses that occur after the balance sheet date but before the financial statements are issued (or available to be issued) can be either recognized or nonrecognized subsequent events. This depends on the nature of the information received after the balance sheet date. While certain amendments were made to ASC 855 as a result of the CECL standard, credit losses were not scoped out of the subsequent events guidance. We believe that the amendments to the subsequent events guidance introduced by ASU 2016-13 were made to reflect that the accounting for credit losses has changed from an incurred loss model to an expected loss model, which requires forecasting future events.

The subsequent occurrence or non-occurrence of a forecasted event may not require a change in estimated credit losses at the balance sheet date when the possibility was already properly considered in the balance sheet estimate. As with any forecast, the estimate for expected credit losses will include imprecision and will not be 100% accurate.

During the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff discussed a consultation relating to the application of the subsequent events guidance in the context of the CECL guidance. The consultation included three examples of information received after the balance sheet date but before the financial statements are issued (or available to be issued). In each case, the information received was significantly different than management's expectations.

In the first fact pattern, the registrant received a servicer report after the balance sheet date that showed delinquencies and prepayments that occurred before the balance sheet date. In the second fact pattern, the registrant received an appraisal report estimating the fair value of loan collateral as of the balance sheet date. In both cases, the SEC staff concluded the registrant must consider the information in its estimate of expected credit losses. The SEC staff noted an important consideration in their conclusion was that it was loan-specific information and related to facts that existed at the balance sheet date.

The third fact pattern related to the US government's announcement of estimated unemployment rates for a period including the balance sheet date. The SEC staff stated that it would not object to the registrant either considering or not considering such rates in its estimate of expected credit losses.

The SEC staff shared their view that in connection with the forward-looking estimate of expected credit losses, there can be recognized and nonrecognized subsequent events. They also articulated some principles on how information received after the balance sheet date but before the financial statements are issued (or are available to be issued) could be evaluated.

In applying the subsequent events guidance, the SEC staff noted that an entity should first consider if the information received indicates a weakness or deficiency in the credit losses estimation process. If

so, the information received subsequent to the balance sheet date but before the financial statements are issued (or available to be issued) should be considered in the credit losses estimate.

- Loan-specific information about factual conditions that existed at the balance sheet date should be considered in an entity's estimate of credit losses (for example, the servicer report and appraisal report discussed above). These would be considered recognized subsequent events and an entity should update its estimation of credit losses with the information when received.
- When the information relating to forecasting assumptions used in establishing expected credit losses does not indicate a weakness or deficiency in the entity's estimation process, the treatment depends on when the information is received. If the information is received before the entity has completed an appropriate credit loss estimation process, an entity may choose to consider or not consider the information in their estimate. However, if the information is received after the entity has completed an appropriate estimation process, an entity should not consider the information in their estimate (i.e., it is a nonrecognized subsequent event).

Finally, the SEC staff reminded entities that nonrecognized subsequent events are required to be disclosed.

We believe an entity should develop an accounting policy with respect to the treatment of subsequent events when information is received relating to forecasting assumptions and it has not completed its estimation process, and consistently apply this accounting policy. In addition, when the information identifies a weakness or deficiency in the entity's estimation process, the entity should make the appropriate enhancements to its process and internal controls.

Question LI 7-28

Would an entity need to revise its expected credit loss estimate if a borrower defaults subsequent to the balance sheet date, but before the financial statements are issued (or are available to be issued)?

PwC response

It depends. Often, the default of a borrower subsequent to the balance sheet date is a culmination of conditions that built up over a period of time, which may include the period before the balance sheet date. An entity would need to consider whether the borrower's default provides additional evidence about conditions that existed and were "known or knowable" at the balance sheet date.

The estimate for expected credit losses may already have included consideration that this event was likely to occur. For example, an entity may have assigned a high probability of default when determining the estimate of expected credit losses on a loan that is individually assessed. In this case, the actual default serves to confirm an event that was already considered in the forward-looking estimate based on information available at the balance sheet date. If the loan was collectively assessed in a pool with other similar loans, the estimation of credit losses may have contemplated some portion of the loans in the pool defaulting, so the subsequent default may be an event that provides specific identification of which of the loans in the pool defaulted. If the entity's estimation process included forecasts of defaults in its forecasted credit losses, it may not be necessary to revisit the balance sheet estimated credit losses.

An entity should first consider if the information received indicates a weakness or deficiency in the credit losses estimation process. If this is the case, the information received subsequent to the balance

sheet date relating to the borrower's default should be considered in the credit losses estimate. In addition, an entity should address the related internal control weakness or deficiency.

Question LI 7-29

Would an entity need to revise its expected credit loss estimate if a borrower defaults due to its plant burning down subsequent to the balance sheet date, but before the financial statements are issued (or are available to be issued)?

PwC response

No. If the default of the borrower is clearly and directly attributable to an event that occurred subsequent to the balance sheet date (e.g., the plant burning down), this would be considered a nonrecognized subsequent event as it does not provide additional evidence about conditions that existed at the balance sheet date. An entity should not adjust its year-end credit losses estimate, but should assess the disclosures required for nonrecognized subsequent events.

***Chapter 8:
Impairment of available-for-
sale debt securities—updated
May 2022***

8.1 Chapter overview: impairment of AFS debt securities

Available-for-sale (AFS) debt securities are not within the scope of the current expected credit loss (CECL) model. ASC 326-30 provides a different impairment model that is a modified version of the other-than-temporary impairment (OTTI) model prescribed by prior GAAP. The new AFS debt security model differs from the prior OTTI model in that it no longer allows consideration of the length of time during which the fair value has been less than its amortized cost basis when determining whether a credit loss exists. The concept of OTTI is no longer relevant under ASC 326-30. The recognition and measurement of impairment will differ between the CECL model and the AFS debt security impairment model.

An AFS debt security is impaired if its fair value is below its amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges). A reporting entity must consider if it intends to sell a security or will more likely than not be required to sell a security before recovery of its amortized cost basis.

This chapter discusses the application of the AFS debt security impairment model in accordance with ASC 326-30. Figure LI 8-1 illustrates where additional information on AFS debt securities can be found within this guide.

Figure LI 8-1

Location of additional information on AFS debt securities

Topic	Location of discussion in guide
Classification of AFS debt securities	LI 3
Application of the AFS impairment model to purchased financial assets with more than insignificant credit deterioration	LI 9
Presentation and disclosure requirements	LI 12

8.1.1 Portfolio layer method

The portfolio layer method permits reporting entities to designate the portion of a closed portfolio of certain financial assets, beneficial interests secured by financial assets, or a combination of the two, that is not expected to be prepaid during the hedge period as the hedged item in a fair value hedge of interest rate risk. Although the portfolio layer method (originally referred to as the last-of-layer model) was designed considering prepayable mortgage loans or mortgage-backed securities, it may be applicable to other assets as well. The guidance allows an entity to essentially ignore prepayment risk in the hedge relationship even when prepayable assets are present in the closed portfolio. It does so by permitting designation of the portion of the pool not expected to be prepaid, defaulted, or sold as the hedged item.

Fair value hedge accounting basis adjustments on active portfolio layer method hedges should not be considered when determining if an available security is impaired. However, consistent with the guidance in ASC 815-25-35-6, the basis adjustment associated with AFS securities would result in an adjustment to the amount recorded in AOCI for those securities. For AFS securities subject to fair value hedges, changes in the fair value of the security for the risk hedged are recognized in earnings as opposed to AOCI.

An active portfolio layer method hedge is an existing hedge relationship designated under the portfolio layer method hedging strategy in ASC 815. Basis adjustments associated with dedesignated portfolio layer method hedges should be considered when determining if an available security is impaired.

ASC 815-25-35-6

If a hedged item is otherwise measured at fair value with changes in fair value reported in other comprehensive income (such as an available-for-sale debt security), the adjustment of the hedged item's carrying amount discussed in paragraph 815-25-35-1(b) shall be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument. If the hedged item is a hedged layer designated in a portfolio layer method hedge on a closed portfolio in accordance with paragraph 815-20-25-12A and the closed portfolio includes only available-for-sale debt securities, the entire gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument. If the closed portfolio includes available-for-sale debt securities and assets that are not available-for-sale debt securities, an entity shall determine the portion of the change in fair value on the hedged item attributable to the hedged risk associated with the available-for-sale debt securities using a systematic and rational method. That amount shall be recognized in earnings rather than in other comprehensive income. However, an entity shall not adjust the carrying amount of the individual available-for-sale debt securities included in the closed portfolio in accordance with paragraph 815-25-35-1(c).

ASC 815-25-35-10

An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

ASC 815-25-35-11

This Subtopic implicitly affects the measurement of credit losses under Subtopic 326-20 on financial instruments measured at amortized cost by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted amortized cost basis in a hedged loan. Paragraph 326-20-55-9 requires that, when the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. That paragraph states that the adjustment under fair value hedge accounting for changes in fair value attributable to the hedged risk under this Subtopic shall be considered to be an adjustment of the loan's amortized cost basis. As discussed in that paragraph, the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Because paragraph 815-25-

35-10 requires that the loan's amortized cost basis be adjusted for hedge accounting before the requirements of Subtopic 326-20 are applied, this Subtopic implicitly supports using the new effective rate and the adjusted amortized cost basis. A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge in accordance with paragraph 815-25-35-1(c) shall not adjust the amortized cost basis of the individual assets or individual beneficial interest included in the closed portfolio. An entity may not apply this guidance by analogy to other components of amortized cost basis.

ASC 815-25-35-12

This guidance applies to all entities applying Subtopic 326-20 to financial assets that are hedged items in a fair value hedge, regardless of whether those entities have delayed amortizing to earnings the adjustments of the loan's amortized cost basis arising from fair value hedge accounting until the hedging relationship is dedesignated. The guidance on recalculating the effective rate is not intended to be applied to all other circumstances that result in an adjustment of a loan's amortized cost basis and is not intended to be applied to the individual assets or individual beneficial interest in an existing portfolio layer method hedge closed portfolio.

ASC 326-30-35-1A

An entity shall not consider a basis adjustment related to an existing portfolio layer method hedge designated in accordance with paragraph 815-20-25-12A when measuring impairment of the individual investments or individual beneficial interest included in a closed portfolio hedged using the portfolio layer method

8.2 *AFS debt security impairment model*

AFS debt securities are required to be individually evaluated for impairment in accordance with ASC 326-30-35-4 and ASC 326-30-35-5. A security is considered impaired if the fair value of the security is less than its amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges).

ASC 326-30-35-1

An investment is impaired if the fair value of the investment is less than its amortized cost basis.

ASC 326-30-35-1A

An entity shall not consider a basis adjustment related to an existing portfolio layer method hedge designated in accordance with paragraph 815-20-25-12A when measuring impairment of the individual investments or individual beneficial interest included in a closed portfolio hedged using the portfolio layer method

ASC 326-30-35-4

Impairment shall be assessed at the individual security level (referred to as an investment). The impairment assessment of the individual securities or individual beneficial interest in a closed portfolio hedged using the portfolio layer method shall not consider the basis adjustment related to an existing portfolio layer method hedge. Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its

debt securities. (For example, debt securities bearing the same Committee on Uniform Security Identification Procedures [CUSIP] number that were purchased in separate trade lots may be aggregated by a reporting entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses for the debt securities.) Providing a general allowance for an unidentified impairment in a portfolio of debt securities is not appropriate.

ASC 326-30-35-5

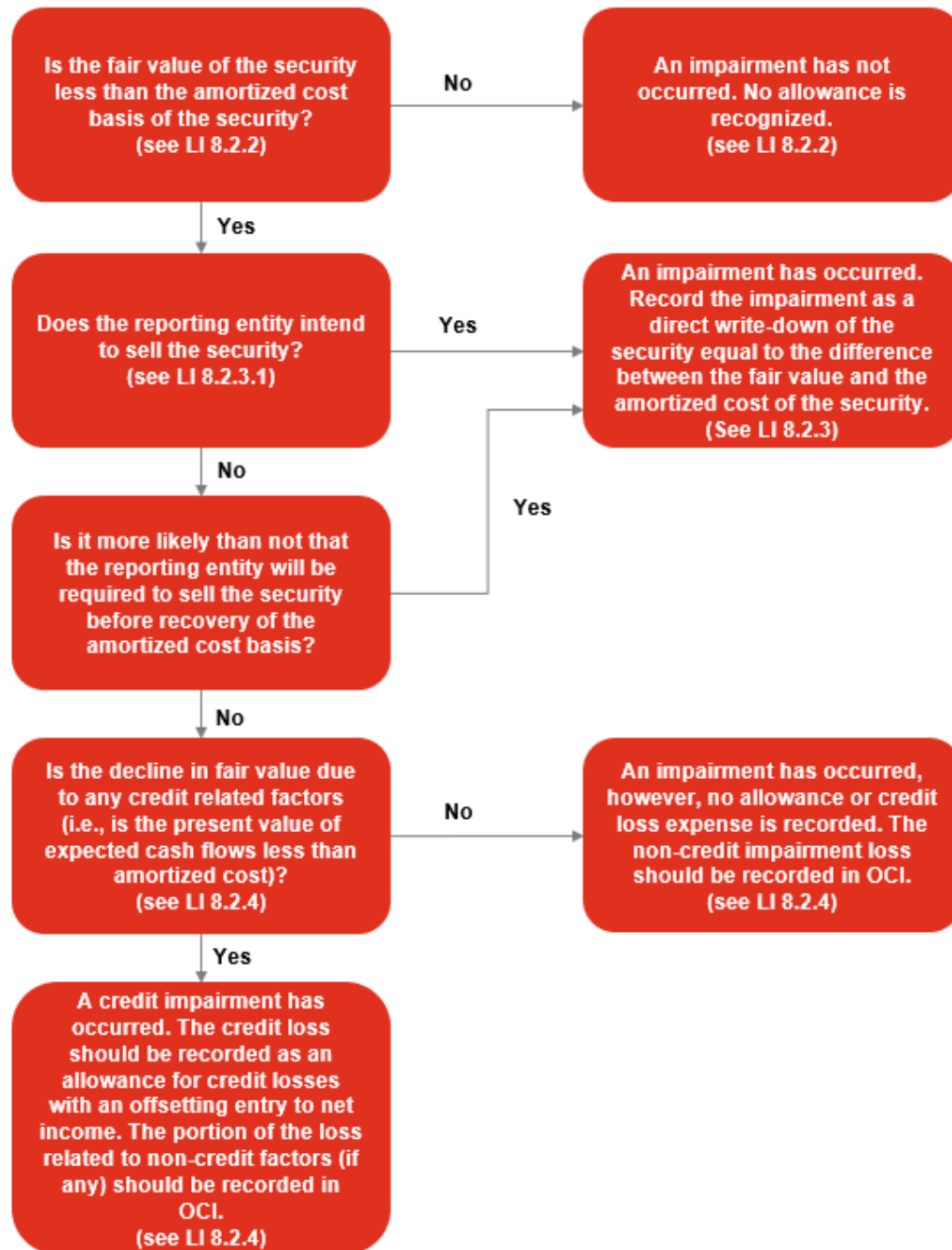
An entity shall not combine separate contracts (a debt security and a guarantee or other credit enhancement) for purposes of determining whether a debt security is impaired or can contractually be prepaid or otherwise settled in such a way that the entity would not recover substantially all of its cost.

If the reporting entity concludes that it does not intend to sell an impaired security and it is not more likely than not required to sell an impaired security before recovery of its amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges), an entity should record the portion of the impairment related to credit losses (if any) in an allowance for credit losses with an offsetting entry to net income. Any portion of the impairment not related to credit losses is recorded through other comprehensive income (OCI) (unless other GAAP such as hedge accounting would dictate other treatment). The amount of the allowance for credit losses is limited to the amount fair value is less than the amortized cost basis.

If the security is impaired and the entity intends to sell or will more likely than not be required to sell the security before recovering its amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges), an entity should first writeoff any previously recognized allowance for credit losses with an offsetting entry to the security's amortized cost basis. If the allowance has been fully written off and fair value is less than amortized cost basis, an entity should directly write down the amortized cost basis of the asset to its fair value with an entry to net income. See Example LI 8-1 in LI 8.2.5, Example LI 8-2 in LI 8.2.6, and Example LI 8-3 in LI 8.2.7. If an unrealized holding loss was deferred in OCI, additional consideration is needed.

Figure LI 8-2 provides an overview of the AFS debt security impairment model.

Figure LI 8-2
 Analysis of impairment of an AFS debt security



Note: Figure LI 8-2 assumes the securities are not designated as hedged items in a portfolio layer method hedge. See LI 8.1.1.

8.2.1 *Guarantees and other credit enhancements*

If a guarantee is a freestanding financial instrument (i.e., distinct legal contract and not a component of the originated or purchased debt security), it should be accounted for separately and cannot be considered in the credit loss analysis performed on the security. The Codification Master Glossary provides information on the definition of a freestanding financial instrument.

Definition from ASC Master Glossary

Freestanding Financial Instrument: A financial instrument that meets either of the following conditions:

- a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.
- b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Additionally, ASC 326-30-35-5 provides information on the accounting for debt securities and guarantees and other credit enhancements.

ASC 326-30-35-5

An entity shall not combine separate contracts (a debt security and a guarantee or other credit enhancement) for purposes of determining whether a debt security is impaired or can contractually be prepaid or otherwise settled in such a way that the entity would not recover substantially all of its cost.

A guarantee or other credit enhancement that is not required to be accounted for as a bifurcated derivative under the guidance in ASC 815 and that is contractually part of the purchased debt security should be considered when determining whether a credit loss exists. For example, a guarantee of principal and interest payments by a third-party guarantor included in the terms of a purchased debt security may create a single legal instrument (i.e., a guaranteed security). In that case, the guaranteed security itself is the unit of account, rather than accounting for the security and guarantee separately.

8.2.2 *Determine if an AFS debt security is impaired*

An investment in an AFS debt security is considered impaired if the fair value of the security is less than its amortized cost (excluding fair value hedge accounting adjustments from active portfolio layer method hedges). If the fair value of the security is higher than its amortized cost basis, the security is not considered impaired.

Question LI 8-1

If an AFS debt security's fair value exceeds its amortized cost basis, but the security has experienced an adverse change in cash flows due to credit-related factors, should an impairment be recorded?

PwC response

No. While a credit loss may exist in a security whose fair value exceeds its amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges), no impairment is recognized. For example, the credit on a fixed-rate bond may have deteriorated (resulting in a decrease in the fair value of the security), but there may also have been a decline in market interest rates since the security was issued (resulting in an increase in the fair value of the security) that could offset the impact of the credit deterioration. Such a security is not considered impaired, as the entity would be able to recover the amortized cost basis of the security by selling it at fair value. Therefore, no impairment would be recognized.

8.2.3 Assess if the entity may sell an impaired AFS debt security

If the AFS debt security is impaired, the reporting entity should determine whether it has decided to sell the security, or will more likely than not be required to sell the security before recovery of its amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges).

8.2.3.1 AFS debt security: intent to sell

ASC 326-30-35-10 states that a reporting entity has the intent to sell when it has decided to sell a security, but it does not provide guidance for determining when such a decision is considered to have been made.

ASC 326-30-35-10

If an entity intends to sell the debt security (that is, it has decided to sell the security), or more likely than not will be required to sell the security before recovery of its amortized cost basis, any allowance for credit losses shall be written off and the amortized cost basis shall be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings. If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs). In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, the entity shall consider the factors in paragraphs 326-30-55-1 through 55-2.

A decision to sell that is contingent on the occurrence of a future event may not be evidence of a present intent to sell. The following indicators, though not all-inclusive, may help determine the point at which a reporting entity has the intent to sell a security:

- A person with the appropriate authority approves the sale of the security subject only to terms that are usual and customary for sales of such securities
- The security is being actively marketed for sale at a price that is reasonable in relation to its current fair value

In general, for marketable securities, we expect a relatively short period of time (measured in days) between a reporting entity's assertion about its decision to sell and an actual sale.

If it is determined that a reporting entity intends to sell the impaired security, then it should record the entire impairment loss in net income as a direct write-down to the amortized cost basis of the security. The write-down amount should equal the difference between the fair value and amortized cost (excluding fair value hedge accounting adjustments from active portfolio layer method hedges), which includes amounts due to both credit and noncredit related factors.

If a reporting entity does not have the intent to sell the impaired security, it should assess whether it will more likely than not be required to sell the security before recovery of its amortized cost basis.

8.2.3.2 AFS debt security: more likely than not required to sell

As discussed in ASC 326-30-35-10, once a reporting entity concludes that it does not have the intent to sell an impaired security, it must assess whether it will more likely than not be required to sell the security before recovery of its amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges).

Excerpt from ASC 326-30-35-10

If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs).

To determine whether it is more likely than not that it will be required to sell an impaired security before recovery of its amortized cost basis, a reporting entity should assess two factors:

- The conditions or events that might require the reporting entity to sell the security
- The likelihood of such conditions or events occurring

In general, only sales that involve a level of legal, regulatory, or operational compulsion should be considered “required” sales, consistent with the guidance in ASC 326-30-35-10. Once the reporting entity has considered available evidence of conditions or events that may require the sale of an impaired security are identified, a reporting entity should determine whether it is more likely than not that these conditions or events will occur. If it is, a reporting entity should assess whether the security would be sold if the events or conditions occur. The potential sale of an impaired debt security, even if considered more likely than not, may not result in a credit loss if that sale is not required before the recovery of the security’s amortized cost basis. Other indicators should be considered to determine whether a reporting entity is more likely than not required to sell an impaired security before recovery of the amortized cost basis. In determining whether a reporting entity will recover the amortized cost basis before it is required to sell the security, a reporting entity should not project changes in market prices that would increase the fair value as of the estimated sales date. Instead, the analysis of whether the amortized cost basis will be recovered should be based solely on the passage of time (i.e., if the asset’s amortized cost basis amortizes to an amount that is equal to or less than its current fair value before a sale could be required, the asset is not impaired).

If it is determined that a reporting entity will more likely than not be required to sell an impaired security before the recovery of the amortized cost basis (excluding fair value hedge accounting

adjustments from active portfolio layer method hedges), then the reporting entity should record the entire impairment loss in net income as a direct write-down of the amortized cost basis. The write-down amount would equal the difference between the fair value and amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges) of the security, which would include both credit and noncredit related factors.

Question LI 8-2

Assume a reporting entity either has the intent to sell an impaired AFS debt security or will more likely than not be required to sell an AFS debt security prior to recovery of its amortized cost basis. Should the reporting entity record two separate impairment amounts – one for credit impairment and another for non-credit impairment?

PwC response

No. If the debt security is impaired (i.e., fair value is less than amortized cost excluding fair value hedge accounting adjustments from active portfolio layer method hedges) and the reporting entity either intends to sell the impaired debt security, or it is more likely than not that the reporting entity will be required to sell the impaired debt security before recovery of its amortized cost basis, the impairment amount should be equal to the difference between the debt security's fair value and its amortized cost (excluding fair value hedge accounting adjustments from active portfolio layer method hedges). Therefore, the credit and noncredit loss components would already be included in the impairment loss and therefore should not be separately calculated and presented in the financial statements.

Question LI 8-3

A reporting entity sells an AFS debt security shortly after it has asserted that it does not intend to sell the security. Does the sale invalidate the reporting entity's assertion regarding its intent not to sell?

PwC response

It depends. If an AFS debt security's fair value is below its amortized cost basis, a reporting entity should have a basis for asserting its intention not to sell and that it is more likely than not it would not be required to sell the security at the reporting date. Subsequent sales of such AFS debt securities may call into question the validity of the reporting entity's previous assertion unless there has been a change in facts and circumstances. The entity should document the rationale for why its original assertion changed in the subsequent period.

Question LI 8-4

If an AFS debt security is impaired and managed by a third-party investment adviser that has discretion to purchase and sell debt securities without management approval, is management required to assert whether there is an intent to sell the security, or if the entity will more likely than not be required to sell the security, before recovery of the security's amortized cost basis?

PwC response

Yes. Management must evaluate whether there is an intent to sell the security, or more likely than not the entity will be required to sell the security, even when assets are managed by a third-party

investment adviser. A third-party investment adviser typically acts as an agent for the entity and performs functions that the entity itself would legally perform. Although the contractual agreement may provide the third-party investment adviser with discretion regarding which assets to buy and sell, this discretion is typically defined within the parameters of a given investment strategy that is approved by the entity. Effectively, the third-party investment adviser is not dissimilar to the entity's internal function, which must comply with internal investment guidelines.

In this situation, management should still be able to assert that it does not intend to sell the security, and that it is not more likely than not that the entity will be required to sell the security simply because the securities are managed by a third-party investment adviser, through discussions with and instructions to the third-party investment adviser.

8.2.4 Assess impairment for credit or non-credit related factors

When an AFS debt security is impaired at the reporting date, and the reporting entity does not meet the guidance for intending to sell or more likely than not being required to sell the security before the amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges) is recovered, the reporting entity should determine whether the impairment is related to credit or noncredit factors, as discussed in ASC 326-30-35-7.

ASC 326-30-35-7

In determining whether a credit loss exists, an entity shall consider the factors in paragraphs 326-30-55-1 through 55-4 and use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in paragraphs 326-30-35-8 through 35-10. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

ASC 326-30-55-1 through ASC 326-30-55-4 discusses some of the many factors to be considered when determining whether a credit loss exists, including:

- the extent to which fair value is less than the amortized cost basis,
- adverse conditions specifically related to the security, an industry, or geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors),
- changes in the quality of the security's credit enhancement,
- the payment structure of the security,
- changes in the security's rating,
- failure of the issuer to make scheduled principal or interest payments on the security,
- remaining payment terms of the security,
- prepayment speeds,
- the issuer's financial condition, and

- the value of any underlying collateral.

The length of time the security has been in an unrealized loss position should not be considered when determining if a credit loss exists.

To determine the amount of impairment related to credit, a reporting entity should compare the present value of the cash flows expected to be collected on the AFS debt security with the security's amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges). If the present value of cash flows expected to be collected is less than the security's amortized cost basis, a credit-related impairment exists, and the difference should be recorded as an allowance for credit losses through net income. After the allowance for credit losses is recorded, any remaining difference between the security's fair value and amortized cost basis is considered to be non-credit-related impairment and should be recorded in OCI (assuming the security is not designated in a fair value hedging relationship). The amount of total impairment recognized is limited to the excess of the amortized cost basis over the fair value of the AFS debt security (i.e., the model contains a "fair value floor").

Question LI 8-5

Can an entity perform a qualitative assessment to determine if a credit loss on an AFS debt security is required under ASC 326-30?

PwC response

In many instances, yes. An entity may not need to calculate the present value of cash flows to assess whether a credit loss exists. Based on an assessment of qualitative factors (including those noted in ASC 326-30-55-1), an entity may determine that a qualitative analysis is sufficient to support its conclusion that the present value of expected cash flows equals or exceeds the security's amortized cost basis (i.e., that it expects to receive all of the contractual cash flows from a security). For example, it may be evident that the fair value is below the amortized cost of the security solely due to changes in market interest rates. In this scenario, an entity could conclude that a credit loss does not exist without performing a quantitative assessment.

If the qualitative assessment suggests a credit loss may exist, the entity would be required to perform a quantitative present value of cash flows analysis to measure any credit loss to confirm whether a credit loss exists. The factors (or "screens," as commonly referred to in practice) used as a basis for an entity's qualitative assessment under ASC 326-30 may differ from those used under previous GAAP.

When a qualitative process concludes there is no credit related impairment, an entity should be able to support that a quantitative analysis would have resulted in the same conclusion. It is important that an entity document and refresh the basis for its conclusions. We expect there to be scenarios when a quantitative assessment, performed because a qualitative analysis suggests there may be a credit loss, will indicate there is no credit loss.

Generally, the more the amortized cost basis of the security (except for fair value hedge accounting adjustments from active portfolio layer method hedges) exceeds its fair value, the more challenging it will be to justify using only a qualitative assessment. In addition, other specific factors, like significant adverse conditions, may also indicate that a quantitative assessment is required.

8.2.4.1 *Calculating the present value of expected cash flows*

The first step in determining whether there is an impairment related to credit on an AFS debt security is to compare the present value of the cash flows expected to be collected with the security's amortized cost basis (excluding fair value hedge accounting adjustments from active portfolio layer method hedges). If the present value of cash flows expected to be collected is less than the security's amortized cost basis, a credit-related impairment exists, and the difference between the present value of the expected cash flows and the amortized cost basis should be recorded as an allowance for credit losses through net income. After the allowance for credit losses is recorded, any remaining difference between the security's fair value and amortized cost basis is considered to be non-credit-related impairment and should be recorded in OCI (assuming the security is not designated in a fair value hedging relationship). The amount of impairment recognized is limited to the fair value floor (the difference between the amortized cost basis and fair value). The mechanics of the calculation used to calculate the present value of the expected cash flows on an AFS debt security will depend on whether the entity uses a single best estimate approach or a probability weighted approach. When using a single best estimate of cash flows, the reporting entity should discount its estimate of expected cash flows using the security's effective interest rate. In contrast, the probability-weighted approach considers various scenarios, some of which result in credit losses, and considers the probability of each of those scenarios occurring. When using a probability-weighted approach for a fixed rate AFS debt security, the discount rate should be the effective interest rate excluding the credit risk impact captured in probability weighting multiple discounted cash flow scenarios. Under the probability-weighted approach, we expect the discount rate to be between the effective interest rate and the risk-free rate at acquisition.

ASC 326-30 does not prescribe a specific method to determine the best estimate of the expected cash flows for AFS debt securities. A reporting entity's estimate should be based on all available evidence, including past events, current conditions, and reasonable and supportable forecasts. ASC 326-30-55-2 provides guidance for determining the estimate of expected future cash flows.

ASC 326-30-55-2

An entity should consider available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected. That information should include all of the following:

- a. The remaining payment terms of the security
- b. Prepayment speeds
- c. The financial condition of the issuer(s)
- d. Expected defaults
- e. The value of any underlying collateral.

A reporting entity's method of estimating the expected cash flows should be consistent with the FASB's intent that such cash flows "represent the cash flows that an entity is likely to collect after a careful assessment of available information." The decision to use either a single best estimate or a probability-

weighted methodology to measure the present value of cash flows expected to be collected is an accounting policy election by similar transaction type. Methodologies that implicitly or explicitly recognize changes in cash flows that are not due to credit would generally not be appropriate (e.g., cash flow changes due to foreign currency volatility).

An entity should consider whether the assumptions underlying its economic forecasts are consistent with its other economic forecasts when appropriate, especially when different sources are used for different assumptions.

Calculating AFS debt securities' effective interest rate

AFS debt securities accounted for under ASC 326-30 are required to use a discounted cash flow (DCF) method to measure credit impairment. When using a DCF method, an entity should discount expected cash flows at the financial asset's effective interest rate. Per ASC 326-30-35-7, the effective interest rate implicit in the financial asset at the date of acquisition should be used.

When an entity uses an unadjusted effective interest rate (i.e., the effective interest rate used for interest income recognition purposes) to discount expected cash flows on fixed and/or floating rate AFS debt securities, that discount rate will generally not include expectations of prepayments. However, in estimating credit losses under ASC 326-30, an entity is required to consider the impact of prepayments in its expected cash flows on these securities. ASC 326-30-35-7A allows an accounting policy election to adjust the effective interest rate used to discount expected cash flows for the consideration of timing (and changes in timing) of expected prepayments of an AFS debt security within the scope of ASC 326-30. This election should be made by major security type.

ASC 326-30-35-7

In determining whether a credit loss exists, an entity shall consider the factors in paragraphs 326-30-55-1 through 55-4 and use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in paragraphs 326-30-35-8 through 35-10. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

ASC 326-30-35-7A

As an accounting policy election for each major security type of debt securities classified as available-for-sale securities, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments.

Entities need to calculate expected cash flows, including future interest (or coupon) payments, in order to determine the effective interest rate. In regard to variable rate AFS debt securities, a company can elect whether to use projections of future interest rate environments to estimate future interest payments used in the calculation of these expected cash flows or they can elect to estimate future interest payments using the current rate. ASC 326-30-35-11 further requires variable rate AFS debt securities to use the same expected cash flows for the purposes of determining both the effective interest rate and the allowance for credit losses. If an entity does elect to project future interest rate environments when using a DCF to estimate credit losses for variable rate securities, it is required to adjust the effective interest rate used in discounting cash flows to consider the timing (and changes in timing) of expected cash flows resulting from prepayments.

ASC 326-30-35-11

If the security's contractual interest rate varies based on subsequent 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, that security's effective interest rate (used to discount expected cash flows as described in paragraph 326-30-35-7) may be calculated based on the factor as it changes over the life of the security or is projected to change over the life of the security, or may be fixed at the rate in effect at the date an entity determines that the security has a credit loss as determined in accordance with paragraphs 326-30-35-1 through 35-2. The entity's choice shall be applied consistently for all securities whose contractual interest rate varies based on subsequent changes in an independent factor. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-30-35-7A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

The elections within ASC 326-30-35-7A and ASC 326-30-35-11 are only applicable to adjusting the effective interest rate for the purposes of estimating credit losses. Interest income is required to be recognized using an effective interest rate in accordance with other GAAP (for example ASC 310-20, which was not amended by ASC 326-30).

Consistent with the guidance in ASC 815-25-35-10 through ASC 815-25-35-12, ASC 326-30-35-1A, and ASC 326-30-35-4, we believe that the effective interest rate used in a DCF approach should not consider the impact of basis adjustments relating to active portfolio layer method hedging relationships.

8.2.4.2 *Fair value/present value of expected cash flow assumptions*

When estimating the present value of cash flows expected to be collected under ASC 326-30, a reporting entity should consider all relevant facts and circumstances, including the market's view of the likelihood and amount of future cash flows. However, the inputs and assumptions are not required to be the same as those used to measure fair value under ASC 820 and exclusive reliance does not need to be placed on market participant assumptions of future cash flows. As the differences between management's assumptions and market participant assumptions increase, though, the level of analysis and objective evidence needed to support the differences also increase.

8.2.5 *Initial measurement of an AFS debt security's allowance*

This section discusses the initial measurement of credit losses for AFS debt securities that are not purchased credit deteriorated (PCD). The initial measurement of the allowance for credit losses for non-PCD AFS debt securities will typically be subsequent to origination or purchase since the securities are generally recognized at fair value. Refer to LI 9 for further information on the initial measurement of the allowance for credit losses for PCD AFS debt securities.

If the present value of expected cash flows is greater than the amortized cost basis (except for fair value hedge accounting adjustments from active portfolio layer method hedges) of an AFS debt security, the impairment is noncredit related. In this case, no allowance for credit losses would be recorded in net income; instead, the decline in fair value would be recorded in OCI.

If the present value of expected cash flows is less than the amortized cost basis of an AFS debt security, then an allowance for credit losses for this difference should be recorded in net income. The amount of allowance for credit losses recorded is limited to the difference between the fair value and amortized cost.

The following example illustrates the initial measurement and recognition of an impairment on an AFS debt security.

EXAMPLE LI 8-1

Initial recognition of impairment on an AFS debt security

On January 1, 20X0, Investor Corp pays \$1,000 for a debt security with the following terms.

Par amount	\$1,000 paid at maturity
Coupon rate	4.5% paid annually
Maturity date	December 31, 20X4

The AFS security is not designated as a hedged item in a fair value hedging relationship.

On December 31, 20X0, the fair value of the security is \$700 and there has been a decline in expected cash flows. Investor Corp determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security.

Year	Contractual cash flows	Cash flows expected at 12/31/X0	Decrease in expected cash flows
20X1	45	45	—
20X2	45	45	—
20X3	45	45	—
20X4	\$1,045	\$905	\$140
Total cash flows	\$1,180	\$1,040	\$140
Present value of cash flows	\$1,000	\$883	\$117

How should Investor Corp assess whether an impairment exists as of December 31, 20X0? If the security is impaired, how should Investor Corp record the impairment?

Analysis

The security is impaired at December 31, 20X0 because the fair value (\$700) is below the amortized cost basis of the security (\$1,000).

Investor Corp should determine whether the loss is related to credit or noncredit factors. Since the present value of expected cash flows to be collected (\$883) is less than the amortized cost basis of the security (\$1,000), a credit loss exists.

Investor Corp would separate the total impairment of \$300 (\$1,000 amortized cost basis – \$700 fair value) into the following components:

- The credit loss or amount representing the decrease in cash flows expected to be collected of \$117
- The noncredit component related to all other factors of \$183 (calculated as the remaining impairment after deducting the credit-related loss)

After the impairment (credit and noncredit), the debt security's amortized cost basis will still be \$1,000 and the security will be carried at its fair value of \$700 as shown in the following table.

Amortized cost basis on December 31, 20X0	\$1,000
Allowance for credit losses	(117)
Net value on December 31, 20X0	883
Unrealized loss	(183)
Fair value on December 31, 20X0	\$700

Investor Corp would record the following entry to recognize the impairment of the debt security (tax effects are ignored for illustration purposes).

Dr. Provision expense	\$117	
Dr. OCI – AFS unrealized loss	\$183	
Cr. Allowance for credit losses		\$117
Cr. AFS security fair value		\$183

8.2.6 *Subsequent measurement of an AFS debt security's allowance*

At each subsequent reporting period, a reporting entity should assess whether there has been a change in the expected cash flows of the asset. If there is a decrease in expected cash flows, the allowance for credit losses may need to increase. If there is an increase in expected cash flows, some portion or all of the allowance for credit losses may need to be reversed. A reversal of the allowance for credit losses should not exceed the allowance amount initially recognized. The reporting entity should determine its allowance for credit losses in subsequent periods by comparing the security's present value of cash flows to its amortized cost basis, similar to initial measurement.

Example LI 8-2 demonstrates the subsequent measurement of impairment on an AFS debt security.

EXAMPLE LI 8-2

Subsequent recognition of impairment on an AFS debt security

On January 1, 20X0, Investor Corp pays \$1,000 for a debt security with the following terms.

Par amount	\$1,000 paid at maturity
Coupon rate	4.5% paid annually
Maturity date	December 31, 20X4

Investor Corp classifies the security as available for sale. The AFS security is not designated as a hedged item in a fair value hedging relationship.

On December 31, 20X0, the fair value of the debt security is \$700. Investor Corp determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. The present value of expected cash flows to be collected is \$883 and the amortized cost basis of the security is \$1,000 (a credit loss exists). As a result, Investor Corp, records an allowance for credit losses of \$117 and an unrealized loss in AOCI of \$183.

On December 31, 20X1, the fair value of the debt security remains at \$700. Investor Corp determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security.

At December 31, 20X1, Investor Corp re-estimates the expected cash flows of the security. The expected cash flows improve as shown in the following table. To calculate the present value, the cash flows are discounted at 4.5%, the original effective interest rate on the security.

Year	Contractual cash flows	Cash flows expected at 12/31/X1	Decrease in expected cash flows
20X2	45	45	—
20X3	45	45	—
20X4	\$1,045	\$935	\$110
Total cash flows	\$1,135	\$1,025	\$110
Present value of cash flows	\$1,000	\$904	\$96

How should Investor Corp measure and recognize the impairment on the debt security as of December 31, 20X1?

Analysis

The security is impaired at December 31, 20X1 because the fair value (\$700) is below the amortized cost basis of the security (\$1,000).

Since the present value of expected cash flows to be collected (\$904) is less than the amortized cost basis of the security (\$1,000), a credit loss exists.

Investor Corp would then separate the total impairment of \$300 (\$1,000 amortized cost basis – \$700 fair value) into the following components:

- The credit loss or present value of the cash flows not expected to be collected of \$96
- The noncredit component related to all other factors of \$204 (calculated as the remaining impairment after deducting the expected credit loss)

Investor Corp would adjust the allowance for credit losses by \$21, to reduce it from \$117 to \$96 and then increase the amount allocated to noncredit impairment in OCI by the same amount.

After the recognition of the impairment (credit and noncredit), the debt security's amortized cost basis will still be \$1,000 and the security will be carried at its fair value of \$700 as shown in the following table.

Amortized cost basis on December 31, 20X1	\$1,000
Allowance for credit losses at January 1, 20X1	(117)
Adjustment to allowance	21
Net value on December 31, 20X1	\$904
Unrealized loss in OCI at January 1, 20X1	(183)
Adjustment to OCI	(21)
Fair value on December 31, 20X1	\$700

Investor Corp would record the following entry to recognize the reversal of the allowance for credit losses in net income and to recognize the additional noncredit impairment loss in OCI.

Dr. Allowance for credit losses	\$21	
Dr. OCI – AFS unrealized loss	\$21	
Cr. Provision expense		\$21
Cr. AFS security fair value		\$21

8.2.6.1 *Subsequent measurement of foreign-currency AFS debt security*

Changes in the fair value of foreign currency-denominated AFS debt securities that are related to changes in foreign exchange rates should be recorded in AOCI, as these changes are considered non-credit related. As a result, the allowance for credit losses on a foreign currency-denominated AFS security will not change if there has been no change in expected cash flows. Per the November 1, 2018 TRG meeting (TRG Memo 14: Cover Memo and TRG Memo 18: Summary of Issues Discussed and Next Steps), unrealized losses related to changes in foreign exchange rates on foreign currency-denominated AFS debt securities should be released from AOCI into earnings at the earliest of the following:

- Maturity of the security

- Sale of the security
- When the entity intends to sell the security
- When the entity is more-likely-than-not required to sell the security before recovery of its amortized cost basis

We believe the allowance for credit losses on foreign-denominated AFS debt securities should be measured by calculating the expected cash flows at the historical exchange rate (i.e., the date the security was acquired) and comparing the present value of those cash flows to the security’s amortized cost basis (measured at the historical exchange rate).

8.2.7 Writeoffs and recoveries of an AFS debt security allowance

Reporting entities should consider whether estimated credit losses recognized in the allowance for credit losses have become uncollectible. When such a scenario occurs, the allowance on the uncollectible portion should be charged off with an offsetting entry to the carrying value of the security.

ASC 326-30-35-12

An entity shall reassess the credit losses each reporting period when there is an allowance for credit losses. An entity shall record subsequent changes in the allowance for credit losses on available-for-sale debt securities with a corresponding adjustment recorded in the credit loss expense on available-for-sale debt securities. An entity shall not reverse a previously recorded allowance for credit losses to an amount below zero.

ASC 326-30-35-13

An entity shall recognize writeoffs of available-for-sale debt securities in accordance with paragraph 326-20-35-8.

ASC 326-20-35-8

Writeoffs of financial assets, which may be full or partial writeoffs, shall be deducted from the allowance. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible.

Example LI 8-3 illustrates the recognition of a writeoff and subsequent recovery of an AFS debt security.

EXAMPLE LI 8-3

Recognition of a writeoff and subsequent recovery on an AFS debt security

On January 1, 20X0, Investor Corp pays \$1,000 for a debt security with the following terms.

Par amount	\$1,000 paid at maturity
Coupon rate	4.5% paid annually
Maturity date	December 31, 20X4

Investor Corp classifies the security as available for sale.

On December 31, 20X1, the fair value of the debt security was \$700. Investor Corp determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. As a result, Investor Corp records an allowance for credit losses of \$96 and an unrealized loss in AOCI of \$204. On March 31, 20X2, the issuer of the debt security files for bankruptcy. Investor Corp determines that the full amount on the security is uncollectible (i.e., the fair value of the security is \$0).

On April 1, 20X3, Investor Corp receives a partial payment from the issuer of \$500.

How should Investor Corp measure and recognize the impairment on the debt security as of March 31, 20X2? How should Investor Corp record the partial recovery on April 1, 20X3?

Analysis

To recognize the impairment on the debt security as of March 31, 20X2, Investor Corp would first measure the full credit loss and then writeoff the entire amortized cost by recording the following journal entry.

Dr. Allowance for credit losses	\$96	
Dr. Provision expense	\$904	
Dr. AFS security – unrealized loss	\$204	
Cr. OCI		\$204
Cr. AFS security – Amortized cost basis		\$1,000

ASC 326-30 permits a recovery of a financial asset previously written off to be recognized when consideration is received if the allowance is already reduced to zero. In this example, the allowance was reduced to zero as of March 31, 20X2, so the April 1, 20X3 recovery is recognized when received. To record the partial recovery on April 1, 20X3, Investor Corp would recognize the payment against provision expense by recording the following entry.

Dr. Cash	\$500	
Cr. Provision expense		\$500

8.2.8 Accrued interest on AFS debt securities

ASC 326-30 defines an asset’s amortized cost basis to include accrued interest.

ASC 326-30-20

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

For entities that have accounting policies to exclude accrued interest from both the fair value and the amortized cost basis of an AFS debt security for purposes of identifying and measuring impairment, ASC 326-30 provides the following additional guidance:

- A reporting entity can elect to develop expected credit losses on its accrued interest receivable balances separate from other components of the amortized cost basis.
- A reporting entity can make an accounting policy election to not measure an allowance for credit losses on accrued interest if an entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be made at the major security-type level and should be disclosed, including the time period they consider timely. This guidance should not be applied by analogy to other components of the amortized cost basis.

ASC 326-30 does not define what is considered a “timely manner.” This could differ between entities, portfolios, and industry practices. We believe that writing off accrued interest amounts once such amounts are greater than 90 days past due may be consistent with current practice for some securities in certain industries following guidance issued by, for example, the US banking regulators. Entities should apply judgment and consider the specific facts and circumstances of their portfolio when determining what time period is considered timely.

- A reporting entity can make an accounting policy election to write off accrued interest by reversing interest income or recognize the write off as a credit loss expense (or a combination of both). This accounting policy election should be made at the major security-type level. This election cannot be applied by analogy to other components of the amortized cost basis. This accounting policy is required to be disclosed and any reversal of interest income should be disclosed by major security type.

If any of the elections are made with regard to AFS debt securities, accrued interest must also be excluded from measuring impairment.

See LI 12 for information regarding the presentation and disclosure requirements related to these elections.

8.3 ***AFS beneficial interests under ASC 325-40***

Many securitization transactions involve the transfer of financial assets to a securitization entity, often a special purpose entity, through one or multiple steps. The securitization entity issues various interests that entitle its holders to the cash flows generated by the entity’s financial assets. These interests are commonly referred to as “beneficial interests” in those assets.

Certain beneficial interests in securitizations (that are not derivatives within the scope of ASC 815) are either debt securities under ASC 320 or are required to be accounted for like debt securities under ASC 320. These beneficial interests can be classified as trading, AFS, or HTM debt securities. Additionally, ASC 325-40 provides guidance on interest income, initial measurement, and subsequent measurement for certain beneficial interests within its scope.

Refer to LI 14 for further information on accounting for AFS beneficial interests that are within the scope of ASC 325-40.

Chapter 9:
Purchased financial assets
with credit deterioration

9.1 Chapter overview – PCD assets

Institutions often purchase loans, debt securities, and other instruments after their origination. Usually, these instruments are purchased at amounts other than the amount contractually due from the borrower, as changes in interest rates and/or the credit quality of the borrower may have taken place since origination.

When institutions purchase financial assets that have experienced an increase in credit risk since their origination, the purchase is often at an amount below par, therefore offering the potential of higher returns in exchange for a higher credit risk profile. These assets can be purchased individually, as part of a portfolio acquisition, or through mergers and acquisitions of other institutions. Given the unique nature of these financial assets and their risk/reward profile, the guidance used to account for the purchase of these instruments differs significantly in some respects, from the accounting guidance used to account for purchases of assets that have not experienced a more-than-insignificant credit deterioration.

ASC 326 includes separate guidance on the initial recognition and measurement of purchased financial assets that have experienced a more-than-insignificant credit deterioration since origination (purchased financial assets with credit deterioration, or PCD assets). The “general” CECL model, which applies to certain financial assets that are not considered PCD, requires an initial estimate of expected credit losses to be recognized through current earnings. Non-PCD AFS debt securities will typically not have an allowance recorded at acquisition. In contrast, the PCD guidance requires the initial estimate of expected credit losses to be recognized through an adjustment to the amortized cost basis of the financial asset (i.e., a balance sheet gross up) with no impact to earnings.

Subsequent to initial recognition, a reporting entity would apply the same interest income and impairment model (e.g., CECL or AFS debt security impairment model) to these PCD assets as it would to non-PCD assets.

This chapter discusses the accounting for PCD assets (except for beneficial interests subject to ASC 325-40). See LI 4 and LI 7 for information on the accounting for purchased assets accounted for under an amortized cost basis without credit deterioration (i.e. non-PCD assets) and LI 3 and LI 8 for the accounting for AFS debt securities without credit deterioration.

See LI 14 for information on the accounting for beneficial interests subject to ASC 325-40 (for both PCD and non-PCD assets).

9.2 Scope of PCD asset model

PCD assets can be loans or debt securities, and if debt securities, could be classified as either HTM or AFS. Under prior GAAP, receivables and debt securities acquired with deteriorated credit quality that met the scope of ASC 310-30 (or when ASC 310-30 was applied by analogy) were generally referred to as purchased credit-impaired (PCI) assets. ASC 326 uses the term “purchased financial assets with credit deterioration” and the definition of PCD assets is broader than the definition of PCI assets. Therefore, some assets that are considered PCD assets under the guidance in ASC 326 may not have been considered PCI assets under prior GAAP. Although the definition of PCD is generally broader than PCI, there may be some instances where PCI assets do not meet the definition of PCD assets under the new guidance.

To provide some relief upon transition, those assets that were accounted for as PCI under prior GAAP are required to be accounted for as PCD under the new guidance. Upon transition, entities should not reassess other previously purchased assets to determine whether those assets, which were not deemed to be PCI under prior GAAP, would meet the definition of PCD assets. See LI 13 for more information on transition.

For financial assets subject to CECL, ASC 326-20-20 provides guidance on identifying PCD assets.

Definition from ASC 326-20-20

Purchased Financial Assets with Credit Deterioration: Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

ASC 326 does not define "a more-than-insignificant deterioration in credit since origination." Therefore, a reporting entity will need to apply judgment to determine whether a purchased financial asset meets the definition of a PCD asset. ASC 326-20-55-59 provides an example that includes factors that may indicate there has been more-than-insignificant deterioration in credit since origination. The listing is not all inclusive.

ASC 326-20-55-59

Entity N assesses what is more-than-insignificant credit deterioration since origination and considers the purchased assets with the following characteristics to be consistent with the factors that affect collectibility in paragraph 326-20-55-4. Entity N records the allowance for credit losses in accordance with paragraph 326-20-30-13 for the following assets:

- a. Financial assets that are delinquent as of the acquisition date
- b. Financial assets that have been downgraded since origination
- c. Financial assets that have been placed on nonaccrual status
- d. Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in its policy.

For AFS debt securities, ASC 326-30-30-2 provides guidance on identifying PCD assets and refers to ASC 326-30-55-1.

ASC 326-30-30-2

A purchased debt security classified as available-for-sale shall be considered to be a purchased financial asset with credit deterioration when the indicators of a credit loss in paragraph 326-30-55-1 have been met. The allowance for credit losses for purchased financial assets with credit deterioration shall be measured at the individual security level in accordance with paragraphs 326-30-35-3 through 35-10. The amortized cost basis for purchased financial assets with credit deterioration shall be considered to be the purchase price plus any allowance for credit losses. See paragraphs 326-30-55-1 through 55-7 for implementation guidance.

ASC 326-30-55-1

There are numerous factors to be considered in determining whether a credit loss exists. The length of time a security has been in an unrealized loss position should not be a factor, by itself or in combination with others, that an entity would use to conclude that a credit loss does not exist. The following list is not meant to be all inclusive. All of the following factors should be considered:

- a. The extent to which the fair value is less than the amortized cost basis
- b. Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors. Examples of those changes include any of the following:
 1. Changes in technology
 2. The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security
 3. Changes in the quality of the credit enhancement.
- c. The payment structure of the debt security (for example, nontraditional loan terms as described in paragraphs 825-10-55-1 through 55-2) and the likelihood of the issuer being able to make payments that increase in the future.
- d. Failure of the issuer of the security to make scheduled interest or principal payments
- e. Any changes to the rating of the security by a rating agency.

When assessing whether the credit quality of the asset has deteriorated, an entity should compare the credit quality of the asset at the time of origination with the credit quality at the time of acquisition. An asset that was originated with low credit quality should not be considered to be PCD if there has not been a more-than-insignificant deterioration in credit since origination. For example, assume a loan is acquired shortly after its origination. Despite the fact that the loan may have a low credit quality at acquisition, it would not be considered PCD if there had not been a credit deterioration since the loan was originated.

The PCD asset guidance should only be applied to instruments that meet the definition of PCD assets and that are within the scope of either the CECL model (i.e., instruments accounted for at amortized cost) or the AFS debt security impairment model (i.e., instruments accounted for at fair value through OCI). It should be applied to financial assets that are acquired individually, as part of an acquisition of a pool of loans, or in a business combination.

It is important to note that when a group of loans, HTM debt securities, or other assets measured at amortized cost is acquired, an entity may, but is not required to, individually assess each financial asset within the pool to determine if it should be classified as PCD. However, for AFS debt securities, an entity should determine whether the acquired asset is deemed to be PCD at the individual asset level.

Entities are allowed to perform the assessment on a group level basis for assets measured at amortized cost because it may be practically unrealistic to individually assess each asset to determine if there was a more-than-insignificant deterioration in credit quality since origination. To evaluate a group of acquired financial assets, the financial assets must first be grouped based on similar risk

characteristics before assessing the pool to determine if they would be considered PCD under ASC 326. The criteria used for grouping should be designed to distinguish assets that have experienced more-than-insignificant deterioration in credit quality since origination from those that have not. A determination that the pool is PCD would not be expected to capture a significant number of individual assets that would not qualify as PCD on their own. While the PCD assessment can be done at the group level, any amortized cost basis adjustment resulting from acquiring a pool of PCD assets and the allowance for credit losses must be allocated to the individual assets within the pool.

The determination of whether there has been a more-than-insignificant deterioration in credit quality is an important step in determining the appropriate accounting for a purchased financial asset. When a reporting entity purchases financial assets that do not meet the definition of a PCD asset, it is prohibited from applying the PCD asset guidance, with the exception of certain beneficial interests (see LI 9.2.1).

Question LI 9-1 addresses whether an entity can account for all loans that are purchased at a discount to par as PCD assets.

Question LI 9-1

Can an entity account for all loans that are purchased at a discount to par as PCD assets?

PwC response

No. An entity cannot automatically consider all financial assets purchased at a discount to be PCD assets. An entity needs to determine whether the purchased financial assets meet the definition of a PCD asset (i.e., has experienced more-than-insignificant deterioration in credit quality since origination) or in the case of certain beneficial interests, there is a significant difference between contractual and estimated cash flows. The purchase of a financial asset at a discount may be a factor to consider in determining if the asset is PCD, but it is not determinative.

Entities often purchase loans, debt securities, and other instruments at amounts less than the amount contractually due from the borrower. However, not all financial assets purchased at a discount are due to an other-than-insignificant deterioration in credit quality since origination. Loans may be purchased at a discount due to changes in interest rates, prepayment estimates, credit spreads, or other market factors since origination.

The PCD asset guidance is not applicable to purchased unfunded commitments giving the borrower the right, but not the obligation to borrow. In order to fall within the scope of the PCD model, there must be a financial asset and an unfunded commitment that gives the borrower the right to borrow does not meet the definition of a financial asset. In these agreements, the lender does not have a right to receive cash or another financial asset or exchange other financial instruments; they have an obligation if the borrower exercises their right.

However, an entity should still consider the guidance related to off-balance sheet credit exposures under the CECL model in ASC 326-20, which requires an entity to estimate the expected credit losses on off-balance sheet loan commitments unless the commitment is unconditionally cancellable by the issuer. See LI 7 for more information.

Question LI 9-2 addresses whether there is a scope exception from the PCD model for revolving lines of credit.

Question LI 9-2

Is there a scope exception from the PCD model for loans drawn under revolving lines of credit under ASC 326?

PwC response

No. Unlike prior GAAP under ASC 310-30, there is no scope exception from the PCD model for revolving lines of credit if the borrower still has revolving privileges. Therefore, the PCD asset guidance applies to purchased loans drawn under revolving credit agreements (e.g., credit cards, home equity loans) that have experienced a more-than-insignificant deterioration in credit quality since origination, as of the date of acquisition.

Question LI 9-3 addresses how the definition of a PCD asset differs from the definition of a PCI asset under prior GAAP.

Question LI 9-3

Are the requirements for classifying an asset within the scope of ASC 326-20 (CECL model) and ASC 326-30 (AFS impairment model) as PCD different than the requirements for classifying an asset as PCI under the previous guidance in ASC 310-30?

PwC response

Yes. The PCI guidance applied to purchased loans and securities with evidence of credit quality deterioration since origination for which it was probable, at acquisition, that all contractual cash flows would not be collected. The new PCD guidance does not include a probability threshold regarding collection. The PCD guidance only requires there to be more-than-insignificant deterioration in an asset's credit quality since origination for an asset to be classified as PCD. In the basis of conclusions of ASU 2016-13, the FASB acknowledged that the definition of PCD is expected to apply to more assets than what would have been considered PCI.

9.2.1 PCD: beneficial interests subject to ASC 325-40

The guidance in ASC 325-40-30-1A, Beneficial Interests in Securitized Financial Assets, requires that the PCD asset guidance be applied to certain beneficial interests classified as either HTM or AFS if it meets certain criteria.

ASC 325-40-30-1A

An entity shall apply the initial measurement guidance for purchased financial assets with credit deterioration in Subtopic 326-20 to a beneficial interest classified as held-to-maturity and in Subtopic 326-30 to a beneficial interest classified as available for sale, if it meets either of the following conditions:

- a. There is a significant difference between contractual cash flows and expected cash flows at the date of recognition.
- b. The beneficial interests meet the definition of purchased financial assets with credit deterioration.

Beneficial interests subject to ASC 325-40 are considered to be PCD if they meet the definition of PCD assets or if there is a significant difference between expected cash flows and "contractual" cash flows as of the acquisition date. See LI 14 for the definition of a beneficial interest (BI) and for further information on the scope and application of PCD for beneficial interests subject to ASC 325-40.

9.2.2 *PCD assets in a variable interest entity (VIE)*

When an entity becomes the primary beneficiary of a VIE, the assets of the VIE are recognized in the consolidated financial statements of the entity upon consolidation of the VIE. Therefore, an entity should determine if the financial assets within the VIE that are required to be consolidated are within the scope of ASC 326 and meet the PCD criteria.

If the entity was the transferor of the financial assets to the VIE and the transfer was not recognized as a sale, then the consolidation of the VIE would not result in initial recognition of these financial assets as of the date of consolidation. Since the transfer of financial assets did not qualify as a sale, the financial assets were always recognized in the financial statements of the entity. Therefore, an entity would not be permitted to apply the PCD criteria as a result of the VIE's consolidation.

If the entity previously transferred financial assets within the scope of ASC 326 that were accounted for as a sale, and then subsequently regains effective control over the assets as a result of the occurrence of an event, ASC 860-20-25-8 and ASC 860-20-25-9 require an entity to account for the re-recognition of the assets in the same manner as if the assets were purchased from the transferee. This would include an assessment for PCD accounting.

9.2.3 *Assessing net investments in leases as potential PCD assets*

For leases that will be accounted for as sales-type or direct financing leases acquired either through a business combination or an asset purchase, we believe an entity should assess whether the acquired leases would be considered PCD assets. To the extent a lease is not considered a PCD asset, the initial measurement of the allowance for credit losses would be reported in current earnings (similar to an originated lease). Refer to LI 7 for further information. If a lease is considered a PCD asset, the initial measurement of the allowance for credit losses will create a basis adjustment to the amortized cost basis of the net investment in lease, as discussed in LI 9.3.

The PCD model is an integral part of the new credit impairment guidance. Since the FASB concluded that the impairment of sales-type and direct financing leases should follow the CECL model (of which the PCD guidance is a component), we believe that the PCD guidance is applicable to these leases as well.

Since a net investment in a lease balance includes non-financial elements, these elements will impact the determination of whether the net investment is considered a PCD asset. For example, the estimated residual value of the leased asset will impact the net investment in a lease. If there has been a decline in the estimated residual value, this decline in value is considered a credit loss and therefore could impact whether the net investment in the acquired lease is considered a PCD asset. In addition,

declines in the estimated residual value of the leased asset since the lease's origination could impact the amount of the "day one" allowance for credit losses for a lease. To estimate the allowance for credit losses upon acquisition of a lease, the purchaser will need to estimate what the residual value of the asset at the end of the lease was forecasted to be at the inception of the lease.

9.3 *PCD: initial recognition and measurement*

ASC 326 has different initial recognition and measurement guidance for PCD assets than for non-PCD assets. The PCD guidance eliminates the asymmetrical treatment of increases and decreases in expected cash flows that existed in prior GAAP, as well as simplifies the calculation of interest income. These changes are intended to more closely align the accounting for these instruments in periods subsequent to acquisition with the accounting for originated assets and purchased assets that do not qualify as PCD.

For PCD assets, an allowance for credit losses will be recognized on initial recognition by estimating the expected credit losses of the purchased assets. Unlike the CECL model for financial assets that are not considered PCD, a reporting entity should not recognize the initial estimate of expected credit losses through net income. Rather, the initial estimate for credit losses would be recorded through an adjustment to the amortized cost basis of the related financial asset at acquisition (i.e., a balance sheet gross-up). As of the date of acquisition, the amount of expected credit losses is added to the purchase price of the financial asset to establish the initial amortized cost basis of the asset. Any difference between the amortized cost basis (purchase price + initial allowance for credit losses) and the unpaid principal balance (or par amount) of the asset is considered to be a non-credit discount/premium and will be accreted/amortized into interest income using the interest method (see LI 6 for more information on interest income recognition).

The theory behind this gross up is that the purchase price discount attributable to credit is eliminated through the adjustment to the amortized cost basis and as a result, the remaining discount is related to factors other than credit risk. Since any remaining discount is not credit related, it can be accreted into interest income following the model in ASC 310. However, ASC 310-10 was amended by ASU 2016-13 to clarify certain elements of the interest recognition guidance specific to PCD assets.

ASC 310-10-35-53B clarifies that only non-credit-related discounts or premiums are permitted to be accreted or amortized into interest income. As noted above, the initial credit-related discount is effectively eliminated through the adjustment to the amortized cost basis created when establishing the initial estimate for credit losses.

If the initial allowance for credit losses is determined on the pool basis as of the acquisition date, it must be allocated to the individual PCD assets within the pool. Entities should choose a method that is reasonable in the context of their facts and circumstances and should document the rationale for the method they chose to perform the allocation.

Example LI 9-1 illustrates the accounting for a PCD loan at acquisition.

EXAMPLE LI 9-1**Accounting for a PCD loan at acquisition**

Bank Corp purchases a loan with a par value of \$100,000 for \$83,000. The loan has experienced a more-than-insignificant deterioration in credit quality since origination. Therefore, Bank Corp determines that the loan meets the definition of a PCD asset.

At the date of acquisition, Bank Corp calculates an allowance for expected credit losses of \$10,000.

How should Bank Corp record the loan at acquisition?

Analysis

Bank Corp should record the loan at an amortized cost basis of \$93,000, which is the \$83,000 purchase price plus the \$10,000 expected credit loss.

Dr. Loan asset balance	\$100,000	
Cr. Loan - non-credit discount		\$7,000
Cr. Allowance for expected credit losses		\$10,000
Cr. Cash		\$83,000

As a result, the loan has an amortized cost basis of \$93,000 (\$83,000 + \$10,000 or \$100,000 - \$7,000). The non-credit discount of \$7,000 (difference between the \$100,000 par amount and the \$93,000 amortized cost basis) will be accreted into interest income using the effective interest method.

Question LI 9-4 addresses whether the PCD gross up can result in an entity recording a premium.

Question LI 9-4

If a loan is purchased at a discount and deemed to be PCD, can the “PCD gross up” result in an entity recording a premium on the asset as of the date of acquisition?

PwC response

Yes. The guidance in ASC 326-20-30-13 contemplates a scenario when the adjustment to the amortized cost basis may result in the acquired loan being reported at a premium by noting: “Any noncredit discount *or premium* resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset” (emphasis added).

9.3.1 Calculating the allowance for credit losses for PCD assets

For PCD assets that are also within the scope of the CECL impairment model (e.g., financial assets carried at amortized cost, including HTM securities), the initial allowance may be estimated based on

a discounted cash flow or non-discounted cash flow approach (consistent with the overall CECL model). The initial allowance will differ depending on whether a discounted cash flow or non-discounted cash flow approach is used to estimate expected credit losses.

For debt securities classified as available-for-sale that meet the definition of PCD and beneficial interests subject to ASC 325-40, the initial allowance must be estimated using the present value of cash flows (consistent with the AFS debt security impairment and ASC 325-40 models). See LI 14 for information on the accounting for beneficial interests subject to ASC 325-40.

9.3.1.1 *Using a DCF method to estimate expected credit losses*

A reporting entity is required to use a discounted cash flow approach to calculate the initial estimate of expected credit losses for AFS debt securities and beneficial interests subject to ASC 325-40. It may use a discounted cash flow approach to calculate the initial estimate of expected credit losses on amortized cost assets (e.g., loans) and HTM debt securities, but it is not required.

A reporting entity using a discounted cash flow approach to estimate the initial allowance for expected credit losses for PCD assets should follow the following steps:

- Step 1: Calculate the effective interest rate by (1) determining the expected cash flows of the instrument and (2) discounting those expected cash flows at a rate that results in a present value equal to the purchase price of the instrument, pursuant to ASC 326-30-30-3.
- Step 2: Calculate the initial allowance by discounting the cash flows not expected to be collected (i.e., the difference between contractual and expected cash flows) by the effective interest rate calculated in Step 1.

Example LI 9-2 illustrates how to calculate the effective interest rate for PCD assets using a discounted cash flow approach.

EXAMPLE LI 9-2

Determining the effective interest rate and initial allowance of a PCD asset using a discounted cash flow approach

Assume Bank Corp. purchases a security with the following key terms and has determined it to be PCD.

Par amount: \$100,000

Purchase price: \$60,000

Remaining term: 2 years with principal due at maturity

Contractual coupon: 2%

Expected cash flows: \$2,000 in year 1 and \$72,000 at maturity

The effective interest rate used to calculate the allowance for credit losses is approximately 11.22%. This was calculated by solving for the discount rate such that the present value of the expected cash (\$2,000 and \$72,000) equals the purchase price of \$60,000. Using this effective interest rate, the

allowance for credit losses as of the date of acquisition is approximately \$24,251. This was determined by taking \$30,000 in year 2 (which is the difference between the total expected cash flows (\$72,000) and the total contractual cash flows (\$102,000), and discounting it using a discount rate of 11.22%.

Bank Corp would record the following entry at acquisition:

Dr. Loan – principal amount	\$100,000	
Cr. Loan - non-credit discount		\$15,749
Cr. Allowance for expected credit losses		\$24,251
Cr. Cash		\$60,000

9.3.1.2 Using a non-DCF method to estimate expected credit losses

If a reporting entity uses an approach to estimate expected credit losses other than a discounted cash flow (DCF) model, such as a loss-rate approach, the initial estimate of expected credit losses should be calculated based on the unpaid principal balance as required under ASC-326-20-30-14. This was needed to avoid a potentially circular calculation in which the allowance is based on the collectibility of the amortized cost basis of an asset, but it also impacts the amortized cost basis through the PCD gross up. Under a loss-rate approach, the loss rate is applied to the par amount of the asset at initial recognition to determine the allowance.

Example LI 9-3 illustrates measurement of a PCD asset’s initial allowance using a loss rate approach.

EXAMPLE LI 9-3

Determining the initial allowance of a PCD asset using a loss rate approach

Assume Bank Corp. purchases a security with the following key terms and has determined it to be PCD.

Par amount: \$100,000

Purchase price: \$60,000

Remaining term: 2 years with principal due at maturity

Contractual coupon: 2%

Expected cash flows: \$2,000 in year 1 and \$72,000 at maturity

Loss rate: 30%

Dr. Loan – principal amount	\$100,000	
Cr. Loan - non-credit discount		\$10,000
Cr. Allowance for expected credit losses		\$30,000

Cr. Cash

\$60,000

Question LI 9-5 addresses if the effective interest rate for PCD assets can differ based on the method used to determine the expected credit losses.

Question LI 9-5

Will the effective interest rate for a PCD asset (carried at amortized cost) be different if expected credit losses are estimated using a discounted cash flow approach versus a loss-rate approach?

PwC response

Yes. Since the initial amortized cost basis is different for a PCD asset when a discounted or non-discounted approach is used, the effective interest rate will be different. The effective interest rate determined using a discounted cash flow approach is the rate that discounts the *expected* cash flows to the purchase price. In Example LI 9-2, this results in an effective interest rate of 11.22%. When using an approach other than a discounted cash flow approach to calculate the allowance, the effective interest rate is the rate that discounts the *contractual* cash flows to the initial amortized cost basis (i.e., the purchase price + allowance for credit losses). In Example LI 9-3, this results in an effective interest rate of 7.58%.

However, the higher effective interest rate resulting from using a discounted cash flow approach to calculate the allowance for credit losses on a PCD asset will be partially offset as, if expected cash flows do not change, the allowance for credit losses will increase due to the passage of time.

9.3.2 Estimating expected credit losses on beneficial interests

When calculating the expected credit losses on beneficial interests, ASC 325-40-35-7 requires an entity to use a present value of expected future cash flows to measure credit losses for a beneficial interest. Therefore, reporting entities that hold HTM securities that are beneficial interests subject to ASC 325-40 should estimate expected credit losses using a discounted cash flow approach. This differs from the usual guidance under ASC 326 for HTM securities that are not beneficial interests subject to ASC 325-40. HTM securities that are not beneficial interests should apply the general CECL model, which provides a reporting entity with the flexibility to decide which model they want to use to estimate expected credit losses.

See LI 14.5 for information on initial recognition and measurement for beneficial interests subject to 325-40.

9.4 Subsequent measurement of PCD assets

The PCD asset accounting model is designed such that in many aspects, the subsequent measurement and presentation of the allowance for credit losses is consistent among similarly classified financial assets (e.g., receivables, loans, HTM securities, AFS debt securities) originated or acquired (but that do not qualify as PCD) by the reporting entity. Refer to LI 7 for further information on subsequent measurement under the CECL model. Refer to LI 8 for further information on subsequent measurement for the AFS model.

When an entity uses a non-DCF method under ASC 326-20, the initial allowance for credit losses for PCD assets should be based on the asset's unpaid principal balance and not its amortized cost basis. The initial allowance is then added to the asset's "initial amortized cost basis" (e.g., purchase price). This is required by the guidance in ASC 326-20-30-14 and was needed to avoid a potentially circular calculation in which the allowance is based on the collectibility of the amortized cost basis of an asset, but it also impacts the amortized cost basis through the PCD gross up. When subsequently measuring the allowance, ASC 326-20-35-1 states that the method used to determine the allowance should generally be applied consistently over time. As such, the allowance on a PCD asset should be consistently based on the unpaid principal balance and not the amortized cost basis of the asset when using a non-DCF approach.

Subsequent changes in expected credit losses will follow either the CECL impairment model or the AFS debt security impairment model, whereby subsequent changes in expected credit losses are recognized as an adjustment to the allowance for credit losses recorded in net income (an increase to the allowance if credit losses increase and a release of the allowance if credit losses decrease) and not as an adjustment to investment yield recognition (with the possible exception of instruments subject to ASC 325-40).

Example LI 9-4 addresses the subsequent measurement accounting for PCD loans

EXAMPLE LI 9-4

Accounting for PCD loans after initial recognition

Bank Corp purchases a loan with a par value of \$100,000 for \$83,000. The loan has experienced a more-than-insignificant deterioration in credit quality since origination. Therefore, Bank Corp determines that the loan meets the definition of a PCD asset. At the date of acquisition, Bank Corp calculates an allowance for expected credit losses of \$10,000.

At the end of the first reporting period subsequent to Bank Corp's purchase of the loan, Bank Corp should recalculate the allowance for credit losses in accordance with the CECL model. Assume that as a result of an improving credit position of the borrower, Bank Corp determines the expected credit loss has declined from \$10,000 to \$7,000.

Bank Corp should account for this decrease in expected credit losses as it would for any other instrument subject to the CECL model. As a result, Bank Corp should decrease its allowance for expected credit losses with an offsetting entry to the income statement.

Dr. Allowance for expected credit losses	\$3,000	
Cr. Credit loss expense		\$3,000

Note that the impact of the decrease in the expected credit loss is reported through net income even though the initial credit loss estimate was recognized as an adjustment to the amortized cost basis of the instrument and did not initially impact net income.

9.4.1 PCD beneficial interests subject to ASC 325-40

When expected cash flows of a beneficial interest subject to ASC 325-40 change from previous estimates, a reporting entity should first apply the CECL or AFS debt security impairment model as appropriate, depending on whether the beneficial interest is classified as HTM or AFS, respectively.

See LI 14 for more information on interest income recognition for beneficial interests subject to ASC 325-40 and for guidance on estimating credit losses for those beneficial interests classified as HTM and AFS.

9.4.2 PCD: determination of nonaccrual status

The guidance on determining when a PCD asset should be placed on nonaccrual status is different than for non-PCD assets. In accordance with ASC 310-10-35-53C, the recognition of income on PCD assets is dependent on having a reasonable expectation about the amount expected to be collected over the life of the asset. When an entity can no longer reasonably estimate the amount expected to be collected, it should place the PCD asset on nonaccrual status. However, the ability to place a financial asset on nonaccrual status cannot be used to circumvent recognition of a credit loss.

See LI 14.6.6 for more information on nonaccrual status for beneficial interests subject to ASC 325-40.

9.4.3 PCD: application of the recoveries guidance

The allowance for credit losses on PCD assets should include expected recoveries of amounts previously written off and expected to be written off and should not exceed the aggregate of amounts previously written off and expected to be written off by the entity. In addition, if an entity estimates expected credit losses using a method other than a DCF method pursuant to ASC 326-20, expected recoveries should not include any amounts that result in an acceleration of the noncredit discount. The noncredit discount is the excess of the contractual amount of principal (or par) of the asset over the amortized cost basis of the asset that includes the adjustment to the amortized cost basis recorded at acquisition related to the allowance for credit losses (i.e., the balance sheet gross-up). This provision was included in the guidance to prevent entities from recording "day one gains" by (1) acquiring PCD assets, (2) recording a "balance sheet gross up" increasing the amortized cost basis, (3) recording a write off of those assets, and then (4) recording estimated recoveries on an undiscounted basis.

ASC 326-20-30-13A also clarifies that estimated recoveries and negative allowances may include increases in expected cash flows after acquisition, subject to the guidance discussed above.

It is important to note that the guidance for recoveries and negative allowances is different for PCD assets than non-PCD assets. In addition, negative allowances are not permitted for available-for-sale securities. Companies should consider these differences in establishing and maintaining policies, procedures, and controls related to their allowance estimates. Refer to LI 7.3.6.4 for further guidance related to recoveries on non-PCD assets.

ASC 326-20-30-13 and ASC 326-20-30-13A provides guidance on the allowance for credit losses and expected recoveries for PCD assets.

ASC 326-20-30-13

An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration in accordance with paragraphs 326-20-30-2 through 30-10, 326-20-30-12, and 326-20-30-13A. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

ASC 326-20-30-13A

The allowance for credit losses for purchased financial assets with credit deterioration shall include expected recoveries of amounts previously written off and expected to be written off by the entity and shall not exceed the aggregate of amounts previously written off and expected to be written off by the entity.

- a. If the entity estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4, expected recoveries shall not include any amounts that result in an acceleration of the noncredit discount.
- b. The entity may include increases in expected cash flows after acquisition.

(See Examples 18 and 19 in paragraphs 326-20-55-86 through 55-90.)

***Chapter 10:
Loan refinancing and
restructuring - after adoption
of ASU 2022-02—added May
2022***

10.1 Chapter overview – Modifications

Lenders may refinance or restructure receivables, loans, and debt agreements for a number of reasons. In some cases, loans will be refinanced or restructured as part of continuing a relationship with a borrower. For example, loans may be refinanced or restructured to have lower interest payments in a declining interest rate environment. In other instances, loans and debt instruments may be restructured as part of a credit management strategy (i.e., to improve the likelihood of payment or amount of repayment). These strategies may be negotiated between a lender and a borrower, as a result of participating in certain government programs, or as the result of restructurings imposed by governing bodies, such as a court in a bankruptcy proceeding. Modifications can include changing the interest rate, guarantee, or collateral provisions; deferring or forgiving payments; and/or extending the maturity of the receivable, loan, or security (or a combination of these).

In March 2022, the FASB issued ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*, which eliminated the accounting guidance for troubled debt restructurings (TDRs) for creditors that have adopted ASU 2016-13. Guidance in this chapter assumes that ASU 2022-02 has been adopted.

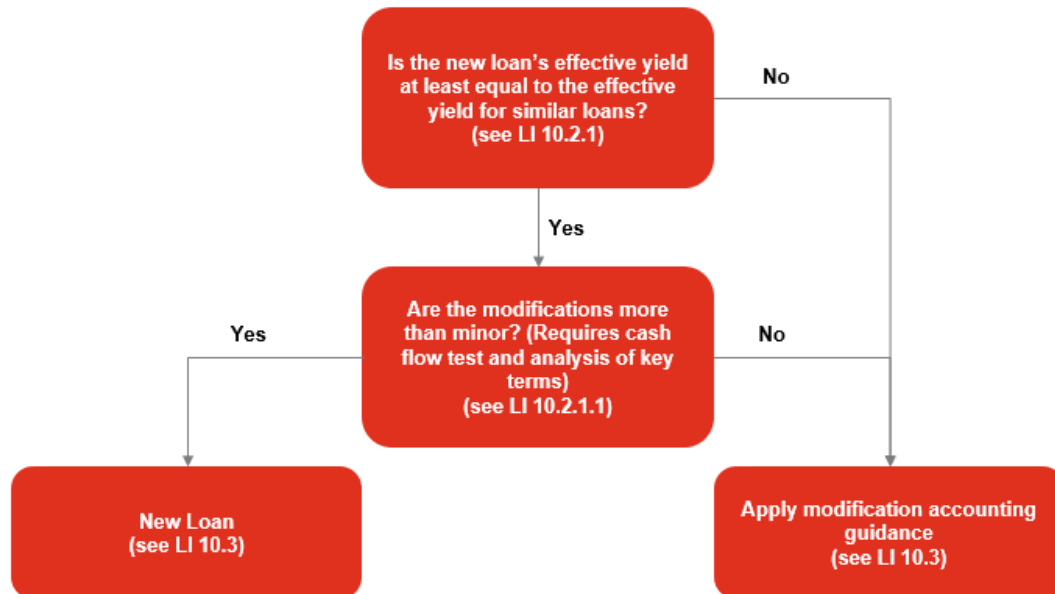
This chapter discusses a lender's accounting for a loan refinancing or restructuring. The debtor's accounting for these transactions is addressed in ASC 470-60 and PwC's *Financing transactions* guide (FG 3).

ASU 2022-02 introduced disclosure requirements relating to certain modifications of receivables from borrowers experiencing financial difficulty. The disclosures related to modifications with borrowers experiencing financial difficulty can be found in LI 12.

10.2 Analyzing a refinancing or restructuring

A creditor should account for the refinancing or restructuring of debt as either a modification of the original instrument or as the extinguishment of the original instrument and issuance of a new instrument. Figure LI 10-1 can be used to determine the appropriate accounting treatment for a loan refinancing or restructuring.

Figure LI 10-1
Lenders' analysis of a debt refinancing or restructuring



10.2.1 Analyzing a refinancing or restructuring

All loan modifications, refinancings and restructurings (including those with borrowers that are experiencing financial difficulty) are subject to the modification guidance in ASC 310-20. As such, an entity needs to evaluate whether the modification creates a new loan or rather should be treated as a continuation of an existing loan. As discussed in ASC 310-20-35-9, a loan refinancing or restructuring should be accounted for as a new loan (i.e., as an extinguishment of the original debt instrument and issuance of a new loan) when *both* of the following occur:

- The new loan’s effective yield is at least equal to the effective yield for similar loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender
- The modifications are more than minor

If these conditions are not met, the refinancing or restructuring should be accounted for as a modification of the original debt instrument, not as a new loan. The determination of whether the restructuring is a modification or the creation of a new instrument impacts the accounting for certain fees and costs and is important in determining the origination date for certain “vintage disclosures.” See LI 12 for information on presentation and disclosure.

Many modifications of loans with borrowers experiencing financial difficulty will not meet the first criterion and as a result, will not result in the modified loan being treated as a new loan.

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or 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 and modifications of the original debt instrument are more than minor. 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. 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.

When determining if the modification of a contract to replace LIBOR, or another reference rate expected to be discontinued should be accounted for as a continuation of the existing contract or as an extinguishment and creation of a new contract, a reporting entity may elect to apply the guidance in ASC 848. See REF 2 for further details.

10.2.1.1 Assessment of more than minor

To determine whether a modification is considered “more than minor,” a reporting entity should perform the assessment shown in Figure LI 10-2, which starts with comparing the present value of cash flows of the new debt with the remaining cash flows of the old debt.

However, when determining if a modification of a contract to replace LIBOR, or another reference rate expected to be discontinued should be accounted for as a continuation of the existing contract or as an extinguishment and creation of a new contract, a reporting entity may elect to apply the guidance in ASC 848. See REF 2 for further details).

Figure LI 10-2**Assessment of more than minor**

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- Step 1** In accordance with ASC 310-20-35-11, compare the present value of the cash flows of the new debt with the present value of the remaining cash flows of the original debt utilizing the guidance in ASC 470. See FG 3 for an illustration of this assessment.
- If the present value of cash flows differs by at least 10%, the modification is considered more than minor.
- If the present value of cash flows differs by less than 10%, further analysis should be performed under Step 2.
- ASC 470-50-40-12 provides specific guidance on performing the 10% test. Key takeaways from this guidance include:
- When performing the 10% test, the cash flows of the new debt instrument should include all amounts paid by the debtor to the lender (i.e., any fees paid to the lender in conjunction with the restructuring should be included in the cash flows of the new debt instrument) as a day-one cash flow.
 - Third-party fees should not be included in the cash flow analysis.
 - If there is a variable interest rate in any of the debt instruments, the spot interest rate on the restructuring date should be used to determine future interest payments.
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- If either debt instrument is callable or puttable, then separate cash flow analyses should be performed assuming exercise and nonexercise of the put and call. The scenario that generates the smallest change should be used.
 - For debt that has been amended more than once in a twelve-month period, the debt terms that existed just prior to the earliest amendment occurring in the prior twelve months should be used to apply the 10% test, provided modification accounting was previously applied.
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Step 2 The creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances surrounding the modification and other relevant considerations. The accounting literature does not provide specific guidance on what factors a reporting entity should consider.

Relevant facts may include considering the impact of the modification on the following:

- Collateral, covenant, or guarantor requirements
 - Put and call features
 - Principal balance, interest rate, payment terms, maturity
 - Other significant features specified in the loan agreement
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10.3 *Accounting for a refinancing or restructuring*

The accounting for any unamortized net fees or costs associated with a loan refinancing or restructuring depends on whether the refinancing or restructuring is a new loan or a modification.

Creditors should follow the guidance in ASC 310-20-35-9 and ASC 310-20-35-10 to determine the treatment of fees or costs associated with refinanced or restructured loans

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or 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 and modifications of the original debt instrument are more than minor. 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. 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.

ASC 310-20-35-10

If the refinancing or restructuring does not meet the condition set forth in paragraph 310-20-35-9 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, any additional funds advanced to the borrower, any fees received, and direct loan origination costs associated with the refinancing or restructuring.

The guidance in ASC 310-20-35-9 and ASC 310-20-35-10 is summarized in Figure LI 10-3.

Figure LI 10-3

Accounting for fees and costs associated with a refinancing or restructuring

New loan	<p>Unamortized net fees or costs from the original loan and any prepayment penalties are recognized in interest income when the new loan is granted.</p> <p>A new effective interest rate will be determined</p>
Modification	<p>The investment in the new loan should comprise the remaining net investment in the original loan, any additional funds advanced to the borrower, any fees received, and direct loan origination costs associated with the refinancing or restructuring.</p> <p>Unamortized net fees or costs from the original loan and any prepayment penalties are carried forward as part of the net investment basis of the new loan.</p> <p>The effective interest rate of the loan should be recalculated based upon the amortized cost basis of the new loan and its revised contractual cash flows.</p>

Once the creditor has considered the guidance in ASC 310-20, the creditor should then apply the CECL impairment model to determine its expected credit losses and the allowance for credit losses in accordance with ASC 326. See LI 7 for further information.

10.4 *Modifications—borrowers experiencing financial difficulty*

Under the CECL model in ASC 326-20, there is no separate impairment model for loans with troubled borrowers that have been restructured. Expected credit losses under CECL may be measured either on a pool or individual asset basis, depending on the asset's facts and circumstances, including whether it shares risk characteristics with other assets. Loans with borrowers that are experiencing financial difficulty that have been restructured may be pooled with loans that have not been restructured when they share similar risk characteristics.

CECL does not require the use of a discounted cash flow (DCF) model. When a reporting entity uses a DCF model to estimate expected credit losses on loans with borrowers experiencing financial difficulty that have been restructured:

- the estimated cash flows should be based on the post-modification contractual terms, and
- the discount rate shall be based on the post-modification effective interest rate.

An entity is prohibited from using the pre-modification effective interest rate as a discount rate as this would be applying a TDR measurement principle that was superseded by ASU 2022-02.

ASU 2022-02 removed the guidance in ASC 326-20 that required entities to consider reasonably expected renewals, modifications, and extensions associated with reasonably expected TDRs. We understand that the removal of this guidance was not designed to require entities to ignore their expected credit loss management strategy in estimating credit losses and record an estimate of credit loss they do not expect to occur. The basis for conclusions of ASU 2022-02 notes that entities are not required to remove from or adjust historical loss data for the impact of expected renewals,

modifications, or extensions undertaken as part of restructuring loans with borrowers experiencing financial difficulty.

If an entity expects that its future loss mitigation efforts will be different than those in the past, it should consider making appropriate adjustments to its loss estimates. For example, if an entity discontinued certain loan modification programs offered to troubled borrowers in the past, this would need to be considered.

Entities with collateralized loans with borrowers experiencing financial difficulty that have been restructured are required to estimate expected credit losses based on the fair value of the collateral when the entity determines foreclosure is probable. Entities also have the ability to elect the collateral-dependent practical expedient on these assets if the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. In both cases (foreclosure is probable or when using the collateral-dependent practical expedient), the estimate of expected credit losses is based on the difference between the fair value of the collateral as of the balance sheet date and the amortized cost basis of the asset. See LI 7.3.6.6 and LI 7.4.1 for further information.

***Chapter 10A:
Loan refinancing and
restructuring including TDRs
– before adoption of ASU
2022-02—updated May 2022***

10A.1 Chapter overview – TDRs and modifications

Lenders may refinance or restructure receivables, loans, and debt agreements for a number of reasons. In some cases, loans will be refinanced or restructured as part of continuing a relationship with a borrower. For example, loans may be refinanced or restructured to have lower interest payments in a declining interest rate environment. In other instances, loans and debt instruments may be restructured as part of a credit management strategy (i.e., to improve the likelihood of payment or amount of repayment). These strategies may be negotiated between a lender and a borrower, as a result of participating in certain government programs, or as the result of restructurings imposed by governing bodies, such as a court in a bankruptcy proceeding. Modifications can include changing the interest rate, guarantee, or collateral provisions; deferring or forgiving payments; and/or extending the maturity of the receivable, loan, or security (or a combination of these).

This chapter discusses a lender's accounting for a loan refinancing or restructuring, including a troubled debt restructuring (TDR). The debtor's accounting for these transactions is addressed in ASC 470-60 and PwC's *Financing transactions* guide (FG 3).

The guidance on TDRs is designed to interact with the current expected credit losses (CECL) model. The disclosure requirements related to TDRs can be found in LI 12.

New guidance

In March 2022, the FASB issued ASU 2022-02, Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures. ASU 2022-02 eliminates the accounting guidance for TDRs in ASC 310-40, Receivables - Troubled Debt Restructurings by Creditors. The elimination of TDRs can only be applied by entities that have adopted the CECL model introduced by ASU 2016-13. For entities that have not adopted ASU 2016-13, the TDR guidance remains applicable until they adopt ASU 2016-13 and the effective dates for the amendments in ASU 2022-02 are the same as the effective dates in ASU 2016-13.

For entities that have adopted ASU 2016-13, the amendments in ASU 2022-02 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Early adoption of ASU 2022-02 is permitted, including adoption in an interim period. If an entity elects to early adopt ASU 2022-02 in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes the interim period.

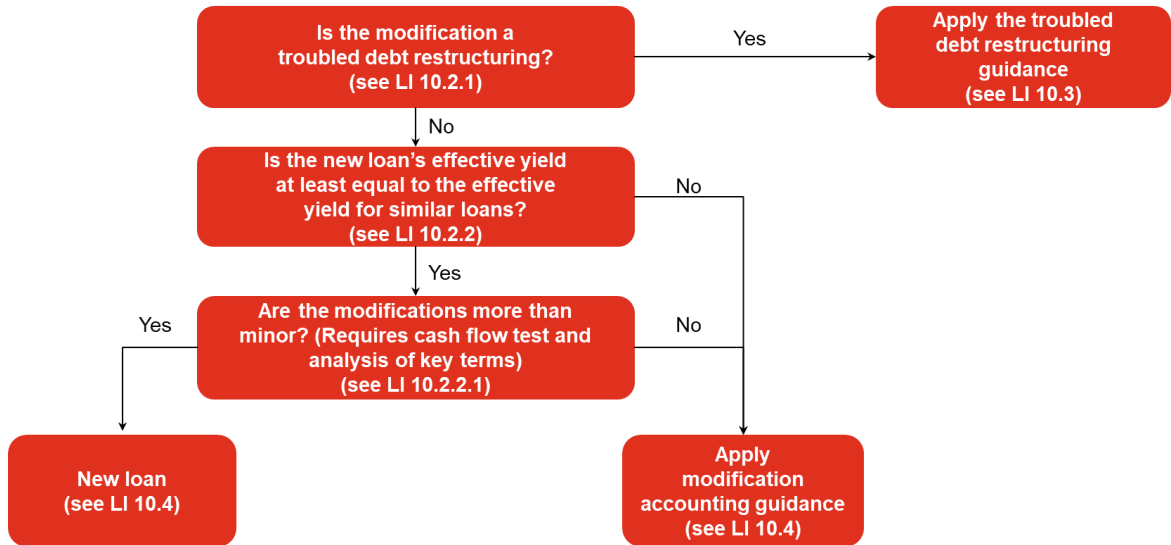
The guidance in this chapter reflects the guidance before a reporting entity has adopted ASU 2022-02. See LI 10 for loan refinancing and restructuring guidance after the adoption of ASU 2022-02.

10A.2 Analyzing a refinancing or restructuring

A creditor should account for the refinancing or restructuring of debt as either a modification of the original instrument or as the extinguishment of the original instrument and issuance of a new instrument. Figure LI 10A-1 can be used to determine the appropriate accounting treatment for a loan refinancing or restructuring.

Figure LI 10A-1

Lenders' analysis of a debt refinancing or restructuring



10A.2.1 Determining whether a refinancing or restructuring is a TDR

A troubled debt restructuring is the result of a creditor trying to maximize recoveries on an existing loan. Under the guidance in ASC 310-40, a troubled debt restructuring is accounted for as a modification, and not the creation of a new loan. ASC 310-40-15-5 provides guidance on when a debt refinancing or restructuring is considered a troubled debt restructuring from a creditor's perspective.

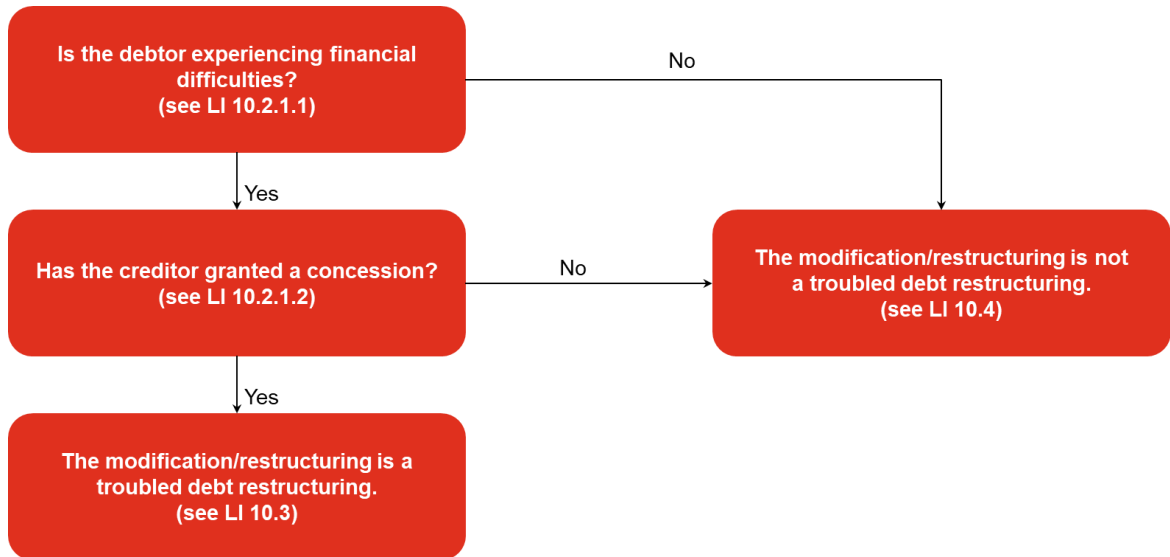
ASC 310-40-15-5

A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

ASC 310-40-15-13 through ASC 310-40-15-20 provides additional guidance for creditors to consider in evaluating whether the borrower is experiencing financial difficulty and whether the creditor has granted a concession.

Figure LI 10A-2 illustrates the ASC 310-40-15-5 assessment criteria.

Figure LI 10A-2
TDR evaluation decision tree



ASC 310-40-15-9 and ASC 310-40-15-10 provide examples of scenarios that may result in a troubled debt restructuring. Those examples include the transfer of assets by the debtor to the creditor/lender to satisfy all or part of the debt, issuance of equity interests by the debtor to the creditor/lender to satisfy all or part of the debt, and modifications to the terms of the loan or debt instrument. The accounting for restructured debt is based on the substance of the modification, irrespective of whether the modification impacts the timing of cash flows, amounts designated as interest, or amounts designated as principal.

ASC 310-40-15-9

A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

- a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)
- b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
- c. Modification of terms of a debt, such as one or a combination of any of the following:
 - 1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
 - 2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk

3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
4. Reduction (absolute or contingent) of accrued interest.

ASC 310-40-15-10

The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto.

ASC 310-40-15-11 and ASC 310-40-15-12 provide examples of transactions that are not considered troubled debt restructurings.

ASC 310-40-15-11

For purposes of this Subtopic, none of the following are considered troubled debt restructurings:

- a. Lease modifications (for guidance, see Topic 842)
- b. Changes in employment-related agreements, for example, pension plans and deferred compensation contracts
- c. Unless they involve an agreement between debtor and creditor to restructure, either of the following:
 1. Debtors' failures to pay trade accounts according to their terms
 2. Creditors' delays in taking legal action to collect overdue amounts of interest and principal.

ASC 310-40-15-12

A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Subtopic even if the debtor is experiencing some financial difficulties. For purposes of this Subtopic, none of the following debt restructurings, for example, are considered troubled debt restructurings:

- a. The fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's amortized cost basis.
- b. The fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable.
- c. The creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate.
- d. The debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.

Question LI 10A-1

Debtors apply the guidance in ASC 470-60-55-10 to determine whether a loan refinancing or restructuring should be accounted for as a troubled debt restructuring. Can a creditor apply the same guidance?

PwC response

No. The guidance in ASC 310-40-15-8A specifically prohibits a creditor from applying the guidance in ASC 470-60-55-10 when evaluating whether a restructuring constitutes a troubled debt restructuring. There can be instances when a modification is a TDR for the creditor and not the debtor.

10A.2.1.1 TDRs - determining if financial difficulties exist

ASC 310-40-15-20 provides indicators to be considered when evaluating whether a borrower is experiencing financial difficulties. In addition to those listed in the guidance, other factors may exist that may indicate that a borrower is experiencing financial difficulties.

ASC 310-40-15-20

In evaluating whether a receivable is a troubled debt restructuring, a creditor must determine whether the debtor is experiencing financial difficulties. In making this determination, a creditor shall consider the following indicators:

- a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.
- b. The debtor has declared or is in the process of declaring bankruptcy.
- c. There is substantial doubt as to whether the debtor will continue to be a going concern.
- d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
- f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

10A.2.1.2 TDRs - determining whether a creditor has granted a concession

ASC 310-40-15-13 provides a starting point for the guidance for evaluating whether a creditor has granted a concession.

ASC 310-40-15-13

A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. In that situation, and if the payment of principal at original maturity is primarily dependent on the value of collateral, an entity shall consider the current value of that collateral in determining whether the principal will be paid.

When a restructuring occurs, the creditor will need to consider all factors that changed to determine if a concession was granted, including changes to collateral that may be used to repay the loan.

ASC 310-40-15-14 provides guidance for evaluating a restructuring in which the creditor receives additional collateral or a guarantee. When this occurs, the creditor should consider whether the nature and amount of the additional collateral or guarantee is sufficient to compensate it for the change in terms associated with the restructuring. The guidance specifies that the creditor should evaluate whether the guarantor has both the ability and willingness to pay. Determining the value of a guarantee may not be straightforward when certain information necessary to evaluate a guarantor's ability to perform is not readily available or current.

ASC 310-40-15-14

A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring. When additional guarantees are received in a restructuring, an entity shall evaluate both a guarantor's ability and its willingness to pay the balance owed.

ASC 310-40-15-15 and ASC 310-40-15-16 provide guidance that requires the creditor to evaluate if the debtor would be able to get the same terms and market rate from a different lender. Market rates for borrowers experiencing financial difficulty may not be readily observable; therefore, when assessing whether market-rate funds are available to borrowers in financial difficulty, creditors may need to refer to other data points, such as acquisitions or sales of troubled loans and the discount rates applied in those transactions. If the debtor would be unable to get the same rate from a different lender, the rate would be considered below market. This fact and all other aspects of the restructuring would need to be considered in determining whether a concession has been granted.

ASC 310-40-15-15

If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

ASC 310-40-15-16

A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below market interest rates for new debt with similar risk characteristics. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

Question LI 10A-2

If a restructuring results in an increase (temporarily or permanently) to the contractual interest rate, does it need to be evaluated as a possible troubled debt restructuring?

PwC response

Yes. As discussed in ASC 310-40-15-16, a temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude a restructuring from being considered a troubled debt restructuring because the new contractual rate, despite being higher than the original contractual rate, may still be below market rates for new debt with similar characteristics. When this occurs, all aspects of the restructuring should be considered in determining whether a concession has been granted.

Even if the restructuring only delays the timing of payments, a concession may have been granted unless the delays are insignificant. Additionally, if the debt has been previously restructured, the reporting entity is required to consider the cumulative impact of all past restructuring when determining if the concession is insignificant. ASC 310-40-15-17 and ASC 310-40-15-18 address whether a restructuring results in a delay in payment that is insignificant.

ASC 310-40-15-17

A restructuring that results in only a delay in payment that is insignificant is not a concession. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

- a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
- b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
 1. The frequency of payments due under the debt
 2. The debt's original contractual maturity
 3. The debt's original expected duration.

ASC 310-40-15-18

If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

Example LI 10A-1 and Example LI 10A-2 illustrate the application of the guidance on insignificant delays.

EXAMPLE LI 10A-1**Two-month interest deferral on a five-year loan**

Bank Corp originates a five-year loan that has a fixed interest rate, with monthly interest payments due of \$1,000 and a balloon payment due at maturity of \$100,000. The loan is collateralized by new construction. Bank Corp expects the loan to be repaid no sooner than maturity.

Six months before the maturity date of the loan, the borrower is unable to make the required interest payments, and Bank Corp determines that the borrower is experiencing financial difficulties as defined in ASC 310-40.

Bank Corp agrees to restructure the loan to defer two interest payments until the completed construction is sold, which is expected to occur in two months. Bank Corp will earn interest on the deferred payments, the value of the collateral has not declined, and the borrower is expected to pay back the principal and interest due.

Is the loan restructuring a troubled debt restructuring?

Analysis

Bank Corp expects to collect all contractual amounts due, despite the two-month delay in payment. In addition, the two months of delayed interest payments are insignificant when compared with the balloon principal due, the delay in timing of the two payments is insignificant relative to the frequency of the payments due, the debt's original contractual maturity, and the debt's original expected duration.

Because the delay in payment as a result of the restructuring is considered insignificant, the restructuring would not be considered a troubled debt restructuring.

EXAMPLE LI 10A-2**One-year interest deferral on two-year loan**

Bank Corp originates a two-year loan that has a fixed interest rate, with quarterly interest payments due of \$3,000 and a balloon payment due at maturity of \$100,000. The loan is collateralized by real estate. Bank Corp expects the loan to be repaid no sooner than maturity.

One year prior to the maturity date of the loan, the borrower is unable to make the required interest payments, and Bank Corp determines that the borrower is experiencing financial difficulties as defined in ASC 310-40.

Bank Corp agrees to restructure the loan to defer all remaining interest payments until maturity. Bank Corp expects to collect all contractual amounts due, despite the payment delay, and the collateral value has not declined significantly.

Is the loan restructuring a troubled debt restructuring?

Analysis

The delayed interest payment amounts are significant when compared with the balloon principal due. The delay in timing of the interest payments is also significant relative to the frequency of the payments due, the debt's original contractual maturity, and the debt's original expected duration.

The delay in payment as a result of the restructuring would be considered significant. Since the borrower is experiencing financial difficulties and Bank Corp has granted a concession, the restructuring would be considered a troubled debt restructuring.

Trial modifications

Some lenders participate in trial modification programs such as the Home Affordable Modification Program (HAMP). Under these programs, lenders enter into an agreement with a borrower to modify their loan for an initial trial period. Upon successful completion of the trial period, the loan is permanently modified.

We are aware that the SEC staff has provided guidance that the lender is considered to have granted to the borrower a modification with a contingent concession that qualifies as a troubled debt restructuring at the start of the trial period when there is a legally binding obligation to the borrower on the part of the lender. In evaluating the significance of the concession granted to the borrower, the SEC staff concluded that the lender should consider the modification of payments both during the trial period as well as the expected modification in loan terms assuming the loan will be permanently modified, notwithstanding the possibility that an individual borrower may not successfully complete the trial period and his loan may not be permanently modified.

This guidance may also apply to other types of trial-period modifications.

10A.2.2 *Analyzing a refinancing or restructuring that is not a TDR*

If a refinancing or restructuring does not meet the requirements to be considered a troubled debt restructuring, it should be analyzed to determine if it is a modification of the original instrument or a new instrument. As discussed in ASC 310-20-35-9, a loan refinancing or restructuring, that is not a troubled debt restructuring, should be accounted for as a new loan (i.e., as an extinguishment of the original debt instrument and issuance of a new loan) when *both* of the following occur:

- The new loan's effective yield is at least equal to the effective yield for similar loans
- The modifications are more than minor

If these conditions are not met, the refinancing or restructuring should be accounted for as a modification of the original debt instrument, not as a new loan. The determination of whether the restructuring is a modification or the creation of a new instrument impacts the accounting for certain

fees and costs and is important in determining the origination date for certain “vintage disclosures.” See LI 12 for information on presentation and disclosure.

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or restructuring, in which the refinancing or restructuring is not itself 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 and modifications of the original debt instrument are more than minor. 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. 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.

When determining if the modification of a contract to replace LIBOR, or another reference rate expected to be discontinued should be accounted for as a continuation of the existing contract or as an extinguishment and creation of a new contract, a reporting entity may elect to apply the guidance in ASC 848. See REF 2 for further details.

10A.2.2.1 Non-TDR refinancing/restructuring: assessment of more than minor

To determine whether a modification is considered “more than minor,” a reporting entity should perform the assessment shown in Figure LI 10A-3, which starts with comparing the present value of cash flows of the new debt with the remaining cash flows of the old debt.

However, when determining if a modification of a contract to replace LIBOR, or another reference rate expected to be discontinued should be accounted for as a continuation of the existing contract or as an extinguishment and creation of a new contract, a reporting entity may elect to apply the guidance in ASC 848. See REF 2 for further details).

Figure LI 10A-3

Assessment of more than minor

Step 1 In accordance with ASC 310-20-35-11, compare the present value of the cash flows of the new debt with the present value of the remaining cash flows of the original debt utilizing the guidance in ASC 470. See FG 3 for an illustration of this assessment.

If the present value of cash flows differs by at least 10%, the modification is considered more than minor.

If the present value of cash flows differs by less than 10%, further analysis should be performed under Step 2.

ASC 470-50-40-12 provides specific guidance on performing the 10% test. Key takeaways from this guidance include:

- When performing the 10% test, the cash flows of the new debt instrument should include all amounts paid by the debtor to the lender (i.e., any fees paid to the lender in
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conjunction with the restructuring should be included in the cash flows of the new debt instrument) as a day-one cash flow.

- Third-party fees should not be included in the cash flow analysis.
 - If there is a variable interest rate in any of the debt instruments, the spot interest rate on the restructuring date should be used to determine future interest payments.
 - If either debt instrument is callable or puttable, then separate cash flow analyses should be performed assuming exercise and nonexercise of the put and call. The scenario that generates the smallest change should be used.
 - For debt that has been amended more than once in a twelve-month period, the debt terms that existed just prior to the earliest amendment occurring in the prior twelve months should be used to apply the 10% test, provided modification accounting was previously applied.
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Step 2 The creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances surrounding the modification and other relevant considerations. The accounting literature does not provide specific guidance on what factors a reporting entity should consider.

Relevant facts may include considering the impact of the modification on the following:

- Collateral, covenant, or guarantor requirements
 - Put and call features
 - Principal balance, interest rate, payment terms, maturity
 - Other significant features specified in the loan agreement
-

10A.3 Accounting for a troubled debt restructuring

Under the guidance in ASC 310-40, a creditor does not recognize a new loan for a troubled debt restructuring. When a creditor has determined that a refinancing or restructuring is a troubled debt restructuring, unamortized fees and costs from the original loan, and other fees and costs associated with the TDR should be accounted for in accordance with the guidance in ASC 310-40 and ASC 310-20-55.

ASC 310-40-35-10 states that a TDR is not accounted for as a new loan.

ASC 310-40-35-10

A loan restructured in a troubled debt restructuring shall not be accounted for as a new loan because a troubled debt restructuring is part of a creditor's ongoing effort to recover its investment in the original loan. Topic 326 provides guidance on measuring credit losses on financial assets and requires credit losses to be recorded through an allowance for credit loss account, including concessions given to the borrower upon a troubled debt restructuring.

Since TDRs are not accounted for as new loans, unamortized fees and costs from the original loan should be carried forward and continue to be included in the amortized cost basis of the loan.

According to ASC 310-40-25-1, legal fees and other direct costs incurred by a creditor in connection with the troubled debt restructuring should be expensed when incurred.

ASC 310-20-35-12 states that any fees received by the creditor in connection with a TDR reduce the amortized cost basis of the loan.

ASC 310-20-35-12

Fees received in connection with a modification of terms of a troubled debt restructuring as defined in Subtopic 310-40 shall be applied as a reduction of the recorded investment in the loan. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

See LI 12 for information on the disclosures creditors are required to make with regard to TDRs.

10A.3.1 TDRs and the allowance for credit losses

Under the CECL model in ASC 326-20, there is no separate impairment model for loans that have been restructured in a TDR. However, an entity may be required to use a discounted cash flow approach to measure the estimated credit losses of a loan that has been restructured in a TDR or if there is a reasonably expected TDR in order to capture the impact of certain concessions.

10A.3.1.1 Identification of a reasonably expected TDR

ASC 326-20 requires an entity to consider all of the effects of a TDR on estimated credit losses when it has a reasonable expectation at the reporting date that it will execute a TDR with the borrower. At the September 6, 2017 FASB meeting, the Board concluded that an entity should identify a TDR when it is reasonably expected at the individual loan level. Once identified (or forecasted), the effects of the TDR, including the benefit of loss mitigation, the economic loss related to concessions and any additional credit exposure over the extended term should be reflected in the estimate of expected credit losses.

Determination of when an entity reasonably expects to execute a TDR on a specific asset requires judgment. We believe a TDR is reasonably expected no later than when the entity determines that modification is the best course of action in an effort to maximize collection from a troubled borrower.

An entity should consider its credit risk management policies and any loan modification programs in place for troubled borrowers. Through leveraging information in servicing systems, entities may be able to identify borrowers with whom they reasonably expect to execute TDRs based on combinations of certain factors, such as delinquency, loan to value ratios, and other metrics. The identification of reasonably expected TDRs is a management judgment that will require processes and controls that should be continually re-evaluated based on management's restructuring practices.

We do not expect each asset identified as a reasonably expected TDR to ultimately result in an executed TDR. Similarly, not all executed TDRs will have been previously identified as reasonably expected TDRs. A reporting entity should make a reasonable effort to appropriately identify reasonably expected TDRs.

10A.3.1.2 TDRs - allowance for credit losses

Although reasonably expected TDRs are required to be identified on an individual asset basis, expected credit losses under CECL may be measured either on a pool or individual asset basis, depending on the asset's facts and circumstances, including whether it shares risk characteristics with other assets. Further, loans for which TDRs are reasonably expected and loans that have been

restructured through TDRs may be pooled with loans that have not experienced and are not expected to experience TDRs when they share similar risk characteristics.

The measurement of the allowance for credit losses for TDRs and reasonably expected TDRs follows the CECL model, which is discussed in LI 7. While the CECL model is applicable to loans that have been restructured through TDRs and loans for which TDRs are reasonably expected, there are some additional items an entity should consider when measuring credit losses on these assets. These items include, but are not limited to, the following:

- Concessions granted through TDRs must be captured in an entity's estimate of expected credit losses. While CECL does not require the use of a discounted cash flow (DCF) model, an entity may be required to use this method to capture certain concessions when measuring the allowance for credit losses on loans that have been restructured through TDRs and loans for which TDRs are reasonably expected. If the impact of a concession can only be measured through a DCF method, then a DCF method must be used. This may be applicable to interest rate concessions and term extensions, as the economic impact of these concessions is partly driven by the time value of money.
- When a reporting entity uses a DCF model to estimate expected credit losses on loans that have been restructured through TDRs or loans for which a TDR is reasonably expected, the effective interest rate used to discount the expected future cash flows should be the original effective rate of the loan, not the rate specified within the restructuring agreement entered into between the creditor and the borrower. By using the original effective rate, any interest concessions will be captured in the analysis. If a reporting entity uses a modeling technique other than a DCF analysis to determine its expected credit losses, it must incorporate the effect of a concession in its estimate.
- Entities are not required to adjust historical loss data that serves as a basis for elements of a CECL estimate to remove the effect of TDRs unless the entity expects that its historic loss mitigation activities are not representative of what it expects it will do in the future. At the September 6, 2017 FASB meeting, the FASB acknowledged that, depending how an entity maintains its historic data, certain effects of TDRs may already be included in an entity's historical loss rates (e.g., the benefit of the loss mitigation achieved through TDRs may already be reflected through lower historical loss rates) while other effects may not be (e.g., the economic loss related to an interest rate concession).

The effects of a TDR, in addition to those embedded in an entity's historical loss data, should be recognized once a reasonable expectation of a TDR has been identified on an individual instrument. When a reasonably expected TDR is identified, an entity should consider its impact that is not already captured in its estimate of expected credit losses.

If an entity expects that its future loss mitigation efforts will be different than those in the past, it should consider making appropriate adjustments to its loss estimates. For example, if an entity discontinued certain TDR programs offered to troubled borrowers in the past, this would need to be considered.

Question LI 10A-3

When assessing whether a concession has been granted on a purchased credit deteriorated (PCD) asset to determine if a restructuring is a TDR, is the lender required to evaluate whether the concession was granted based on contractual or expected cash flows?

PwC response

A lender should base the evaluation of whether a concession has been granted on a PCD asset on the contractual terms and cash flows, similar to non-PCD assets. ASC 310-40-15-13 states that a creditor has granted a concession when, as a result of a loan modification, it does not expect to collect all amounts due, including interest accrued at the original contractual rate. See LI 9 for further information on PCD assets.

Entities with collateralized loans that have been restructured through TDRs and collateralized loans when a TDR is reasonably expected are required to estimate expected credit losses based on the fair value of the collateral when the entity determines foreclosure is probable. Entities also have the ability to elect the collateral-dependent practical expedient on these assets if the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. In both cases (foreclosure is probable or when using the collateral-dependent practical expedient), the estimate of expected credit losses is based on the difference between the fair value of the collateral as of the balance sheet date and the amortized cost basis of the asset. See LI 7.3.6.6 and LI 7.4.1 for further information.

Question LI 10A-4

Assume an entity has a reasonable expectation to execute a TDR involving an interest rate concession on a collateralized loan. The loan qualifies for and the entity has elected to apply the collateral-dependent practical expedient for measuring expected credit losses. Should the entity adjust the fair value of the collateral to reflect the anticipated interest rate concessions when estimating expected credit losses?

PwC response

No. When an entity elects the practical expedient, ASC 326-20-35-5 requires the estimate of credit losses to be based on the difference between the fair value of the collateral (less costs to sell, as applicable) as of the balance sheet date and the amortized cost basis of the asset. The economic impact of any concessions that may relate to the reasonably expected or executed TDRs should not be added to the allowance calculated under the practical expedient, as the fair value of the asset is used to determine expected credit losses.

Question LI 10A-5

Assume an entity had previously restructured a loan in a TDR by giving an interest rate concession and has now concluded that foreclosure is probable. When estimating expected credit losses, should the entity adjust the fair value of the collateral to reflect the economic impact of the interest rate concession?

PwC response

No. When foreclosure of a collateralized asset is probable, ASC 326-20-35-4 requires the estimate of credit losses to be based on the difference between the fair value of the collateral (less costs to sell, as applicable) as of the balance sheet date and the amortized cost basis of the asset. The economic impact of any concessions that may relate to the executed TDR should not be added to the allowance calculated based on the fair value of the asset.

10A.4 Accounting for a refinancing or restructuring that is not a TDR

The accounting for any unamortized net fees or costs associated with a loan refinancing or restructuring that is not a troubled debt restructuring depends on whether the refinancing or restructuring is a new loan or a modification.

Creditors should follow the guidance in ASC 310-20-35-9 and ASC 310-20-35-10 to determine the treatment of fees or costs associated with refinanced or restructured loans that are not TDRs.

ASC 310-20-35-9

If the terms of the new loan resulting from a loan refinancing or restructuring, in which the refinancing or restructuring is not itself 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 and modifications of the original debt instrument are more than minor. 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. 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.

ASC 310-20-35-10

If the refinancing or restructuring does not meet the condition set forth in the preceding paragraph 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, any additional amounts loaned, any fees received, and direct loan origination costs associated with the refinancing or restructuring.

The guidance in ASC 310-20-35-9 and ASC 310-20-35-10 is summarized in Figure LI 10A-4.

Figure LI 10A-4

Accounting for fees and costs associated with a refinancing or restructuring that is not a troubled debt restructuring

New loan	Unamortized net fees or costs from the original loan and any prepayment penalties are recognized in interest income when the new loan is granted.
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Modification	The amortized cost basis of the new loan should comprise the remaining amortized cost basis in the original loan, any additional amounts loaned, any fees received, and direct loan origination costs associated with the refinancing or restructuring.
	Unamortized net fees or costs from the original loan and any prepayment penalties are carried forward as part of the amortized cost basis of the new loan.

When a restructuring is accounted for as a modification, the effective interest rate of the loan may need to be recalculated based upon the amortized cost basis of the new loan and its revised contractual cash flows.

Once the creditor has considered the guidance in ASC 310-20, the creditor should then apply the CECL impairment model to determine its expected credit losses and the allowance for credit losses in accordance with ASC 326. See LI 7 for further information.

***Chapter 11:
Accounting for foreclosures
and sales of real estate—
updated May 2022***

11.1 Chapter overview — foreclosures and sales of real estate

A lending institution may receive real estate assets in full or partial satisfaction of a receivable from a borrower experiencing financial difficulty either through surrender of the real estate asset or as a result of formal foreclosure proceedings.

In March 2022, the FASB issued ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*, which eliminated the accounting guidance for troubled debt restructurings (TDRs) for creditors that have adopted ASU 2016-13. Guidance in this chapter has been updated to reflect the new ASU. Impacted sections are denoted as before or after adoption of ASU 2022-02.

Sales of other real estate owned (OREO), foreclosed property that is classified as held for sale, are accounted for in accordance with ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*. The guidance addresses conditions that may prevent derecognition of nonfinancial assets, including real estate assets, at the time of sale. See PPE 6.4 for guidance on accounting for the subsequent sale of real estate assets by a creditor.

11.2 Accounting for mortgage loans upon foreclosure — after adoption of ASU 2022-02

ASC 310-20, *Nonrefundable fees and other costs*, provides guidance on the classification of residential real estate acquired that served as collateral to a mortgage loan and the classification of certain government-guaranteed mortgage loans upon foreclosure. This guidance applies to all creditors.

11.2.1 Foreclosure of residential real estate collateralized loans — after adoption of ASU 2022-02

When a creditor receives physical possession of residential real estate property that collateralized a mortgage loan (through an in substance repossession or foreclosure), it should derecognize the loan receivable and recognize the real estate property. ASC 310-20-55-18F provides guidance on when a creditor is considered to have received physical possession of such real estate property related to consumer mortgage loans.

ASC 310-20-55-18F

A creditor is considered to have received physical possession (resulting from an in substance repossession or foreclosure) of residential real estate property collateralizing a consumer mortgage loan only upon the occurrence of either of the following:

- a. The creditor obtains legal title to the residential real estate property upon completion of a foreclosure. A creditor may obtain legal title to the residential real estate property even if the borrower has redemption rights that provide the borrower with a legal right for a period of time after a foreclosure to reclaim the real estate property by paying certain amounts specified by law.

- b. The borrower conveys all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

In many legal jurisdictions, a borrower has a legal right to reclaim a foreclosed real estate property, for some period of time, by paying an amount specified by law. A creditor should not wait until this redemption period has expired to reclassify a consumer mortgage loan to residential real estate. The creditor obtains physical possession when it obtains legal title because it generally has the right to sell the property subject to the borrower's right of redemption.

Foreclosed or repossessed real estate should be presented on the balance sheet as a separate amount or included in other assets and disclosed in the notes to the financial statements. ASC 310-10-50 also requires a creditor to disclose (1) the carrying amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure.

11.2.2 Foreclosure of government guaranteed mortgage loans – after adoption of ASU 2022-02

As discussed in ASC 310-20-40-7, upon the foreclosure on property collateralizing a government-guaranteed mortgage loan, a creditor should derecognize the government-guaranteed mortgage loan and recognize either a real estate asset or a standalone government guarantee receivable (if certain conditions are met). Government-guaranteed mortgage loans include loans guaranteed by the Federal Housing Administration (FHA), the US Department of Housing and Urban Development (HUD), or the US Department of Veterans Affairs (VA). A government loan guarantee entitles the creditor to recover all or a portion of the unpaid principal balance from the governmental entity upon a borrower default on the loan.

ASC 310-20-40-7

A guaranteed mortgage loan receivable shall be derecognized and a separate other receivable shall be recognized upon foreclosure (that is, when a creditor receives physical possession of real estate property collateralizing a mortgage loan in accordance with the guidance in paragraph 310-20-40-6) if the following conditions are met:

- a. The loan has a government guarantee that is not separable from the loan before foreclosure.
- b. At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim. A creditor would be considered to have the ability to recover under the guarantee at the time of foreclosure if the creditor determines that it has maintained compliance with the conditions and procedures required by the guarantee program.
- c. At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

11.2A Accounting for mortgage loans upon foreclosure – before adoption of ASU 2022-02

ASC 310-40, *Troubled Debt Restructurings by Creditors*, provides guidance on the classification of residential real estate acquired that served as collateral to a mortgage loan and the classification of certain government-guaranteed mortgage loans upon foreclosure. This guidance applies to all creditors.

11.2A.1 Foreclosure of residential real estate collateralized loans – before adoption of ASU 2022-02

When a creditor receives physical possession of residential real estate property that collateralized a mortgage loan (through an in substance repossession or foreclosure), it should derecognize the loan receivable and recognize the real estate property. ASC 310-40-55-10A provides guidance on when a creditor is considered to have received physical possession of such real estate property related to consumer mortgage loans.

ASC 310-40-55-10A

A creditor is considered to have received physical possession (resulting from an in substance repossession or foreclosure) of residential real estate property collateralizing a consumer mortgage loan only upon the occurrence of either of the following:

- a. The creditor obtains legal title to the residential real estate property upon completion of a foreclosure. A creditor may obtain legal title to the residential real estate property even if the borrower has redemption rights that provide the borrower with a legal right for a period of time after a foreclosure to reclaim the real estate property by paying certain amounts specified by law.
- b. The borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

In many legal jurisdictions, a borrower has a legal right to reclaim a foreclosed real estate property, for some period of time, by paying an amount specified by law. A creditor should not wait until this redemption period has expired to reclassify a consumer mortgage loan to residential real estate. The creditor obtains physical possession when it obtains legal title because it generally has the right to sell the property subject to the borrower's right of redemption.

Foreclosed or reposessed real estate should be presented on the balance sheet as a separate amount or included in other assets and disclosed in the notes to the financial statements. ASC 310-10-50 also requires a creditor to disclose (1) the carrying amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure.

11.2A.2 Foreclosure of government guaranteed mortgage loans – before adoption of ASU 2022-02

As discussed in ASC 310-40-40-7A, upon the foreclosure on property collateralizing a government-guaranteed mortgage loan, a creditor should derecognize the government-guaranteed mortgage loan and recognize either a real estate asset or a standalone government guarantee receivable (if certain conditions are met). Government-guaranteed mortgage loans include loans guaranteed by the Federal Housing Administration (FHA), the US Department of Housing and Urban Development (HUD), or the US Department of Veterans Affairs (VA). A government loan guarantee entitles the creditor to recover all or a portion of the unpaid principal balance from the governmental entity upon a borrower default on the loan.

ASC 310-40-40-7A

A guaranteed mortgage loan receivable shall be derecognized and a separate other receivable shall be recognized upon foreclosure (that is, when a creditor receives physical possession of real estate property collateralizing a mortgage loan in accordance with the guidance in paragraph 310-40-40-6) if the following conditions are met:

- a. The loan has a government guarantee that is not separable from the loan before foreclosure.
- b. At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim. A creditor would be considered to have the ability to recover under the guarantee at the time of foreclosure if the creditor determines that it has maintained compliance with the conditions and procedures required by the guarantee program.
- c. At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

11.3 Foreclosure and sales of real estate – after adoption of ASU 2022-02

A creditor that receives physical possession of residential or commercial real estate property through an in substance repossession or foreclosure should recognize the real estate property.

If a company decides to hold such real estate property for use, it should account for the property in accordance with ASC 360, *Property, plant and equipment*. See PPE 5.3 for guidance on held-for-sale classification criteria. As discussed in ASC 310-20-40-3, a creditor should initially record foreclosed property that is classified as held for sale at fair value less the estimated costs to sell the property. Fair value should be determined using the measurement guidance in ASC 820-10.

The fair value less estimated cost to sell becomes the new cost basis for the asset, which is often referred to as other real estate owned (OREO).

If the amortized cost basis in the loan exceeds the cost basis established for the OREO, the difference should be recorded as a provision for credit loss. Conversely, if the OREO cost basis is higher than the

amortized cost basis in the loan, the difference should be recorded as a recovery of previous amounts written off up to the original cost basis of the loan and a gain on disposition of loans thereafter.

11.3.1 Subsequent measurement of OREO classified as held for sale – after adoption of ASU 2022-02

Subsequent declines in the fair value of OREO should be recorded through the use of a valuation allowance. Changes in fair value should be determined on a property-by-property basis; an allowance allocated to one property may not be used to offset losses incurred on another property. In addition, unallocated valuation allowances are not permitted.

Subsequent increases in the fair value of a property may be used to reduce the valuation allowance, but only to an amount that does not exceed the OREO's foreclosure date cost basis of the property, as illustrated in ASC 310-20-55-51 through ASC 310-20-55-53. Refer to PPE 5 for further discussion on accounting for assets classified as held for sale.

EXAMPLE LI 11-1

Subsequent measurement of OREO classified as held for sale

On December 10, 20X5, Bank Corp received a real estate property in satisfaction of a loan. Bank Corp's recorded investment in the loan at the time was \$160,000. The estimated fair value of the property was \$162,000 and estimated costs to sell were \$7,000; therefore, the new cost basis of the OREO asset was \$155,000.

As of March 31, 20X6, the fair value of the property declined to \$160,000 and the estimated cost to sell remained at \$7,000, resulting in a value of \$153,000. Bank Corp recorded the decline in value by establishing a \$2,000 valuation allowance.

As of June 30, 20X6, the fair value of the property increased to \$165,000 while estimated costs to sell declined to \$5,000.

How should Bank Corp record the increase in the fair value of the property as of June 30, 20X6?

Analysis

The value of the property less costs to sell as of June 30, 20X6 is \$160,000 (\$165,000 fair value – \$5,000 costs to sell). However, Bank Corp can only increase the carrying value of the OREO to the OREO's foreclosure date cost basis of \$155,000. Therefore, Bank Corp can reverse the previously recorded valuation allowance of \$2,000, but may not increase the value of the OREO any further.

11.3.2 Use of appraisals when estimating fair value of OREO – after adoption of ASU 2022-02

Appraisals are a common resource used in estimating the fair value of OREO. Companies should consider available information when evaluating appraisals, including any changes in economic conditions or other circumstances between the date of the appraisal and the reporting date, back testing of prior OREO sales, and the type of appraisal. If concern exists about the accuracy of the appraisal, further analysis should be performed and circumstances may justify other approaches to establish the fair value.

11.3A *Foreclosure and sales of real estate – before adoption of ASU 2022-02*

A creditor that receives physical possession of residential or commercial real estate property through an in substance repossession or foreclosure should recognize the real estate property.

If a company decides to hold such real estate property for use, it should account for the property in accordance with ASC 360, *Property, plant and equipment*. See PPE 5.3 for guidance on held-for-sale classification criteria. As discussed in ASC 310-40-40-3, a creditor should initially record foreclosed property that is classified as held for sale at fair value less the estimated costs to sell the property. Fair value should be determined using the measurement guidance in ASC 820-10.

The fair value less estimated cost to sell becomes the new cost basis for the asset, which is often referred to as other real estate owned (OREO).

If the amortized cost basis in the loan exceeds the cost basis established for the OREO, the difference should be recorded as a provision for credit loss. Conversely, if the OREO cost basis is higher than the amortized cost basis in the loan, the difference should be recorded as a recovery of previous amounts written off up to the original cost basis of the loan and a gain on disposition of loans thereafter.

11.3A.1 *Subsequent measurement of OREO classified as held for sale – before adoption of ASU 2022-02*

Subsequent declines in the fair value of OREO should be recorded through the use of a valuation allowance. Changes in fair value should be determined on a property-by-property basis; an allowance allocated to one property may not be used to offset losses incurred on another property. In addition, unallocated valuation allowances are not permitted.

Subsequent increases in the fair value of a property may be used to reduce the valuation allowance, but only to an amount that does not exceed the OREO's foreclosure date cost basis of the property, as illustrated in ASC 310-40-55-13 through ASC 310-40-55-15. Refer to PPE 5 for further discussion on accounting for assets classified as held for sale.

EXAMPLE LI 11-1A

Subsequent measurement of OREO classified as held for sale

On December 10, 20X5, Bank Corp received a real estate property in satisfaction of a loan. Bank Corp's recorded investment in the loan at the time was \$160,000. The estimated fair value of the property was \$162,000 and estimated costs to sell were \$7,000; therefore, the new cost basis of the OREO asset was \$155,000.

As of March 31, 20X6, the fair value of the property declined to \$160,000 and the estimated cost to sell remained at \$7,000, resulting in a value of \$153,000. Bank Corp recorded the decline in value by establishing a \$2,000 valuation allowance.

As of June 30, 20X6, the fair value of the property increased to \$165,000 while estimated costs to sell declined to \$5,000.

How should Bank Corp record the increase in the fair value of the property as of June 30, 20X6?

Analysis

The value of the property less costs to sell as of June 30, 20X6 is \$160,000 (\$165,000 fair value — \$5,000 costs to sell). However, Bank Corp can only increase the carrying value of the OREO to the OREO's foreclosure date cost basis of \$155,000. Therefore, Bank Corp can reverse the previously recorded valuation allowance of \$2,000, but may not increase the value of the OREO any further.

11.3A.2 *Use of appraisals when estimating fair value of OREO – before adoption of ASU 2022-02*

Appraisals are a common resource used in estimating the fair value of OREO. Companies should consider available information when evaluating appraisals, including any changes in economic conditions or other circumstances between the date of the appraisal and the reporting date, back testing of prior OREO sales, and the type of appraisal. If concern exists about the accuracy of the appraisal, further analysis should be performed and circumstances may justify other approaches to establish the fair value.

Chapter 12:
Presentation and disclosure
—updated May 2022

12.1 Chapter overview – disclosure of loans and investments—updated September 2022

The codification provides guidance on the financial statement presentation of loans and investments and the related credit allowance. In addition to the information provided on the face of the financial statements, certain disclosures must be made in the notes.

This chapter discusses certain considerations for the presentation and disclosure of loans and investments. See PwC's *Financial statement presentation* guide for more general information on the presentation of the balance sheet and income statement. See FSP 6.7 for information on the statement of cash flow presentation.

This chapter assumes that an entity has adopted ASU 2022-01, *Derivatives and Hedging (Topic 815), Fair Value Hedging – Portfolio Layer Method*.

Recent standard setting

In June 2022, the FASB issued ASU 2022-03, *Fair Value Measurements of Equity Securities Subject to Contractual Sale Restrictions*. ASU 2022-03 clarified that a contractual restriction on the sale of an equity security (for example, an underwriter lock-up agreement) is not considered part of the unit of account of an equity security. As a result, such restriction is not considered in measuring the fair value of the equity security. ASU 2022-03 is effective for public business entities for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

This chapter assumes that an entity has adopted ASU 2022-03, *Fair Value Measurements of Equity Securities Subject to Contractual Sale Restrictions*.

12.2 Loans and investments: balance sheet presentation

Reporting entities that present a classified balance sheet should see FSP 2.3.4 and FSP 9.4.1 for information on the presentation of loans, receivables, and investments as current and noncurrent.

ASC 825-10-45-1A requires entities to present financial assets and financial liabilities separately by measurement category and form of financial asset (i.e., securities or loans and receivables) in the statement of financial position or in the notes.

Reporting entities subject to Article 5 of SEC Regulation S-X may be required to present all items in excess of 5% of total assets separately on the face of the balance sheet or in a note based on the requirements of S-X 5-02(17). See LI 12.11 and LI 12.12 for additional considerations for insurance and banking entities subject to Article 7 or Article 9 of Regulation S-X, respectively.

12.2.1 Disclosure of loans and receivables

Generally, ASC 310 permits loans and receivables to be presented on the balance sheet as aggregate amounts. Major categories of loans or receivables should be presented separately either on the balance

sheet or in the notes. Loans and receivables that are held for sale should be presented separately on the face of the balance sheet.

See FSP 8.3 for additional information on the presentation of loans and receivables, including the presentation of loans from officers, employees, or affiliated companies. See LI 12.9 for considerations regarding the presentation and disclosures related to investments in insurance contracts.

12.2.1.1 Disclosure of discount/premium on loans and receivables

Often, the face amount of a note receivable or a loan does not represent the current value of the consideration given or received in the exchange. In this situation, a discount or premium is recorded. Unearned discounts (other than cash or quantity discounts), finance charges, and prepaid interest are also recorded as a discount on (or reduction to) the related receivable.

ASC 835-30 includes the presentation requirements for discounts or premiums on note receivables.

Excerpt from ASC 835-30-45-1A

The discount or premium resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note.

See FSP 12 for information on discount and premium presentation and disclosure considerations from the debtor's perspective.

12.2.1.2 Disclosure of loan origination and other fees

The unamortized balance of loan origination fees, commitment fees or other fees or costs, and purchase premiums and discounts that are being recognized as a yield adjustment, should be reported on the balance sheet as part of the loan balance to which they relate. Any fees received for a commitment to originate or purchase a loan or group of loans that meet the criteria in ASC 310-20-35-3 should be classified as deferred income on the balance sheet.

See LI 4 for information on the accounting for loan origination and other fees.

12.2.2 Disclosure of debt and equity securities

A reporting entity should present assets that are measured at fair value separate from similar assets that are carried at amortized cost on the face of the balance sheet based on the guidance in ASC 320-10-45-1, ASC 825-10-45-1A, ASC 825-10-45-1B, and Regulation S-X 5-02. To accomplish this, a reporting entity should present either of the following.

- The aggregate of the fair value and non-fair value amounts in the same line item in the balance sheet and parenthetically disclose the fair value amount included in the aggregate amount
- The fair value and non-fair value carrying amounts in two separate line items

For available-for-sale debt securities, which are measured and presented on the balance sheet at fair value, the amortized cost and allowance for credit losses should be presented parenthetically.

While S-X 5-02 requires reporting entities to have a separate line item for “marketable securities,” it refers to the disclosure requirements for current marketable equity securities prescribed by GAAP. Those requirements are detailed in ASC 321. For marketable securities other than equity securities, S-X 5-02 requires reporting entities to state parenthetically on the balance sheet or in the notes the basis for determining the aggregate amount presented in the balance sheet. Amortized cost is required to be disclosed if the securities are presented at fair value and, likewise, fair value is required to be disclosed if the securities are presented at amortized cost.

We believe that complying with ASC 320 and ASC 321 satisfies the requirements of S-X 5-02 in that investments in debt and equity securities will be presented separately from other assets. We do not believe that the term “marketable securities” is required on the face of the balance sheet.

Reporting entities subject to industry-specific guidance under Regulation S-X, such as bank holding companies and insurers, have different reporting requirements with regard to balance sheet captions. For example, insurers are required to present fixed-maturity securities separate from equity securities on the face of the balance sheet. This chapter does not address all of the industry-specific guidance for balance sheet presentation. See LI 12.11 and LI 12.12 for additional considerations for insurance and banking entities subject to Article 7 or Article 9 of Regulation S-X.

See FSP 5 for information on the presentation of a subsidiary’s investment in its parent’s stock.

12.2.3 Disclosure of credit losses

For assets subject to ASC 326, reporting entities should separately present the estimate of expected credit losses on the face of the balance sheet as an allowance that reduces the amortized cost basis of the relevant financial asset. The same presentation is required for purchased financial assets with credit deterioration. See LI 9 for information on purchased financial assets with credit deterioration.

ASC 326 also contains presentation guidance for off-balance sheet credit exposures that are in its scope, such as loan commitments, standby letters of credit, financial guarantees, and similar instruments (provided they are not accounted for as insurance or derivatives under ASC 815). The guidance requires reporting entities to present an estimate of expected losses for these types of exposures on the balance sheet as a liability. If an off-balance sheet credit exposure is related to a recognized financial asset (e.g., a partially drawn revolving line of credit), then the expected credit loss liability related to the off-balance sheet amount should be recorded and presented separate from the allowance for credit losses related to the drawn amount, which is deducted from the asset’s amortized cost basis.

The allowance for credit losses for available-for-sale securities should be shown parenthetically on the face of the balance sheet per ASC 326-30-45-1. Accumulated other comprehensive income on available-for-sale securities for which an allowance for credit losses has been recorded should be presented separate from other components of accumulated other comprehensive income on the balance sheet and in the statement of changes in equity.

12.2.4 Portfolio layer method

For any entities that have adopted ASU 2022-01, utilizing a portfolio layer method hedge, there are specific balance sheet presentation and disclosure considerations for presenting basis adjustments resulting from these hedges.

The “portfolio layer method” permits reporting entities to designate the portion of a closed portfolio of financial assets, beneficial interests secured by financial assets, or a combination of the two, that is not expected to be prepaid during the hedge period as the hedged item in a fair value hedge of interest rate risk. Although the portfolio layer method (originally referred to as the last-of-layer model) was designed considering prepayable mortgage loans or mortgage-backed securities, it may be applicable to other assets as well. The guidance allows an entity to essentially ignore prepayment risk in the hedge relationship even when prepayable assets are present in the closed portfolio. It does so by permitting designation of the portion of the pool not expected to be prepaid, defaulted, or sold as the hedged item.

For an active portfolio layer hedge, the basis adjustment would not be allocated to individual assets until the hedge is dedesignated. The basis adjustment is maintained on the closed portfolio of assets and therefore adjusts the carrying amount of the balance sheet line item in which the closed portfolio of assets is presented. If the closed portfolio of assets consists of available-for-sale debt securities, the basis adjustment will adjust the amount recorded in accumulated other comprehensive income, but will not adjust the fair value of the available-for-sale securities. If the assets included in the closed portfolio are presented in different balance sheet line items, the total basis adjustment should be allocated to the different financial statement lines in a systematic and rational method. Refer to FSP 19.3.4 for further information.

12.3 *Loans and investments – income statement classification*

The codification does not provide specific guidance on the appropriate income statement classification for certain items included in net income, including the following.

- Unrealized holding gains and losses on equity securities, trading securities, and securities for which the fair value option has been elected. Gains and losses on these items are typically classified as “trading gains and losses” or “other income,” but other presentation may be appropriate.
- For debt securities classified as trading under ASC 320 that are transferred to another category, ASC 320-10-45-7 specifically states that gains and losses that have accumulated before the transfer should be classified consistently with realized gains and losses for the category from which the security is being transferred (and not the category into which it is being transferred).

For certain other items, the codification provides specific guidance on which line in the income statement an item should be recorded, including the following items.

- Interest income – includes amortization of discount or premium as well as loan origination, commitment, and other fees and costs recognized as an adjustment of the effective interest rate
- Credit loss expense – for financial instruments measured at amortized cost and certain off-balance sheet credit exposures, the adjustment performed every period to align the allowance for expected credit losses to management’s current estimate is reported as credit loss expense (or a reversal of credit loss expense, if applicable)

ASC 326-20-45-3 and ASC 326-30-45-3 note that when a discounted cash flow approach is used to estimate expected credit losses, the change in present value from one reporting period to the next

may result both from the passage of time and from changes in estimates of the timing or amounts of expected cash flows. Reporting entities are permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense), or alternatively they might report the change in present value attributable to the passage of time within interest income (see LI 12.7.1.1 and LI 12.7.3.1 for disclosure requirements in case the latter alternative is chosen).

Similarly, credit-related impairment on available-for-sale debt securities should be classified as a credit loss expense on available-for-sale securities.

When using the fair value of collateral to determine the allowance for credit losses for a collateral-dependent financial asset, changes in the fair value of the collateral impact the allowance and are included in credit loss expense.

- Service fee income – includes amortization of commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires

See LI 12.9 for considerations regarding investments in insurance contracts.

12.4 *Loan and receivable disclosure requirements*

ASC 310-10-50-2 specifies the information required to be addressed in an accounting policy note for all loans and trade receivables.

ASC 310-10-50-2

The summary of significant accounting policies shall include the following:

- a. The basis for accounting for loans and trade receivables
- b. The method used in determining the lower of amortized cost basis or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis)
- c. The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment
- d. The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

Reporting entities are also required to disclose the allowance for credit losses (i.e., allowance for loan losses or allowance for doubtful accounts), unearned income, unamortized premiums and discounts, and net unamortized deferred fees and costs in its financial statements. See LI 12.7 for disclosure requirements related to credit quality and the allowance for doubtful accounts on loans and receivables. Further, entities are required to disclose the recorded investment for all mortgage loans backed by residential real estate properties when formal foreclosure proceedings are in process.

If major categories of loans or trade receivables are not presented separately on the face of the balance sheet, they should be presented in the notes.

ASC 835-30-45-2 requires that the description of a note receivable include the effective interest rate. In addition, the face amount should be disclosed on the face of the financial statements or in the notes.

Receivables are generally considered to be financial assets, and as such, reporting entities are required to comply with the fair value disclosure requirements of ASC 825, *Financial Instruments*, discussed in FSP 20. However, reporting entities do not need to provide the fair value disclosures for trade receivables if they are due in less than a year. Reporting entities are not required to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

SEC registrants are required to separately disclose major categories of accounts and notes receivable, including receivables from customers (trade); related parties; underwriters, promoters, and employees (other than related parties) that arose in a manner other than the ordinary course of business; and receivables held for sale (reported at lower of cost or fair value).

In addition, in accordance with S-X 5-02(3)(b), if the aggregate amount of notes receivable exceeds 10% of the aggregate amount of receivables, SEC registrants must separately disclose accounts receivable and notes receivable either on the face of the balance sheet or in the notes.

Additional disclosure requirements apply under S-X 5-02(3)(c) when receivables include amounts due under long-term contracts. See LI 12.11 and LI 12.12 for additional considerations that apply to insurance and banking entities that are subject to Article 7 and Article 9 of Regulation S-X, respectively.

Finally, if loans and trade receivables have contractual terms that expose the reporting entities to risks and uncertainties, the disclosure requirements of ASC 275, *Risks and Uncertainties*, may be required. See FSP 24 for discussion of disclosure requirements associated with risks and uncertainties.

12.4.1 Portfolio layer method

For any entities using a portfolio layer method hedge, there are specific balance sheet presentation and disclosure considerations for presenting basis adjustments resulting from these hedges.

The “portfolio layer method” permits reporting entities to designate a portion of a closed portfolio of financial assets, beneficial interests secured by financial assets, or a combination of the two, that is not expected to be prepaid during the hedge period as the hedged item in a fair value hedge of interest rate risk. Although the portfolio layer method (originally referred to as the last-of-layer model) was designed considering prepayable mortgage loans or mortgage-backed securities, it may be applicable to other assets as well. The guidance allows an entity to essentially ignore prepayment risk in the hedge relationship even when prepayable assets are present in the closed portfolio. It does so by permitting designation of the portion of the pool not expected to be prepaid, defaulted, or sold as the hedged item.

For an active portfolio layer hedge, the basis adjustment is not allocated to individual assets until the hedge is dedesignated. The basis adjustment is maintained on the closed portfolio of assets and therefore adjusts the carrying amount of the balance sheet line item in which the closed portfolio of assets is presented.

For disclosure purposes, the guidance in ASC 815-10-50-5B states that for active portfolio layer method hedges, when a reporting entity is required to disclose the amortized cost basis on a more disaggregated basis than the balance sheet line item, the entity should exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets and separately disclose the basis adjustment that has been excluded from the disclosure as a reconciling item. Refer to FSP 19.5.4.2 for further information.

If a portfolio layer method hedge relationship is dedesignated, ASC 815-25-40-9 and 815-25-40-9A require the basis adjustments to be allocated to individual assets. Subsequently, the basis adjustment is considered part of the amortized cost basis of the individual assets and included in the amortized cost disclosures, similar to any other fair value hedge basis adjustment. Refer to DH 10.3.8 for further information.

12.4.2 Class of financing receivables and portfolio segment

Some disclosures are required to be provided by class or by portfolio segment. The master glossary defines portfolio segments and class of financing receivables.

Definitions from ASC Master Glossary

Portfolio Segment: The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses.

Class of Financing Receivable: A group of financing receivables determined on the basis of both of the following:

- a. Risk characteristics of the financing receivable
- b. An entity's method for monitoring and assessing credit risk.

Reporting entities should base their determination of portfolio segments and classes on their business model and industry, risk management practices, and how they manage their portfolios.

The portfolio segment is generally the starting point for the required degree of disaggregation in the disclosures. Finance receivables categorized by type, industry, or other risk (such as risk rating) could be the basis for portfolio segment.

The determination of class of financing receivables is principally based on the level that a reporting entity uses when assessing and monitoring the risk and performance of the portfolio. The grouping into classes for disclosure purposes is normally based on the internal reporting processes of the reporting entity. In determining the appropriate level of internal reporting that a reporting entity should use when making these disclosures, it should consider the level of detail needed by financial statement users to understand the risks inherent in the reporting entity's financing receivables.

ASC 326-20-55-12 provides the following examples of factors that can be used to disaggregate financing receivables for disclosure purposes.

- Categorization of borrowers (e.g., commercial loan borrowers, consumer loan borrowers and related party borrowers)

- Type of financing receivables (e.g., mortgage loans, credit card loans, interest-only loans and finance leases)
- Industry sector
- Type of collateral (e.g., residential property, commercial property, government-guaranteed collateral and unsecured)
- Geographic distribution (Domestic, international and local)
- Additional factors related to concentration of credit risk as discussed in ASC 825-10-55

12.4.3 Disclosure of net fees and costs

Reporting entities may acquire a loan by initially lending money or by purchasing the loan from another party. Typically, nonrefundable fees and costs are associated with these lending activities and loan purchases.

As part of the disclosure of the method for recognizing interest income on loans, reporting entities should also include their accounting policy for related fees and costs and their method of amortizing net deferred fees or costs.

ASC 310-20-50 includes other required disclosures related to net fees and costs.

ASC 310-20-50-2

Entities that anticipate prepayments in applying the interest method shall disclose that policy and the significant assumptions underlying the prepayment estimates.

ASC 310-20-50-3

The unamortized net fees and costs shall be reported as a part of each loan category. Additional disclosures such as unamortized net fees and costs may be included in the notes to financial statements if the lender believes that such information is useful to the users of financial statements.

ASC 310-20-50-4 requires reporting entities to disclose the net amount of credit card fees received and costs for both purchased and originated credit cards capitalized at the balance sheet date and the related accounting policy and amortization periods.

12.4.4 Disclosure of modifications with borrowers experiencing financial difficulty by a creditor – after adoption of ASU 2022-02

ASC 310-10-50-39 indicates that the disclosure requirements apply to assets for which the accounting for modifications is within the scope of ASC 310-20. This would include loans, but would not include leases.

These disclosure requirements apply to modifications of instruments with borrowers experiencing financial difficulty that result in a direct change in the timing or amount of contractual cash flows. As a result, the disclosures are applicable to situations when there is

- principal forgiveness,
- interest rate reductions,
- other-than-insignificant payment delays,
- term extensions, or
- a combination of the above.

ASC 310-10-50-39

The disclosures in paragraphs 310-10-50-42 through 50-44 shall be provided for modifications of receivables to borrowers experiencing financial difficulty in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension made within the scope of this Topic. For purposes of those disclosures, covenant waivers and modifications of contingent acceleration clauses would not be considered term extensions.

Since the concept of a concession was removed in conjunction with the elimination of TDRs for creditors, disclosures are required for modifications of loans with borrowers experiencing financial difficulty, regardless of whether the modification is considered to be a concession as defined in previous guidance. That is, modifications of loans with borrowers experiencing financial difficulty that may not have been considered concessions and therefore not accounted for or disclosed as TDRs may now be within the scope of the required disclosures. For example, if a creditor lowers the interest rate on a loan to a borrower experiencing financial difficulty in exchange for receiving additional collateral, the modification may have not been considered a concession under previous GAAP; however, such a modification is in the scope of the disclosures required by the revised guidance.

Other situations, such as covenant waivers and modifications of contingent acceleration clauses, may have only indirect changes to the timing of cash flows. For example, as a result of a covenant waiver, a loan's principal amount may no longer be subject to potential acceleration. Since this is not a direct change to the timing or amount of contractual cash flows, ASC 310-10-50-39 indicates that in the absence of other modifications, the loan would not be required to be included in the disclosures.

With respect to delays in payments, if a modification of a loan with a borrower experiencing financial difficulty only involves an insignificant delay in payment, it is not required to be included in the disclosures. The guidance requires the consideration of a 12-month lookback period when determining whether a delay in payment resulting from the current restructuring is insignificant.

ASC 310-10-50-47

If the debt has been previously restructured, an entity shall consider the cumulative effect of past restructurings made within the 12-month period before the current restructuring when determining whether a delay in payment resulting from the current restructuring is insignificant.

Summary of disclosures

ASC 310-10-50-42 through ASC 310-10-50-44 provide disclosure requirements designed to provide users with information about the types of modifications made to receivables with borrowers

experiencing financial difficulty, the magnitude of those modifications, and the degree of success of the modifications in mitigating potential credit losses. The disclosures are applicable regardless of whether a modification of a receivable from a troubled debtor is treated as a new loan or a continuation of an existing loan.

Certain financing receivables (such those that are measured at fair value with changes in fair value reported in current earnings) are not subject to the disclosures. The disclosures required in the guidance are applicable regardless of whether a modification to a receivable from a debtor experiencing financial difficulty results in a new receivable or a modified receivable.

For all income statement periods presented, ASC 310-10-50-42 requires reporting entities to disclose the following for modifications of receivables made to debtors experiencing financial difficulty that are in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension:

- Qualitative and quantitative information, by class of financing receivable, including:
 - By type of modification, the total period-end amortized cost basis of modified receivables, and the percentage relative to the total period-end amortized cost basis of receivables in the class of financing receivable.
 - The financial effect of the modification, providing information about the changes to the contractual terms as a result of the modification, including:
 - the incremental effect of principal forgiveness on the amortized cost basis, and/or
 - the reduction in the weighted-average interest rate (versus a range) for interest rate reductions.
 - The performance of the asset in the 12 months following the modification.
- Qualitative information, by portfolio segment, discussing how such modifications factored into the determination of the allowance for credit losses.

ASC 310-10-50-43 requires that if the same receivable is modified in more than one manner (e.g., an interest rate reduction and principal forgiveness), the modification be shown in a separate category of modification type.

ASC 310-10-50-44 requires that for all income statement periods presented, if there was a payment default during the period and the receivable had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension within the previous 12 months preceding the payment default when the debtor was experiencing financial difficulty, the reporting entity should also disclose the following:

- Qualitative and quantitative information, by class of financing receivable, about:
 - the types of contractual change that the modification provided. and
 - the amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted.

- Qualitative information, by portfolio segment, discussing how such defaults factored into the determination of the allowance for credit losses.

For an illustration of the disclosures noted above, refer to Example 3 within ASC 310-10-55-12A. These disclosures are required to be included in annual and interim periods in accordance with ASC 270-10-50-1.

ASC 310-10-50-41

The disclosures required in paragraphs 310-10-50-42 through 50-44 are applicable regardless of whether a modification of a receivable to a debtor experiencing financial difficulty results in a new loan in accordance with paragraphs 310-20-35-9 through 35-11. As a practical expedient, an entity may exclude the accrued interest receivable balance that is included in the amortized cost basis of financing receivables for the purposes of the disclosure requirements in Subtopic 326-20. If an entity has applied that practical expedient, an entity may do the same for the disclosures in paragraphs 310-10-50-42 through 50-44 and shall disclose the total amount of accrued interest excluded from the disclosed amortized cost basis.

ASC 310-10-50-42

For each period for which a statement of income is presented, an entity shall disclose the following information related to modifications of receivables that are in the form of principal forgiveness, an interest rate reduction, an other than-insignificant payment delay, or a term extension (or a combination thereof) made to debtors experiencing financial difficulty during the reporting period:

- a. By class of financing receivable, qualitative and quantitative information about:
 1. The types of modifications utilized by an entity, including the total period-end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to debtors experiencing financial difficulty relative to the total period-end amortized cost basis of receivables in the class of financing receivable.
 2. The financial effect of the modification by type of modification, which shall provide information about the changes to the contractual terms as a result of the modification and shall include the incremental effect of principal forgiveness on the amortized cost basis of the modified receivables, as applicable, or the reduction in weighted-average interest rates (versus a range) for interest rate reductions.
 3. Receivable performance in the 12 months after a modification of a receivable made to a debtor experiencing financial difficulty.
- b. By portfolio segment, qualitative information about how those modifications and the debtors' subsequent performance are factored into determining the allowance for credit losses.

ASC 310-10-50-43

Receivables may be modified in more than one manner. An entity that modifies the same receivable in more than one manner shall provide disclosures sufficient for users to understand the different types of combinations of modifications provided to borrowers. For example, a receivable may be modified to provide both principal forgiveness and an interest rate reduction. In that case, an entity shall disclose the period-end amortized cost basis of that receivable in a separate category that reflects that a

combination of modification types has been granted. If another receivable was modified to provide both an interest rate reduction and a term extension, the period-end amortized cost basis of that receivable shall be presented in a different category. Multiple separate combination categories may be necessary if significant. The same receivable's period-end amortized cost basis shall not be presented in multiple categories.

ASC 310-10-50-44

For each period for which a statement of income is presented, an entity shall disclose the following information about financing receivables that had a payment default during the period and had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or a combination thereof) within the previous 12 months preceding the payment default when the debtor was experiencing financial difficulty at the time of the modification:

- a. By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the following:
 1. The type of contractual change that the modification provided
 2. The amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted.
- b. By portfolio segment, qualitative information about how those defaults are factored into determining the allowance for credit losses.

ASC 310-10-50-36 also requires creditors to disclose the amount of any commitments to lend additional funds to debtors experiencing financial difficulty for which the creditor has modified the terms of the receivables in the form of principal forgiveness, an interest rate reduction, other-than-insignificant payment delay, or a term extension in the current reporting period.

Question LI 12-1

Is the same population of loans captured in the different disclosures in ASC 310-10-50-42(a)?

PwC response

It depends. ASC 310-10-50-42(a)(3) requires disclosure of the performance of receivables in the 12-months after a modification to a debtor experiencing financial difficulty. ASC 310-10-50-44 requires information about receivables that had a payment default during the period and had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or combination thereof) within the previous 12 months preceding the payment default. For these disclosures, the 12-month period begins the date the receivable was modified (i.e. the date of the most recent modification). However, the disclosures in ASC 310-10-50-42(a)(1) through 50-42(a)(2) are based on modifications made *during* the reporting period. The example in ASC 310-10-55-12A illustrates these disclosures in annual financial statements. The amounts included in these disclosures for *interim* reporting periods may not tie to amounts disclosed in accordance with ASC 310-10-50-42(a)(3) and ASC 310-10-50-44. For example, if a calendar year reporting entity modified a receivable in the middle of November of the current period:

- The current year annual financial statements would include information related to this modification under ASC 310-10-50-42(a)(1) through 50-42(a)(3) (and ASC 310-10-50-44, if applicable).
- Next year's first, second, and third quarter financial statements would include information related to this modification under ASC 310-10-50-42(a)(3) and ASC 310-10-50-44 (if applicable); Disclosures related to this modification under ASC 310-10-50-42(a)(1) through 50-42(a)(2) would not be required because the modification occurred in a previous reporting period.
- Next year's annual financial statements would include information related to this modification only in the comparative information presented.

12.4.4A *Disclosure of troubled debt restructurings by a creditor – before adoption of ASU 2022-02*

ASC 310-40 requires creditors to disclose the amount of any commitments to lend additional funds to debtors whose receivables to the creditor have been modified in a troubled debt restructuring.

ASC 310-10-50-31 through ASC 310-10-50-34 also provide disclosure requirements for a creditor's troubled debt restructuring of financing receivables, including a creditor's modification of a lease receivable that meets the definition of a troubled debt restructuring. This guidance is not applicable to certain receivables listed in ASC 310-10-50-32 (i.e., certain trade accounts receivable, receivables measured at fair value with changes in fair value reported in earnings, receivables measured at lower of amortized cost basis or fair value, and participant loans in defined contribution pension plans).

For all income statement periods presented, reporting entities must disclose the following for any troubled debt restructurings of financing receivables occurring during the period:

- Qualitative and quantitative information, by class, including how the receivable was modified and the modification's effects (see LI 12.4.2 for information on determining class)
- Qualitative information, by portfolio segment, discussing how such modifications factored into the determination of the allowance for credit losses (see LI 12.4.2 for information on determining the portfolio segment)

If there was a payment default (after the restructuring) on any financing receivables that were modified within the last twelve months, the reporting entity should also disclose the following for each income statement period presented:

- Qualitative and quantitative information, by class, indicating the types of financing receivables that defaulted and their amount
- Qualitative information, by portfolio segment, discussing how such defaults factored into the determination of the allowance for credit losses

12.4.5 *Assets under CECL: accrued interest and related disclosure*

For financial assets within the scope of ASC 326-20, the literature provides the following additional guidance on accrued interest receivable disclosures (see LI 7.3.4.3 for further information on accounting for accrued interest receivable):

- If a reporting entity elects to measure expected credit losses on its accrued interest receivable balances separately from other components of the amortized cost basis, disclosure of the accrued interest balance, net of allowance for credit losses (if any), and in which line item on the balance sheet the amount is presented is required. See ASC 326-20-50-3A.
- If a reporting entity makes an accounting policy election to not measure an allowance for credit losses on accrued interest due to the entity writing off uncollectible accrued interest in a timely manner, the election should be disclosed, including the time period or periods the entity considers timely. Disclosure of what time period or periods are considered timely is required by class of financing receivable or major security type. See ASC 326-20-50-3C.
- If a reporting entity makes an accounting policy election to write off accrued interest by reversing interest income or recognizing the write off as a credit loss expense (or a combination of both), the accounting policy election is required to be disclosed in addition to the amount of accrued interest receivable written off by reversing interest income by portfolio segment or major security type. See ASC 326-20-50-3D.
- If an entity elects the practical expedient to exclude the accrued interest receivable balance from the amortized cost disclosure requirements in ASC 326-20-50-4 through ASC 326-20-50-22, the total amount of accrued interest excluded from the amortized cost should be disclosed. See ASC 326-20-50-3B.
- If for the purposes of identifying and measuring an impairment the accrued interest is excluded from the amortized cost basis of an HTM debt security, an entity may elect a practical expedient to exclude the accrued interest that is included in the amortized cost basis for the purposes of the disclosure requirements in ASC 320-10-50-5. If an entity elects this practical expedient, it should disclose the total amount of accrued interest, net of the allowance for credit losses (if any), excluded from the disclosed amortized cost basis. See LI 12.5.4 and LI 12.5.5 for further information regarding the disclosure requirements in ASC 320-10-50-5.

12.5 Debt security disclosure requirements

ASC 320-10-50 provides disclosure guidance related to investments in debt securities. Generally, the disclosures are required to be segregated by security accounting classification (i.e., trading, AFS, or HTM), and highlight key information to investors about the types and terms of securities held. ASC 326 also requires disclosures about the credit quality and impairment of debt securities, which are detailed in LI 12.7.

12.5.1 Portfolio layer method

For any entities using a portfolio layer method hedge in accordance with ASU 2022-01, there are specific balance sheet presentation and disclosure considerations for presenting basis adjustments resulting from these hedges.

The “portfolio layer” method permits reporting entities to designate a portion of a closed portfolio of financial assets, beneficial interests secured by financial assets, or a combination of the two, that is not expected to be prepaid during the hedge period as the hedged item in a fair value hedge of interest rate risk. Although the portfolio layer method (originally referred to as the last-of-layer model) was designed considering prepayable mortgage loans or mortgage-backed securities, it may be applicable

to other assets as well. The guidance allows an entity to essentially ignore prepayment risk in the hedge relationship even when prepayable assets are present in the closed portfolio. It does so by permitting designation of the portion of the pool not expected to be prepaid, defaulted, or sold as the hedged item.

For an active portfolio layer hedge, the basis adjustment is not allocated to individual assets until the hedge is dedesignated. The basis adjustment is maintained on the closed portfolio of assets and therefore adjusts the carrying amount of the balance sheet line item in which the closed portfolio of assets is presented.

The guidance in ASC 815-10-50-5B states that for active portfolio layer method hedges, when a reporting entity is required to disclose the amortized cost basis on a more disaggregated basis than the balance sheet line item, the entity needs to exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets and separately disclose the basis adjustment that has been excluded from the disclosure as a reconciling item. Refer to FSP 19.5.4.2 for further information.

If a portfolio layer method hedge relationship is dedesignated, ASC 815-25-40-9 and ASC 815-25-40-9A require the basis adjustments to be allocated to individual assets. Subsequently, the basis adjustment is considered part of the amortized cost basis of the individual assets and included in the amortized cost disclosures, similar to any other fair value hedge basis adjustment. Refer to DH 10.3.8 for further information.

12.5.2 *Debt securities: major security types*

Many investments disclosures, including those discussed in LI 12.5.3 and LI 12.5.4, are required to be provided by major security type. ASC 320-10-50-1B provides guidance to help reporting entities evaluating the level at which the disclosures should be provided. It requires reporting entities to consider whether the discussion of certain security types should be further disaggregated based on common characteristics underlying the securities (e.g., geographic concentration, credit quality, economic characteristics). For example, a reporting entity that separates fixed-maturity AFS securities into government bonds and mortgage-backed securities may want to consider whether further detail would be beneficial to investors. If so, the reporting entity may consider separating government bonds between US and foreign, or separating mortgage-backed securities into commercial and residential.

The figures in the remainder of this chapter include sample disclosures that present fixed maturity securities disaggregated into three major security types. These are only examples; the level of disaggregation will vary by reporting entity and the nature of its portfolio.

12.5.3 *Disclosures for securities classified as AFS*

When disclosing securities classified as AFS in accordance with ASC 320-10-50-2, a reporting entity should disclose the following information by major security type for the securities held as of each balance sheet date presented.

- Amortized cost basis
- Aggregate fair value
- Total allowance for credit losses

- Total unrealized gains for securities with net gains in AOCI
- Total unrealized losses for securities with net losses in AOCI
- Information about the contractual maturities (only required as of the date of the most recent statement of financial position presented)

Figure LI 12-1 illustrates these disclosure requirements assuming three classes of instruments.

Figure LI 12-1

Example disclosure for AFS securities

Excerpt of Note X: Investments

The following table summarizes the unrealized positions for available-for-sale fixed-maturity securities, disaggregated by class of instrument.

[For example purposes, only a single year is shown and the ASC reference is provided. Assume that none of these securities are designated as part of an active portfolio layer method hedge.]

ASC 320-10-50-2 reference	a	aaa	b	c	aa
	Amortized cost	Allowance for credit losses ¹	Total unrealized gains	Total unrealized losses	Fair value
US Treasury securities	\$500	\$0	\$50	\$3	\$547
Foreign government bonds	780	5	10	25	760
Asset-backed securities	20	6	17	1	30
Total AFS debt securities	\$1,300	\$11	\$77	\$29	\$1,337

¹ Represents the amount of impairment that has resulted from credit-related factors, and therefore was recognized in the statement of financial operations (as a credit loss expense on AFS debt securities). Amount excludes unrealized losses relating to non-credit factors.

See LI 12.5.5 for disclosures related to investments in AFS securities by maturity date, LI 12.7.3 for required disclosures related to credit risk and the allowance for credit losses on AFS debt securities, LI 12.7.3.2 for disclosures required for purchased AFS securities with credit deterioration, and FSP 4 for required disclosures related to other comprehensive income. For disclosure purposes, the guidance in ASC 815-10-50-5B states that for active portfolio layer method hedges, when a reporting entity is required to disclose the amortized cost basis on a more disaggregated basis than the balance sheet line item, the entity needs to exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets and separately disclose the basis adjustment that has been excluded from the disclosure as a reconciling item. Refer to FSP 19.5.4.2 for further information.

12.5.3.1 *Reclassifications out of AOCI for AFS securities*

For each income statement presented, ASC 320-10-50-9 requires a reporting entity to disclose the change in net unrealized holding gain or loss on AFS securities reported in AOCI during the period and the amount of gains and losses reclassified out of OCI into net income upon sale of the securities. For AFS securities, the unrealized gain or loss is reclassified out of AOCI and into a “Realized gain/loss” line on the income statement upon the sale of the security. ASC 220-10-45-17 requires reporting entities to disclose the location in the income statement to which amounts reclassified from AOCI were recorded. FSP 4.5.6.1 includes a sample disclosure.

These required disclosures can either be shown as part of the statement of changes in equity or in a footnote.

12.5.4 *Disclosures for securities classified as HTM*

In accordance with ASC 320-10-50-5 and ASC 320-10-50-5A, a reporting entity should disclose the following information for securities classified as HTM detailed major security type, as of the date of each balance sheet presented.

- Amortized cost basis
- Aggregate fair value (PBEs only)
- Total allowance for credit losses
- Gross unrecognized holding gains (PBEs only)
- Gross unrecognized holding losses (PBEs only)
- Net carrying amount
- Gross gains and losses in AOCI for any derivatives that hedged the forecasted acquisition of the HTM securities
- Information about the contractual maturities combined in appropriate groupings (only required of the date of the most recent statement of financial position presented). See LI 12.5.5 for more information.

Figure LI 12-2 illustrates these disclosure requirements for HTM securities for a PBE.

Figure LI 12-2 Example disclosure for HTM securities

[For example purposes, only a single year is shown and the ASC reference is provided.]

Excerpt of Note X: Investments

The following table summarizes the unrealized positions and the allowance for credit losses for held-to-maturity securities, disaggregated by class of instrument.

ASC 320-10-50-5 and 5A reference	a	aaa	d	b	c	5A-a
	Amortized cost	Allowance for credit losses	Net Carrying Amount	Gross unrealized gains	Gross unrealized losses	Fair value
US Treasury securities	\$410	\$0	\$410	\$67	\$13	\$464
Foreign government bonds	285	5	280	28	30	278
Asset-backed securities	96	6	90	11	14	87
Total	\$791	\$11	\$780	\$106	\$57	\$829

12.5.5 Disclosures for AFS and HTM securities by maturity date

In addition to the disclosures discussed in LI 12.5.3 and LI 12.5.4, ASC 320-10-50-3 and ASC 320-10-50-5 and ASC 320-10-50-5B require presentation of investments in AFS and HTM securities, respectively, by maturity date. This disclosure should include the fair value and net carrying amount (if different than the fair value). The disaggregation by contractual maturity illustrated in Figure LI 12-3 is the minimum level of disaggregation required by ASC 942-320 for financial institutions. All other reporting entities may use judgment to determine the level of disaggregation. The fair value and net carrying value for debt securities that do not have a single maturity date, such as mortgage-backed securities, could be disclosed separate from those included in the aging groupings. Alternatively, if a reporting entity chooses to allocate such securities across the aging categories, it should disclose the basis for allocation.

Figure LI 12-3 illustrates the disclosure requirements for AFS and HTM securities.

Figure LI 12-3

Example disclosure of AFS and HTM securities by contractual maturity

Excerpt of Note X: Investments

The following table summarizes the fair value and net carrying amount of the available-for-sale and held-to-maturity securities by contractual maturity.

[For example purposes, only a single year is shown. Assume none of the securities are designated as part of an active portfolio layer method hedge.]

	Available-for-sale		Held-to-maturity	
	Net carrying amount	Fair value	Net carrying amount	Fair value
Due within one year	\$433	\$429	\$117	\$121
Due after one year through five years	234	241	78	92
Due after five years through ten years	212	211	289	306
Due after ten years	396	426	206	223
Asset-backed securities	14	30	90	87
Total	\$1,289	\$1,337	\$780	\$829

Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations.

For disclosure purposes, the guidance in ASC 815-10-50-5B states that for active portfolio layer method hedges, when a reporting entity is required to disclose the amortized cost basis on a more disaggregated basis than the balance sheet line item, the entity needs to exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets and separately disclose the basis adjustment that has been excluded from the disclosure as a reconciling item. Refer to FSP 19.5.4.2 for further information.

12.5.6 Disclosures of sales, transfers, and related matters

Additional disclosures are required when investments in available-for-sale debt securities are sold during a period or transferred between classifications (e.g., from AFS to HTM), as outlined in ASC 320-10-50-9 through ASC 320-10-50-12.

For each period for which an income statement is presented, ASC 320-10-50-9 requires the following disclosures for AFS securities.

- Proceeds from sales and maturities
- Gross realized gains and losses
- The basis on which the cost of a security sold or the amount reclassified out of AOCI into income was determined (e.g., specific identification, average cost, or other method)
- The amount of the net unrealized holding gain or loss for the period included in AOCI
- The amount of gains and losses reclassified out of AOCI into income for the period

ASC 320-10-50-9 also requires disclosure of trading gains and losses on trading securities still held at the balance sheet date.

Figure LI 12-4 illustrates the disclosure of the proceeds from sales or maturities and the gross realized gains and losses. FSP 4.5 details the disclosure requirements associated with the amounts in, and reclassified out of, AOCI.

Figure LI 12-4

Example disclosure of the proceeds and gross realized gains and losses from sales or maturities of AFS securities

Excerpt of Note X: Investments

The following table summarizes the proceeds and gross realized gains and losses from sales or maturities of AFS securities.

[For example purposes, only a single year is shown.]

	Gross realized gains	Gross realized losses	Gross proceeds from sales	Gross proceeds from maturities
Fixed-maturity AFS securities	314	149	2,100	300

The gross proceeds from sales and maturities may alternatively be presented on the face of the statement of cash flows.

For any sales of, or transfers from, securities classified as HTM, a reporting entity should disclose all of the following in the notes for each period for which an income statement is presented.

Excerpt from ASC 320-10-50-10

- a. The net carrying amount of the sold or transferred security
- b. The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security
- c. The related realized or unrealized gain or loss
- d. The circumstances leading to the decision to sell or transfer the security. (Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph 320-10-25-6(a) through (f).)

For transfers into the HTM classification, the security's new amortized cost basis is determined as the amortized cost basis at the transfer date (which is reduced by any previous writeoffs but excludes any allowance for credit losses) plus or minus the amount of any remaining unrealized holding gain or loss reported in accumulated other comprehensive income. See ASC 320-10-35-16. This amortized cost basis would not include any basis adjustments as a result of portfolio layer method hedges unless this transfer into HTM created an actual or anticipated breach in the hedge relationship. See DH 10.3.8 for information on breaches associated with portfolio layer method hedges.

In the rare circumstance, as defined by ASC 320-10-35-12, that a security is transferred from AFS to trading, the reporting entity should disclose the gross gains and gross losses included in income from the transfer.

12.5.6.1 *Beneficial interest in securitized assets disclosures*

A reporting entity may own debt securities representing beneficial interests in securitized financial assets that have been accounted for as sales. If so, in addition to meeting the disclosure requirements of ASC 320 and ASC 326, the reporting entity should consider the disclosure requirements in ASC 860-20-50-4 that may apply to those beneficial interests. Refer to FSP 22 for additional information on transfers.

From a presentation perspective, ASC 325-40-45-1 states that the amount of accretable yield may not be displayed in the balance sheet.

12.5.7 *AFS debt security: accrued interest and related disclosure*

For entities that have accounting policies to exclude accrued interest from both the fair value and the amortized cost basis of an AFS debt security for purposes of identifying and measuring impairment, ASC 326-30 provides the following guidance on accrued interest receivable disclosures (see LI 8.2.8 for further information on accounting for accrued interest receivable):

- If a reporting entity elects to develop expected credit losses on its accrued interest receivable balances separate from other components of the amortized cost basis, disclosure of the amounts of accrued interest, net of allowance for credit losses (if any), and in which line item on the balance sheet the amount is presented is required. See ASC 326-30-50-3A and ASC 326-30-45-1.
- If a reporting entity makes an accounting policy election to not measure an allowance for credit losses on accrued interest due to the entity writing off the uncollectible accrued interest in a timely manner, the election should be disclosed, including the time period or periods the entity considers timely. Disclosure of what time period or periods are considered timely by major security type is also required. See ASC 326-30-50-3C.
- If a reporting entity makes an accounting policy election to write off accrued interest by reversing interest income or recognizing the write off as a credit loss expense (or a combination of both), the accounting policy election is required to be disclosed in addition to the amount of accrued interest receivable written off by reversing interest income by major security type. See ASC 326-30-50-3D.
- If an entity elects the practical expedient to exclude the accrued interest receivable balance from the amortized cost disclosure requirements in ASC 326-30-50-4 through ASC 326-30-50-10, the total amount of accrued interest, net of the allowance for credit losses (if any), excluded from the amortized cost should be disclosed. See ASC 326-30-50-3B.
- An entity may elect a practical expedient to exclude the accrued interest that is included in the amortized cost basis for the purposes of the disclosure requirements in ASC 320-10-50-2. If an entity elects this practical expedient, it should disclose the total amount of accrued interest, net of the allowance for credit losses (if any), excluded from the disclosed amortized cost basis. See LI 12.5.3 and LI 12.5.5 for further information regarding the disclosure requirements in ASC 320-10-50-2.

12.6 Equity investment disclosure requirements

ASC 321-10-50 provides disclosure guidance on equity investments (not accounted for under the equity method of accounting or resulting in consolidation). The disclosure requirements apply for investments held at the end of the periods presented in the financial statements.

Additional disclosures could be required for investments measured at fair value, see FSP 20.4.

12.6.1 Measurement alternative disclosures

As explained in LI 2.3.2, ASC 321-10-35-2 provides an elective measurement alternative for equity investments without readily determinable fair values. When a reporting entity elects the measurement alternative in ASC 321, ASC 321-10-50-3 lists specific disclosure requirements for investments measured under this election.

In each interim and annual reporting period, the following disclosures are required for equity investments that are accounted for under the measurement alternative:

- The carrying amount of these equity investments
- The amount of impairments and downward adjustments, if any, on both an annual and cumulative basis
- The amount of upward adjustments, if any, on both an annual and cumulative basis
- Additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.

We believe that these disclosures should only include equity investments that are accounted for under the measurement alternative held by the reporting entity at the end of the period.

The additional information supporting the quantitative disclosures is required as of the date of the most recent statement of financial position, so comparative narrative disclosure is not required. All other disclosures should be provided for all comparative years presented in the financial statements.

Additionally, as the measurement alternative is a nonrecurring fair value measurement, an entity should follow the applicable disclosure requirements in ASC 820-10-50.

The carrying value disclosed should agree to the amounts recorded on the statement of financial position as of the period end date for each period presented.

Impairments and adjustments due to observable prices

ASC 321-10-50-3 specifically requires disclosure of the upward and downward adjustments on a gross basis; they should not be combined into one net number. However, we believe that downward adjustments due to impairments and downward adjustments due to observable price changes can be combined for the purposes of this disclosure. That said, reporting entities should consider whether

separate presentation of impairments and downward adjustments due to observable price changes would provide decision-useful information to users of the financial statements.

In interim periods, impairments and adjustments due to observable price changes should be presented both on a quarter-to-date and year-to-date basis consistent with the income statement periods presented.

12.6.2 Disclosures for all equity investments – updated September 2022

Separate from the disclosures for equity investments accounted for under the measurement alternative, ASC 321-10-50-4 requires reporting entities to disclose the amount of unrealized gains and losses for all equity investments for each period in which a statement of operations is presented. This disclosure includes equity investments accounted for under the measurement alternative and equity investments that are reported on a fair value basis.

ASC 321 provides an example of the formula for calculating the unrealized gains and losses to be disclosed.

Excerpt from ASC 321-10-50-4	
Net gains and losses recognized during the period on equity securities	\$105
Less: Net gains and losses recognized during the period on equity securities sold during the period	(80)
Unrealized gains and losses recognized during the reporting period on equity securities still held at the reporting date	\$25

Only the amount of unrealized gains and losses on equity investments still held at the reporting date (i.e., the \$25) is required to be disclosed, though a reporting entity is not precluded from presenting how this number was calculated.

Refer to FSP 20 for the required disclosures related to fair value, including disclosure requirements for equity securities subject to contractual sale restrictions as a result of ASU 2022-03. Refer to FV 4.8 for fair value measurement considerations for restricted securities.

12.7 Credit losses and credit quality of financial instruments

The financial statement disclosures related to credit losses are intended to enable users of financial statements to understand the credit risk inherent in a reporting entity's portfolio, how management monitors this risk, management's estimate of expected credit losses, and the changes in the estimate that has taken place during the period. As discussed in ASC 326-20-50-3, each reporting entity should determine how much detail it should provide based on its specific facts and circumstances. The disclosure should strike a balance between too much aggregation and excessive detail that could overwhelm financial statement users.

A reporting entity should also consider the requirement of S-X 12-09. This rule requires entities to list, by major classes, all valuation and qualifying accounts not included in specific schedules, grouped by those that are deducted from balance sheet assets and those that are included under the “reserves” line item in the balance sheet. This information can be included in a separate schedule or in the notes to the financial statements.

12.7.1 *Financial instruments measured at amortized cost disclosure – after adoption of ASU 2022-02*

For each class of financial assets (see LI 12.4.2 for information on determining class of financial asset) and major security type, a reporting entity should provide qualitative and quantitative information about credit quality. The information should be presented based on the applicable credit quality indicator, which is defined in the ASC Master Glossary.

Definition from ASC Master Glossary

Credit Quality Indicator: A statistic about the credit quality of a financial asset.

Examples of credit quality indicators include:

- Consumer credit risk scores
- Credit rating agency ratings
- A reporting entity’s internal credit risk grades
- Debt-to-value ratios
- Collateral
- Collection experience
- Other internal metrics

For each class of financial assets, a reporting entity should describe the credit quality indicator it is using, and then disclose the amortized cost basis of the asset (which would not include any active portfolio layer method basis adjustments; however, reporting entities would be required to disclose total active portfolio layer hedge basis adjustments separately), grouped by credit quality indicator. If a reporting entity provides disclosure grouped by internal risk ratings, then it should provide qualitative information on how those internal risk ratings relate to the likelihood of loss. See ASC 326-20-55-79 for an example disclosure.

In addition, for every credit quality indicator, a reporting entity should disclose the date or range of dates on which the information was last updated. The reporting entity should use the most current information available prior to the balance sheet date.

A reporting entity might use different credit quality indicators for different classes of financial assets. For example, a reporting entity could present residential mortgages based on loan-to-value percentages while reporting other consumer loans based on FICO ratings.

For financing receivables and net investments in leases, a reporting entity that is a public business entity (PBE) should disclose the amortized cost basis grouped by credit quality indicator and detailed by year of origination. This requirement does not apply to reinsurance receivables and funded or unfunded amounts of line-of-credit arrangements, such as credit cards. For this purpose, the year of origination is the initial date on which the instrument was issued, and not the year in which it was purchased by the reporting entity. For origination years before the fifth annual period, a reporting entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate.

In addition, PBEs are required to disclose the current-period gross writeoffs by year of origination in the vintage tables. Entities are not required to disclose gross recoveries in the vintage disclosures.

The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for a reporting entity that is not a PBE. PBEs that are not SEC filers are permitted to provide the new required vintage disclosures using a phased-in transition approach. In the year of adoption, the reporting entity would present the three most recent origination years. An incremental year is required to be disclosed in each of the next two fiscal years such that thereafter the five separate fiscal years are disclosed.

For revolving lending arrangements, determining the appropriate origination year is more complex. In a revolving lending arrangement, such as a line-of-credit, the timing of the underwriting decision may not align with the borrower's drawdown of funds. In some instances, the borrower may not drawdown funds until years after the initial underwriting by the lender. As a result, the guidance does not require revolving lending arrangements to disclose credit quality indicators by vintage year, but instead within a separate column of the vintage disclosure table disaggregated by class of financing receivable and credit quality indicator.

Further, the guidance does not require an entity to present the amortized cost basis of line-of-credit arrangements that were converted (either by contractual terms or a modification) into term loans by vintage year. Instead, the amortized cost basis of line-of-credit arrangements that were converted into term loans are required to be disclosed by class of financing receivable and credit quality indicator within a separate column of the vintage disclosure table that is not disaggregated by vintage year. This topic was the subject of a TRG discussion (TRG Memo 16: Vintage Disclosures for Revolving Loans).

The provisions of ASC 310-20-35-9 through ASC 310-20-35-12 govern whether a modification of a loan should be accounted for as the creation of a new debt instrument and the extinguishment of the original debt instrument or whether the modification should be accounted for as the continuation of the original instrument. The results of this analysis should be used to evaluate whether modifications result in a loan being considered originated in the current period. For the net investment in leases, the provisions of ASC 842-10-25-8 and ASC 842-10-25-9 should be used to determine whether a lease modification should be presented as a current-period origination.

Credit quality disclosures are not required for trade receivables that are due in less than a year and that result from revenue transactions in the scope of ASC 606, except for credit card receivables, and are also not required for receivables measured at the lower of amortized cost basis or fair value.

The disclosure requirements for financing receivables apply also to net investment in leases, since they are in the scope of ASC 326-20.

Question LI 12-2

Are reporting entities required to disclose credit quality information in accordance with ASC 326-20-50 for contract assets recognized under ASC 606?

PwC response

ASC 606-10-45-3 states “A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).” In the list of required disclosures under ASC 606, ASC 606-10-50-4(b) includes: “Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or contract assets arising from an entity’s contracts with customers, which the entity shall disclose separately from credit losses from other contracts.”

Because contract assets are subject to ASC 326-20, reporting entities are required to disclose certain credit quality information on contract assets in accordance with ASC 326-20-50. Therefore, we believe the credit quality disclosures required by ASC 326-20-50-4 and ASC 326-20-50-5 apply to contract assets recognized under ASC 606.

It is important to note, however, that a contract asset would not meet the definition of a financing receivable if it does not represent a contractual right to receive money either on demand or on fixed or determinable dates. As the explicit quantitative credit quality information disclosures in ASC 326-20-50-5 only apply to financing receivables, contract assets that are not financing receivables would not be subject to these disclosures. Specifically, reporting entities are not required to present credit quality information on contract assets by vintage year, as described within ASC 326-20-50-6.

Question LI 12-3

Are reporting entities required to provide the ASC 326-20-50-6 vintage disclosures in its interim financial statements?

PwC response

Yes. The ASC 326-20-50-6 vintage disclosures are required in a reporting entity’s interim financial statements. Although ASC 326 does not explicitly refer to interim disclosures, reporting entities should consider the guidance in ASC 270, Interim Reporting.

ASC 270-10-50-1(p) requires reporting entities to disclose, at a minimum, the following information about the credit quality of financial assets and the allowance for credit losses in accordance with ASC 326-20:

- Nonaccrual and past due financial assets
- Allowance for expected credit losses related to financial assets
- Credit-quality information related to instruments within the scope of ASC 326-20
- Modifications of financing receivables

These disclosures should be provided for all periods presented.

The vintage disclosures in ASC 326-20-50-6 are considered part of the credit quality indicator disclosures referenced in ASC 270-10-50-1(p), and therefore entities should present comparative vintage disclosures in their interim financial statements.

Reporting entities should also consider the other requirements in ASC 270, including disclosures of significant changes from prior reporting periods. See FSP 29 for further information.

12.7.1A *Financial instruments measured at amortized cost disclosure – before adoption of ASU 2022-02*

For each class of financial assets (see LI 12.4.2 for information on determining class of financial asset) and major security type, a reporting entity should provide qualitative and quantitative information about credit quality. The information should be presented based on the applicable credit quality indicator, which is defined in the ASC Master Glossary.

Definition from ASC Master Glossary

Credit Quality Indicator: A statistic about the credit quality of a financial asset.

Examples of credit quality indicators include:

- Consumer credit risk scores
- Credit rating agency ratings
- A reporting entity's internal credit risk grades
- Debt-to-value ratios
- Collateral
- Collection experience
- Other internal metrics

For each class of financial assets, a reporting entity should describe the credit quality indicator it is using, and then disclose the amortized cost basis of the asset (which would not include any active portfolio layer method basis adjustments, however, reporting entities would be required to disclose total active portfolio layer hedge basis adjustments separately), grouped by credit quality indicator. If a reporting entity provides disclosure grouped by internal risk ratings, then it should provide qualitative information on how those internal risk ratings relate to the likelihood of loss. See ASC 326-20-55-79 for an example disclosure.

In addition, for each credit quality indicator, a reporting entity should disclose the date or range of dates on which the information was last updated. The reporting entity should use the most current information available prior to the balance sheet date.

A reporting entity might use different credit quality indicators for different classes of financial assets. For example, a reporting entity could present residential mortgages based on loan-to-value percentages while reporting other consumer loans based on FICO ratings.

For financing receivables and net investments in leases, a reporting entity that is a public business entity (PBE) should disclose the amortized cost basis grouped by credit quality indicator and detailed by year of origination. This requirement does not apply to reinsurance receivables and funded or unfunded amounts of line-of-credit arrangements, such as credit cards. For this purpose, the year of origination is the initial date on which the instrument was issued, and not the year in which it was purchased by the reporting entity. For origination years before the fifth annual period, a reporting entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate.

The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for a reporting entity that is not a PBE. PBEs that are not SEC filers are permitted to provide the new required vintage disclosures using a phased-in transition approach. In the year of adoption, the reporting entity would present the three most recent origination years. An incremental year is required to be disclosed in each of the next two fiscal years such that thereafter the five separate fiscal years are disclosed.

For revolving lending arrangements, determining the appropriate origination year is more complex. In a revolving lending arrangement, such as a line-of-credit, the timing of the underwriting decision may not align with the borrower's drawdown of funds. In some instances, the borrower may not drawdown funds until years after the initial underwriting by the lender. As a result, the guidance does not require revolving lending arrangements to disclose credit quality indicators by vintage year, but instead within a separate column of the vintage disclosure table disaggregated by class of financing receivable and credit quality indicator.

Further, the guidance does not require an entity to present the amortized cost basis of line-of-credit arrangements that were converted (either by contractual terms or a modification) into term loans by vintage year. Instead, the amortized cost basis of line-of-credit arrangements that were converted into term loans are required to be disclosed by class of financing receivable and credit quality indicator within a separate column of the vintage disclosure table that is not disaggregated by vintage year. This topic was the subject of a TRG discussion (TRG Memo 16: Vintage Disclosures for Revolving Loans).

The provisions of ASC 310-20-35-9 through ASC 310-20-35-12 govern whether a modification of a loan should be accounted for as the creation of a new debt instrument and the extinguishment of the original debt instrument or whether the modification should be accounted for as the continuation of the original instrument. The results of this analysis should be used to evaluate whether modifications result in a loan being considered originated in the current period. For the net investment in leases, the provisions of ASC 842-10-25-8 and ASC 842-10-25-9 should be used to determine whether a lease modification should be presented as a current-period origination.

Credit quality disclosures are not required for trade receivables that are due in less than a year and that result from revenue transactions in the scope of ASC 606, except for credit card receivables, and are also not required for receivables measured at the lower of amortized cost basis or fair value.

The disclosure requirements for financing receivables apply also to net investment in leases, since they are in the scope of ASC 326-20.

Question LI 12-2A

Are reporting entities required to disclose credit quality information in accordance with ASC 326-20-50 for contract assets recognized under ASC 606?

PwC response

ASC 606-10-45-3 states “A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).” In the list of required disclosures under ASC 606, ASC 606-10-50-4(b) includes: “Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or contract assets arising from an entity’s contracts with customers, which the entity shall disclose separately from credit losses from other contracts.”

Because contract assets are subject to ASC 326-20, reporting entities are required to disclose certain credit quality information on contract assets in accordance with ASC 326-20-50. Therefore, we believe the credit quality disclosures required by ASC 326-20-50-4 and ASC 326-20-50-5 apply to contract assets recognized under ASC 606.

It is important to note, however, that a contract asset would not meet the definition of a financing receivable if it does not represent a contractual right to receive money either on demand or on fixed or determinable dates. As the explicit quantitative credit quality information disclosures in ASC 326-20-50-5 only apply to financing receivables, contract assets that are not financing receivables would not be subject to these disclosures. Specifically, reporting entities are not required to present credit quality information on contract assets by vintage year, as described within ASC 326-20-50-6.

Question LI 12-3A

Are reporting entities required to provide the ASC 326-20-50-6 vintage disclosures in its interim financial statements?

PwC response

Yes. The ASC 326-20-50-6 vintage disclosures are required in a reporting entity’s interim financial statements. Although ASC 326 does not explicitly refer to interim disclosures, reporting entities should consider the guidance in ASC 270, Interim Reporting.

ASC 270-10-50-1(p) requires reporting entities to disclose, at a minimum, the following information about the credit quality of financial assets and the allowance for credit losses in accordance with ASC 326-20:

- Nonaccrual and past due financial assets
- Allowance for expected credit losses related to financial assets
- Credit-quality information related to instruments within the scope of ASC 326-20
- Modifications of financing receivables

These disclosures should be provided for all periods presented.

The vintage disclosures in ASC 326-20-50-6 are considered part of the credit quality indicator disclosures referenced in ASC 270-10-50-1(p), and therefore entities should present comparative vintage disclosures in their interim financial statements.

Reporting entities should also consider the other requirements in ASC 270, including disclosures of significant changes from prior reporting periods. See FSP 29 for further information.

12.7.1.1 Disclosures for the allowance for credit losses

The disclosures related to the allowance for credit losses are designed to provide financial statement users not only with the measurement of the allowance during the period, but also with an understanding of management's method for developing the allowance.

To provide financial statement's users with this information, ASC 326-20-50-11 requires a reporting entity to disclose, by portfolio segment and major security type, all of the following.

Excerpt from ASC 326-20-50-11

- a. A description of how expected loss estimates are developed
- b. A description of the entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
 1. Past events
 2. Current conditions
 3. Reasonable and supportable forecasts about the future.
- c. A discussion of risk characteristics relevant to each portfolio segment
- d. A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- e. Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, its rationale for those changes, and the quantitative effect of those changes
- f. Reasons for significant changes in the amount of writeoffs, if applicable
- g. A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period
- h. The amount of any significant purchases of financial assets during each reporting period
- i. The amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period.

In addition, in order to enable users to understand the activity in the allowance for expected credit losses for each period, a reporting entity should provide a rollforward of the allowance for each portfolio segment and major security type in accordance with ASC 326-20-50-13.

The rollforward should include:

- The beginning balance in the allowance
- Current period provision
- The initial allowance for credit losses recognized on financial assets accounted for as purchased financial assets with credit deterioration (including beneficial interest that meet the conditions in ASC 325-40-30-1A and therefore are initially measured under the same guidance), if applicable
- Writeoffs charged against the allowance
- Recoveries collected
- The ending balance in the allowance

Disclosure about interest income and credit loss expense

When a reporting entity chooses to use a discounted cash flow approach to estimate expected credit losses and elects to classify the change in present value attributable to the passage of time as interest income, it should disclose the amount recorded to interest income that results from such election.

See LI 12.3 for information on the election to classify the changes in present value attributable to the passage of time as interest income.

12.7.1.2 Disclosures for past due and nonaccrual status

A reporting entity should provide an aging analysis for financial assets that are past due at the end of the reporting period, reflecting amortized cost disaggregated at the portfolio segment level and by major security type. See ASC 326-20-55-80 for an example disclosure. The amortized cost basis would not include any basis adjustments from active portfolio layer method hedges, but a reporting entity would be required to separately disclose any basis adjustments from active portfolio layer method hedges.

In addition, a reporting entity should disclose the accounting policies detailed in ASC 326-20-50-17.

Excerpt from ASC 326-20-50-17

- a. Nonaccrual policies, including the policies for discontinuing accrual of interest, recording payments received on nonaccrual assets (including the cost recovery method, cash basis method, or some combination of those methods), and resuming accrual of interest, if applicable
- b. The policy for determining past-due or delinquency status
- c. The policy for recognizing writeoffs within the allowance for credit losses.

As discussed in ASC 326-20-50-16, a reporting entity should disclose information sufficient to enable financial statement users to understand the credit risk and interest income recognized on financial assets on nonaccrual status. To do that, it should disclose the following for financial assets on nonaccrual status disaggregated by class of financing receivable and major security type:

- Amortized cost basis as of the beginning and the end of the reporting period
- Interest income recognized during the period on such assets
- The amortized cost basis of financial assets that are 90 days or more past due, but are not on nonaccrual status as of the reporting date
- Amortized cost basis of such assets for which there are no allowances for credit losses as of the reporting date

The amortized cost basis above would not include any basis adjustments from active portfolio layer method hedges, but a reporting entity would be required to separately any basis adjustments from active portfolio layer method hedges.

The disclosures related to past-due and nonaccrual status financial assets are not required for trade receivables that are due in less than a year and that result from revenue transactions in the scope of ASC 606, except for credit card receivables. They are also not required for receivables measured at the lower of amortized cost basis or fair value.

12.7.1.3 Credit losses: disclosures for PCD assets

A reporting entity should provide a reconciliation between the purchase price and par value of financial assets purchased with credit deterioration during the period. This reconciliation should include the allowance for credit losses at the acquisition date and the discount (or premium) attributable to other factors.

12.7.1.4 Disclosures for collateralized financial assets

For a financial asset for which (1) repayment is expected to be provided substantially through the operation or sale of the collateral (on the basis of an assessment as of the reporting date) and (2) the borrower is experiencing financial difficulty, a reporting entity should describe the type of collateral by class of financing receivable and major security type.

The reporting entity should also describe the extent to which collateral secures its financial assets and include a qualitative explanation by class of financing receivables and major security type of the significant changes in the extent to which collateral secures those assets (whether due to a general deterioration or due to other reasons).

12.7.2 Disclosures for off-balance sheet credit exposures

Reporting entities may have credit exposure related to off-balance sheet loan commitments, standby letters of credit, certain financial guarantees, and other similar instruments (other than those within the scope of ASC 815, *Derivatives and Hedging*). In addition to the disclosures required by other topics (such as ASC 450, *Contingencies*, discussed in FSP 23), reporting entities should also describe the accounting policies and methods used to estimate its liabilities related to off-balance sheet credit

exposures and related changes. The disclosure should discuss factors that influenced management's judgment (e.g., historical losses, existing economic conditions, and reasonable and supportable forecasts) and a discussion of risk elements relevant to particular categories of financial instruments.

12.7.3 *Credit losses: disclosures for AFS debt securities*

Specific disclosures are required regarding credit quality and related to the allowance for credit losses for available-for-sale debt securities.

12.7.3.1 *AFS debt securities: allowance for credit losses*

For reporting periods in which an allowance for credit losses for available-for-sale debt securities is measured, a reporting entity should disclose by major security type the methodology and significant inputs used to measure the credit loss, including its accounting policy for recognizing writeoffs of uncollectible available-for-sale debt securities. See examples of significant inputs included in ASC 326-30-50-7.

ASC 326-30-50-9 requires a reporting entity to disclose a tabular rollforward of the allowance for credit losses by major security type. The rollforward is meant to provide investors with additional information regarding management's expectations of credit losses, how those expectations develop over time, and how actual experience compares to prior expectations.

Figure LI 12-5 illustrates a rollforward of the allowance for credit losses on available-for-sale debt securities.

Figure LI 12-5

Example of a rollforward of the allowance for credit losses on available-for-sale debt securities.

Excerpt of Note X: Investments

The following table displays the rollforward of the allowance for credit losses for the period:

[For example purposes, only a single year is shown.]

	Foreign government bonds	Municipal bonds	Asset backed securities	Total
Balance, beginning of year	129	20	0	149
Credit losses on securities for which credit losses were not previously recorded	31	15	0	46
Securities purchased with credit deterioration	10	0	12	22
Reduction due to sales	(48)	0	0	(48)
Reduction due to intent to sell	(12)	0	0	(12)

	Foreign government bonds	Municipal bonds	Asset backed securities	Total
Net increases (decreases) in allowance on previously impaired securities	7	(12)	0	(5)
Writeoffs charged against the allowance	(13)	0	(3)	(16)
Recoveries of amounts previously written off	4	0	0	4
Increases due to the passage of time	3	1	0	4
Balance, end of year	111	24	9	144

Disclosure about interest income and credit loss expense

When a reporting entity chooses to use a discounted cash flow approach to estimate expected credit losses and elects to classify the change in present value attributable to the passage of time as interest income, it should disclose the amount recorded to interest income that represents the change in present value attributable to the passage of time.

See LI 12.3 for information on the election to classify all changes in discounted cash flows as credit loss.

12.7.3.2 *Purchased AFS securities with credit deterioration*

A reporting entity should provide a reconciliation between the purchase price and par value of available-for-sale debt securities purchased with credit deterioration during the period. This reconciliation should include the discount attributable to expected credit losses and the discount (or premium) attributable to other factors. This disclosure requirement applies to both financial assets measured at amortized cost and to AFS securities (provided they were acquired with credit deterioration).

The reconciliation should include the purchase price, the allowance for credit losses at the acquisition date, the discount or premium attributable to other factors, and the par value.

12.7.3.3 *Securities in unrealized loss position without allowance*

Certain quantitative and qualitative disclosures are required for available-for-sale debt securities in unrealized loss position for which no allowance has been recognized or when an allowance has only been recognized for a portion of the credit losses (i.e. there is a non-credit portion recognized in AOCI). The same requirements apply to beneficial interests in securitized financial assets in the scope of ASC 325-40. See ASC 326-30-55-8 and ASC 326-30-55-9 for examples of the required disclosures.

Quantitative disclosures

A reporting entity should disclose both of the following, aggregated by major security type as of each balance sheet date (in a tabular format):

- Aggregate fair value of investments with unrealized losses
- Aggregate amount of unrealized losses (the amount by which amortized cost basis exceeds fair value). This would not include any basis adjustments from active portfolio layer method hedges, but a reporting entity would be required to separately disclose any basis adjustments from active portfolio layer method hedges

These amounts should be disaggregated by those investments in a continuous unrealized loss position for (1) less than 12 months and (2) 12 months or longer.

To establish the duration of the loss position a reporting entity should use the end of the interim reporting period in which the non-credit related impairment was first recognized in OCI as a reference point.

Figure LI 12-6 illustrates the disclosures related to unrealized losses.

Figure LI 12-6

Example disclosure of unrealized losses, by major security type

Excerpt of Note X: Investments

The following table summarizes the fair value and gross unrealized losses by category and disaggregated by the length of time that individual debt securities have been in a continuous unrealized loss position.

[For example purposes, only a single year is shown. Assume none of the securities are designated as part of an active portfolio layer method hedge.]

	Less than twelve months		Twelve months or greater		Total	
	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss
US Treasury securities	687	16	324	0	1,011	16
Foreign government bonds	608	29	430	31	1,038	60
Asset-backed securities	30	14	87	7	117	21

	Less than twelve months		Twelve months or greater		Total	
	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss
Total debt securities	1,325	59	841	38	2,166	97

Qualitative disclosures

As of the latest balance sheet date, a reporting entity should include a narrative disclosure that allows a financial statement user to understand the information (both positive and negative) that the reporting entity considered in reaching its conclusion as to why no allowance for credit losses was deemed necessary. The reporting entity may aggregate the disclosure by investment category unless there are individually significant unrealized losses. Individually significant unrealized losses should be appropriately disclosed and discussed. ASC 326 outlines examples of the information reporting entities should consider including in this qualitative disclosure.

Excerpt from ASC 326-30-50-4(b)

This disclosure could include all of the following:

1. The nature of the investment(s)
2. The cause(s) of the impairment(s)
3. The number of investment positions that are in an unrealized loss position
4. The severity of the impairment(s)
5. Other evidence considered by the investor in reaching its conclusion that an allowance for credit losses is not necessary, including, for example, any of the following:
 - i. Performance indicators of the underlying assets in the security, including any of the following:
 01. Default rates
 02. Delinquency rates
 03. Percentage of nonperforming assets.
 - ii. Debt-to-collateral-value ratios
 - iii. Third-party guarantees
 - iv. Current levels of subordination

- v. Vintage
- vi. Geographic concentration
- vii. Industry analyst reports
- viii. Credit ratings
- ix. Volatility of the security's fair value
- x. Interest rate changes since purchase
- xi. Any other information that the investor considers relevant.

ASC 326-30-55-9 provides an example of a detailed narrative disclosure.

Reporting entities should consider what additional information may be necessary to allow the user to understand management's considerations in determining that an allowance for credit losses was unnecessary.

12.8 Other disclosure requirements for loans and investments

The following sections address additional disclosure considerations related to loans and investments.

12.8.1 Fair value disclosures

The general requirements for disclosures related to the fair value of loans and investments are described in FSP 20. Additional disclosures related to concentrations of credit risk and to market risk of all financial instruments are also described in FSP 20, and could be relevant to loans and investments.

12.8.2 Purchased options and forwards that do not qualify for derivative accounting

When a reporting entity enters into forward contracts or purchased options that (1) are not derivatives subject to ASC 815 and (2) involve the acquisition of securities that will be accounted for under ASC 320 or ASC 321, it should report those contracts consistent with the accounting, presentation, and disclosure requirements of ASC 320 or ASC 321. Reporting entities should not consider whether upon settlement of the forward contract or purchased option, the underlying securities would be accounted for under the equity method in ASC 323. Thus, purchased options and forwards that are not derivatives subject to ASC 815 to acquire securities that, upon acquisition, will be accounted for under ASC 323 should apply the guidance in ASC 321.

ASC 815-10-50-9 requires that the reporting entity disclose its accounting policy for the premium paid to acquire such an option that is classified as held to maturity or available-for-sale.

12.8.3 Disclosure: assets serving as collateral

Specific disclosures are required when loans, trade receivables, securities, and financial instruments serve as collateral for borrowings. See ASC 860-30-50-1A and FSP 22.6.6 for these disclosure requirements.

S-X 4-08(b) requires disclosure of the amount of assets mortgaged, pledged, or otherwise subject to lien. Any obligations collateralized should also be identified.

12.9 Disclosures: investments in insurance contracts

ASC 325-30 provides guidance on the accounting for investments in insurance contracts.

For investments in life insurance contracts that do not meet the definition of life settlement contracts, the policy holder should disclose contractual restrictions on the ability to surrender the policy. Additional presentation guidance and disclosures requirements are provided for life settlement contracts.

12.9.1 Presentation of life settlement contracts

As discussed in LI 5, life settlement contracts can be accounted for using the fair value method or the investment method. On the balance sheet, a reporting entity should report its investments that are remeasured at fair value separate from those accounted for under the investment method. This can be achieved either by presenting separate line items for each or by aggregating all investments in life settlement contracts into one line item and parenthetically disclosing the amount of contracts accounted for under the fair value method.

On the income statement, ASC 325-30-45-2 states that the amount recognized upon the death of the insured should be recognized in earnings, but it does not provide specific guidance on the appropriate income statement classification. The income is typically presented in other income or net investment income.

A reporting entity should separately present its investment income from investments in life settlement contracts accounted for under the two different measurement models on the face of the income statement. This can be achieved either by displaying separate line items on the income statement, or by presenting the aggregate investment income for life settlement contracts and parenthetically disclosing the investment income from those contracts accounted for under the fair value method.

For investments accounted for under the fair value method, premiums paid and life insurance proceeds received should be classified in the same line as the changes in fair value of those investments.

For presentation on the statement of cash flows, see FSP 6.9.23.

12.9.2 Disclosures for life settlement contracts

A reporting entity should disclose its accounting policy for life settlement contracts (including the classification of related cash flows).

ASC 325-30-50-3 clarifies that the specific disclosure requirements for life settlement contracts do not eliminate disclosure requirements in other topics, including those relating to fair value (see LI 12.8.1).

Regardless of the method elected to account for life settlement contracts, a reporting entity should disclose the following, based on the remaining life expectancy for each of the first five succeeding years from the date of the statement of financial position and thereafter, as well as in the aggregate:

- The number of life settlement contracts
- The carrying value of the life settlement contracts
- The face value (death benefits) of the life insurance policies underlying the contracts

If the fair value method is used, the entity must also disclose the reasons for significant changes in the disclosure items referenced above.

Disclosures for life settlement contracts accounted for under the investment method

A reporting entity that has investments for life settlement contracts accounted for under the investment method should disclose, as of the date of the most recent statement of financial position presented, the life insurance premiums anticipated to be paid for each of the five succeeding fiscal years to keep the life settlement contracts in force.

If the reporting entity becomes aware of new or updated information that causes it to change its expectations on the timing of the realization of proceeds from the investments in these types of contracts, it should disclose the nature of the information and the related effect on the timing of the realization of proceeds. Similarly, the reporting entity should disclose significant changes to the number or carrying value of life settlement contracts or the face value of the life insurance contracts underlying the contracts.

Disclosures for life settlement contracts accounted for under the fair value method

A reporting entity that has investments in life settlement contracts accounted for under the fair value method should disclose the methods and significant assumptions used to estimate the fair value, including any mortality assumptions.

The entity should disclose the reasons for changes in its expectation of the timing of the realization of the investments in life settlement contracts.

For each reporting period presented in the income statement, a reporting entity should also disclose:

- The gains or losses recognized during the period on investments sold during the period
- The unrealized gains or losses recognized during the period on investments that are still held at the date of the statement of financial position

12.10 Disclosure considerations for private companies

The presentation and disclosure requirements are generally applicable to both public and private reporting entities. There are certain disclosure requirements discussed in this chapter that may not be applicable to private entities. Therefore, entities should consider the requirements specific to their circumstances.

12.11 Disclosure considerations for insurance companies

Article 7 of Regulation S-X sets forth the financial statement requirements relating to insurance companies and provides rules for the form and content of insurance company financial statements filed with the SEC. The SEC requirements are in addition to meeting all of the GAAP requirements. Entities should disclose how basis adjustments from active portfolio hedging relationships are reflected within the Regulation S-X disclosures.

12.11.1 Balance sheet presentation and disclosures (insurance)

S-X 7-03 lists the various items that, if applicable, should appear on the face of the balance sheet of an insurance company. The following line items are relevant in the context of loans and investments:

- Investments—other than investments in related parties:
 - Fixed maturities (including bonds, notes, marketable certificates of deposit with maturities beyond one year and redeemable preferred stock)
 - Equity securities (including common stocks and nonredeemable preferred stocks)
 - Mortgage loans on real estate
 - Investment real estate
 - Policy loans
 - Other long-term investments (the amount of any class of investments included under this item should be disclosed separately in a note if it exceeds 10% of stockholder's equity)
 - Short-term investments (commercial paper maturing within one year, marketable certificates of deposit maturing within one year, saving accounts, time deposits and other cash accounts and cash equivalents earning interest)
 - Total investments
- Securities and indebtedness of related parties (stating separately investments in related parties and indebtedness from such parties)
- Accrued investment income
- Accounts and notes receivable (including receivables from agents and insureds, uncollected premiums and other receivables. Any category in excess of 5% of total asset should be separately disclosed).

S-X 7-03 does not require insurance companies to present classified balance sheets; therefore, the distinction between current and noncurrent is not relevant for insurance companies. However, short-term investments (generally, investments maturing within one year) are to be presented separate from other investments.

S-X 7-03 also requires reporting entities to state parenthetically on the balance sheet the basis for determining the aggregate amount presented in the balance sheet. For investments classified as fixed maturities and equity securities, disclosure is required of amortized cost, if the securities are presented at fair value, and fair value, if the securities are presented at amortized cost.

Reporting entities are also required to disclose the name of any entity (or legal person), in which the total amount invested in the entity and its affiliates, exceeds 10% of total stockholder's equity.

In addition, reporting entities are required to disclose the amount of fixed maturities, mortgage loans on real estate, investment real estate and other long-term investments that have been non-income producing for the 12 months preceding the balance sheet date.

ASC 944-825-50-1A requires insurance entities to disclose the carrying amount of securities deposited with state regulatory authorities. ASU 2016-01 and ASU 2016-13 superseded many of the specific requirements previously included in ASC 944 that related to presentation and disclosure of investments for insurance companies.

12.11.2 *Income statement and disclosures (insurance companies)*

S-X 7-04 lists the various items that, if applicable, should appear on the face of the income statement of an insurance company. It also details specific disclosure requirements. The following disclosures, among others detailed in S-X 7-04(2) and S-X 7-04(3), are relevant for loans and investments:

- In a note to the financial statements, in tabular form, disclose the amounts of: (a) investment income from each category of investments that exceeds 5% of total investment income; (b) total investment income; (c) applicable expenses; and (d) net investment income.
- Separately disclose net realized investment gains and losses, the method followed in determining the cost of investments sold, and realized and unrealized investment gains and losses on fixed maturities and equity securities.

12.11.3 *Financial statement schedules (insurance companies)*

S-X 7-05 requires that insurance companies present as Schedule I a summary of investments as of the date of the balance sheet other than investments in related parties. The format of the schedule is prescribed by S-X 12-15, and includes the cost, value, and carrying amount of the investments, presented separately by type of security (e.g., fixed maturities, equity securities, policy loans).

A schedule of valuation and qualifying accounts, required by S-X 7-05, should be filed for each period for which an audited income statement is presented. The specific requirements are prescribed in S-X 12-09, and include a reconciliation or rollforward, by major classes, of specified valuation accounts from the balance at the beginning of the period to the closing balance. This is relevant for loans and investments because the allowance for loan losses would be an account that should be included in this schedule.

12.12 Disclosure considerations for banks

Article 9 of Regulation S-X sets forth the special financial statement requirements relating to banks and bank holding companies and provides rules for the form and content of bank financial statements filed with the SEC. The SEC requirements are in addition to meeting all of the GAAP requirements. Entities should disclose how basis adjustments from active portfolio hedging relationships are disclosed within the Regulation S-X disclosures.

12.12.1 Balance sheet presentation and disclosures (banks)

There are several sources of specific disclosure requirements related to loans and investments.

12.12.1.1 Regulation S-X (banks)

S-X 9-03 lists the various items that, if applicable, should appear on the face of the balance sheet of banks and bank holding companies. The following line items are relevant in the context of loans and investments:

- Interest-bearing deposits in other banks
- Federal funds sold and securities purchased under resale agreements or similar arrangements (which should be presented gross rather than netted against Federal funds purchased and securities sold under repurchase agreements).
- Trading account assets (which include securities or any other investments held for trading purposes only)
- Other short-term investments
- Investment securities

Companies are required to disclose the aggregate book value of investment securities and show the aggregate market value on the face of the balance sheet. The carrying value and market value of should be disclosed in a note for securities of:

1. US treasury and other government agencies and corporations
 2. States of the US and political subdivisions
 3. Other securities
- Loans

Separate disclosure is required for total loans, the related allowance for losses, and unearned income.

On the balance sheet or in the notes, reporting entities should disclose the amount of total loans by categories (e.g., commercial, financial, and agricultural; real estate – construction; real estate – mortgage; installment loans to individuals; lease financing; foreign; and other). However, other categories may be used if more appropriate.

The amount of foreign loans is required to be disclosed if S-X 9-05 applies. S-X 9-05 applies once foreign activities – measured by specific indicators such as assets, revenue, and other – exceed a threshold of 10% for that indicator.

For each period for which an income statement is presented, disclosure is required of changes in the allowance for loan losses showing the balance at the beginning and end of the period, the provision charged to income, recoveries of amounts charged off, and losses charged to the allowance.

As of each balance sheet date, disclosure is required of all loans above a specified threshold granted to directors, executive officers, or principal holders of securities, or any associate of such persons. If the aggregate amount of such loans exceeds 5% of stockholder's equity, an analysis of activity for the most recent year should be provided.

Question LI 12-4

Do the disclosure requirements of Regulation S-X Article 9 and Guide 3 also apply to registrants that are not bank holding companies but that are engaged in similar lending and deposit activities?

PwC response

ASC 942-10-S99-4 explains that while S-X Article 9 and Guide 3 apply to bank holding companies, they may provide useful guidance to certain other registrants, including savings and loan holding companies, on disclosures relevant to an understanding of the registrant's operations. To the extent particular guidance is relevant and material to the operations of a reporting entity, the SEC staff believes that comparable data should be provided.

S-X 9-03 does not require banks to present classified balance sheets; therefore, the distinction between current and noncurrent is not relevant for banks and bank holding companies.

12.12.1.2 ASC 942, Financial services—Depository and Lending

If deposits in other institutions are material, then those deposits should be presented as a separate amount in the balance sheet.

The following disclosures apply to banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities. Debt and equity securities in the scope of ASC 942-320 are required to be disclosed based on the following major security type (additional types also may be necessary):

- Equity securities, segregated by either industry type, entity size, or investment objective
- Debt securities issued by the US Treasury and other US government corporations and agencies. Investments in mutual funds that invest only in US government debt securities may be shown separately.
- Debt securities issued by states of the United States and political subdivisions of the states
- Debt securities issued by foreign governments

- Corporate debt securities
- Residential mortgage-backed securities
- Commercial mortgage-backed securities
- Collateralized debt obligations
- Other debt obligations

In addition, the specified financial institutions are also required to disclose the fair value and the net carrying amount of their debt securities that are in the scope of ASC 942-320, segregated by at least the following four maturity groupings (within 1 year, 1- 5 years, 5-10 years, and after 10 years). This would not include any basis adjustments from active portfolio layer method hedges, but a reporting entity would be required to separately disclose any basis adjustments from active portfolio layer method hedges.

The carrying amount of investment assets that serve as collateral to secure public funds, securities sold under repurchase agreements, and other borrowings, that are not otherwise disclosed under ASC 860, *Transfers and Servicing*, should also be disclosed.

Investments in Federal Home Loan Bank or Federal Reserve Bank stock cannot be shown with securities accounted for under ASC 321, and are usually presented in other investments or other assets.

See ASC 942-825-50-1 and ASC 942-825-50-2 for specific requirements related to the disclosure of off-balance sheet credit risk.

12.12.1.3 ASC 948, Financial Services—Mortgage Banking

Mortgage banking entities should distinguish between mortgage loans held for sale and mortgage loans held for long-term investment. Mortgage banking entities are required to disclose the method used in determining the lower of cost or fair value of mortgage loans (aggregate or individual loan basis).

12.12.2 Income statement presentation and disclosures (banks)

S-X 9-04 lists the various items that, if applicable, should appear on the face of the income statement of banks and bank holding companies. It also details specific disclosure requirements. The following disclosures are relevant for loans and investments:

- Interest and fees on loans. This line item should include commitment and origination fees, late charges, and the current amortization of premium and accretion of discount on loans that are related to (or are an adjustment of) the loan interest rate.
- Interest and dividends on investment securities. Separate disclosure should be made for (1) taxable interest income, (2) nontaxable interest income, and (3) dividends.
- Trading account interest

- Other interest income
- Total interest income
- Interest on deposits
- Provision for loan losses. S-X 9-03 requires disclosure of the changes in the allowance for each period for which an income statement is required.

12.12.3 Financial statement schedules (banks)

In accordance with ASC 948-310-S99-1, the financial statement schedule required by S-X 12-29, which contains details regarding mortgage loans on real estate held by real estate companies, is also required for companies subject to ASC 948.

12.13 Transition disclosures: ASU 2016-13

Certain specific disclosures are required in the period in which a reporting entity adopts ASU 2016-13.

ASC 326-10-65-1(f)

An entity shall disclose the following in the period that the entity adopts the pending content that links to this paragraph:

1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
2. The method of applying the change.
3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is effective.

Public business entities that are not SEC filers are permitted to provide the new required vintage disclosures using a phased-in transition approach. In the year of adoption, the reporting entity would present the three most recent origination years. An incremental year is required to be disclosed in each of the next two fiscal years such that thereafter the five separate fiscal years are disclosed.

***Chapter 13:
Effective date and transition—
updated May 2022***

13.1 Effective dates: ASU 2016-01 and ASU 2016-13

Figure LI 13-1 summarizes the effective dates for ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* and ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (825-10), Recognition and Measurement of Financial Assets and Liabilities* (recognition and measurement) and ASU 2020-01, *Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) –Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*. Figure LI 13-2 summarizes the effective dates for ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, ASU 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief* (impairment), and ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*. Targeted improvements were made to both recognition and measurement and impairment in ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*.

Early adoption of these standards is allowed in limited circumstances. See LI 13.1.1, LI 13.1.2, and LI 13.1.3 for information on early adoption of each standard.

Figure LI 13-1

Summary of effective dates – ASU 2016-01

Type of reporting entity	ASU 2016-01: Recognition and measurement
Public business entities (PBEs)	ASU 2016-01, ASU 2018-03, ASU 2019-04 and ASU 2020-01 are currently effective.
Other entities (including not-for-profit organizations and certain employee benefit plans)	ASU 2016-01, ASU 2018-03, and ASU 2019-04 are currently effective. ASU 2020-01 is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years.

On November 15, 2019, the FASB issued ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, which deferred the effective date of ASU 2016-13 for certain public business entities (PBEs) and non-PBEs.

Figure LI 13-2

Summary of effective dates – ASU 2016-13

Type of reporting entity	ASU 2016-13: Impairment
PBEs that meet the definition of an SEC filer, excluding smaller reporting companies (SRCs)	<p>ASU 2016-13, ASU 2019-04, and ASU 2019-05 are currently effective.</p> <p>ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.</p>
All other entities including all other PBEs (including SEC filers that are SRCs), private companies, not-for-profit organizations and certain employee benefit plans	<p>Fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.</p> <p>For entities that have not yet adopted ASU 2016-13, the effective dates for ASU 2019-04, ASU 2019-05, and ASU 2022-02 are the same as the effective date for ASU 2016-13.</p> <p>For entities that have early adopted ASU 2016-13, ASU 2019-04 and ASU 2019-05 are currently effective and ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.</p>

ASC 326-10-20 defines an SEC filer.

ASC 326-10-20

Securities and Exchange Commission (SEC) filer

An entity that is required to file or furnish its financial statements with either of the following:

- a. The Securities and Exchange Commission (SEC)
- b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

The one-time determination of whether an entity is eligible to be a smaller reporting company shall be based on an entity's most recent determination as of November 15, 2019, in accordance with SEC regulations.

13.1.1 Early adoption of ASU 2020-01

A reporting entity is allowed to early adopt the amendments in ASU 2020-01 in an interim period.

13.1.2 *Early adoption of impairment standard*

Early adoption of the impairment standard is permitted for all reporting entities for fiscal years beginning after December 15, 2018, including the interim periods therein. For the amendments in ASU 2019-04, ASU 2019-05, and ASU 2022-02, early adoption is permitted in any interim period as long as the entity has adopted the amendments in ASU 2016-13.

13.1.3 *Early adoption of ASU 2022-02*

For entities that have adopted ASU 2016-13, early adoption of ASU 2022-02 is permitted, including adoption in an interim period. If an entity elects to early adopt ASU 2022-02 in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes the interim period. For example, if a calendar year-end entity adopts this guidance in the second quarter of 2022, it will need to adopt the guidance as of January 1, 2022.

An entity may elect to early adopt the amendments related to TDRs separately from the amendments related to vintage disclosures. If an entity elects to early adopt amendments to TDRs, it is required to adopt both the accounting and disclosure amendments relating to modifications of loans with borrowers experiencing financial difficulties concurrently.

13.1.3.1 *Early adoption of ASU 2022-02 – SEC filings*

If a calendar year-end public entity adopts the new guidance in ASU 2022-02 in an interim period, it will need to reflect the change as of January 1, 2022. This is required even if it is not adopted in the first quarter. If an entity does not adopt the guidance in the first quarter (for example, they adopt in Q3), the entity will include the recast prior quarter information within the year-to-date disclosures presented in the Q3 financial statements and comparative 2022 information in future filings (e.g., in the 2022 information presented for comparative purposes in 2023 quarterly filings). Companies should consult with their auditors and SEC counsel to determine whether previously issued Form 10-Qs may be required to be recast (e.g., via a Form 8-K) in connection with capital markets transactions and/or registration statements if the guidance is not adopted in the first quarter.

Entities may also need to disclose revised quarterly supplementary financial information in the Form 10-K if the recast data is materially different from the amounts previously disclosed in the Form 10-Qs (as per Regulation S-K Item 302). The selected financial data table in the Form 10-K (if presented on a voluntary basis) is not impacted because the prior year amounts are not affected by the adoption of the new guidance.

Entities also need to consider if there were any significant changes in internal controls over financial reporting in the period of adoption that may need to be disclosed in Item 9A of the Form 10-K if ASU 2022-02 (if adopted in the fourth quarter) or in Item 4 of the Form 10-Q if adopted in an interim period.

13.2 *Transition guidance – recognition and measurement*

LI 13.2.1 describes a transition-related matter for insurance companies that adopted the recognition and measurement guidance, and LI 13.2.2 describes the transition provisions of ASU 2020-01.

13.2.1 Insurance companies using the measurement alternative

Insurance companies previously accounted for equity securities without a readily determinable fair value under ASC 944, *Financial Services – Insurance*. ASC 944-325 required the securities to be accounted for at fair value with changes in fair value recorded in other comprehensive income. Under the recognition and measurement standard, an insurance company can elect the measurement alternative for those equity investments. If an insurance company elects the measurement alternative, the guidance should be applied prospectively.

Any amounts recorded previously in AOCI will be released to earnings on a prospective basis. Insurance companies should adopt an appropriate methodology for the subsequent accounting for the balances in AOCI that is logical and consistently applied to all securities accounted for using the measurement alternative. We believe each of the following alternatives are acceptable:

- AOCI is “frozen” and fully released when the security is sold. Consistent with the recognition and measurement standard, all impairments and adjustments for observable transactions occurring subsequent to the adoption date would be recorded through earnings.
- AOCI is fully released at the first instance of identified impairment or an observable transaction.
- AOCI is released incrementally to the extent that changes recorded under the equity securities’ fair value model are “opposite” of the amounts in AOCI. For example, if a security was in an unrealized gain position at the adoption date and there is a subsequent impairment identified, the entity would release the portion of AOCI that offsets the amount of the impairment. If the impact of the impairments exceeds the amount deferred in AOCI, the excess would be recorded in current period earnings. In contrast, if the same security was in an unrealized gain position at the adoption date and had an observable transaction indicating an increase in its fair value, the AOCI would remain unchanged and the gain would be recorded in current period earnings.

There may be other acceptable alternatives for the subsequent accounting of the related AOCI. However, subsequent to derecognition, including sale, there should be no remaining AOCI related to the derecognized equity security. An insurance company’s accounting policy should be disclosed in the notes to the financial statements.

13.2.2 ASU 2020-01 transition

A reporting entity shall apply ASU 2020-01 on a prospective basis at the beginning of the interim period that includes the adoption date.

13.3 Transition guidance – impairment

The following sections describe the transition provisions of the impairment standard.

13.3.1 Impairment: Non-PCI debt securities (transition)

The FASB recognized that the changes to the impairment model for debt securities would likely create a number of transition issues. Historically, an impairment of a debt security was recorded as a basis adjustment to the amortized cost basis of the instrument. Any subsequent improvements in cash flows following an impairment were reflected through an increased yield on the instrument. Reversing the impact of the prior accounting and replacing it with the establishment (or release) of an allowance for

credit losses would require historical data that many reporting entities may not have available. As a result, retrospective adoption or calculating a cumulative effect would have been challenging. Therefore, the FASB decided to have the impairment guidance apply to debt securities that were previously impaired on a prospective basis.

Upon adoption, the amortized cost basis of debt securities is unchanged. Previous write-downs recorded on debt securities should not be reversed. In addition, the effective interest rate remains unchanged at initial adoption. The carrying amount and effective interest rate of the debt security will be utilized to apply the model prospectively. ASC 326-10-65-1(e) also requires any amount previously recognized in AOCI that relates to improvements in cash flows to continue to be accreted into interest income over the remaining life of the debt security on a level-yield basis.

While the amortized cost basis of debt securities is unchanged, in certain circumstances an entity may be required to record an allowance for credit losses on its securities at transition. The prospective application required by ASC 326-10-65-1(e) was specifically limited to the determination of the amortized cost basis. Therefore, an allowance recognized in connection with adopting the guidance in ASC 326 should be recognized as a cumulative effect adjustment to opening retained earnings in accordance with ASC 326-10-65-1(c) for both HTM and AFS debt securities.

For securities that have experienced an improvement in cash flows subsequent to the adoption date, but experienced an impairment prior to the adoption date, the transition guidance in ASC 326-10-65-1(e) requires recoveries of amounts written off before the adoption date relating to improvements in cash flows forecasted after the date of adoption to be recorded to income in the period received and not in the period in which the entity's credit loss expectation changed. Therefore, the entity is required to wait to record the impact of any expected improvement in those cash flows until the cash is actually received.

A debt security could experience both (1) an impairment prior to adoption and (2) an incremental expected credit loss recorded as an allowance after adoption. When an entity subsequently forecasts collection of all contractual cash flows, we believe an entity could immediately reverse the allowance for credit losses recognized under ASC 326. Any additional improvements in expected cash flows relating to an impairment recorded prior to adoption can only be recorded in the period when the cash is received. There may be additional considerations when an entity has write offs both before adoption and after adoption followed by an increase in expected recoveries.

Question LI 13-1

On transition to ASC 326-20 for HTM debt securities, is an entity expected to record an allowance for credit losses for a security that was previously impaired?

PwC response

While the amortized cost basis of the debt security with previous impairment remains unchanged under the transition requirements, the credit loss model for HTM debt securities changed as a result of ASU 2016-13. Therefore, an entity may be required to recognize an allowance for credit losses at adoption. For example, under previous GAAP, an entity's impairment assessment of HTM debt securities was based on its best estimate of the present value of cash flows expected to be collected. ASC 326-20-30-10 requires an entity to include a measure of the expected risk of credit loss even if that risk is remote. This could result in an allowance for credit losses being required upon transition.

This specific example is not applicable for AFS debt securities as ASC 326-30-35-7 requires an entity to use its best estimate of the present value of cash flows expected to be collected, which is consistent with previous GAAP.

In addition, under previous GAAP, an entity was required to use a discounted cash flow (DCF) method to estimate and recognize a credit loss impairment. For HTM debt securities, ASC 326-20 does not require the use of a particular method. While a DCF method is permitted, an entity may elect to use other methods (e.g., a loss rate or a probability-of-default/loss given default method). When a method other than a DCF method is used to estimate expected credit losses, an allowance for credit losses may be required upon transition. This specific example would not be applicable for AFS debt securities as ASC 326-30-35-6 requires the use of a DCF method when estimating credit losses, which is similar to previous GAAP.

13.3.2 *Impairment: Loans and receivables (transition)*

The guidance in the impairment standard should be applied to loans (other than purchased loans with credit deterioration) using a modified retrospective approach. A reporting entity will be required to recognize the cumulative effect of initially applying the impairment standard as an adjustment to opening retained earnings in the period of initial application.

The CECL impairment model represents a significant change from previous guidance in calculating the allowance for credit losses. As a result, the cumulative effect adjustment will reflect the difference between today's model and the CECL impairment model (except for purchased assets with credit deterioration).

Additional changes when applying the CECL model may include changes to how loans are pooled when applying the CECL impairment model compared to how they are pooled today for the purposes of calculating incurred losses. As the risk characteristics driving the calculation of the allowance for credit losses in a CECL impairment model may be different than those in the incurred loss model, reporting entities may need to develop loan pools based on different risk characteristics than in the past.

The amendments in ASU 2022-02 related to the recognition and measurement of TDRs (i.e., the elimination of TDRs) can be applied prospectively with the guidance applied to modifications occurring after the date of adoption of ASU 2022-02 or applied on a modified retrospective method, resulting in a cumulative-effect adjustment to retained earnings.

13.3.2.1 *CECL transition relief for troubled debt restructurings – after the issuance of ASU 2022-02*

Entities that have not adopted ASU 2016-13 (which introduced the CECL model) will be required to adopt ASU 2022-02 when they adopt ASU 2016-13. ASU 2016-13 is generally required to be adopted by means of a cumulative-effect adjustment to opening retained earnings. ASU 2022-02 provides for two methods of adopting the guidance relating to recognition and measurements of TDRs (i.e., the elimination of TDRs). The transition approach selected will impact the CECL transition relief for TDRs.

Prospective adoption of ASU 2022-02 for TDRs

For entities that have elected to adopt ASU 2022-02 on a prospective basis, the transition relief guidance for TDRs in ASU 2016-13 remains unchanged. The amendments in ASU 2022-02 relating to TDRs should be applied to modifications occurring after the date of adoption.

Modified retrospective adoption of ASU 2022-02

For entities that have elected to adopt ASU 2022-02 on a modified retrospective approach, the CECL transition relief for TDRs under ASU 2016-13 is no longer applicable as this adoption approach eliminates the concept of a TDR.

If an entity elects prospective adoption of ASU 2022-02 for TDRs, there is a potential that earnings could be impacted. Refer to LI 13.3.6 for further details around the transition for ASU 2022-02.

13.3.2.1 *CECL transition relief for troubled debt restructurings – before issuance of ASU 2022-02*

ASC 326-20 provides entities that use a DCF method to estimate expected credit losses with an accounting policy election (available in certain circumstances and required in others) to adjust the effective interest rate used to discount expected cash flows for the consideration of timing (and changes in timing) of expected prepayments. However, that guidance also states that when a loan is restructured through a troubled debt restructuring (TDR), the effective interest rate used to discount cash flows should not be adjusted because of subsequent changes in the expected timing of cash flows.

Stakeholders noted that it would be difficult in transition to calculate an effective interest rate to be used for discounting for loans that experienced a TDR prior to the adoption date of the credit loss standard by using prepayment assumptions in effect immediately before the restructuring. As a result, the FASB amended the transition guidance to allow an entity to make an accounting policy election to calculate the prepayment-adjusted effective interest rate used to discount cash flows on loans restructured through a TDR prior to the effective date using the prepayment assumptions that exist as of the date the entity adopts ASC 326-20.

13.3.3 *Impairment: PCD assets (transition)*

For purchased assets with credit deterioration, the transition to the new guidance is prospective. Upon adoption, reporting entities should not “reassess” the classification of existing assets to determine whether they met the definition of purchased assets with credit deterioration (PCD assets) when acquired. Assets that were previously accounted for as purchased credit impaired (PCI) under ASC 310-30 (including assets for which ASC 310-30 was applied by analogy) will be accounted for as PCD assets under the impairment standard.

When instruments that were accounted for as PCI are transitioned to the new PCD model, a “gross up” will need to be recorded to the amortized cost basis of the asset and the allowance for credit losses of these instruments. Any noncredit discount will be accreted to interest income using the interest method. The effective interest rate for the PCD instruments should be determined after the adjustment to the amortized cost basis at adoption.

Under ASC 310-30, if ASC 310-30 was applied on a pool basis, the pool was considered to be the unit of account for calculating both impairment and interest income. Under the CECL model, there is no

such concept and (with the exception of an election at transition for existing pools) the guidance does not permit treatment of a pool of loans as a single unit of account that cannot be “broken” and instead requires an entity to pool assets based on similar risk characteristics at the reporting date. The impairment and interest income models for PCD assets are not part of a single integrated model. Therefore, the pools used for loan impairment and interest income recognition can differ.

For PCI pools that exist at the time of adoption, reporting entities may make one of the following accounting policy elections:

- Dissolve the existing PCI pools and calculate the “gross-up” on an individual loan basis at the adoption date. Subsequent to adoption, an entity is then required to pool assets based on similar risk characteristics at each reporting date in accordance with the new guidance.
- Maintain the existing PCI pools solely for the purposes of calculating the “gross-up” at the adoption date. The gross up would then be allocated to individual loans. The loans would be accounted for prospectively in accordance with the new guidance. If an entity elects to not maintain previous PCI pools on an ongoing basis, post transition an entity is required to pool assets based on similar risk characteristics at each reporting date.
- Maintain the existing PCI pools as a single unit of account subsequent to transition. The FASB staff has noted that when maintaining these pools, reporting entities should apply the following paragraphs relevant to the pool unit of account in previous GAAP (ASC 310-30-15-6, ASC 310-30-35-15, and ASC 310-30-40-1 through ASC 310-30-40-2).

As noted in ASC 326-10-65-1(d), reporting entities should not reassess whether modifications that occurred prior to the adoption of the guidance to individual acquired financial assets accounted for in PCD pools were troubled debt restructurings.

Existing instruments that were not accounted for as PCI under ASC 310-30 will not be considered PCD under the new standard. As such, they should follow the relevant transition provisions for non-PCD instruments.

Question LI 13-2

Assume an entity adopting ASU 2016-13 owns an AFS debt security previously accounted for under ASC 310-30. As a result, the security will be considered PCD upon transition. At the transition date, the fair value of the security is higher than its amortized cost basis. What should the entity record as part of its transition adjustment in adopting ASU 2016-13?

PwC response

ASC 326-10-65-1(d) provides transition guidance for AFS debt securities previously accounted for under ASC 310-30. It requires entities to consider these to be PCD and apply the guidance on a prospective basis, which will generally result in a “gross up” of the security’s amortized cost basis to reflect the addition of the allowance for credit losses. The initial recognition guidance for PCD AFS debt securities in ASC 326-30-30-2 requires that the initial allowance be computed in accordance with the AFS debt security impairment model in ASC 326-30-35-3 through ASC 326-30-35-10. This guidance states (in part) that an allowance for credit losses is limited by the amount that the fair value is less than the amortized cost basis. In addition, the AFS impairment model indicates that a security is only considered impaired if its fair value is less than its amortized cost.

For PCD AFS securities when the fair value exceeds amortized cost upon adoption of ASC 326, any allowance recorded at transition would increase the amortized cost basis and result in an allowance that exceeds the difference between the adjusted amortized cost basis and fair value of the security. We believe this would be inconsistent with the overall AFS impairment model guidance in ASC 326-30 that prohibits recording an allowance in these situations. We do not believe the transition guidance was intended to require recording an allowance that would be inconsistent with GAAP. Under this view, an entity should not record an allowance for credit losses nor should it record a “gross up” of a security’s amortized cost basis at transition in these circumstances. Therefore, the amortized cost basis at the transition date would remain unchanged.

Subsequent to adoption, if the PCD AFS security is subject to ASC 325-40, subsequent changes in cash flows would be accounted for in accordance with that Subtopic. Refer to LI 14.6 for further information. If the PCD AFS security is not subject to ASC 325-40, ASC 310-10-35-53B would prohibit any credit-related discount from being accreted into interest income.

13.3.4 Fair value option election at transition to ASC 326

ASC 326-10-65-1(i) allows an entity to irrevocably elect the fair value option on an instrument-by-instrument basis for certain financial instruments that are both within the scope of ASC 326-20 and eligible for the fair value option in ASC 825-10, *Financial Instruments—Overall*. However, this election does not apply to held-to-maturity debt securities. Entities choosing the fair value option upon transition to ASC 326-20 should subsequently apply the guidance in ASC 820-10 and ASC 825-10.

13.3.5 Impairment – transition disclosure overview

For specific disclosures required in the period of adoption and additional transition relief provided to public business entities that are not SEC filers, see LI 12.13.

13.3.6 ASU 2022-02 transition

For the changes to the recognition and measurement of TDRs (i.e., the elimination of TDRs), an entity has the option to apply a modified retrospective transition method, resulting in a cumulative-effect adjustment to retained earnings. If an entity elects a prospective approach for the elimination of recognition and measurement guidance on TDRs, the guidance is applied to modifications occurring after the date of adoption of ASU 2022-02. In addition, if an entity elects prospective adoption of ASU 2022-02 for TDRs, there is a potential that earnings could be impacted due to the elimination of the requirement to consider reasonably expected TDRs when estimating credit losses.

Question LI 13-3

Assume an entity adopts ASU 2022-02 using the prospective approach. Subsequent to the adoption of ASU 2022-02, the entity modifies a loan (the “current modification”) that was previously modified in a TDR prior to the adoption of ASU 2022-02. Should an entity apply the guidance in ASU 2022-02 to the current modification?

PwC response

Yes. An entity that elects to apply ASU 2022-02 on a prospective basis should apply this guidance to any modification after its adoption date. As a result, the current modification should be analyzed to

determine if it is a new loan or a continuation of the existing loan (see LI 10.2). This is required even if the borrower is currently experiencing financial difficulties.

In addition, the “once a TDR always a TDR” guidance that existed prior to the adoption of ASU 2022-02 is no longer applicable. As a result, in calculating the allowance for credit losses for this loan following the current modification, the entity is not required to use a DCF approach. If the entity elects to continue to use a DCF approach,

- the estimated cash flows should be based on the post-modification contractual terms, and
- the discount rate shall be based on the post-modification effective interest rate.

The new and amended disclosures should be applied prospectively beginning in the period of adoption. For the modification disclosures required in ASC 310-10-50-38 through ASC 310-10-50-44, information on modifications made prior to the adoption date do not need to be disclosed. Modifications made before the date of the adoption do not need to be included in the disclosures that require information about modifications made in the previous 12 months. Information related to gross writeoffs made prior to the adoption date required by ASC 326-20-50-6 do not need to be disclosed.

When comparative periods are presented, the disclosures related to prior periods that were required during those reporting periods (prior to the adoption of ASU 2022-02) should be carried forward. For example, the disclosures that were required in prior periods by GAAP that was superseded by ASU 2022-02 should be included in comparative financial statements.

Chapter 14:
Beneficial interests—updated
June 2021

14.1 *Beneficial interests*

Many securitization transactions involve the transfer of financial assets to a limited-purpose entity through one or multiple steps. Beneficial interests are formed when a special purpose entity issues various interests in security form (hence the term “securitization”) to third parties. The interests entitle the third parties to the cash flows generated by the securitization entity’s underlying financial assets.

Beneficial interests can involve cash flow and risk profiles that differ from other investments. As a result, certain beneficial interests are required to follow the more specialized accounting model in ASC 325-40. Beneficial interest that do not fall within the scope of ASC 325-40 may be accounted for as:

- derivatives subject to ASC 815 (see DH 2),
- debt securities subject to the guidance in ASC 310-20 (see LI 3 and LI 6) and the impairment guidance in ASC 326-30 (see LI 8) or ASC 326-20 (see LI 7),
- loans subject to the guidance in ASC 310 (see LI 4), or
- other accounting guidance.

ASC 860, *Transfers and servicing*, defines beneficial interests.

Definition from ASC 860-10-20

Beneficial Interests: Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

- a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
- b. Premiums due to guarantors
- c. Commercial paper obligations
- d. Residual interests, whether in the form of debt or equity

Beneficial interests can take many different forms, ranging from debt securities to equity interests issued by a limited partnership or LLC. Examples of beneficial interests in securitizations include mortgage-backed securities, asset-backed securities, credit-linked notes, collateralized debt obligations, and interest-only (IO) or principal-only (PO) strips. The primary investors in beneficial interests in securitizations are insurance companies, banks, broker-dealers, hedge funds, pension funds, and other individuals or companies that maintain a significant investment or trading portfolio. Corporate treasury groups may also invest in beneficial interests. For example, many corporations invest in mortgage-backed securities guaranteed by government-sponsored enterprises such as Freddie Mac or Fannie Mae.

Beneficial interests should be evaluated to determine whether they meet the definition of a derivative in ASC 815. Beneficial interests that are not derivatives in their entirety should also be evaluated to determine whether they contain embedded derivatives that should be accounted for separately. See DH 4.4.6 for guidance on determining whether beneficial interests contain embedded derivatives that

should be bifurcated from the host contract. ASC 815 provides an exception to derivative accounting for certain IO and PO strips, but the scope exception is limited to the most basic IO and PO instruments. See DH 3.2.12 for guidance on applying the scope exception for IO and PO instruments.

Certain beneficial interests in securitizations that are not derivatives within the scope of ASC 815 are accounted for like debt securities under ASC 320, as detailed in ASC 860-20-35-2.

ASC 860-20-35-2

Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of securities are included in the scope of that Topic. Therefore, all relevant provisions of that Topic (including the disclosure requirements) shall be applied. See related implementation guidance beginning in paragraph 860-20-55-33.

The term “substantially all” is not defined in ASC 860. However, based on other accounting literature, “substantially all” is generally interpreted in practice to mean 90% of the investment. Financial assets that can be contractually prepaid or otherwise settled in a way that would prevent the holder from recovering substantially all of its recorded investment often contain embedded derivatives that should be accounted for separately in accordance with the guidance in ASC 815. See DH 4 for additional information on embedded derivatives. When an embedded derivative is bifurcated, the applicable accounting guidance for beneficial interests would be applied to the host instrument.

ASC 860-20-35-2 requires accounting consistent with ASC 320 even if the financial instrument is not within the scope of that Topic (e.g., non-certificated beneficial interests). Subsequent changes in the fair value of these financial assets should also be recognized in accordance with ASC 320 (through OCI for available-for-sale securities and through net income for trading securities). Because these securities can be contractually prepaid or settled in a manner in which the investor would not recover substantially all of its recorded investment, they may not be classified as held to maturity.

14.2 The ASC 325-40 model

ASC 325-40 is an integrated interest income and impairment model for beneficial interests classified as held to maturity (HTM), available for sale (AFS), or trading. For the purposes of impairment, while ASC 325-40 is broadly based on the guidance in ASC 326-20 for HTM securities (i.e., CECL model), and ASC 326-30 for AFS securities (i.e., AFS impairment model), but it has some notable differences. ASC 325-40 provides specific requirements in applying ASC 326-20 and ASC 326-30. ASC 325-40 requires changes in either the timing or amount of cash flows to be reflected as an adjustment to the allowance for credit losses in applying ASC 326-20 and ASC 326-30. In addition, when applying ASC 326-20 to a beneficial interest subject to ASC 325-40, the use of a discounted cash flow method is required to measure expected credit losses.

14.3 *Scope of ASC 325-40*

ASC 325-40 guidance applies to beneficial interests classified as held to maturity, available for sale, or trading. ASC 325-40 includes in its scope for interest income recognition purposes, entities that account for beneficial interests as trading or other accounting models whereby the beneficial interest is measured at fair value with changes in fair value recorded in earnings. The scope of ASC 325-40 begins in ASC 325-40-15-1 through ASC 325-40-15-3.

ASC 325-40-15-1

The guidance in this Subtopic applies to all entities.

ASC 325-40-15-2

The guidance in this Subtopic applies to a transferor's interests in securitization transactions that are accounted for as sales under Topic 860 and purchased beneficial interests in securitized financial assets.

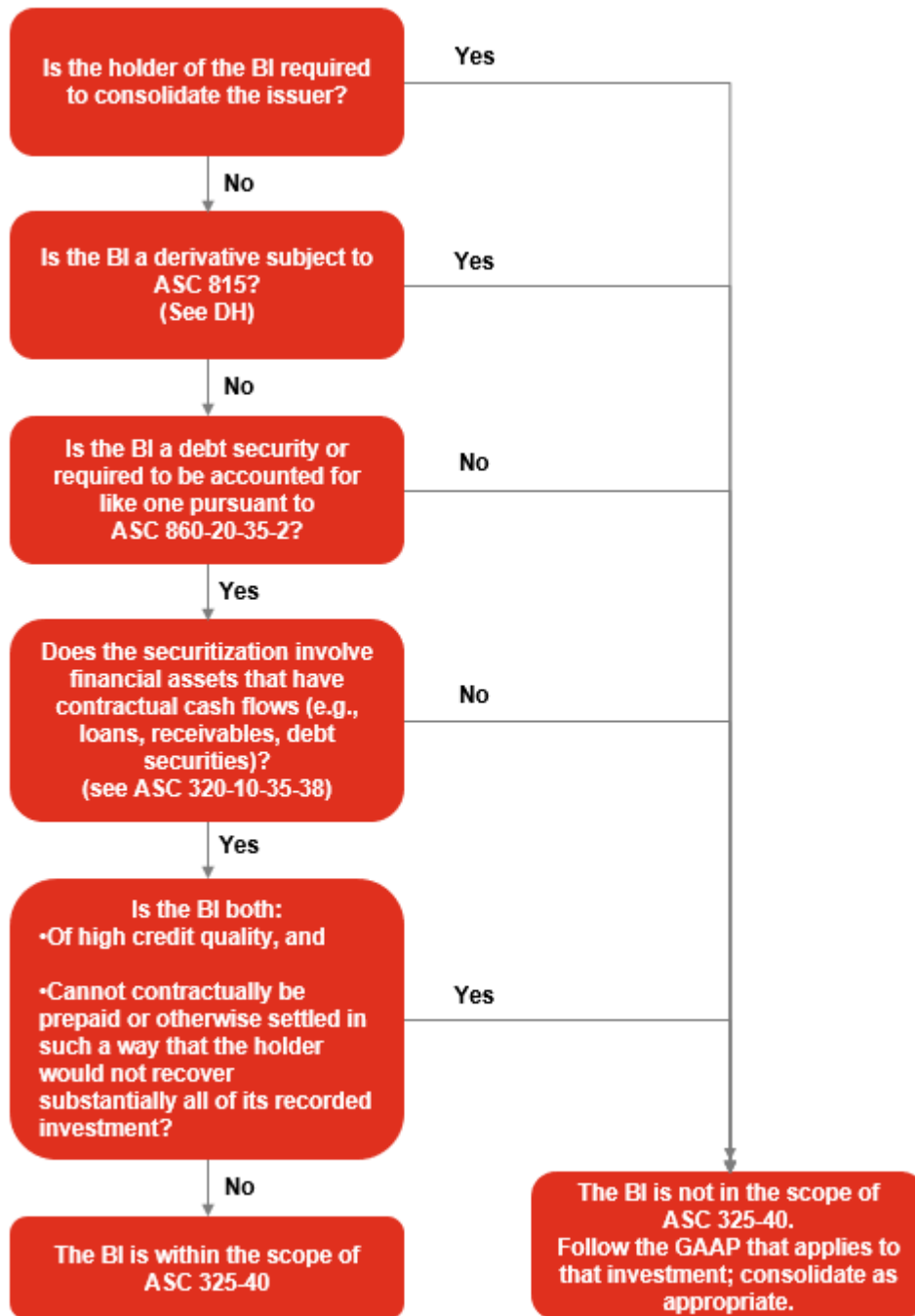
ASC 325-40-15-3

The guidance in this Subtopic applies to beneficial interests that have all of the following characteristics:

- a. Are either debt securities under Subtopic 320-10 or required to be accounted for like debt securities under that Subtopic pursuant to paragraph 860-20-35-2.
- b. Involve securitized financial assets that have contractual cash flows (for example, loans, receivables, debt securities, and guaranteed lease residuals, among other items). Thus, the guidance in this Subtopic does not apply to securitized financial assets that do not involve contractual cash flows (for example, common stock equity securities, among other items). See paragraph 320-10-35-38 for guidance on beneficial interests involving securitized financial assets that do not involve contractual cash flows.
- c. Do not result in consolidation of the entity issuing the beneficial interest by the holder of the beneficial interests.
- d. Subparagraph superseded by Accounting Standards Update No. 2016-13.
- e. Are not beneficial interests in securitized financial assets that have both of the following characteristics:
 1. Are of high credit quality (for example, guaranteed by the U.S. government, its agencies, or other creditworthy guarantors, and loans or securities sufficiently collateralized to ensure that the possibility of credit loss is remote)
 2. Cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

Figure LI 14-1 summarizes how an investor would determine whether a beneficial interest (BI) is within the scope of ASC 325-40.

Figure LI 14-1
ASC 325-40: scoping decision tree



14.3.1 *High credit quality*

While ASC 325-40-15-3(e)(1) refers to “high credit quality,” ASC 325-40 does not detail how to evaluate it. In our view, and the view of the SEC, a beneficial interest rated AA or above by S&P (or similarly rated by other rating agencies), or having an equivalent shadow rating, should be considered of high credit quality, and thus (if the other criteria are met) need not be accounted for in accordance with ASC 325-40. An investor would look instead to other relevant guidance such as ASC 310 or ASC 320 when accounting for the investment.

A beneficial interest deemed to be of high credit quality when purchased may not satisfy that condition at a later date (e.g., as a consequence of a rating agency downgrade). In these circumstances, we believe the investor may continue to apply the income recognition and measurement guidance deemed appropriate at the acquisition date. Alternatively, going forward, the investor may treat the beneficial interest as subject to ASC 325-40. In either case, the policy election should be applied consistently.

14.3.2 *PCD scope for beneficial interests subject to ASC 325-40*

The guidance in ASC 325-40-30-1A related to beneficial interests in securitized financial assets requires the purchased financial asset with credit deterioration (PCD) asset guidance to be applied to certain beneficial interests classified as either held to maturity or available for sale if it meets certain criteria.

ASC 325-40-30-1A

An entity shall apply the initial measurement guidance for purchased financial assets with credit deterioration in Subtopic 326-20 to a beneficial interest classified as held-to-maturity and in Subtopic 326-30 to a beneficial interest classified as available for sale, if it meets either of the following conditions:

- a. There is a significant difference between contractual cash flows and expected cash flows at the date of recognition.
- b. The beneficial interests meet the definition of purchased financial assets with credit deterioration.

Beneficial interests subject to ASC 325-40 are considered to be PCD if they meet the definition of PCD assets or if they have a significant difference between expected cash flows and “contractual” cash flows as of the acquisition date. At the June 12, 2017 Transition Resource Group meeting (TRG Memo 2: Scope of PCD Assets for Beneficial Interests), the TRG discussed how “contractual cash flows” should be determined for the purposes of applying the PCD guidance. How the term “contractual cash flows” is defined impacts initial and subsequent measurement of beneficial interests that are PCD. Contractual cash flows used for initial measurement determine whether the beneficial interest is accounted for as a PCD asset and the amount of the day 1 allowance if the beneficial interest is a PCD asset. It is also used to determine the accretable yield for beneficial interests that are treated as PCD.

When determining the contractual cash flows of the beneficial interest in the PCD determination, an entity should first look to the stated contractual terms of the asset or the stated contractual terms of the underlying assets if the beneficial interest does not have stated terms (e.g., residual interests). Contractual cash flows should be computed considering expected prepayments at the date of recognition and assuming no credit losses. Under this approach, estimated prepayments would not impact the determination of whether the beneficial interest is considered to be PCD and also limits the

day 1 allowance to cash flows not expected to be received solely due to credit losses. Consistent with the beneficial interest model, changes in expected cash flows, whether due to credit, prepayment, or other factors may impact the allowance and/or the accretable yield in subsequent periods.

Question LI 14-1 addresses what is considered a significant difference between contractual and expected cash flows.

Question LI 14-1

What is considered a significant difference between contractual cash flows and expected cash flows at the date of recognition?

PwC response

ASC 326 does not define what is considered a significant difference between contractual and expected cash flows at the date of recognition. Therefore, judgment is required. The FASB has stated that most residual tranches in securitizations (e.g., the subordinated note in a collateralized loan obligation securitization) could be considered to have a significant difference between contractual cash flows and expected cash flows at the date of initial recognition.

14.4 Initial recognition and measurement of non-PCD BIs

Typically, beneficial interests are acquired through: (1) transfer of financial assets to a special purpose entity with the transferor receiving a beneficial interest as a part of proceeds or (2) purchase in the marketplace. For both scenarios, ASC 860-20-30 would apply, and the initial investment would be recorded at the fair value of the beneficial interest.

14.4.1 Calculating the initial allowance: AFS beneficial interest

Generally, no allowance is recorded for non-PCD AFS beneficial interests within the scope of ASC 325-40 at initial recognition since generally they are initially recognized at fair value and the guidance in ASC 326-30-35-3 limits the allowance to the amount that fair value is less than the amortized cost basis.

14.4.2 Calculating initial accretable yield—trading, AFS and HTM

ASC 325-40 requires the calculation of the accretable yield, which is used in calculating interest income under the effective interest method and discounting future cash flows. The accretable yield is calculated based on expected cash flows and the initial investment of the beneficial interest.

Upon acquiring a beneficial interest subject to ASC 325-40, an entity is required to determine the excess of all cash flows expected to be collected over the interest's initial investment (generally the fair value of the beneficial interest as of the acquisition or transaction date). That excess (the accretable yield) is recognized as interest income over the life of the beneficial interest using the effective yield method. The accretable yield calculated at the acquisition date is subject to periodic reassessment, as discussed in LI 14.6.

ASC 325-40-30-2 and ASC 325-40-30-3 provide guidance on the calculation of the accretable yield.

ASC 325-40-30-2

For beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of *all cash flows expected to be collected* attributable to the beneficial interest estimated at the acquisition-transaction date (the transaction date) over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition-transaction date (the transaction date) over the amortized cost basis (the purchase price plus the initial allowance for credit losses).

ASC 325-40-30-3

At the transaction date, *all cash flows expected to be collected* means the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under Topic 860.

14.5 Initial recognition and measurement of AFS/HTM PCD BIs

ASC 325-40-35-7 requires an entity to use a present value of expected future cash flows to measure credit losses for a beneficial interest (BI). Therefore, reporting entities that hold held to maturity securities that are beneficial interests subject to ASC 325-40 should estimate expected credit losses using a discounted cash flow approach. This differs from the usual guidance under ASC 326 for HTM securities that are not beneficial interests subject to ASC 325-40. HTM securities that are not beneficial interests should apply the general CECL model, which provides a reporting entity with the flexibility to decide whether to use a discounted cash flow or another method to estimate to estimate expected credit losses.

If an entity has determined that the beneficial interest is considered to be PCD and they have calculated the initial allowance for credit losses, the beneficial interest is recorded with a balance sheet gross up whereby the allowance for credit losses is added to the purchase price to determine the initial amortized cost basis of the beneficial interest. Similar to other PCD assets, the initial allowance for credit losses does not have an impact on earnings.

14.5.1 PCD: Calculating initial accretable yield AFS and HTM

ASC 325-40 requires the calculation of the accretable yield that will be used in calculating interest income under the effective interest method and discounting future cash flows. The accretable yield is calculated based on expected cash flows and the carrying amount of the beneficial interest.

ASC 325-40-30-2 provides guidance on the calculation of the accretable yield for beneficial interests in purchased financial assets with credit deterioration.

ASC 325-40-30-2

For beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of *all cash flows expected to be collected* attributable to the beneficial interest estimated at the acquisition-transaction date (the transaction date) over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition-transaction date (the transaction date) over the amortized cost basis (the purchase price plus the initial allowance for credit losses).

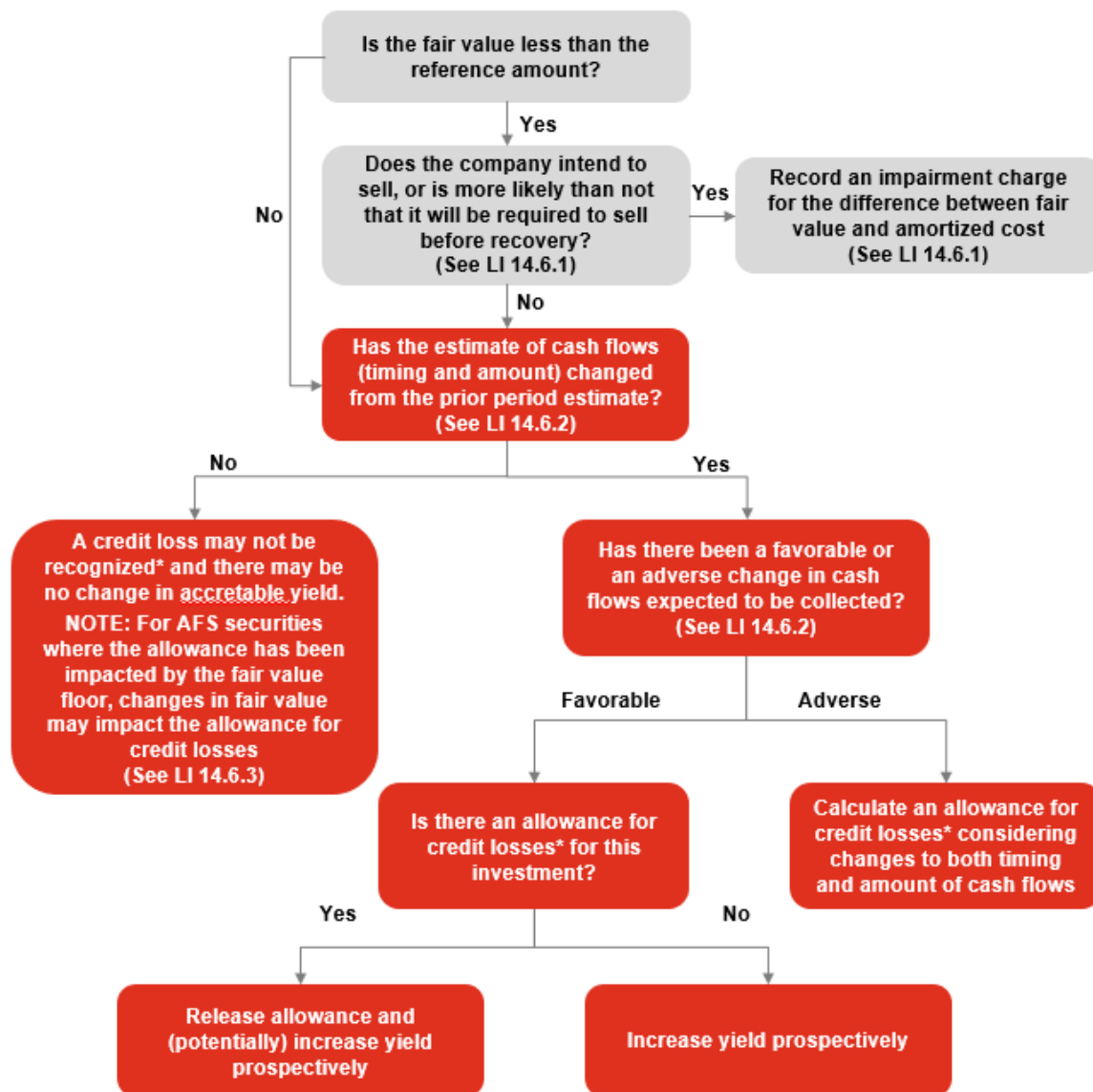
For acquired beneficial interests subject to ASC 325-40 that are determined to be PCD, an entity is required to determine the excess of all cash flows expected to be collected over the amortized cost basis (i.e., the purchase price plus the initial allowance for credit losses as of the acquisition (transaction) date). Any difference between the “contractual cash flows” and the initial amortized cost basis is considered to be accretable yield and will be accreted/amortized into interest income using the interest method. Refer to LI 14.3.2 for further details on how to calculate “contractual cash flows.” Similar to non-PCD assets, the accretable yield calculated at the acquisition date for PCD beneficial interests is subject to periodic reassessment, as described in LI 14.6.

14.6 Subsequent measurement of beneficial interests

Figure LI 14-2 provides a high-level summary of the subsequent measurement model for HTM and AFS securities subject to ASC 325-40.

Figure LI 14-2

ASC 325-40: High level summary of subsequent measurement



■ This aspect of the ASC 325-40 model applies to both AFS and HTM securities

■ This aspect of the ASC 325-40 model only applies to AFS securities

* For AFS securities, the allowance is limited by the fair value floor. As a result, changes in fair value may also impact the allowance for credit losses. In instances where the fair value is greater than the reference amount, the allowance would be zero. See LI 14.6.3

14.6.1 ***AFS beneficial interest: Intent to sell/required to sell***

When a beneficial interest classified as available for sale is impaired (i.e., fair value is below the reference amount), the reporting entity should determine whether it has the intention to sell the security, or will more likely than not be required to sell the security before recovery of its amortized cost basis. If it is determined that an entity intends to sell, or more likely than not will be required to sell an AFS beneficial interest before recovery, the reporting entity should record the entire impairment loss in net income as a direct write-down of the amortized cost basis (see LI 8.2.3).

ASC 326-30-35-10 provides guidance on impairments of AFS securities if an entity intends to sell, or more likely than not will be required to sell a security before recovery of its amortized cost basis.

ASC 326-30-35-10

If an entity intends to sell the debt security (that is, it has decided to sell the security), or more likely than not will be required to sell the security before recovery of its amortized cost basis, any allowance for credit losses shall be written off and the amortized cost basis shall be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings. If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs). In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, the entity shall consider the factors in paragraphs 326-30-55-1 through 55-2.

14.6.2 ***Changes in expected cash flows: AFS/HTM beneficial interests***

A reporting entity should recognize accretable yield as interest income over the life of the beneficial interest for both PCD and non-PCD beneficial interests using the effective interest method. ASC 325-40 requires a reporting entity to periodically assess whether there have been favorable or adverse changes in either the timing or amount of cash flows expected to be collected regardless of whether the beneficial interest is classified as available for sale or held to maturity. Changes in expected cash flows may impact the allowance for credit losses, require the yield on the instrument to be updated, or both. The updated yield should be applied prospectively to the recognition of interest income and also applied as the discount rate when performing the net present value calculation.

ASC 325-40-35-5 through ASC 325-40-35-6 provide guidance on determining whether there has been a favorable (or an adverse) change in cash flows expected to be collected.

ASC 325-40-35-5

Determining whether there has been a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected (taking into consideration both the timing and amount of the cash flows expected to be collected) involves comparing the present value of the remaining cash flows expected to be collected at the initial transaction date (or at the last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date.

ASC 325-40-35-6

The cash flows, including the assessment of expected credit losses, shall be discounted at a rate equal to the current yield used to accrete the beneficial interest.

ASC 325-40-35-4 provides guidance on accounting for changes in cash flows for beneficial interests classified as HTM within its scope and ASC 325-40-35-4A provides guidance for beneficial interests classified as AFS.

ASC 325-40-35-4

If upon evaluation of a held-to-maturity classified beneficial interest there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the investor shall first apply the guidance in Subtopic 326-20 on financial instruments measured at amortized cost to account for that favorable (or adverse) change. After application of the guidance in Subtopic 326-20, if the amount of the favorable (or adverse) change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses in accordance with Subtopic 326-20, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.

ASC 325-40-35-4A

If upon evaluation of an available-for-sale classified beneficial interest there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the investor shall apply the guidance in Subtopic 326-30 on measuring credit losses on available-for-sale debt securities to account for that favorable (or adverse) change. After application of the guidance in Subtopic 326-30, if the amount of the favorable (or adverse) change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses in accordance with Subtopic 326-30, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.

ASC 325-40-35-4B

The reference amount in paragraphs 325-40-35-4 through 35-4A is equal to the initial investment (or initial amortized cost basis for beneficial interests that apply the accounting for purchased financial assets with credit deterioration) minus cash received to date minus writeoff of amortized cost basis plus the yield accreted to date.

To determine whether there has been a change in expected cash flows, a reporting entity should compare the present value of the remaining expected cash flows as of the reporting date to the present value of expected cash flows at either the initial acquisition (or transaction) date or the last date on which the calculation was performed (e.g., previous reporting date). When performing the present value calculation, all cash flows should be discounted at the beneficial interest's current accretable yield (i.e., effective interest rate). A reporting entity should use the same date for the purposes of discounting.

The applicable expected credit loss guidance will depend on whether the beneficial interest is categorized as held to maturity or available for sale. The CECL impairment model should be applied to

HTM beneficial interests (see LI 7) and the AFS impairment model should be applied to AFS beneficial interests (see LI 8).

Generally, when there is a change in expected cash flows, a reporting entity should first calculate an adjustment to the allowance for credit losses (or recognize an allowance for credit losses) pursuant to ASC 326-20 for beneficial interests classified as HTM or ASC 326-30 for beneficial interests classified as AFS. However, ASC 325-40 provides some specific rules in applying ASC 326-20 and ASC 326-30. ASC 325-40 requires changes in either the timing or amount of cash flows to be reflected as an adjustment to the allowance for credit losses in applying ASC 326-20 and ASC 326-30. In addition, when applying ASC 326-20 to a security subject to ASC 325-40, the use of a discounted cash flow method is required.

If the amount of the favorable (or adverse) change in cash flows is not fully captured as an adjustment to the allowance for credit losses, ASC 325-40 requires such change to be reflected through an adjustment of the accretable yield. This may occur in a number of situations, such as when there is favorable change in cash flows and the security does not have an allowance for credit losses. It may also occur with beneficial interests classified as AFS as a result of the application of the “fair value floor” in ASC 326-30. The application of the “fair value floor” may also result in the need for a reporting entity to adjust the allowance for credit losses and accretable yield even when the cash flows expected to be collected have not changed.

Example LI 14-1 illustrates a situation when there has been an adverse change in cash flow due solely to a change in the timing of cash flows.

EXAMPLE LI 14-1

Adverse change – gross cash unchanged but timing is unfavorable

Transferor Corp owns a beneficial interest subject to the guidance in ASC 325-40. At the end of 20X1, Transferor Corp updates its cash flow estimates as shown in the following table. The updated estimate considers both the amounts expected to be collected in future periods and the timing of their receipt. Transferor Corp uses a discount rate of 15% in its evaluation, as this was the internal rate of return (accretable yield) used to recognize interest income on the beneficial interest during 20X1.

	20X1	20X2	20X3	20X4	20X5	Gross cash	NPV at 15%
Original estimate	\$25	\$20	\$20	\$30	\$0	\$95	
Present value	\$21.74	\$15.12	\$13.15	\$17.15			\$67.16
Revision at end of 20X1	\$25	\$15	\$15	\$20	\$20	\$95	
Present value	\$21.74	\$11.34	\$9.86	\$11.44	\$9.94		\$64.32

Has an adverse or favorable change occurred in the expected cash flows?

Analysis

The gross amount of cash flows expected to be received remains unchanged from the original estimate. However, the revised estimate indicates that there has been extension in the timing of the projected receipts. As a result, the NPV of the revised cash flow estimate (\$64.32) is less than the original estimate (\$67.16), which is an adverse change.

For HTM securities, this adverse change in cash flows would lead to the recognition of an allowance for credit losses (or an increase in the allowance for credit losses).

For AFS securities, if the fair value of the beneficial interest is greater than or equal to its reference amount, the change (decrease) in yield would be recognized prospectively. This is because an AFS security is not considered impaired unless its fair value is below its reference amount. However, if the fair value of the beneficial interest is less than its reference amount, an allowance for credit losses would be recognized, but may be limited by the fair value floor.

Example LI 14-2 illustrates a situation when there has been a favorable change in cash flows.

EXAMPLE LI 14-2

Favorable change – gross cash increase

Transferor Corp owns a beneficial interest subject to the guidance in ASC 325-40. At the end of 20X1, Transferor Corp updates its cash flow estimates as shown in the following table. The updated estimate considers both the amounts expected to be collected in future periods and the timing of their receipt. Transferor Corp uses a discount rate of 15% in its evaluation, as this was the internal rate of return (accretable yield) used to recognize interest income on the beneficial interest during 20X1.

	20X1	20X2	20X3	20X4	20X5	Gross cash	NPV at 15%
Original estimate	\$25	\$25	\$25	\$25	\$5	\$105	
Present value	\$21.74	\$18.90	\$16.44	\$14.29	\$2.49		\$73.86
Revision at end of 20X1	\$30	\$25	\$25	\$25	\$5	\$110	
Present value	\$26.09	\$18.90	\$16.44	\$14.29	\$2.49		\$78.21

Has an adverse or favorable change occurred in the expected cash flows?

Analysis

The timing and amounts of cash flows expected to be received subsequent to 20X1 remains unchanged from the original estimate. However, cash received in 20X1 was \$5 more than anticipated. As a result, the NPV of the revised cash flow estimate (\$78.21) is greater than the original estimate (\$73.86). The change (increase) in yield would be recognized prospectively assuming there is no existing allowance for credit losses (applicable to both AFS and HTM beneficial interests). If there were an existing

allowance for credit losses, this increase in cash flows would first be reflected through a reduction of the allowance for credit losses and then, if applicable, a prospective yield adjustment.

14.6.3 AFS beneficial interests: fair value floor

As discussed in LI 8, the allowance for credit losses may be limited by the “fair value floor” contained in the available-for-sale debt security impairment model. The allowance for credit losses on an AFS debt security is limited to the excess of the reference amount above fair value. For scenarios in which the allowance for credit losses is limited (i.e., the decline in expected cash flows is not fully captured as part of the allowance for credit losses), a reporting entity should adjust accretable yield and apply the new effective interest rate prospectively.

In these situations, it is our understanding that the FASB’s intent was to not have the adverse change in cash flows “double counted” through the allowance for credit losses and a prospective yield adjustment. One method that could be used in calculating an updated prospective yield would be to calculate an updated yield as the excess of expected cash flows over the beneficial interest’s reference amount less the allowance for credit losses. However, absent further standard setting efforts by the FASB, other methods for adjusting yield may be appropriate.

The updated yield should be applied prospectively to the recognition of interest income and also applied as the discount rate when performing the net present value calculation in the next period. A reporting entity should recognize future interest income based on the yield of the instrument applied to the amortized cost basis of the instrument (which does not include the allowance for credit losses).

The “fair value floor” contained in the AFS debt security impairment model may also impact how an entity calculates write offs. For example, if a reporting entity deems an originally expected cash flow (or a portion thereof) uncollectible, it would write off a portion of the allowance. However, the application of the fair value floor may result in situations when the entire impact of an uncollectible cash flow is not captured in the allowance. There may be various methods that are appropriate to calculate the write off of a portion of the allowance for credit losses limited by the “fair value floor.”

Example LI 14-3 illustrates the accounting for a beneficial interest classified as AFS.

EXAMPLE LI 14-3

Non-PCD beneficial interest classified as AFS

On 1/1/20X1, Bank Corp. purchases a beneficial interest for \$110,000. Bank Corp. determines that the beneficial interest will be classified as available for sale, it is not deemed to be PCD, and is subject to ASC 325-40. Bank Corp. projects the expected cash flows of the beneficial interest through its expected life. At the date of acquisition, Bank Corp. determines the effective yield is 17.95%, which equals the market rate of return. Note that for the purposes of this example, certain amounts have been rounded.

Period	Expected cash flows
1/1/20X1	(\$110,000)
12/31/20X1	\$30,000
12/31/20X2	\$50,000
12/31/20X3	\$40,000
12/31/20X4	\$30,000
12/31/20X5	\$20,000
Effective yield	17.95%

Bank Corp. would record the following entry at acquisition:

Dr. AFS Investment – BI	\$110,000
Cr. Cash	\$110,000

At the end of the first reporting period (12/31/20X1), Bank Corp. receives \$30,000 as expected at acquisition and updates its expectation of future cash flows. Bank Corp. projects an adverse change (i.e., a shortfall) in expected cash flows compared to the expected cash flows at acquisition in periods 2, 3, and 5. However, due to a decline in interest rates, the market rate of return for the security has declined to 16%. As a result of the decline in expected cash flows, Bank Corp. determines the present value of the revised expected cash flows discounted at the beneficial interest yield (17.95%) would result in allowance for credit losses of \$14,009. However, since the beneficial interest is an available-for-sale security, the allowance is limited to the fair value amount below the carrying amount (\$11,158). In other words, the allowance is limited by the fair value floor.

12/31/20X1

	Beginning reference amount	Interest Income	Cash received	Ending reference amount		
	\$110,000	\$19,750	\$30,000	\$99,750		
Period	Revised expected cash flows	Original expected cash flows	Change in expected cash flows	NPV of revised expected cash flows discounted at market rate (fair value)	NPV of revised expected cash flows discounted at EIR	
12/31/20X2	\$45,000	\$50,000	(\$5,000)	\$38,793	\$38,150	
12/31/20X3	\$30,000	\$40,000	(\$10,000)	\$22,295	\$21,562	
12/31/20X4	\$30,000	\$30,000	\$0	\$19,220	\$18,280	
12/31/20X5	\$15,000	\$20,000	(\$5,000)	\$8,284	\$7,749	
Market yield	16.00%		Total	\$88,592	\$85,741	

Bank Corp. would calculate the allowance for credit losses as follows:

Present value of expected cash flows

Reference amount	\$99,750
NPV of expected cash flows at EIR	\$85,741
Allowance (pre FV “floor”)	\$14,009

Calculation of “fair value floor”

Reference amount	\$99,750
Fair value	\$88,592
Fair value floor	\$11,158

Bank Corp. would record the following entries at 12/31/20X1:

Dr. Cash	\$30,000	
Cr. Interest Income		\$19,750
Cr. AFS Investment - BI		\$10,250

To record the cash received and interest income

Dr. Credit Loss Expense	\$11,158	
Cr. Allowance for Credit Losses - AFS		\$11,158

To record the allowance for credit losses

Since the decline in expected cash flows was not fully captured as part of the allowance for credit losses, Bank Corp. determines a new effective yield based on the revised future expected cash flows and the reference amount, net of the allowance for credit losses. Bank Corp. determines a new effective yield of 16%, which should be applied prospectively. Since the net carrying amount of the security (reference amount/amortized cost basis of \$99,750 less the allowance for credit losses of \$11,158) equals the fair value of the security (\$88,592), the security is on the balance sheet at fair value and as such there are no amounts reported in AOCI.

Updated accretable yield calculation

Reference amount, net of allowance for credit losses	Period	Original expected cash flow	Shortfall in cash flow	Expected cash flows
\$88,592				
	12/31/20X2	\$50,000	(\$5,000)	\$45,000
	12/31/20X3	\$40,000	(\$10,000)	\$30,000
	12/31/20X4	\$30,000	\$0	\$30,000
	12/31/20X5	\$20,000	(\$5,000)	\$15,000
		Updated accretable yield		16.00%

At the end of the second reporting period (12/31/20X2), Bank Corp. receives \$45,000. However, this is an adverse change (i.e., a shortfall) of \$5,000 as compared to the original expected cash flow of \$50,000 at acquisition. Bank Corp. determines this amount is uncollectible and records a write-off of \$4,030, which is less than the \$5,000 shortfall that was deemed uncollectible. This is because the allowance for credit losses (which included the \$5,000 shortfall) was limited by the “fair value floor.” Bank Corp. applied a reasonable and rational method of allocating the impact of the “fair value floor” to expected cash shortfalls. The method that Bank Corp. used was based upon a pro-rata allocation to periods with a shortfall in cash flows after considering the impact of discounting and time value of money.

Bank Corp. updates its expectation of future cash flows and determines that its estimated cash flows have not changed from its previous estimate. Bank Corp. determines the allowance for credit losses of \$8,913 by taking the excess of the reference amount (subsequent to the \$4,030 write-off) over the net present value of the revised expected cash flows, discounted at the updated effective yield of 16%. Since the changes in cash flows were fully captured in the allowance for credit losses, Bank Corp. determines that a prospective yield adjustment is not necessary.

12/31/20X2

Beginning reference amount	Beginning allowance for credit losses	Reference amount, net of allowance for credit losses	Interest Income	Cash received	Write off	Ending reference amount
\$99,750	\$11,158	\$88,592	\$15,960	\$45,000	\$4,030	\$66,680
Period	Revised expected cash flows	Original expected cash flows	Shortfall	NPV of revised expected cash flows discounted at market rate (fair value)	NPV of revised expected cash flows discounted at EIR	
12/31/20X3	\$30,000	\$40,000	(\$10,000)	\$25,862	\$25,862	
12/31/20X4	\$30,000	\$30,000	\$0	\$22,295	\$22,295	
12/31/20X5	\$15,000	\$20,000	(\$5,000)	\$9,610	\$9,610	
Market yield	16.00%		Total	\$57,767	\$57,767	

Bank Corp. would calculate the allowance for credit losses as follows:

Present value of expected cash flows

Reference amount	\$66,680
NPV of expected cash flows at EIR	\$57,767
Allowance (pre FV "floor")	\$8,914

Calculation of "fair value floor"

Reference amount	\$66,680
Fair value	\$57,767
Fair value floor	\$8,914

Allowance 12/31/X1	\$11,158
Write off	(\$4,030)
Current period credit loss expense	\$1,785
Allowance 12/31/X2	\$8,914

Bank Corp. would record the following entries at 12/31/20X2:

Dr. Allowance for Credit Losses - AFS	\$4,030	
Cr. AFS Investment - BI		\$4,030

To record the write-off of \$4,030 which is a portion of the cash flows deemed uncollectible

Dr. Cash	\$45,000	
Cr. Interest Income		\$15,960
Cr. AFS Investment - BI		\$29,040

To record the cash received and interest income

Dr. Credit Loss Expense	\$1,785	
Cr. Allowance for Credit Losses – AFS		\$1,785

To record additional credit loss expense (driven by passage of time). The calculation of credit loss expense is illustrated above as the change in the allowance for credit losses after the adjustment for write-offs.

Since the net carrying amount of the security (comprised of the reference amount/amortized cost basis of \$66,680 less the allowance for credit losses of \$8,914) equals the fair value of the security (\$57,767), the security is on the balance sheet at fair value and as such there are no amounts reported in AOCI.

14.6.4 Change in expected cash flows: Trading beneficial interest

The requirement to periodically assess whether there has been a favorable or adverse change in expected cash flows and to record interest income is not limited to beneficial interests classified as available for sale or held to maturity, it applies to beneficial interests recorded at fair value with changes in fair value recognized in income if an entity separately presents interest income.

Question LI 14-2 addresses the application of ASC 325-40 to instruments carried at fair value with changes in fair value reported in current earnings.

Question LI 14-2

How should interest income be calculated for beneficial interests within the scope of ASC 325-40 that are measured at fair value with changes in fair value recorded in current earnings?

PwC response

At the November 1, 2018 TRG meeting (TRG Memo 14: Cover Memo and TRG Memo 18: Summary of Issues Discussed and Next Steps), the FASB staff noted that the guidance in ASC 325-40 applies to beneficial interests measured at fair value with changes in fair value recorded in current earnings for the purposes of interest income recognition. The FASB staff noted that they believe that entities will need to apply reasonable judgment to determine the amount of accretable yield for beneficial interests measured at fair value with changes in fair value recorded in current earnings.

We believe that either of the following methods is appropriate for recognizing interest income on beneficial interests in the scope of ASC 325-40 that are measured at fair value with changes in fair value recorded in current earnings:

- Reflect all changes in estimated cash flows as a prospective yield adjustment. However, there are additional considerations if this would result in a negative yield.
- Maintain a “shadow allowance for credit losses” solely for the purposes of calculating interest income. The “shadow allowance” used for determining accretable yield would be calculated in accordance with the amended applicable guidance for AFS beneficial interests in ASC 325-40-35-4A (see LI 14.6.2). In summary, subsequent declines in expected cash flows may not create yield adjustments and subsequent improvements in cash flows would first reduce the “shadow allowance” before a prospective yield adjustment. Note that the “shadow allowance” is an operational account for the purposes of determining and calculating accretable yield and would not be recorded in an entity’s financial statements.

Question LI 14-3 discusses whether a reporting entity should apply PCD accounting to a beneficial interest recognized at fair value with changes in fair value recorded in current earnings when it elects to maintain a shadow allowance for the purposes of calculating interest income.

Question LI 14-3

If a reporting entity maintains a shadow allowance for the purpose of recognizing interest income on a beneficial interest in scope of ASC 325-40 that is measured at fair value with changes in fair value recorded in earnings, should the reporting entity apply PCD accounting?

PwC response

No. Although the beneficial interest may have been considered PCD if it was classified as AFS or HTM, we do not believe a reporting entity should apply PCD accounting to a beneficial interest that will be measured at fair value with changes in fair value reported in current earnings.

14.6.5 Changes in expected cash flows: Plain-vanilla BIs

ASC 325-40-35-9 provides some relief from the credit loss impairment requirements for “plain-vanilla” beneficial interest subject to ASC 325-40.

ASC 325-40-35-9

However, unless the guidance in Topic 326 indicates that a credit loss has occurred, changes in the interest rate of a plain-vanilla, variable-rate beneficial interest generally should not result in the recognition and measurement of a credit loss (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).

For “plain-vanilla” variable-rate beneficial interests, a reporting entity would not record an allowance for credit losses based on applying the guidance in ASC 325-40-35-4 if it concludes that:

- the adverse change in cash flows on the beneficial interest is solely due to changes in interest rates,

- there are no adverse changes related to credit or the timing of cash flows,
- it still expects to receive all contractual payments of principal and interest when due, and
- it has the ability and intent to hold the beneficial interest; that is, it does not intend to sell the investment, and it is not more likely than not that it will be required to sell the beneficial interest before it recovers its investment.

The determination of what would be considered a “plain-vanilla” variable rate beneficial interest requires judgement.

14.6.6 *Nonaccrual status of beneficial interests*

The guidance on determining when a beneficial interest should be placed on nonaccrual status is consistent for both non-PCD and PCD beneficial interests. Beneficial interests within the scope of ASC 325-40 are required to use the cost recovery method when designated as nonaccrual, as stated in ASC 325-40-35-16. These beneficial interests are placed on nonaccrual status when an entity can no longer reliably estimate cash flows. See LI 6 for information on the cost recovery method.

> Nonaccrual Status-Cash Flows Not Reliably Estimable

ASC 325-40-35-16 This Subtopic does not address when a holder of a beneficial interest would place that interest on nonaccrual status or when a holder cannot reliably estimate cash flows. However, for beneficial interests placed on nonaccrual status or when a holder cannot reliably estimate cash flows, the cost recovery method shall be used

14.6.7 *Writeoffs of beneficial interests*

Consistent with the guidance in ASC 326-20-35-8 for HTM securities and ASC 326-30-35-13 for AFS securities, write offs of beneficial interests, which may be full or partial write offs, are recorded in the period in which such amounts are deemed uncollectible.