FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO

Memo No. **8**

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Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post-Issuance**
Issue	**Capitalized Interest**

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Memo Purpose

1. The purpose of this memo is to address a question raised by stakeholders on the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The memo includes:

   (a) Background information on the treatment of premiums and discounts when measuring the expected credit loss as required in Subtopic 326-20. In addition, the staff will discuss the intent of the guidance in paragraph 326-20-30-5 with the objective of clarifying that multiple approaches may be applied when calculating the allowance for credit losses using a method other than a discounted cash flow (DCF) method.

   (b) The staff's analysis addressing stakeholders' question about how capitalized interest should be considered when estimating the expected credit loss using a method other than a discounted cash flow method.

2. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG) on the implementation question about capitalized interest.

Question for TRG Members
1. Does the TRG have feedback on the staff's interpretation of the issues in this memo?

Background—Components of Amortized Cost Basis

3. Certain stakeholders have identified a particular area of Subtopic 326-20 that has raised differing opinions on the application of the guidance. The differing opinions directly affect *both* stakeholders' understanding of capitalized interest, and, more importantly, the overall application of the standard when calculating the expected credit loss using a method other than a DCF method.

4. To address stakeholders' questions on capitalized interest, the staff believes it is important to provide TRG members with an overview of the expected credit loss guidance in Subtopic 326-20**,** specifically the inclusion of premiums and discounts when calculating the allowance for credit losses when using a method other than the DCF method. The staff believes it is important to provide an overview because the staff would like to clarify the intent of paragraph 326-20-30-5, which allows entities to calculate the allowance for credit losses by following a method other than the DCF method. The staff understands that certain stakeholders currently have opposing views of what paragraph 326-20-30-5 is intended to address.

5. Paragraph 326-20-30-1 states that the allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. Because the amortized cost basis of the asset(s) is the starting point for calculating the allowance, the Board considered how each of the components of amortized cost would be assessed for expected credit losses. These components are outlined in the Master Glossary definition of *amortized cost basis,* as follows:

> 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.

6. When calculating the allowance for credit losses using a DCF method, all components of the amortized cost basis are inherently considered because the allowance reflects the difference between the amortized cost basis and the present value of expected cash flows.

7. When using a method other than a DCF method, the guidance directs preparers to paragraph 326-20-30-5 when estimating the expected credit loss, which states:

> **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 both of the following:
>
> a. Amortized cost basis, excluding 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.

8. Certain stakeholders provided the staff with feedback on paragraph 326-20-30-5, as follows:

   (a) Stakeholders highlighted in paragraph 326-20-30-5 what appears to be a conflict between the sentence containing the phrase "…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*" and the sentence containing the phrase "…when an entity expects to accrete a discount into interest income, the discount *should not offset the entity's expectation of credit losses*" (emphasis added).

   (b) Certain stakeholders stated that they interpret the phrase "…when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses" to mean that preparers must estimate the timing of the loss in order to apply the discount/premium guidance when measuring the allowance for the separate amortized cost components, even when using a non-DCF method, such as a loss rate method. Therefore, entities applying a non-DCF method believe they would be *precluded* from applying the expected credit loss guidance in a manner that results in an allowance that increases (or decreases) over time as the amortized cost basis increases (or decreases).

9. In the staff's view, the interpretation described in paragraph 8(b) above by certain stakeholders not only has a direct effect on application of the overall model but is perhaps the basis used by those stakeholders who believe entities must consider future capitalized interest when estimating the expected credit loss. Those stakeholders view capitalized interest to be akin to the discount on a discounted financial asset or a zero-coupon bond. Those stakeholders are making this analogy because they believe that if a default were to occur, it would take place after interest has been capitalized on the loan, which is likely to occur in a future period after any accrued interest has been capitalized. Therefore, they believe capitalized interest is similar to a discount.

10. Consequently, the staff believes that if an entity combines its analogy that accrued interest is similar to a discount with the interpretation that paragraph 326-20-30-5 precludes an entity from recording an allowance for credit losses that increases (or decreases), then the allowance calculation would result in requiring entities to estimate expected credit losses for the financial asset based on the asset's future amount if the entity expects to fully accrete (or amortize) the discount (or premium) of a financial asset. Therefore, by extension, if an entity expected that in a future period that it would capitalize any outstanding accrued interest and that amount would subsequently be used to determine repayment because capitalized interest is similar to the discount on financial assets, the entity is required to consider the balance of the financial asset that includes expected capitalized interest and base the allowance on that amount. The staff can see how a particular stakeholder could reach the conclusion that the allowance for credit losses must be determined on the future financial asset amount for which the full allowance for credit losses is recorded on day 1, because of a particular view on discounts (and premiums) and the literal interpretation of paragraph 326-20-30-5. However, the staff believes that (a) the interpretation of paragraph 326-20-30-5 is inappropriate for reasons discussed in paragraphs 11 through 12 and (2) the analogy of accrued interest to a discount also is inappropriate for reasons stated in paragraph 22.

11. The staff believes that particular stakeholders' interpretation of paragraph 326-20-30-5 as expressed in paragraph 8(b) above is an inappropriate application of the Board's intentions for the following reasons:

    (a) It was noted during deliberations that a non-DCF method implicitly considers timing of writeoffs because the amount written off, which is captured in the numerator of the loss rate calculation, will reflect the unamortized premium or unaccreted discount at the time of the writeoff. Therefore, the application cannot avoid timing considerations. For example, for financial assets at a premium that only experience writeoffs at maturity, the application would not have any expected credit losses in its loss rate relating to the premium element because at the time of the writeoff, there no longer is any unamortized premium remaining to be written off against the allowance. The Board's deliberations placed weight on the fact that a DCF approach using the effective interest rate was and continues to be widely supported as an appropriate method to estimate credit losses and that approach utilizes the effective interest rate that incorporates premiums and discounts and references the amortized cost basis in determining the amount of the allowance. The Board's decision utilizes those same considerations in the loss rate application.

    (b) The guidance in paragraph 326-20-30-5 that states "…when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses" was intended to prohibit entities from waiting until the discount is fully or partially

accreted to earnings prior to recognizing a loss. The phrase was not intended to force entities to project the amortized cost basis when applying a non-DCF method.

(c) In review of Board meetings that took place during deliberations, the Board acknowledged the flexibility in measuring credit losses by permitting multiple loss estimation techniques. However, the Board decided the starting point (that is, the balance sheet amount) on which the allowance for credit losses is calculated is the same regardless of the loss estimation technique that is applied (that is, an entity should apply a loss rate computed by a non-DCF method to a current balance sheet amount). The Board's intention to provide entities with flexibility in calculating the allowance for credit losses when not following a DCF method is reflected in the following areas of ASU 2016-13:

(i) Example 1 in Subtopic 326-20 (paragraphs 326-20-55-18 through 55-22) illustrates how an entity may choose to use historical data adjusted for reasonable and supportable forecasts when calculating the allowance for credit losses. In Example 1, the adjusted historical loss rate is applied to the amortized cost basis *as of the reporting date*, which reflects a point-in-time estimate of expected losses.

(ii) Paragraph BC60 in Update 2016-13 highlights the multiple ways that the allowance for credit losses can be calculated when following a non-DCF method. BC60 states:

> Separately, use of amortized cost also can be reflected in a loss-rate approach that has a par amount in the denominator as long as that loss rate is then applied against the par amount of the financial asset. There are two key considerations. First, the numerator should consider the expected credit loss of the amortized cost basis of the financial asset. Second, the basis in the denominator (amortized cost or par amount) and the basis of the financial asset to which the loss rate is applied (amortized cost or par amount) are the same.

While a combined loss rate (that is, a loss rate based on amortized cost) should reflect losses on the total amortized cost basis of an asset in the numerator, the basis in the denominator should be the amortized cost so long as the loss rate is similarly applied to the current amortized cost basis. Alternatively, if an entity decides to calculate the allowance for credit losses by separately measuring the components of the amortized cost basis, the loss rate should (a) reflect losses on the total par amount of the asset in the numerator with the basis in the denominator as the par amount applying that loss rate to the current par amount and (b) reflect losses on the total premium or discount of the financial asset in the numerator with the basis in the denominator as the premium or discount of the financial asset applying that loss rate to the current premium or discount. Consequently, the staff notes that there are multiple ways to determine loss rates and the ultimate allowance for credit losses. Moreover, some of these methods could result in an allowance that increases or decreases over time, depending

on the discount or premium of the financial asset, and that non-DCF methods in many cases will not produce an allowance equal to that which would result from using a DCF method.

(d) Finally, the option provided in paragraph 326-20-30-5 that allows entities to perform the allowance calculation separately for the unpaid principal balance and all the remaining components of amortized cost basis is not meant to provide an alternative to the overall methodology for non-DCF methods, but rather to minimize disruption to the processes entities currently use to measure credit losses.

12. In summary, based on the staff's research of previous deliberations and the Board's previous decisions, the staff believes that when using a non-DCF method to calculate the allowance for credit losses that an entity should measure expected losses on the amortized cost basis *as of the reporting date or by separately measuring the components of the amortized cost basis that include the unpaid principal balance and the premium or discount as of the reporting date (assuming there are no other components of amortized cost basis to be included*). This can be accomplished in a number of ways because the Board did not prescribe a single method or approach to apply when measuring the allowance for credit losses when following a non-DCF method. Consequently, the staff does not think entities are precluded from applying the expected credit loss guidance in a manner that results in an allowance that increases (or decreases) over time as the amortized cost basis increases (or decreases) when using a non-DCF methodology, such as loss rates. The only exception to the principle in paragraph 326-20-30-5 is that the basis on which the allowance for credit losses is calculated must be the amount recorded on the balance sheet (or a component of the balance sheet amount) at the reporting date—that is, an entity should not apply a loss rate to a balance that does not exist or has not yet been recorded on the balance sheet as of the reporting date. The staff acknowledges that if an entity calculates the allowance for credit losses by separating the components of the amortized cost basis, there may be scenarios in which the computed allowance represents only an allowance on the par amount because the entity expects to fully accrete (or amortize) a discount (or premium). Said differently, an entity could develop a loss rate for the par amount component and a separate loss rate for the discount/premium amount. If the entity did not expect a loss on the discount or premium because the loss that may occur would be at maturity, then in that scenario the allowance for credit losses would reflect only an allowance for the par component with no offset. To illustrate the staff view, see Appendix A.

Issue Description

13. As noted above, certain stakeholders have asked the staff through submission of an issues paper to the TRG (the submission) how entities should consider interest amounts that *will be earned* when estimating the expected credit losses, when following a method other than the DCF method.

14. For context, the submission provided an example to articulate their views. Entity A underwrites a loan that requires interest to be paid only at the end of the contractual term of four years. The par/principal

amount is $60 and interest that will be due at the end of 4 years is $40. At the end of Year 4, the $40 will be capitalized into the principal balance of the loan. Entity A does not apply nonaccrual policies. Entity A determined its historical loss given default, based on the amortized cost at the date of writeoff (not the initial amortized cost), is 40 percent and the probability of default is 5 percent. Entity A projects that defaults (if any) would occur at the end of the contractual term.

15. The submission considered the following views when determining if unearned accrued interest should be considered when applying the expected credit loss guidance:

    (a) View A, Consider Expected Future Capitalized Interest—Under this view, an entity would develop an allowance for credit losses associated with the par/principal amount and the expected future capitalized interest. In the context of the example provided by stakeholders, Entity A would record an allowance at the date of origination based on the principal amount of $60 plus $40 of expected future capitalized interest. Therefore, the base amount used in calculating the expected credit loss would be $100.

    (b) View B, No Consideration of Expected Future Capitalizable Interest—Under this view, an entity would develop an allowance for credit losses without considering future expected capitalizable interest. In the context of the example provided by stakeholders, Entity A would record an allowance at the date of origination based on the principal amount of $60 and no expected accrued interest would be considered.

    (c) View C, Future Expected Capitalized Interest Would be Treated Like an Unfunded Loan Commitment—Under this view an entity would develop an allowance for credit losses on the principal amount of $60. Then an additional liability would be recorded to reflect the expected credit loss for the off-balance sheet credit exposure of $40.

Stakeholder Feedback

16. During outreach with financial statement preparers and auditors, the staff asked stakeholders if they would consider including unearned accrued interest when calculating the allowance for credit losses by following a method other than the discounted cash flow method.

17. Most stakeholders who participated in the outreach stated they supported View B because the definition of amortized cost basis indicates that the financing receivable should be adjusted for applicable accrued interest, which these stakeholders interpreted as accrued interest that has been earned as of the reporting date, not expected accrued interest. Because of this interpretation, entities who supported View B believe that the guidance is clear that unearned accrued interest could not be considered when measuring the allowance for credit losses in accordance with paragraph 326-20-30-5. In addition, stakeholders who supported View B, stated it would be inappropriate to record an allowance for credit losses on assets that do not exist at the reporting date.

18. Some stakeholders who participated in the outreach were proponents of View A. These stakeholders suggested that the unearned accrued interest is similar to the discount on a zero-coupon bond because the entity expects a default to occur when the loan begins repayment and any accrued interest would be capitalized to the loan's principal balance. Therefore, accrued interest is being analogized to a discount on a debt security.

19. One stakeholder who participated in the outreach indicated that this question would not have a particular effect on their entity but viewed unearned accrued interest as a loan commitment. This stakeholder stated the interest that accrues over the life of the loan is similar to a borrower drawing down on a loan commitment over a long duration.

Staff Analysis

20. To address the question raised by stakeholders, the staff considered each of the alternative views presented above.

View A—Consider Expected Future Capitalized Interest

21. Some stakeholders who participated in outreach noted that future capitalized interest should be treated similar to a discount on a debt security and, therefore, the discount amount (that is, the expected future capitalizable interest) should be added to the unpaid principal balance when computing the allowance for credit losses. One other stakeholder suggested that including expected future capitalizable interest in the calculation of the allowance for credit losses would provide decision-useful information because it highlights the entity's view of lifetime losses on a loan balance. Said differently, if the entity believes that a default would occur during the repayment period and not during a deferment period, then the allowance for credit losses should be calculated on the loan's balance during the repayment period.

22. The staff disagrees with View A for several reasons:

    (a) View A would record an allowance for credit losses on an asset that does not exist at the reporting date. This would result in an inconsistency between the balance sheet and income statement because on day one, the loan receivable is recorded at the amortized cost basis, which would be the unpaid principal balance as no interest has been accrued while the income statement will report an expense that is based on future expected cash flows. View A would front-load the allowance for credit losses before having an amortized cost basis instead of increasing the allowance overtime as the loan balance grows due to the accrual of interest. As mentioned in the discussion in paragraphs 3 through 12 above, the Board decided that the starting point for all expected credit losses is the same regardless of methodology and that starting point is the amortized cost basis at the reporting date.

(b) Stakeholders who supported View A were asked that if expected accrued interest is akin to a discount on a zero-coupon bond, should entities be required to calculate the allowance for credit losses on day one on the unpaid principal balance plus all expected future interest income for *all* loans? Stakeholders were unable to provide a response to this question and indicated this would be a consequence of View A. If the Board intended entities to consider future expected interest income when calculating the allowance, the staff believes the Board would have stated that only a discounted cash flow model could be used when calculating the allowance. The staff also believes this highlights the fact that unearned expected interest is fundamentally different from discounts and premiums.

(c) A *discount* is defined as the difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. In the context of the example provided above, the loan is issued to the borrower at par. That is, the net proceeds are equal to the amount that is repayable (the face value of the loan). The loan will accrue interest as time passes, which gets added to the face value of the loan and, therefore, the net proceeds and face value remain consistent over the term of the loan. Because the face value of the loan continues to increase (as interest accrues on the loan), the analogy to a discount appears inappropriate.

(d) The staff believes that the borrower is not obligated to repay the lender an amount greater than the outstanding principal plus any accrued interest to date, unlike a bond or debt security for which the issuing entity is obligated to pay the stated face value of the instrument at any point between the issuance date and maturity. Therefore, the comparison of a loan plus expected accrued interest to a debt security purchased at a discount appears to be inappropriate.

(e) The guidance in paragraph 326-20-30-5 does not indicate that entities should forecast or project the future amortized cost basis when calculating the allowance for credit losses when using a method other than a discount cash flow method described in paragraph 326-20-30-4. Therefore, it would be incorrect application of the guidance in paragraph 326-20-30-5 if an entity projected future amortized cost basis to then calculate the allowance on that future balance as discussed in paragraphs 3 through 12 above. Also, as noted in paragraph BC46, the Board concluded that the measurement of credit losses should be based on an entity's expectations about the collectibility of financial assets held at the reporting date. Even though the entity must estimate expected credit losses over the entire contractual term of the financial assets (recognizing that expected prepayments affect the estimated life), the Board decided not to characterize expected credit losses as "lifetime" expected credit losses.

View B—No Consideration of Expected Future Capitalized Interest

23. As noted above, most stakeholders who participated in recent outreach supported View B. The staff agreed with these stakeholders because under that view it would be inappropriate to consider unearned

accrued interest when calculating the allowance for credit losses when following a method other than the discounted cash flow approach.

24. The staff believes it would be inappropriate to calculate an allowance for credit losses on a nonexistent asset. An entity has not earned expected accrued interest, which can only be earned through the passage of time. View A would overstate the allowance for credit losses.

25. The staff believes that if the Board wanted to require entities to consider future interest income, then it would have permitted only the discounted cash flow approach and would have stated in the definition of amortized cost basis that entities should include *expected* applicable accrued interest instead of stating applicable accrued interest.

26. Lastly, the staff believes that the Board intended entities to calculate the allowance for credit losses by using an amount in the denominator that is also the basis of the financial asset to which the loss rate is applied. For example, the numerator would consider expected credit losses of the amortized cost basis of the financial asset and the denominator could be set equal to the amortized cost basis, and the basis of the financial asset to which the loss rate is applied are the same.

View C—Future Expected Capitalized Interest Would be Treated Like an Unfunded Loan Commitment

27. Stakeholders that are proponents of View C agreed with View B that an allowance cannot be recognized on future unearned accrued interest. However, proponents stated that the expected future capitalized interest is similar to the unfunded portion of a loan commitment and, therefore, an entity should record a *liability* for expected credit losses for the off-balance-sheet credit exposure. Proponents noted that an entity should look at the lending relationship holistically and should capture, on day one, the lifetime expected credit loss by recording an allowance related to the principal amount outstanding and the off-balance-sheet commitment.

28. By definition, loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement. The staff believes that unearned accrued interest cannot be considered as a loan commitment because those amounts represent the time value of money or the cost to borrow money from the lender. The lender has already dispersed the loan to the borrower; therefore, the obligation to repay lies solely with the borrower.

29. In addition, stakeholders who supported this View were unable to explain how they would prevent the loan commitment View from applying to all types of loans. For example, would a lender consider principal plus future expected interest as the loan commitment balance for a residential loan that has

not yet been disbursed to the borrower? If so, the liability the entity would record may not represent the expected cash flows related to that particular loan.

Staff Recommendation

30. The staff believes it is inappropriate to compare accrued interest to a discount. To address the question raised by stakeholders who asked whether the allowance for credit losses should be calculated on the current amortized cost basis or the future expected amortized cost basis, the staff recommends View B. View A would be inappropriate because entities would have to consider all expected interest income when calculating the allowance for credit losses using a method other than a DCF approach, which the Board did not intend because paragraph 326-20-30-5 is a simplified approach to calculating the allowance if a discounted cash flow method cannot be performed. View C would not be appropriate because accrued interest represents the time value of money or the cost of borrowing principal that is owed to the lender on amounts previously dispersed.

31. For all the reasons discussed in this memo, the staff believes the guidance is clear in this area and recommends no further work on this issue.

Appendix A—Illustration of Staff View of Paragraph 326-20-30-5

A1. In addressing the question raised by stakeholders, the staff believes that an illustration would be helpful to depict the staff's interpretation of the guidance in paragraph 326-20-30-5. As noted in paragraph 11(b) above, the staff interpreted the phrase "…when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses" as the intention to prohibit entities from waiting until the discount is fully accreted to earnings before recognizing a loss (that is, the allowance for credit losses). This phrase did not intend to prohibit entities from calculating an allowance for credit losses that increases (or decreases) over time as the amortized cost basis increases (that is, as a discount is unwound) or decreases (that is, as a premium is unwound). To illustrate the staff's view raised in the memo, the staff developed the following illustrations. It is important to note that the illustrations below are not intended to represent all the methods that can be used to calculate the allowance for credit losses when an entity is using a method other than a DCF method, but simply to highlight the optionality that exists in Subtopic 326-20.

Scenario 1—A student loan is issued on day 1 for $60,000. The loan will be in deferment for four years. At the end of year 4, the student loan balance will increase to $100,000 ($60,000 from the initial cash lent to the borrower plus $40,000 in interest that has accrued on the loan during the deferment period). Assume there are no other components of amortized cost basis (that is, premiums, discounts, or net deferred fees or costs). The entity decides to calculate the allowance for credit losses by utilizing a loss rate approach.

Option A: Loss Rate Calculation with a Basis of Amortized Cost

Numerator – Expected Credit Losses on Amortized Cost Basis at the Writeoff Date
Denominator – Amortized Cost Basis at the Writeoff Date
Basis to which the loss rate is applied is the Current Amortized Cost Basis, which is the balance of the loan recorded on the balance sheet on Day 1.

$$\frac{\$10{,}000 - \text{Expected Losses at the Date of Writeoff}}{\$100{,}000 - \text{Amortized Cost at the Date of Writeoff}} \times \begin{array}{c}\$60{,}000 - \text{Current Amortized Cost} \\ \text{Basis at the Reporting Period Date}\end{array} = \$6{,}000 \text{ Allowance}$$

Option B: Loss Rate Calculation on Separate Components of Amortized Cost Basis

Unpaid Principal Balance Component

Numerator – Expected Credit Losses on Unpaid Principal at the Writeoff Date
Denominator – Unpaid Principal Balance at the Writeoff Date
Basis to which the loss rate is applied is the Current Unpaid Principal Balance, which is the component of the amortized cost basis of the loan recorded on the balance sheet on Day 1.

$$\frac{\$10{,}000 - \text{Expected Losses at the Date of Writeoff}}{\$100{,}000 - \text{Unpaid Principal Balance at the Date of Writeoff}} \times \begin{array}{c}\$60{,}000 - \text{Current Unpaid Principal} \\ \text{Balance at the Reporting Period} \\ \text{Date}\end{array} = \$6{,}000 \text{ Allowance}$$

Note: Because the staff believes that expected accrued interest cannot be treated like a discount, the only component in this scenario would be the unpaid principal balance. Therefore, a loss rate of 10 percent cannot be applied to the future expected value of the loan, which would include interest that will be accrued during the deferment period.

Scenario 2—An entity purchases a zero-coupon bond with a par value of $100,000 for $60,000. Therefore, the entity purchases a zero-coupon bond at a discount of $40,000. Assume there are no other components of amortized cost basis (that is, net deferred fees or costs). The entity decides to calculate the allowance for credit losses by utilizing a loss rate approach.

Option A: Loss Rate Calculation with a Basis of Amortized Cost

Numerator – Expected Credit Losses on Amortized Cost Basis at the Writeoff Date
Denominator – Amortized Cost Basis at the Writeoff Date
Basis to which the loss rate is applied is the Current Amortized Cost Basis, which is the balance of the loan recorded on the balance sheet on Day 1.

$$\frac{\text{\$10,000 – Expected Losses on Amortized Cost at the Date of Writeoff}}{\text{\$100,000 – Amortized Cost at the Date of Writeoff}} \times \text{\$60,000 - Current Amortized Cost Basis at the Reporting Period Date} = \text{\$6,000 Allowance}$$

Option B: Loss Rate Calculation on Separate Components of Amortized Cost Basis

Par Balance Component

Numerator – Expected Credit Losses on Par at the Writeoff Date
Denominator – Par at the Writeoff Date
Basis to which the loss rate is applied is the Current Par Value, which is the component of the amortized cost basis of the zero-coupon bond recorded on the balance sheet on Day 1.

$$\frac{\text{\$10,000 – Expected Losses on Par at the Date of Writeoff}}{\text{\$100,000 – Par at Date of Writeoff}} \times \text{\$100,000 - Current Par Balance at the Reporting Period Date} = \text{\$10,000 Allowance}$$

Discount Component

Numerator – Expected Credit Losses on the Discount at the Writeoff Date
Denominator – Discount at the Writeoff Date
Basis to which the loss rate is applied is the Current Discount, which is the component of the amortized cost basis of the zero-coupon bond recorded on the balance sheet on Day 1.

$$\frac{\text{\$0 – Expected Losses on the Discount at the Date of Writeoff}}{\text{\$0 – Discount at Date of Writeoff (Fully Accreted)}} \times \text{\$40,000 - Current Discount at the Reporting Period Date} = \text{\$0 Allowance}$$

Total Allowance on Day 1 for Zero-Coupon Bond is $10,000 Sum $10,000 (Allowance on Par) – $0 (Allowance on Discount)

Appendix B—Relevant Literature

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.

326-20-30-1 The allowance for credit losses is a valuation account that is deducted from the **amortized cost basis** of the **financial asset(s)** to present the net amount expected to be collected on the financial asset. 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).

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 both of the following:

a. Amortized cost basis, excluding 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.

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.

> > Example 1: Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation)

326-20-55-18 This Example illustrates one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

326-20-55-19 Community Bank A provides 10-year amortizing loans to customers. Community Bank A manages those loans on a collective basis based on similar risk characteristics. The loans within the portfolio were originated over the last 10 years, and the portfolio has an amortized cost basis of $3 million.

326-20-55-20 After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A's historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts but determined none were necessary.

326-20-55-21 In accordance with paragraph 326-20-55-4, Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates a 10-basis-point increase in credit losses incremental to the 1.5 percent historical lifetime loss rate due to the expected decrease in real estate values and a 5-basis-point increase in credit losses incremental to the historical lifetime loss rate due to expected deterioration in unemployment rates. Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment rates beyond the reasonable and supportable forecast period. Under this loss-rate method, the incremental credit losses for the current

conditions and reasonable and supportable forecast (the 15 basis points) is added to the 1.5 percent rate that serves as the basis for the expected credit loss rate. No further reversion adjustments are needed because Community Bank A has applied a 1.65 percent loss rate where it has immediately reverted into historical losses reflective of the contractual term in accordance with paragraphs 326-20-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

326-20-55-22 The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be $49,500.

BC46. The Board concluded that the measurement of credit losses should be based on an entity's expectations about the collectibilitity of financial assets held at the reporting date. Even though an entity must estimate credit losses over the entire contractual term of the financial assets (recognizing that expected prepayments affect the estimated life), the Board decided not to characterize expected credit losses as "lifetime" expected credit losses. The use of the term *lifetime* is interpreted in many different ways and may lead some to believe that an entity must identify the exact amount and timing of uncollectible cash flows in each year of the asset's life for use in a discounted cash flow technique to estimate expected credit losses. For others, the term *lifetime* suggests the measurement of a stress-case (or worst-case) credit loss scenario after a default has occurred. Also, the term *lifetime* may lead some to believe that estimating expected credit losses must be done on an individual asset basis rather than having the ability to estimate expected credit losses on a collective (pool) basis.

BC60. The Board considered how the use of amortized cost basis may affect financial assets recorded with a premium; for example, if a loan was recorded at $102 upon origination and the entity expected a credit loss of $2 at maturity, whether the allowance would require a full write-down of the premium upon origination. That approach would be an inappropriate application of the amendments in this Update because amortized cost inherently considers both the timing and amount of the expected credit loss. For example, if a principal loss was expected at the maturity date, the premium would be fully amortized at that time and no allowance would be necessary for the premium upon origination. The loss rate would reflect the expected loss of the amortized cost basis in the numerator, and implicitly consider the timing of future amortization of premiums and discounts. Separately, use of amortized cost also can be reflected in a loss- rate approach that has a par amount in the denominator if that loss rate is then applied against the par amount of the financial asset. There are two key considerations. First, the numerator should consider the expected credit loss of the amortized cost basis of the financial asset. Second, the basis in the denominator (amortized cost or par amount) and the basis of the financial asset to which the loss rate is applied (amortized cost or par amount) are the same.