
CHAPTER 2

INVESTMENTS IN DEBT SECURITIES

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IMPORTANT NOTICE: NEW FASB STANDARD ON CREDIT LOSSES

In July 2016, the FASB issued Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The guidance creates a new “current expected credit loss” (CECL) model applicable to held-to-maturity and available-for-sale debt investment securities under which the allowance for expected credit losses would reflect the entity’s current estimate of the contractual cash flows not expected to be collected, based on its assessment of credit risk as of the reporting date. The new guidance will replace the current “other-than-temporary” impairment guidance for these debt securities.

The new guidance is effective for calendar-year-end public companies as of January 1, 2020, and for all other companies as of January 1, 2021. Early adoption is permitted for fiscal years beginning after December 15, 2018. Due to the protracted effective date of ASU 2016-13, this edition continues to include current GAAP related to other-than-temporary impairment of securities. However, this chapter discusses the new guidance on credit losses as it applies to held-to-maturity and available-for-sale debt securities in the sections on Impairment of Securities and Disclosures.

OVERVIEW

Accounting for debt securities varies, depending on the type and marketability of the security, management’s intended holding period for the security, the nature of the transaction, and the type of entity holding the security. The major accounting issue for investments in debt securities is how they are measured in the financial statements. Multiple measurement models are used for different investments in different situations, although all investments in debt securities, except

those requiring consolidation, are permitted (and some are required) to be measured at fair value with changes in fair value recognized in net income.

If the "fair value option" is not used, an investor in a debt security that has the intent and ability to hold a debt security to maturity may classify the security as "held-to-maturity" and carry it at amortized cost. All other debt securities must be carried at fair value. Investments in debt securities that are bought to generate profits on short-term price changes are classified as "trading." Changes in fair value of trading debt securities are recorded in net income. Investments in debt securities that an investor intends to hold for indefinite periods of time are classified as "available-for-sale." Changes in fair value of available-for-sale debt securities are recorded in other comprehensive income. There are restrictions against certain transfers between the classifications of debt securities.

Under current GAAP, impairment of debt securities is recognized in earnings when a decline in value has occurred that is deemed to be other than temporary, and the current fair value becomes the new cost basis for the security. However, as noted in the Important Notice at the beginning of this chapter, a new accounting standard on measuring credit losses was issued in 2016 that will significantly change this guidance.

Numerous disclosures are required about securities, including the net carrying amounts, measurement category and form of the investment, fair values, and maturities. Not-for profit organizations follow different rules, which are summarized in this chapter.

BACKGROUND

Accounting for investments in debt securities is addressed primarily by ASC 320, *Investments—Debt and Equity Securities*. ASC 946, *Financial Services—Investment Companies*, sets forth specialized accounting guidance for investment companies. Under that guidance, investment companies (such as mutual funds) are required to mark to fair value all of their investments through earnings. Paragraph 946-10-05-3 indicates that those investments typically consist of securities of other entities, but may also include commodities, securities based on indexes, derivative instruments, real estate, and other forms of investments. The accounting guidance for investment companies is beyond the scope of this book.

Definition of a Security

Whether a financial instrument is a security or not is important, because investments are accounted for differently, depending in part on their legal form. (The ASC glossary term, "Security" was modeled after the definition of a security in the Uniform Commercial Code that existed when the guidance that underpins the accounting for investments in securities was originally issued.) For accounting purposes, a security is:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that (a) either is 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) 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, and (c) 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.

Each instrument must be tested against the accounting definition to determine whether it is a security. The FASB resolved the question for a few common instruments:

- Accounts receivable, leases, and loans, including conforming mortgage loans and insured loans, do not meet the definition of a security unless legally they have been converted into securities (in a securitization or through a debt restructuring). (ASC glossary term, "Security"); (ASC 320-10-55-2 and 55-3)
- Most options to buy and sell securities are derivatives that should be accounted for under ASC 815, *Derivatives and Hedging*, not as securities. (ASC 321-10-55-3) Whether an instrument is considered a derivative for accounting purposes is discussed in detail in Chapter 13, "Derivatives Accounting."
- Some securities have embedded derivatives that must be accounted for separately under ASC 815-15, *Derivatives/Embedded Derivatives*. For example, investments in convertible debt securities that involve publicly traded stocks are considered to represent a debt instrument (the host contract) and an embedded equity derivative (an option). (ASC 815-15-55-220)
- If an embedded derivative is separated from a host contract that is a security, the remaining security-host component is accounted for as a security that does not contain an embedded derivative. (ASC 320-10-15-7(a)) Embedded derivatives are discussed in detail in Chapter 14, "Embedded Derivatives."

In addition, the SEC staff believes that *beneficial interests* that are in the form of certificates generally meet the definition of a security. (December 10, 1997, speech by Robert Uhl, then a Professional Accounting Fellow at the SEC)

PRACTICE POINTER: It is not advisable to generalize about whether certain types of instruments are securities. For example, most Certificates of Deposit (CDs) would not meet the definition, but a negotiable CD might. If questions arise about whether a particular instrument is a security, it may be necessary to engage legal counsel.

OBSERVATION: Under current U.S. GAAP, securities and nonsecurities, such as loans, are accounted for differently. The accounting for investments in financial instruments that are not securities is discussed in Chapter 4, "Loans and the Allowance for Credit Losses." Practitioners should be cognizant of "accounting arbitrage," that is, the ability to select between different accounting models that exist between securities and other forms of investment and ensure that the instruments are properly categorized for accounting purposes.

Debt Securities

A debt security is a security that represents a creditor relationship (i.e., one party owes another party a specified or determinable amount of money). For example, according to the ASC glossary term, "Debt Security," the following types of instruments are considered debt securities:

- U.S. Treasury bonds, notes, and bills and government agency securities
- Municipal bonds
- Corporate bonds and commercial paper
- Convertible debt
- Securitized debt instruments, including collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs)
- *Interest-only* and *principal-only* strips
- Preferred stock that is mandatorily redeemable by the issuer or that is redeemable at the option of the investor
- Securitized financial assets issued in equity form that nonetheless represent a creditor relationship (see ASC 325-40, *Investments—Other/Beneficial Interests in Securitized Financial Assets*).

Similar instruments issued by foreign entities are also debt securities.

All debt securities are accounted for under ASC 320, including the following:

- Loans restructured as securities;
- Beneficial interests in securitized financial assets that are in equity form but that meet the definition of a debt security; and
- Convertible preferred stock that is mandatorily redeemable. (ASC 320-10-55-2)

PRACTICE POINTER: After the securitization of a mortgage loan held for sale, any retained mortgage-backed security must be classified in accordance with ASC 320. (ASC 320-10-55-3)

Other Instruments That Must Be Accounted for Like Debt Securities

ASC 815 provides a scope exception from derivative accounting for interest-only and principal-only strips with specific characteristics. A security that qualifies for the scope exception should be accounted for like a debt security, as discussed in this section. An interest-only strip or principal-only strip is outside the scope of ASC 815 if it meets both of the following conditions:

- It represents only the rights to receive only a specified proportion of the contractual interest or principal cash flows of a specific debt instrument, and
- It does not incorporate any terms that are *not* present in the original debt instrument.

Except for instruments that are within the scope of ASC 815, financial assets (such as interest-only strips, other beneficial interests issued in securitization transactions, loans, or other receivables) that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment must be subsequently measured like investments in debt securities under ASC 320—*whether or not they are actually securities*. (ASC 860-20-35-2 and 310-10-35-45) All of the measurement provisions of ASC 320, including impairment and transfers, and the related interpretive guidance apply to instruments with these characteristics. (ASC 860-20-35-3) However, the disclosure requirements of ASC 320 need only be applied to instruments that are actually securities. (ASC 860-20-35-3)

PRACTICE POINTER: This provision applies primarily to prepayable debt instruments purchased at a significant premium over the amount at which they can be prepaid and prepayable instruments with no "principal" balance, such as interest-only strips. ASC 320 requires that instruments with significant prepayment risk be carried at fair value, not amortized cost. (See restrictions under "Held-to-Maturity Securities" section.)

All other instruments that have contractual terms that allow the instrument to be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment must be evaluated in accordance with ASC 815 to determine if they are freestanding instruments or hybrid instruments containing an embedded derivative that must be accounted for separately.

PRACTICE POINTER: Chapter 13, "Derivatives Accounting," discusses the types of instruments discussed above that would be considered derivatives in their own right; Chapter 14, "Embedded Derivatives," discusses which of these instruments contain embedded derivatives that require separate accounting.

ACCOUNTING FOR DEBT SECURITIES BY FOR-PROFIT ENTERPRISES**Date at Which to Recognize Transactions**

Securities transactions generally do not close (or "settle") immediately when an agreement is reached. For example, a contract to trade a publicly traded debt security in the United States typically settles in three business days, meaning that there is a gap between the date the transaction is committed to (the "trade date") and the date the cash and the security change hands (the "settlement date").

U.S. GAAP does not provide comprehensive guidance on whether to recognize these transactions at the trade date or settlement date. Entities within the scope of the following ASC Topics are generally required to recognize regular-way (i.e., transactions that settle in the way such transactions normally settle in the market in which the transactions occur) securities transactions on the trade date:

- ASC 940, *Financial Services—Brokers and Dealers in Securities*
- ASC 942, *Financial Services—Depository and Lending*
- ASC 946, *Financial Services—Investment Companies*
- ASC 960, *Plan Accounting—Defined Benefit Pension Plans*
- ASC 962, *Plan Accounting—Defined Contribution Pension Plans*
- ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*

All other entities may recognize regular-way securities transactions on either the trade date or the settlement date, as the matter is treated as an accounting policy election.

Trade Date Accounting

Under trade date accounting, purchases of securities are recognized in the balance sheet at the trade date, not the date the security is actually received and paid for.

| | | |
|--------------------|---------|---------|
| Security | | |
| Trade date payable | XXX,XXX | XXX,XXX |

Gains and losses on sales or disposals of securities also are recognized in the statement of operations on the trade date.

| | | |
|------------------------|---------|---------|
| Trade date receivable | | |
| Security | XXX,XXX | XXX,XXX |
| Gain (or loss) on sale | | X,XXX |

Because the transaction is recognized at the trade date, there is no need to account for the open contract itself between the trade date and the settlement date. (ASC 815-10-15-15) Instead, the only entry needed upon settlement is to recognize the payment.

Settlement Date Accounting

Under settlement date accounting, the security is not recognized until the transaction closes (or settles), because it is not considered to be controlled until that time. As the security is not recognized at the trade date, the payable or receivable relating to the impending cash payment is also not recognized.

While settlement date accounting requires no accounting for the security and payment right/obligation at the trade date, the contract itself may require accounting between the trade date and the settlement date. Under ASC 815, a commitment to buy or sell a security in the future meets the definition of a derivative (a forward contract) if the underlying security is readily convertible to cash or the contract can be net settled, generally for cash. However, paragraph ASC 815-10-15-15, *Derivatives and Hedging/Overall/Scope* provides a scope exception for (1) securities trades that are recognized on the trade date under other U.S. GAAP (either due to a requirement or a policy election), and (2) securities trades with the following characteristics:

- The transaction is “regular-way.” That is, it requires delivery of an existing security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed and the transaction cannot be net settled, either through the provisions of the contract or through a market mechanism.
- Forward purchases or sales of “to-be-announced” or “when-issued” securities when: (1) there is no other way to purchase the security, (2) delivery will occur within the shortest possible period for that security, and (3) it is probable throughout the life of the transaction that delivery will occur (i.e., the transaction will not be settled net). (ASC 815-10-15-17(c))

If the transaction meets these conditions, it is *not* subject to derivative accounting and other U.S. GAAP applies.

Certain contracts to purchase securities are accounted for under ASC 815-10, *Certain Contracts on Debt and Equity Securities Subsections* (discussed later in this chapter). All other purchases and sales of securities should be accounted for under ASC 860, *Transfers and Servicing*. Under ASC 860, a sale (or purchase) of a financial asset is recorded only when certain conditions are met (see Chapter 6, “Transfers of Financial Assets,” for a detailed discussion of these conditions).

**EXHIBIT 2-1
ASC 815 AND TRADE DATE ACCOUNTING**

| | Regular-Way Transactions | When-Issueds, TBAs, and Other Transactions That Are beyond Regular-Way |
|--|---|---|
| Qualifications for scope exception under ASC 815 | Specific U.S. GAAP requires trade date accounting (or a policy election is made) <i>OR</i> —Settles according to normal market conventions <i>AND</i> —Cannot be net settled | Specific U.S. GAAP requires trade date accounting (or a policy election is made) <i>OR</i> —No other way to purchase or sell that security, —The terms indicate the earliest possible delivery date <i>AND</i> —It is probable that delivery will occur |
| Transaction does not meet ASC 815 definition | Apply ASC 815-10, Certain Contracts on Debt and Equity Securities Subsections to certain purchases and ASC 860 to all other transactions | Apply ASC 815-10, Certain Contracts on Debt and Equity Securities Subsections to certain purchases and ASC 860 to all other transactions |

OBSERVATION: Trade date accounting only applies to certain securities transactions. Trade date accounting practices may not be extended to originations of loans, issuances of debt, or subsequent transactions involving those instruments.

Initial Measurement of Debt Securities

A purchased security should be recorded at its cost, which is the fair value of the consideration given. The amount recorded for a purchased debt security includes the amount paid to the seller plus any fees paid or less any fees received. (ASC 310-20-30-5)

PRACTICE POINTER: The FASB's Valuation Resource Group (a non-decision making advisory group on fair value measurement issues) discussed the issue of accounting for transaction costs for investments classified as available-for-sale under ASC 320. ASC 820, *Fair Value Measurement*, indicates that transaction costs are not an attribute of an asset (therefore, they are not considered in the fair value of the asset) and should be accounted for in accordance with other U.S. GAAP. The FASB staff initially suggested that this indicates that transaction costs should be expensed for such investments, but ultimately indicated that entities need *not* change their policy for treatment of initial measurement of available-for-sale securities under ASC 320. ASC 820 did not change measurements prescribed by other U.S. GAAP, and accordingly, did not amend ASC 320's measurement provisions.

Classification and Subsequent Measurement of Debt Securities under ASC 320

ASC 320 requires that, at acquisition, an enterprise classify debt securities into one of three categories:

1. Held-to-maturity (HTM)
2. Trading
3. Available-for-sale (AFS)

At each reporting date, the appropriateness of the classification must be reassessed. (ASC 320-10-35-5)

The focus of this reassessment is on the investor's current ability to hold the debt security, as well as its continued intent to do so, if the debt security has been classified as held-to-maturity. The restrictions on held-to-maturity debt securities and the limitations on transfers between the categories discussed below still apply. (ASC 320-10-25-5 and 320-10-35-6)

PRACTICE POINTER: Classification decisions should be made at acquisition and, preferably, formally documented. It is not appropriate to use "hindsight" to classify debt securities transactions, as this could allow consideration of changes in value after acquisition.

An entity decides how to classify debt securities based on its intended holding period for each individual security, using the framework in ASC 320. In establishing its intent, an entity should consider relevant trends and experience, such as previous sales and transfers of debt securities.

EXHIBIT 2-2 CLASSIFICATION UNDER ASC 320

| Classification | Ongoing Measurement Attribute |
|--------------------|---|
| Held-to-maturity | Amortized cost |
| Trading securities | Fair value, with changes in fair value recorded in earnings |
| Available-for-sale | Fair value, with changes in fair value recorded in other comprehensive income |

Held-to-Maturity Debt Securities

Held-to-maturity debt securities are measured at amortized cost, meaning that the amount paid is adjusted for the amortization of any premium or discount over time. To qualify for the held-to-maturity category, the investor must have the positive intent and ability to hold the debt security in question to maturity. (ASC 320-10-25-1(c)) Changes in an investor's intent or ability to hold a held-to-maturity debt security can call into question the investor's intent to hold other debt securities to maturity in the future. That is, if an investor subsequently sells or transfers a held-to-maturity debt security for a reason other than one of the specific exceptions discussed below, any remaining held-to-maturity debt securities may need to be reclassified to another category. A pattern of sales or transfers of held-to-maturity debt securities is inconsistent with an expressed current intent to hold similar debt securities to maturity. (ASC 320-10-25-3)

PRACTICE POINTER: The SEC has strictly interpreted and enforced the held-to-maturity requirements in practice. A mere lack of intent to sell is not adequate support for the held-to-maturity category. The investor must plan to hold the securities to maturity, even if favorable market opportunities subsequently arise.

Acceptable reasons to sell or transfer held-to-maturity debt securities A sale or transfer of a held-to-maturity debt security will not call into question the investor's original classification, or the investor's classification of other securities as held-to-maturity, if it occurs for one of the following reasons:

- Evidence of a significant deterioration in the issuer's creditworthiness. A downgrading of an issuer's published credit rating is an example of such evidence (ASC 320-10-25-6(a)), but an enterprise need not wait for an actual downgrading in the issuer's published credit rating or inclusion on a "credit watch" list. (ASC 320-10-25-5(d))
- A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not changes that affect the investor's marginal tax rate). (ASC 320-10-25-6(b)) Securities that may need to be

sold to implement tax-planning strategies should be classified as available-for-sale, not held-to-maturity. (ASC 320-10-25-5(c))

- A major business combination or a major disposition (such as the sale of a component of an entity) that necessitates the sale or transfer of securities to maintain the investor's existing interest rate risk or credit policy. (ASC 320-10-25-6(c)) Sales of securities to fund an acquisition do not meet this condition. (ASC 320-10-25-13(b)) *Necessary* sales or transfers should occur concurrent with or shortly after the business combination or disposition, not before. (ASC 320-10-25-12(a))
- A change in statutory or regulatory requirements that modifies either what constitutes a permissible investment or the maximum level of investment in certain types of securities for all entities affected by the requirements such that the investor must sell the security. (ASC 320-10-25-6(d)) A regulator's overall divestiture authority does not automatically preclude an institution from concluding it has the intent and ability to hold any security to maturity; the specific facts and circumstances must be evaluated. (ASC 942-320-55-2, *Financial Services-Depository and Lending/Investments—Debt and Equity Securities*)
- A significant increase in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities. (ASC 320-10-25-6(e)) A sale of held-to-maturity securities to realize gains to replenish regulatory capital that had been reduced by a provision for loan losses does not meet this condition. (ASC 320-10-25-5(e))
- A significant increase in the risk-based capital requirements for debt securities. (ASC 320-10-25-6(f))
- Other events that are isolated, nonrecurring, and unusual and that could not have been reasonably anticipated by the investor. (ASC 320-10-25-9) ASC 320 provides an example of an "extremely remote disaster scenario, such as a run on a bank or insurance company." Very few events would meet this condition. (ASC 320-10-25-10) An unsolicited tender offer for the securities does not meet this condition. (ASC 320-10-25-13(d))

PRACTICE POINTER: Several of the acceptable reasons to sell held-to-maturity securities involve regulations affecting the type of security held. Note that only some *changes* in those regulations justify sales of securities. Investors are expected to understand all of the relevant regulations before they initially classify debt securities.

In addition, for practical reasons, ASC 320-10-25-14 allows the following types of transactions to be considered *de facto* maturities, not sales:

- The sale of a debt security that occurs close enough to its maturity date (or call date if exercise of the call is probable) such that changes in market interest rates would not have a significant effect on the security's fair value.

- The sale of a debt security that occurs after the enterprise has already collected a substantial portion (at least 85%) 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 (of both principal and interest) over its term (e.g., certain level-payment mortgage-backed securities). For variable-rate securities, the payments should be equal absent a change in interest rates. (ASC 320-10-25-15 and 25-16)

In addition, the following implementation guidance allows certain transactions involving held-to-maturity securities without causing a *taint* of remaining securities:

- Transactions involving held-to-maturity securities *that are not accounted for as sales under ASC 860*. Examples include pledges of held-to-maturity securities as collateral and repurchase agreements that are accounted for as secured borrowings, provided that the entity intends and expects to be able to repay the borrowing. (ASC 320-10-25-18(e))
- Certain exchanges involving held-to-maturity securities *that are not accounted for as sales under ASC 860*. Examples include desecuritization of held-to-maturity securities into loans (i.e., the process by which securities are transformed into their underlying loans or financial assets), provided that the assets received are held to maturity. (ASC 320-10-25-18(e)(3)) Most bond swaps and wash sales *would be* accounted for as sales under ASC 860, and therefore would *not* meet this condition (except when there is a concurrent contract to repurchase the transferred asset from the buyer). (ASC 860-10-55-57)
- The issuer's exercise of a call option on callable debt. (ASC 320-10-25-18(c))

OBSERVATION: These specific "acceptable reasons" or exceptions are the *only* circumstances that will not jeopardize the accounting for held-to-maturity securities. It is not appropriate to analogize to these exceptions in other seemingly similar circumstances. (ASC 320-10-25-7)

Restrictions against held-to-maturity classification An entity may not classify a security as held-to-maturity if the investor intends to hold the security for only an indefinite period of time. A debt security should *not* be classified as held-to-maturity if the investor anticipates that the security might be sold (or tendered in an exchange), for example, in response to the following events or circumstances: (ASC 320-10-25-4)

- Liquidity needs,
- Changes in funding sources and terms,
- Changes in market interest rates and related changes in the security's prepayment risk,
- Changes in the availability of and the yield on alternative investments,
- Changes in foreign currency risk,

- Exercise of a conversion feature on convertible debt, even if the components are accounted for separately under ASC 815, or (ASC 320-10-25-5(g))
- Exercise of a put option on a debt security. (ASC 320-10-25-5(f))

Even if the investor does not anticipate that a debt security might be sold, a security may not be classified as held-to-maturity in the following circumstances:

- The security is designated as a hedged item under ASC 815 and the designated risk is either interest rate risk or the risk of changes in the overall fair value of the security. (However, it is acceptable to designate foreign currency risk, credit risk, or, in a fair value hedge, the price risk from a prepayment option.) (ASC 815-20-25-12(d) and 25-15(f))
- The debt security has contractual terms that allow it to be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. (ASC 320-10-25-5(a)) The *likelihood* of prepayment or other form of settlement is irrelevant. (ASC 860-20-35-5)

This restriction does not apply to potential losses from noncontractual events, such as losses from changes in foreign currency exchange rates or borrower default. (ASC 860-20-55-34 and 55-37)

PRACTICE POINTER: A prepayable debt security that is purchased late enough in its life such that the investor would recover substantially all of its recorded investment if the instrument were prepaid could be classified as held-to-maturity. (ASC 320-10-25-5(a))

Consequences of unacceptable sales or transfers A sale or transfer of a held-to-maturity security for any reason other than those specifically mentioned in ASC 320-10-25-6 and 25-14 and related interpretive guidance (listed under "acceptable reasons" above) calls into question whether any remaining held-to-maturity securities should continue to be classified in that category. Any remaining held-to-maturity securities should be reclassified to the available-for-sale category when the sale or transfer represents a material contradiction with the entity's stated intent or when a pattern of such sales has occurred. The reclassification would be recorded in the period in which the sale or transfer occurred and accounted for as a transfer of securities. (ASC 320-10-35-9) This "taint" applies not just to the type of security that was sold or transferred, but to *all remaining securities* that are classified as "held-to-maturity." (ASC 320-10-35-8)

PRACTICE POINTER: The FASB did not specify how long a held-to-maturity securities portfolio would be "tainted." (ASC 320-10-35-7) However, the SEC staff has imposed a two-year ban against the use of the held-to-maturity category for registrants that have sold or transferred securities from the held-to-maturity category for "unacceptable" reasons. (December 11, 1996, speech by Armando Pimentel, then a Professional Accounting Fellow at the SEC)

Trading Securities

The trading securities category includes securities that are bought and held principally for the purpose of selling them in the short term. 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) "Short-term," in this context, is intended to be measured in hours and days, rather than in months or years. However, an entity is not precluded from classifying as trading a security it plans to hold for a longer period, as long as that designation occurs *at acquisition*. (ASC 320-10-25-1(a))

Trading debt securities are carried at fair value in the balance sheet and unrealized holding gains and losses are recognized in earnings currently. (ASC 320-10-35-1(a)) This measurement approach is also called "mark-to-market" or "fair value accounting."

Required classification as trading Certain types of transactions are required to be classified as trading activities.

- *Certain mortgage banking activities.* After the securitization of a mortgage loan held for sale that meets the conditions for a sale in ASC 860-10-40-5, a mortgage banking enterprise must classify as trading any mortgage-backed securities received by the transferor as proceeds that it commits to sell before or during the securitization process. (ASC 948-310-35-3A)
- *Certain structured notes.* Structured notes should first be evaluated under ASC 815 to determine whether they contain embedded derivatives that must be accounted for separately. (Embedded derivatives are discussed in detail in Chapter 14, "Embedded Derivatives.") If the instrument does not have an embedded derivative or the embedded derivative is not required to be accounted for separately under ASC 815, and the terms of the instrument suggest it is reasonably possible that the investor could lose substantially all of its original investment amount (other than through default), then the structured note should be marked to market with all changes in fair value reported in earnings. If not, then the retrospective interest method should generally be applied for structured notes classified as available for sale or held to maturity debt securities. (ASC 320-10-35-38 through 35-43, *Investments in Debt Securities/Overall/Subsequent Measurement*)

PRACTICE POINTER: A structured note with the potential for significant loss would most likely contain an embedded derivative under ASC 815-15, *Derivatives and Hedging—Embedded Derivatives*.

Elective use of trading category Companies may elect to classify debt securities that they plan to hold for longer periods of time as trading. (ASC

320-10-25-1(a)) For example, a company might desire symmetry in the accounting for a deferred compensation obligation that is adjusted to fair value and the debt securities being held to fund the obligation. ASC 710-10-25-18 discusses this transaction. However, the decision to classify a debt security as trading must occur at acquisition; securities may not subsequently be transferred into the trading category for this reason.

Hedges of trading securities ASC 815 does not permit hedge accounting for items that are (or will be) carried at fair value with changes in fair value recognized currently in earnings, including existing and forecasted purchases or sales of trading securities. (ASC 815-20-25-12(c) and 815-20-25-15(d))

Hedge accounting was not perceived as necessary, because the changes in fair value of both the security and the derivative are recognized in earnings in the same period. Entities should describe their objectives in holding derivatives that are economic (but not accounting) hedges of trading securities.

Available-for-Sale Securities

Available-for-sale is the “default” category for debt securities. It includes debt securities held for indefinite periods of time that are not classified either as trading securities or as held-to-maturity securities. Available-for-sale debt securities are carried at fair value in the balance sheet. Unrealized holding gains and losses are excluded from earnings and recognized in a separate component of other comprehensive income (OCI), net of the related tax effects, until realized. (ASC 320-10-35-1(b)) However, if an available-for-sale debt security is designated as being the hedged item in a fair value hedge, all or a portion of the unrealized holding gain and loss is recognized in earnings during the period of the hedge (to match the treatment of the derivative—see Chapter 15, “Hedge Accounting”).

OBSERVATION: Available-for-sale debt securities may be sold for any reason without impacting the accounting for other debt securities and may be hedged as permitted by ASC 815. Temporary changes in value are reported outside of net income (other comprehensive income). As a result, many financial institutions prefer not to classify debt securities as held-to-maturity so that they have the flexibility to respond to changes in market conditions and other developments without an accounting “taint” or penalty. However, some banks changed this strategy in response to recent changes in capital regulations requiring that changes in the fair value of available-for-sale debt securities that are recognized in OCI be included in the calculation of capital for regulatory purposes.

PRACTICE POINTER: It is permissible to segregate a debt securities portfolio into a portion that is available to be sold and a portion that is not available for sale. The debt securities unavailable for sale may be classified as held-to-maturity only if the entity has the positive intent and ability to hold those individual securities to maturity. (ASC 320-10-25-18(a))

Foreign currency considerations for available-for-sale debt securities ASC 830-20, *Foreign Currency Matters/Foreign Currency Translation* (foreign currency translation) generally requires that transaction gains and losses on foreign-currency-denominated monetary assets and liabilities be reported in earnings. ASC 320 requires that changes in the fair value of available-for-sale debt securities be reported in a separate component of other comprehensive income until realized. In the case of foreign-currency-denominated available-for-sale debt securities, the change in fair value expressed in an entity’s functional currency is the total of (1) the change in market price of the security as expressed in the local currency due to factors such as changes in interest rates and credit risk and (2) the change in the exchange rate between the local currency and the entity’s functional currency.

ASC 830-20-35-36, *Foreign Currency Matters/Foreign Currency Transactions/Subsequent Measurement* requires that the entire change in the fair value of foreign-currency-denominated available-for-sale debt securities be reported in other comprehensive income (*not* divided between foreign currency transaction gains and losses and other market changes). However, in a fair value hedge of an available-for-sale debt security, the adjustment of the hedged item’s carrying amount should be recognized in earnings rather than in other comprehensive income in order to offset the gain or loss on the hedging instrument. Thus, only the changes in the available-for-sale debt security’s fair value attributable to unhedged risks are reported in other comprehensive income.

Deferred tax and available-for-sale debt securities ASC 740-10-30-16, *Income Taxes/Overall/Initial Measurement*, provides that the assessment of the need for a valuation allowance for a deferred tax asset related to available-for-sale debt securities should be made in combination with an entity’s other deferred tax assets. ASC 740-20-45, *Income Taxes/Interperiod Tax Allocation/Other Presentation Matters*, provides the following guidance on reporting the tax effects of unrealized holding gains and losses:

- The tax effects of unrealized holding gains and losses on available-for-sale debt securities reported in other comprehensive income are required to be presented in other comprehensive income or a related component of shareholders’ equity. (ASC 740-20-45-11(b))
- The need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities is considered in combination with the assessment of the need for a valuation allowance on other deferred tax assets. (ASC 740-10-30-16) Thus, the fact that an unrealized loss on an available-for-sale security is expected to reverse before maturity is not sufficient to conclude that no valuation allowance is needed on the related deferred tax asset.
- If an entity establishes a deferred tax asset that relates only to an unrealized loss on an available-for-sale debt security, and the entity concludes in the current year that it is more likely than not that the asset will not be realized, the offsetting entry to the valuation allowance is reported in the same component of other comprehensive income as is the revaluation of

the debt security. (ASC 720-20-45-15) If the entity determines in a subsequent year that the asset will likely not be realized, the offsetting entry should be included in income from continuing operations, not other comprehensive income. (ASC 740-20-45-16)

- An entity might have deferred tax assets that relate both to other deductible temporary differences in a previous year (say pension expense) and an unrealized loss on an available-for-sale debt security in the current year. If the entity concludes that the asset is not realizable, a valuation allowance must be established. The offset should be included in other comprehensive income only to the extent that the valuation allowance is related directly to the unrealized loss on the available-for-sale debt securities that arose in the current year. The remainder should be included in income from continuing operations. (ASC 740-10-30-18)

Transfers between Categories

ASC 320-10-35-11 states that transfers from the held-to-maturity category should be rare, except for transfers that occur for one of the specific "acceptable" reasons in ASC 320-10-25-6 and 25-14 and other authoritative implementation guidance. Transfers to and from the trading category also should be rare. (ASC 320-10-35-12)

Transfers should be recorded at fair value. (ASC 310-20-35-10) The unrealized holding gain or loss at the date of transfer should be treated as follows:

- *From trading.* Do not reverse any unrealized gain or loss out of earnings.
- *To trading.* Recognize any unrealized gain or loss in earnings (that has not previously been recognized, for example, as part of hedge accounting). The gain or loss should be classified in a manner consistent with the classification of realized gains and losses for the category *from which* the security is being transferred, not the category into which the security is being transferred. (ASC 320-10-45-7)
- *From HTM to AFS.* Record any unrealized gain or loss in other comprehensive income. The security's amortized cost basis carries over to the available-for-sale category for the following purposes: (1) the subsequent amortization of the historical premium or discount, (2) the comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses, and (3) the required disclosures of amortized cost. (ASC 320-10-35-15)
- *From AFS to HTM.* The difference between the par value of the security and its fair value at the date of transfer remains in other comprehensive income, but is amortized as a yield adjustment, generally over the remaining life of the debt security. (ASC 320-10-35-15) Chapter 8, "Interest on Loans and Other Debt Investments," addresses the effective yield method. That fair value amount, adjusted for subsequent amortization, becomes the security's amortized cost basis for disclosure purposes. (ASC 320-10-35-16)

PRACTICE POINTER: When an investor decides to sell an available-for-sale security, it should not first transfer the security into the trading category prior to the sale. Similarly, if an investor decides to sell a held-to-maturity security (even for an "acceptable" reason), it should not first transfer it into the available-for-sale category. (ASC 320-10-35-13)

OBSERVATION: The restrictions against transfers are to prevent "cherry picking" of gains and losses in earnings. Very few transactions would qualify as an acceptable reason to transfer securities into or out of trading. One transaction that the FASB staff has reportedly accepted is a transfer between a broker-dealer subsidiary and a bank subsidiary of the same financial institution, where the broker-dealer buys and sells securities on behalf of the bank.

REGULATORY ALERT: ASC 320 indicates that transfers into and from the trading account should be "rare." The SEC staff has reminded registrants that "rare" in this case doesn't just mean infrequent, but also that there must be a substantive reason for the transfer. The SEC staff believes there is a very high threshold for such transfers to be permissible and observes that the following reasons for transferring securities into and out of the trading account are inconsistent with the notion that such transfers should be rare: (1) changes in investment strategies, (2) achieving accounting results that more closely match economic hedging activities, and (3) repositioning a portfolio due to anticipated changes in the economic outlook. (Speech by John M. James, then a Professional Accounting Fellow, Office of the Chief Accountant of the SEC, at the December 2004 AICPA National Conference on SEC and PCAOB Developments)

Reclassification of prepayable loan accounted for like a security A loan that when initially acquired or retained was required to be accounted for like a security because it had substantial prepayment risk (ASC 860-20-35-2) may be reclassified from trading or available-for-sale to held for investment (and carried at cost) later in its life if:

- It would no longer be possible for the holder not to recover substantially all of its recorded investment upon contractual prepayment or settlement; and
- The conditions for amortized cost accounting are met (e.g., ASC 948-310-25-1 and ASC 310-10-35-47).

Any unrealized holding gain or loss arising under the available-for-sale classification that exists at the date of the reclassification would continue to be reported in other comprehensive income, but should be amortized over the remaining life of the loan as an adjustment of yield. (The loan would not be classified as held-to-maturity because, under ASC 320, only debt securities may be classified as held-to-maturity.) (ASC 860-20-55-38) If the loan had been classified as trading, any unrealized trading gain or loss would not be reversed.

Impairment of Debt Securities

ASC 320-10-35, *Investments-Debt Securities/Overall/Subsequent Measurement*, addresses the recognition of impairment on debt investment securities. It addresses the determination as to when an investment is impaired, whether the impairment is other-than-temporary, and the measurement of an impairment loss.

Determining Whether an Investment Is Impaired

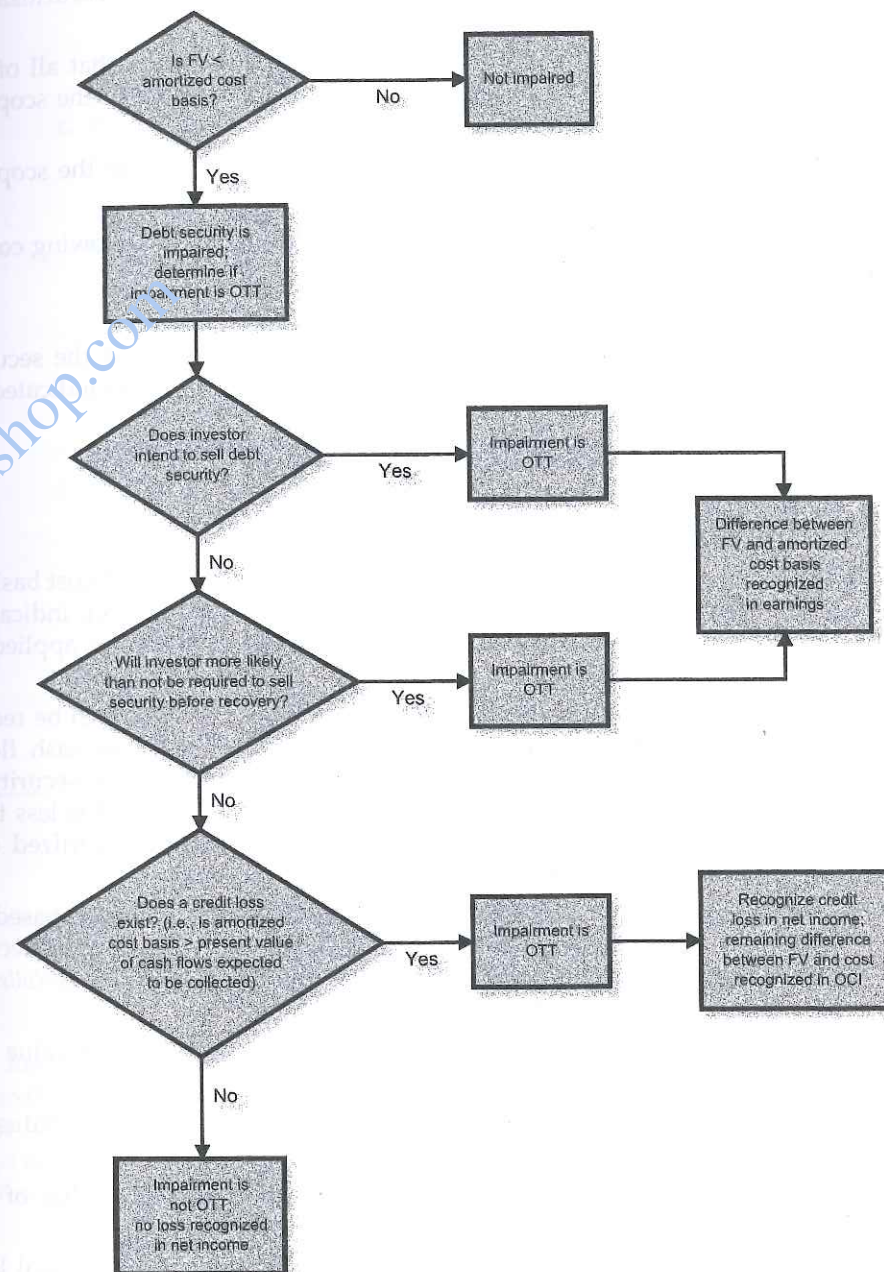
A debt security is impaired if the fair value of the investment is less than its cost basis. For debt securities, amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings, and fair value hedge accounting adjustments. Impairment must be evaluated at the individual security level (i.e., the level and method of aggregation used to measure realized and unrealized gains and losses of securities). The term *individual security level* takes into account situations in which an investor aggregates equity securities with the same CUSIP number purchased in separate trade lots for the purposes of measuring realized and unrealized gains and losses. Securities may not be combined with guarantees, credit enhancements, or other contracts for the purposes of determining whether impairment exists.

PRACTICE POINTER: It is not appropriate to record a general reserve for unidentified impairment in a portfolio of debt securities. (ASC 320-10-35-18)

OBSERVATION: "Impairment" of a trading security is recognized on an ongoing basis as it is marked to market.

If the fair value of an investment is less than its cost, an investment is considered impaired and the investor must evaluate whether the impairment is other-than-temporary. Exhibit 2-3 is a flowchart that depicts the determination of whether impairment is other than temporary for debt securities. In addition, the sections below discuss the determination whether an impairment is other than temporary and, if so, the recognition and measurement of the impairment.

EXHIBIT 2-3
DETERMINING WHETHER A DEBT INVESTMENT SECURITY IS OTHER-THAN-TEMPORARILY IMPAIRED



| | Fair Value of Proceeds |
|--------------------|---------------------------|
| Cash proceeds | 51,000,000 |
| Interest rate swap | 400,000 |
| Servicing asset | 700,000 |
| Residual interest | 2,000,000 |
| Net proceeds | 54,100,000 |

Gain on sale calculation

| | |
|-------------------------------|--------------|
| Net proceeds | 54,100,000 |
| Carrying amount of loans sold | (50,000,000) |
| Gain on sale | 4,100,000 |

Journal entries

| | | |
|--------------------|------------|---------------------------------|
| Cash | 51,000,000 | |
| Interest rate swap | 400,000 | At fair value |
| Servicing asset | 700,000 | At fair value |
| Residual interest | 2,000,000 | |
| Loans | 50,000,000 | At allocated carrying amount |
| Gain on sale | 4,100,000 | |

To record the sale of loans, new assets obtained, and the gain on sale. (ASC 860-20-25-1) Chapter 13, "Derivatives Accounting," addresses the subsequent accounting for the interest rate swap. Chapter 5, "Servicing of Financial Assets," addresses the subsequent measurement of the servicing asset. Chapter 2, "Investments in Debt Securities," addresses the subsequent accounting for the residual interest (assuming it does not contain an embedded derivative). The residual must be accounted for like an available-for-sale or trading security because it bears significant prepayment risk. (ASC 320-10-25-1) Chapter 5, "Servicing of Financial Assets," addresses the subsequent accounting for servicing rights.

CHAPTER 8

INTEREST ON LOANS AND OTHER DEBT INVESTMENTS

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IMPORTANT NOTICE: NEW FASB STANDARD ON CREDIT LOSSES

In July 2016, the FASB issued Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The guidance creates a new "current expected credit loss" (CECL) model applicable to financial assets measured at amortized cost (including held-to-maturity debt securities) and to available-for-sale debt securities. Under that model, the allowance for expected credit losses would reflect the entity's current estimate of the contractual cash flows not expected to be collected, based on its assessment of credit risk as of the reporting date. As a result of the Update, some of the specialized guidance in this chapter related to recognition of yield and impairment on certain beneficial interests and purchased credit impaired loans would change.

The new guidance is effective for calendar-year-end public companies as of January 1, 2020, and for all other companies as of January 1, 2021. Due to the protracted effective date of ASU 2016-13, this edition continues to include current GAAP related to those specialized interest income recognition and impairment models. However, this chapter details the new guidance in the sections entitled "Beneficial Interests in a Securitization Trust" and "Instruments Purchased at a Discount Due to Credit Quality."

OVERVIEW

Interest should be recognized on a debt instrument using the effective yield method (also called the *interest method*). The objective of the interest method is to report interest income or expense in a manner that reflects a constant effective yield on the recorded amount of the receivable or payable (i.e., the principal amount adjusted by unamortized premium or discount and certain other items).

This general principle applies to both assets and liabilities that are not being marked to market through earnings. Specific issues relating to liabilities are discussed in Chapter 9, "Debt Financing."

Certain types of loan origination fees and costs are deferred by the lender and amortized as an adjustment of the yield of the instrument. Generally, origination fees and costs are netted and amortized over the contractual life of the instrument; prepayments may be anticipated in certain circumstances. Other types of lending fees are generally recognized when they are earned and other types of costs are generally recognized as expenses as they are incurred.

There are special ways of applying the interest method for investments purchased at a discount that is related to credit concerns, structured notes, and beneficial interests in a special-purpose entity. Some debt instruments with unusual rates or payment terms contain embedded derivatives that must be accounted for separately.

Certain conditions must be met to treat a loan refinancing or a modification of terms as a new loan. The requirements are different for the lender and the borrower. When the revised loan is not considered new, many of the related fees and costs are treated as a prospective yield adjustment, rather than as current income or expense.

BACKGROUND

The primary accounting literature applicable to recognizing interest on investments in debt instruments is ASC 835-30, *Interest/Imputation of Interest*, and ASC 310-20, *Receivables/Nonrefundable Fees and Other Costs*. ASC 835-30 applies to both receivables and payables and establishes the general principle that interest should be recognized using an effective rate of interest, not the nominal or stated rate. ASC 310-20 addresses how to factor in nonrefundable fees and costs relating to originations and purchases of loans and debt securities held as assets, as well as the treatment of callable and prepayable instruments. ASC 310-30 addresses accounting for loans or debt securities purchased at a discount that is attributable in part to credit concerns. Other literature addresses unusual yields on investments in debt instruments, including ASC 320-10-35-38 through 35-43, *Investments/Debt Securities/Subsequent Measurement*, and ASC 325-40, *Investments/Other/Beneficial Interests in Securitized Financial Assets*. CON-7 discusses the objective of present value measurements and methods to estimate cash flows.

This chapter discusses the effective yield method and issues relating to debt instruments held as investments (assets to the reporting entity). Chapter 9, "Debt Financing," addresses issues relating to the calculation of interest expense on debt financing (liabilities to the reporting entity).

Applicability of Concepts Statement 7

ASC 820 establishes fair value measurement guidance applicable whenever such a measure is used. ASC 820 incorporates guidance from Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (CON-7) related to the use of present value techniques to measure fair value.

CON-7 provides a framework for using future cash flows as the basis for accounting measurements at initial recognition, and for the interest method of amortization. CON-7 establishes principles that govern the use of present value, especially when the amount of future cash flows, their timing, or both, are uncertain. Present value techniques are used often to estimate the fair value of a financial instrument, to impute an interest rate, and to amortize a premium or discount on a note.

Those techniques include the discount rate adjustment technique and the expected present value technique. The measurement for receivables and payables under ASC 835-30 using a present value technique is a fair value measurement under ASC 820. The discount rate for contractual cash flows described in ASC 835-30 (rate that is commensurate with the risk) is consistent with the discount rate used in the traditional approach (the discount rate adjusted technique) in CON-7.

Terminology to Describe Cost Basis of Investments

A variety of terms are used to describe the cost basis of an investment in a debt instrument. The following chart summarizes the common elements of the cost basis of an investment, and how they are reflected in various terms. Note that there is overlap among some commonly used terms. The primary distinguishing factor is whether the allowance for doubtful accounts is included in the measure.

Terminology to Describe Cost Basis of Investments

| Terminology | U.S. GAAP Reference | Amount Due at Maturity | Unamortized Premium Discount | Accrued Interest | Deferred Fees and Costs | FV Hedge Gains and Losses | Direct Write Downs | Allowance for Doubtful Accounts |
|-----------------------------------|--|------------------------|------------------------------|------------------|-------------------------|---------------------------|--------------------|---------------------------------|
| Amortized cost | Conceptually defined in ASC 320-10-35-38 through 35-43. Also used in ASC 320.† Narrowly defined in ASC 310-30. | ✓ | ✓ | ✓* | ✓ | ✓ | ✓ | |
| Recorded Investment | ASC 310-40-40-3 and ASC 310-10-35-24; ASC 310-10-35-31 | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | |
| Net carrying amount ^{††} | ASC 310-10-35-24 | ✓ | ✓ | ✓ | ✓ | ✓* | ✓ | ✓ |
| Net investment in original loan | ASC glossary term, "Net Investment in an Original Loan" | ✓ | ✓ | ✓ | ✓ | ✓* | | |

* Not stated explicitly.

† ASC 470-60-35-3 uses a variation of amortized cost called the reference amount, which equals the initial investment (or allocated carrying amount) less cash received to date, plus yield accrued to date, less any other-than-temporary impairment recognized to date.

†† ASC 325-40 uses the term "carrying amount" with the same meaning as "net carrying amount."

IMPUTING INTEREST ON RECEIVABLES

Receivables represent contractual rights to receive money on fixed or determinable dates, whether or not there is any stated provision for interest. Receivables include loans, notes, long-term trade receivables, amounts due under sales-type or direct finance leases, and debt securities. ASC 835-30 is the primary source of guidance on when interest must be imputed on receivables. ASC 835-30 is not intended to apply in the following circumstances:

- Trade receivables that are due in customary trade terms within one year;
- Deposits or prepayments for the purchase of goods and services;
- Security deposits or down payments;
- Customary lending activities of banks (covered by ASC 310-20);
- Transactions where interest rates are affected by tax attributes or legal restrictions; and
- Related party transactions.

AUTHOR'S NOTE: In May, 2014, the FASB published ASU 2014-09, *Revenue from Contracts with Customers*, which changes the guidance in U.S. GAAP for recognition of revenue. ASU 2014-09 changes the requirements regarding imputation of interest when payment occurs before or after the delivery of goods or services. The new guidance will require that interest be imputed on such amounts if the contract is deemed to include a significant financing component. ASU 2014-09 is mandatorily effective for public companies in fiscal years beginning after December 15, 2017 and private companies in fiscal years beginning after December 15, 2018.

Often, a receivable (for simplicity, a note) will bear a stated rate of interest called the coupon, which reflects the general level of interest in the marketplace for a note of that term, the creditworthiness of the borrower (the "credit spread"), and other factors at the time the arrangement is made. In that case, the present value of the contractual cash flows will equal the par value or principal amount of the note at inception.

Interest must be imputed on a note in any of the following situations:

- There is no stated interest rate.
- The stated interest rate is not reasonable, that is, the rate does not reflect the general level of interest rates, the creditworthiness of that particular borrower, or the amount of time until payments are due.
- The face amount of the note differs materially from the fair value of the goods or services received in exchange.

In those cases, the par value of the note does not represent the present value of the contractual cash flows. To determine the present value, an appropriate interest rate must be identified (or imputed). (ASC 835-30-25-10 and 25-11)

Imputing Interest

Imputing interest means identifying the interest rate that equates the contractual cash flows with the present value of the note. The note is recorded on the balance sheet at its present value, and any difference between the par value and discounted value is recognized as an adjustment of interest income. When notes are traded in the open market, the market rate of interest and fair value of the note provide evidence of the present value of the note. (ASC 835-30-25-2)

Selecting a Discount Rate

The objective in selecting a discount rate is to approximate the rate that an independent borrower and lender would negotiate in a similar transaction under comparable terms and conditions, with the option to pay the cash price upon purchase or to give a note for the amount of the purchase that bears the prevailing rate of interest to maturity. (ASC 835-30-10-1)

PRACTICE POINTER: Prevailing rates for similar instruments of issuers with similar credit ratings often will help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance.

The selection of a rate may be affected by many considerations. For example, the choice of a rate may be influenced by:

- Prevailing market rates for the source of credit that would provide market for sale or assignment of the note;
- The prime rate for notes that are discounted with banks, giving due weight to the credit standing of the issuer;
- Published market rates for similar quality bonds;
- Current rates for debentures with substantially identical terms and risks that are traded in open markets; and
- The current rate charged by investors for first or second mortgage loans on similar property. (ASC 835-30-25-13)

Premiums and Discounts

When the stated (contractual) interest rate on a note equals the rate that a current lender would charge for an instrument with the same credit quality, maturity and timing of cash flows, the note would be issued or purchased at par value.

When the stated (contractual) interest rate on a note is less than the rate that a current lender would charge for an instrument with the same credit quality, maturity and cash flows, the note would be issued or purchased at a discount, that is, an amount lower than par value. Investors are not willing to pay the face amount, because they could earn more on an alternative investment. The amount of proceeds is adjusted so that the investment bears a market rate of return.

When the stated (contractual) interest rate on a note is higher than the current market rate for a comparable instrument issued by that debtor, the note would be issued or purchased at a premium, that is, an amount higher than par

value. Investors are willing to pay more than the face amount of the note, because the contractual cash flows are more than those of alternative market investments. The amount of proceeds is adjusted so that the investment yields a current market return.

The discount or premium resulting from the determination of present value in cash or noncash transactions must be presented in the balance sheet as a direct deduction or addition to the face amount of the note. (ASC 835-30-45-1A)

EXHIBIT 8-1 PAR VALUE, PREMIUMS AND DISCOUNTS

Assumes a \$100,000, 4-year note with semi-annual interest payments.

| | | Contractual Rate | | |
|-------------|-----|------------------|---------|---------|
| | | 7% | 8% | 10% |
| Market Rate | 7% | 100,000 | 103,437 | 110,311 |
| | 8% | 96,634 | 100,000 | 106,733 |
| | 10% | 90,305 | 93,537 | 100,000 |

Amortizing Premiums and Discounts

The difference between the par value and present value of the note is amortized over the life of the note, so that the sum of any stated interest plus the amortization (which could be positive or negative) results in a level effective rate of interest on the outstanding balance at the beginning of any period. The effective rate should represent the market rate of interest that existed at the inception (or subsequent purchase) of the note. Unless the note has an explicit variable rate, the initial effective rate should not be adjusted for subsequent changes in market rates. Variable rates are discussed later in this chapter.

In March 2017, the FASB issued Accounting Standards Update 2017-09, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities*. The guidance changes the amortization period for debt securities held at a premium that have explicit, noncontingent call features such that they are callable at fixed prices on preset dates. The guidance requires that the amortization period for such securities is to the earliest call date, unless the guidance in Subtopic 310-20 is applied to consider estimated prepayments. After the earliest call date, if the call option is not exercised, the entity must reset the effective yield using the payment terms of the debt security. If there were additional future call dates, the entity would consider whether a premium existed and, if so, the excess would be amortized to the next call date. For all other debt securities held at a premium, and for debt securities held at a discount, amortization is to the maturity date. The guidance is effective for calendar-year public business entities as of January 1, 2019. (ASC 310-20-35-33 and ASU 2017-09, par. BC21)

PRACTICE POINTER: If an entity has designated a callable debt security, subject to this guidance, that is a hedged item in a hedging relationship under ASC 815, *Derivatives and Hedging*, and the hedge is open, the entity should follow its policies on amortization of basis adjustments. However, to the extent a hedging relationship is discontinued and a basis adjustment remains, entities must follow the new guidance in ASC 310-20-35-33. (ASU 2017-09, par. BC12)

A note amortization table is typically set up as follows:

| Dates | Cash Interest | Market Yield | Premium or Discount Amortization | Balance Unamortized Premium or Discount | Cost Basis of Note |
|---------------|-------------------------------|--|--|---|--|
| | Coupon times principal amount | Carrying amount times market rate at inception | Cash interest minus market times market rate | Initially, difference between par value and present value. Subsequently adjusted for this period's amortization | Par value plus unamortized premium or discount |
| Starting date | | | | | xx,xxx,xxx |
| Year 1 | xx,xxx | xx,xxx | x,xxx | xxx,xxx | x,xxx,xxx |
| Year 2 | xx,xxx | xx,xxx | xxx | xx,xxx | x,xxx,xxx |
| Year 3 | xx,xxx | xx,xxx | xxx | 0 | 0 |

Illustration 8-1 at the end of this chapter includes a numerical example of the amortization of a discount under the interest method.

Notes with Bundled Rights and Privileges

If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges must generally be carved out and recorded separately. The premium or discount created by the allocation of the note's carrying amount should be amortized over the life of the note as a yield adjustment. (ASC 835-30-25-4 and 25-6) One notable exception is the accounting for convertible debt when the conversion feature is not separable and does not meet the definition of a derivative under ASC 815, *Derivatives and Hedging*. Convertible debt is discussed in Chapter 11, "Convertible Debt and Similar Instruments."

Notes Exchanged for Goods or Services

When interest must be imputed on a note that is received in exchange for goods or services, the note, the sales price, and the cost of the property, goods, or services exchanged for the note should be recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the fair value of the note, whichever is the more clearly determinable. (ASC 835-30-25-10)

PRACTICE POINTER: Transactions in which captive finance companies offer favorable financing to increase sales of related companies must be accounted for under ASC 835-30. (ASC 835-30-15-1)

Notes with Embedded Derivatives That Must Be Accounted for Separately under ASC 815-15

Under ASC 815-15, certain hybrid instruments that contain multiple risk characteristics must be split apart and accounted for separately. For example, a debt instrument with a return that is linked to changes in an equity index is considered a debt instrument and an embedded equity derivative. When a derivative is required to be separated or bifurcated from the host contract, the amount allocated to the host instrument often will differ from the face value of the instrument. Any premium or discount resulting from the allocation process should be amortized in accordance with ASC 310-20 or ASC 835-30, as appropriate. ASC 815-15 also provides a fair value measurement election, subject to certain scope limitations, for certain debt instruments that are hybrid financial instruments with an identified embedded derivative that would otherwise be required to be bifurcated. Such instruments are eligible to be initially and subsequently measured at fair value, with changes in fair value recognized currently in earnings. Chapter 14, "Embedded Derivatives," discusses how to identify embedded derivatives, the fair value election for hybrid financial instruments, and other related issues in detail.

Notes Measured at Fair Value under the Fair Value Option

Companies may elect to measure notes as well as other types of financial instruments discussed in this chapter (e.g., loans, loan commitments) at fair value under the fair value option provided by ASC 825-10, *Financial Instruments/Overall/Fair Value Option Subsections*. The fair value option is discussed in detail in Chapter 20, "The Fair Value Option for Financial Instruments." If the fair value option is elected, a note is initially measured at fair value and subsequent changes in fair value are recognized in earnings. The guidance related to amortization of premium or discount under ASC 835-30 does not apply to items for which the fair value option has been elected. In addition, ASC 825-10, *Fair Value Option Subsections*, does not specify a method to be used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option has been elected; however, ASC 825-10, *Fair Value Option Subsections*, requires disclosure of a description of how interest and dividends are measured and where they are reported in the income statement for each period for which an income statement is presented.

ASC 820 is the primary guidance for fair value measurement under U.S. GAAP. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Chapter 19, "Fair Value Measurements," provides specific fair value measurement guidance applicable to all financial instruments required to be measured at fair value under U.S. GAAP.

FEES AND COSTS FROM LENDING AND INVESTING ACTIVITIES

Interest income is imputed on loans and other investments in debt securities. For certain types of lending activities, the fees charged and related transaction costs can be significant. ASC 310-20 addresses how those fees and costs are factored into the yield calculation.

ASC 310-20 addresses the treatment of nonrefundable fees and costs associated with:

- Lending transactions, such as making loans, extending lines of credit, and issuing credit cards;
- Making commitments to lend;
- Refinancing and restructuring outstanding loans;
- Syndicating loans (coordinating multiple lenders for a large loan);
- Purchasing debt instruments; and
- Direct finance leasing transactions.

ASC 310-20 also addresses the accounting for:

- Variable interest rates; and
- Prepayment rights and penalties.

All of these items affect the effective yield calculation in certain circumstances.

OBSERVATION: It is important to properly identify a fee or cost as an origination, commitment, or service fee, because they are classified differently in the income statement and potentially recognized over different periods of time.

ASC 310-20 does *not* address the accounting for:

- Yields on instruments that are carried at fair value with changes in fair value recorded in earnings, including those for which the fair value option in ASC 825-10, *Fair Value Option Subsections*, is elected.
- Nonaccrual loans or securities.

PRACTICE POINTER: ASC 310-20 applies to available-for-sale debt securities, even though they are carried at fair value because the changes in fair value are recognized in other comprehensive income, not earnings.

PRACTICE POINTER: The interest method is required even if there are no significant origination fees or costs associated with a transaction. Alternative methods, such as the straight-line method, may be used only if the results do not differ materially from those obtained by using the interest method, even if interest is collectible on a loan using one of those methods. (ASC 835-30-35-4, ASC 835-30-55-3, and ASC 835-30-55-2)

OBSERVATION: ASC 310-20 applies to all entities engaged in lending, certain leasing activities, and investing in debt instruments, such as loans, notes, and bonds. ASC 948, *Financial Services—Mortgage Banking*, provides a few exceptions for mortgage bankers (discussed later in this chapter). All other industries must apply ASC 310-20 for U.S. GAAP reporting purposes, as long as the loan or other investment is performing and not specifically excluded above.

Loan Origination Fees and Costs

ASC 310-20 requires that certain nonrefundable loan origination fees and costs be recorded as an adjustment of the carrying amount of the loan and amortized over the life of the loan as an adjustment to interest income (a yield adjustment). Specifically, deferring loan origination fees and costs has the following effect on yields:

- *Deferring fees received* Enhances yield over life of loan.
- *Deferring costs paid* Reduces yield over life of loan.

PRACTICE POINTER: ASC 310-20 identifies the only circumstances where lending fees and costs should be offset and deferred. The accounting is required, not elective.

Only one entity originates a loan, even if there are subsequent investors in the loan. Origination means the entity that underwrites the loan—evaluates the creditworthiness of the borrower, prepares the loan documentation, and disburses cash to the borrower. Purchases of loans and other investments are *not* considered loan originations. Fees and costs on purchased loans are accounted for differently, as discussed below.

Loan Origination Fees

Loan origination fees are fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan or lease. The following fees are considered loan origination fees (ASC 310-20, glossary term, “Loan Origination Fees” and ASC 310-20-55-15):

- Fees to reimburse the lender for origination activities, including application fees, management, arrangement, and placement fees.
- Fees that are charged to the borrower as “prepaid” interest or to reduce the loan’s nominal interest rate, such as points and interest “buy-downs” (explicit yield adjustments).
- Fees that are, in substance, implicit yield adjustments because a loan is granted at off-market terms (e.g., certain syndication fees).
- Underwriting fees charged to the borrower that relate directly to making the loan (e.g., fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly).
- Loan syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender. (ASC 310-20-25-24)

Loan Origination Costs

ASC 310-20 permits deferral of only two categories of loan origination costs:

1. Incremental direct costs incurred in transactions with independent third parties for that loan—so called “external costs.”
2. Certain internal costs directly related to specified loan origination activities performed by the lender for that loan. (ASC 310-20-25-2 and ASC 310-20, glossary term, “Direct Loan Origination Costs”)

External loan origination costs External loan origination costs must have both of the following characteristics:

- The costs result directly from and are essential to the lending transaction; and
- The costs would *not* have been incurred by the lender had that lending transaction not occurred. (ASC 310-20, glossary term, “Incremental Direct Costs”)

“Independent third parties” generally possess the following characteristics (ASC 310-20-55-9):

- They are not employees of the lender.
- They are not receiving employee benefits from the lender.
- They also provide similar services to other entities unrelated to the lender.
- They are not under the control or significant influence of the lender.

A nominal passive investment from the standpoint of both the lender and the provider of service probably would not affect the provider’s independence. (ASC 310-20-55-10)

PRACTICE POINTER: Costs incurred with third parties that are not considered “independent” may be treated as internal costs, as long as they represent origination costs, as defined below. (ASC 310-20-25-25)

PRACTICE POINTER: ASC 310-20 does not apply to costs that are incurred by a lender in transactions with independent third parties *if* the lender bills those costs directly to the borrower. However, costs that are not billed directly to the borrower, but instead, are expected to be recovered through the interest rate charged to the borrower, are within the scope of ASC 310-20. (ASC 310-20-55-2)

PRACTICE POINTER: Fees paid to a service bureau for loan processing are not eligible for deferral because the services are not related to loan origination, that is, the services are performed *after* the loan has been made. (ASC 310-20-25-5)

Internal loan origination costs Certain internal costs, such as employees’ salaries and benefits, directly related to specified loan origination activities performed by the lender for that loan should be deferred and amortized as a reduction of the yield on the loan. Exhibit 8-2 evaluates various activities and outlines the types of internal costs that should be deferred and the types of internal costs that should be expensed as incurred.

EXHIBIT 8-2
TREATMENT OF INTERNAL COSTS FROM LENDING ACTIVITIES

| Costs from Loan Origination Activities That Should Be Deferred | Costs That Should Be Expensed as Incurred |
|--|---|
| <p><i>Source: ASC 310-20, glossary term, “Direct Loan Origination Costs”, ASC 310-20-55-15</i></p> <p>Evaluating the prospective borrower’s financial condition</p> <p>Initial credit analysis and investigation</p> <p>Appraisals</p> <p>Evaluating and recording guarantees, collateral, and other security arrangements</p> <p>Negotiating loan terms, including discussing alternative borrowing arrangements with borrowers</p> <p>Preparing and processing loan documents</p> <p>Quality control review performed during the underwriting period internally</p> <p>Loan evaluation and approval committees (all activities involved in origination decisions)</p> <p>Closing the transaction</p> | <p>ASC 310-20-25-3, 310-20-25-4, 310-20-25-26; 310-20-25-27, 310-20-55-14</p> <p>Advertising, soliciting potential borrowers</p> <p>Supervision and administration</p> <p>Establishing and monitoring credit policies</p> <p>Servicing existing loans</p> <p>Unsuccessful loan origination efforts and idle time</p> <p>Administrative costs, rent, depreciation, and all other occupancy and equipment costs (including data processing equipment and software dedicated to originating loans)</p> <p>Investment advisory costs, whether paid to third parties or incurred</p> |

Calculating internal costs Internal employee costs must be allocated to origination activities based upon the time spent by the employee on loan origination activities for successful loans in comparison to the employee’s total time spent on the job. Other allocations (e.g., treating a commission paid on the basis of loan production as an origination cost) are not permitted. Only that portion of the employees’ total compensation (including bonuses) 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 should be deferred. (ASC 310-20, glossary term, "Direct Loan Origination Costs" and ASC 310-20-25-6) Examples of such costs include:

- The portion of executive compensation, such as salaries of members of a loan approval committee, attributable to review of successful loans prior to funding. (ASC 310-20-55-13)
- For an employee paid commissions only for successful loan production, the portion relating to loan *origination* activities. (ASC 310-20-25-7)
- Reimbursement of travel costs, itemized telephone calls, and reimbursement for mileage and tolls to personnel involved in a successful loan origination. (ASC 310-20-55-11)
- Fringe benefits, including payroll taxes, insurance, retirement plans, stock compensation plans, and overtime meal allowances. (ASC 310-20-55-12)

Standard costing methods may be used to calculate direct loan origination costs, provided that the costs of originating loans are similar. (ASC 310-20-25-8) A successful-efforts-based system should be developed at the functional level (e.g., application, verification, underwriting, appraisal, closing) and may be based on the percentage of successful and unsuccessful efforts determined for each function, adjusted for idle time and time spent on activities for which the related costs cannot be deferred. (ASC 310-20-25-9)

PRACTICE POINTER: Idle time represents the time that a lender's employees are not actively involved in performing origination activities for specific loans. Idle time can be measured through the establishment of standard costs, time studies, ratios of productive and nonproductive time, and other methods. (ASC 310-20, glossary term, "Idle Time")

Costs on pending loans Origination costs on a loan in process may be deferred until the loan is either closed or considered an unsuccessful effort. If a loan in process is determined to be unsuccessful after the balance sheet date but before the financial statements are issued, costs that have been deferred through the balance sheet date should be charged to expense in the period ending with the balance sheet date. (ASC 310-20-25-10)

Fees and Costs on Purchased Loans

Purchased loans are recorded at the amount paid to the seller, plus any transaction fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This premium or discount should be recognized as an adjustment of yield over the life of the loan. All costs incurred in connection with acquiring loans or committing to purchase loans should be charged to expense as incurred. (ASC 310-20-25-22) This includes loans acquired through a loan participation. (ASC 310-20-25-23 and 25-24) Loans purchased at a discount that is due in part to credit concerns are accounted for under ASC 310-30, not ASC 310-20 as discussed later in this chapter.

OBSERVATION: A purchased loan has already been originated by another party. Therefore, the purchaser is not allowed to defer any costs as "origination" fees or costs, including the cost of due diligence reviews.

Loans Purchased as a Group

A purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts should be used to apply the interest method, except when prepayments are anticipated, as allowed by ASC 310-20-35-26. If prepayments are not anticipated and prepayments occur or some of the purchased loans are sold, a proportionate amount of the related deferred fees and purchase premium or discount should be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged. (ASC 310-20-35-16) (As discussed later in this chapter, ASC 310-10-25-7, *Receivables/Overall/Recognition*, and ASC 310-10-35-52, *Receivables/Overall/Subsequent Measurement*, provide guidance for credit card receivables purchased as a group.)

Fees and Costs on Refinancings and Restructurings (Other Than a Troubled Debt Restructuring)

When the terms of a loan are contractually revised in a nontroubled situation, the lender must determine whether the revised agreement should be accounted for as a new loan (an origination) or a continuation of the old loan.

PRACTICE POINTER: A concession made to reflect a general decline in market interest rates or a decrease in risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at current market rates is generally *not* a troubled debt restructuring. (ASC 470-60-15-12)

Tests for a New Loan

A loan with revised terms should be considered a "new loan" if both of the following conditions are met:

- The terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender. This condition would be met if the new loan's effective yield were at least equal to the effective yield for such loans.
- The modifications of the terms of a loan are more than *minor*. (ASC 310-20-35-9 and 35-10) A modification of a loan should be considered 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 instrument. If the difference is less than 10%, a creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances

(and other relevant considerations) surrounding the modification. The 10% test should be performed using the computational guidance in ASC 470-50, *Debt—Modifications and Extinguishments*. (ASC 310-20-35-11) Chapter 12, "Extinguishments of Debt," discusses the provisions of ASC 470-50 in detail.

PRACTICE POINTER: The definition of *minor* is only relevant to the creditor's accounting for a loan refinancing or restructuring when the terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are *not* refinancing or restructuring.

The accounting for any unamortized fees and costs and any new fees and costs would be:

- *If new loan conditions are met:* Write off any unamortized fees and costs to interest income when the new loan is granted. (ASC 310-20-35-9) Defer any fees received to modify an existing loan, net of any direct loan origination costs and recognize over the remaining life of the loan as an adjustment of yield. (ASC 310-20-35-34)
- *If new loan conditions are not met:* Carry forward any unamortized fees and costs as a part of the net investment in the new loan. The new loan balance would 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. (ASC 310-20-35-10)

Blended-rate Loans

Blended-rate loans involve lending new funds at market interest rates combined with existing loans at rates currently lower than market rates. The combined loan yields an interest rate between the existing loan rate and the market rate. This arrangement is a refinancing, but it does not meet the "new loan" yield test, that is, the blended rate is below the market rate of loans with similar collection risks made to the lender's other customers. Thus, the unamortized net fees and costs on the existing loan as well as the net fees and costs relating to the refinancing should carry over to the new loan. (ASC 310-20-35-35 and ASC 310-20, glossary term, "Blended-Rate Loans")

Other Types of Fees, Including Commitments

Loan Commitments

Fees received for a commitment to originate or purchase a loan or group of loans are generally netted against any direct loan origination costs (ASC 310-20-25-12), deferred, and:

- If the commitment is exercised, recognized over the life of the loan as an adjustment of yield, or
- If the commitment expires unexercised, recognized in income upon expiration of the commitment. (ASC 310-20-40-1)

Lines of credit and credit cards are viewed as forms of loan commitments under ASC 310-20.

The recognition of commitment fees depends on the circumstances of the transaction, as follows:

- *Exercise of commitment is remote*—If, based on the entity's experience with similar arrangements, it is remote that the commitment will be exercised, a net commitment fee should 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 should be recognized over the life of the loan as an adjustment of yield. (ASC 310-20-35-3(a)) Any *net cost* should be charged to expense immediately. (ASC 310-20-25-13)
- *Commitment fees determined retrospectively*—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, the commitment fee should be recognized as service fee income as of the determination date if:
 - That percentage is nominal in relation to the stated interest rate on any related borrowing, and
 - That borrowing will bear a market interest rate at the date the loan is made. (ASC 310-20-35-3(b))
- *Lines of credit*—Qualifying origination costs should be deferred and amortized based on the terms of the line of credit or commitment facility.
 - Revolving line of credit: Straight-line basis over the period that the revolving line of credit is active.
 - Revolver with option to convert to a term loan: Straight-line basis over the combined life of the revolving line of credit and term loan.
 - Not a revolving line of credit: Straight-line basis over the commitment period. (ASC 310-20-55-3)
- *Credit facilities with multiple, unscheduled drawdowns with varying maturities*—The commitment fee should be deferred until the facility is exercised and a drawdown is made. Given the multiple, unscheduled drawdowns intended under the facility, a *pro rata* portion of the commitment fee (equal to the percentage of the loan drawn down to the total facility) should be recognized over the life of the applicable drawdown as an adjustment of its yield. (ASC 310-20-55-49)

PRACTICE POINTER: Some lenders offer "multi-option facilities," which contain several credit structures that borrowers may use in any combination. Lenders may receive a variety of fees in connection with that type of facility.

Generally, all fees received must be deferred. However, the fees must be allocated to each product in the facility because the amortization of certain fees must be reported as service fee income while the amortization of other fees must be reported as interest income. (ASC 310-20-55-4)

Credit Card Fees and Costs

Various types of entities issue credit cards, debit cards, bank charge cards, and other similar cards (collectively, credit cards) with a variety of terms. Fees charged in connection with credit card issuances are viewed as loan commitment fees and certain costs associated with issuing a credit card are viewed as origination costs.

Credit card originations—ASC 310-20-25-18, *Receivables/Nonrefundable Fees and Other Costs/Recognition*, concludes that credit card origination costs that qualify for deferral under ASC 310-20 should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the “privilege period” as an adjustment of interest income. “Privilege period” means:

- *If a significant fee is charged*—The period that the fee entitles the cardholder to use the credit card.
- *If no significant fee is charged*—One year.

Individual credit card originations and purchases—Amounts paid to a third party to acquire individual credit card accounts should be treated as originations, that is, deferred and netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. (ASC 310-20-25-18, *Receivables/Nonrefundable Fees and Other Costs/Recognition*, and ASC 310-20-35-8, *Receivables/Nonrefundable Fees and Other Costs/Subsequent Measurement*)

Fees paid for solicitations of new customers—When a lender pays a fixed fee to an independent third party to solicit new cardholders, none of the fee is eligible for deferral, because the lender would have incurred all of the solicitation costs regardless of the number of credit cards issued. Accordingly, the entire fee should be charged to expense. (ASC 310-20-55-5)

Renewal fees—Periodic renewal fees for the continued extension of credit card privileges generally cover many services to cardholders. Renewal fees should be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card as service fee income. (ASC 310-20-35-5)

Purchases of credit card portfolios—ASC 310-10-25-7 and 35-52 require that when an enterprise purchases a credit card portfolio including the cardholder relationships, the credit card receivables should be recorded at their fair values. The difference between the amount paid and the fair value of the credit card loans at the date of purchase (the premium) should be attributed to the card-

holder relationships acquired. The amount relating to the cardholder relationships represents an identifiable intangible asset that should be amortized over the period estimated to be benefited in accordance with ASC 350-30-35-6. Any difference between the fair value and principal balances of the loans should be amortized over the life of the loans in accordance with ASC 310-20.

Loan Commitments that Must be Accounted for as Derivatives

Loan commitments that relate to the origination of mortgage loans that will be held for resale, as discussed in ASC 948-310-25-3, must be accounted for as derivative instruments in accordance with ASC 815 by the lender (but not the borrower). In addition, commitments to buy and sell existing loans must be evaluated under ASC 815. However, loan commitments that relate to the origination of mortgage loans that will be held for investment and all other commitments to originate loans should be accounted for as described in this section, even if they technically meet the definition of a derivative. (ASC 815-10-15-13(i) and ASC 815-10-15-69 through 15-71)

OBSERVATION: After the issuance of ASC 815, the FASB learned that many types of loan commitments would meet the definition of a derivative under ASC 815, either because the loan commitments are transferable (and therefore can be “net settled”) or because the underlying loans were readily convertible to cash (such as in the case of a conforming mortgage loan). ASC 815-10-15-69 through 15-71 creates a scope exception for most loan commitments involving originated (new) loans, except for the creditor when the loan is considered held for resale under the specialized mortgage banking model.

Standby Commitments to Purchase Loans

A standby commitment is, in substance, a written put option that will be exercised only if the value of the loans is less than or equal to the strike price. If a standby commitment meets the definition of a derivative, it must be accounted for under ASC 815.

Standby commitments that are not derivatives should be accounted for in accordance with ASC 310-20-35-3 if (a) the settlement date is within a reasonable period of time (e.g., a normal loan commitment period) and (b) the entity has the intent and ability to accept delivery without selling assets. Loans purchased under such standby commitments should be recorded at cost on the settlement date, net of the standby commitment fee received.

Standby commitments that are not derivatives, but do not meet the criteria in the previous paragraph should be recorded as a liability and accounted for at the greater of the initial standby commitment fee or the fair value of the written put option. Unrealized gains (i.e., recoveries of unrealized losses) or losses should be credited or charged to current operations. (ASC 310-10-25-6, 30-7, and 35-46)

OBSERVATION: If a standby commitment does not meet the definition of a derivative under ASC 815 but must be accounted for “like” a derivative (a written put option), the commitment may not be designated as a hedge.

Loan Syndication Fees

When a company seeks to borrow a large amount of money, lenders sometimes share the risk by forming a syndicate. One lender typically manages the transaction with the borrower (the syndicator), but each member of the syndicate funds its respective portion of the loan. Typically, the lead syndicator receives a fee from the borrower and passes through some or all of that fee to the other lenders.

The institution managing a loan syndication (the syndicator) should recognize loan syndication fees as follows:

- *If a portion of the loan is retained*—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 (including the fees passed through by the syndicator). Any excess should be recognized as revenue when the syndication is complete.
- *No loan retained*—Recognize as revenue when the syndication is complete. (ASC 310-20-25-19)

Delinquency Fees

Delinquency fees should be recognized in income when chargeable, assuming collectibility is reasonably assured. (ASC 310-10-25-13)

Prepayment Fees

Prepayment penalties should not be recognized in income until loans or trade receivables are prepaid, except that the existence of prepayment penalties could affect the application of ASC 310-20-35-18(a), which is discussed later in this chapter. (ASC 310-10-25-12)

Rebates

Rebates represent refunds of finance charges on installment loans or trade receivables that occur when payments are made early. The possibility that rebates may be calculated using a method different from the interest method should not affect the accrual of interest income on installment loans or trade receivables, except that the possibility of rebates could affect the application of ASC 310-20-35-18(a). Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans or trade receivables are prepaid or renewed. (ASC 310-10-25-11)

Factoring Commissions

Factoring usually involves selling accounts receivable to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the

event of a loss. The accounting for factoring commissions by the factor depends on whether the transfer is accounted for as a purchase/sale or a secured borrowing under ASC 860. (Chapter 6, “Transfers of Financial Assets,” discusses the conditions necessary for a sale or financing in detail.) If the transaction is accounted for as a purchase of receivables by the factor, the purchase discount (factoring commission) should be accounted for under either ASC 310-20 or ASC 310-30, as appropriate, depending on whether the discount is attributable in part to concerns about credit quality. If the transaction is accounted for as a secured loan, factoring commissions should be recognized over the period of the loan contract under ASC 310-20, beginning when the entity funds a customer’s credit and ending when the customer’s account is settled. (ASC 310-10-25-3)

APPLICATION OF THE INTEREST METHOD

The objective of the interest method is to arrive at periodic interest income that represents a constant effective yield on the net investment in the receivable (i.e., the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). Certain gains and losses on fair value hedges are also included in the carrying amount of a loan or debt security. Hedge accounting is discussed in Chapter 15, “Hedge Accounting.”

As discussed in the previous section, when an entity originates a loan, certain fees and costs are required to be deferred and amortized as an adjustment of the yield of the loan under ASC 310-20. Loan origination fees and direct loan origination costs for a given loan should be offset and only the net amount should be deferred and amortized. (ASC 310-20-30-2) All other lending-related costs should be expensed as incurred. (ASC 310-20-25-3)

Aggregation of Loans

Loans may be aggregated if the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated (ASC 310-20-35-26) or if the resulting recognition does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis. (ASC 310-20-15-5)

Subsequent Sale of Aggregated Loan

If loans are aggregated and a loan in the pool is subsequently sold, the deferred net fees and costs should be allocated either on a *pro rata* basis (based on the ratio of the outstanding principal balances of the loans sold) or, if detailed records are available, on a specific identification basis to calculate the gain or loss. (ASC 310-20-35-32)

PRACTICE POINTER: Recognizing net fees over the estimated average life of a group of dissimilar loans is not in accordance with U.S. GAAP.

- The U.S. dollar,
- The Mexican peso,
- The Venezuelan bolivar, or
- The pound sterling.

If the lease were denominated in any other currency, the lease would contain an embedded foreign currency derivative that requires separate accounting. (ASC 815-15-55-213 through 55-215; 815-15-55-91 through 55-93)

CHAPTER 15 HEDGE ACCOUNTING

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IMPORTANT NOTICE: NEW FASB STANDARD ON HEDGE ACCOUNTING

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities* (ASU 2017-12). This ASU completes the FASB's comprehensive project to reconsider many aspects of financial instruments accounting.

Rather than a wholesale reconsideration of hedge accounting, the FASB decided to pursue several targeted topics. These changes, in general, make hedge accounting easier to qualify for, simplify certain aspects of the accounting for hedged items and hedging instruments, make the documentation requirements for qualifying hedge relationships less rigid, and change certain presentation and disclosure requirements related to hedge accounting.

The significant changes made pursuant to ASU 2017-12 include:

1. allowing contractually-specified components of nonfinancial items to be hedged in a cash flow hedge;
2. allowing the specified index rate in a variable-rate instrument to be the hedged interest rate risk, instead of requiring a benchmark rate to be the hedged risk;
3. adding the SIFMA Municipal Swap Rate as an eligible benchmark interest rate for fair value hedges of interest rate risk;
4. permitting an entity to measure the change in fair value of the hedged item in a fair value hedge of interest rate risk based on the benchmark

- rate component of the contractual coupon cash flows, rather than the entire coupon cash flows;
5. permitting the measurement of the hedged item in a partial-term hedge of interest rate risk by considering only the changes in fair value of the designated cash flows being hedged;
 6. for fair value hedges of prepayable financial instruments, permitting an entity to measure the change in fair value of the hedged item considering only how changes in the benchmark interest rate affect the decision to prepay;
 7. allowing an entity to designate as the hedged item in a fair value hedge of interest rate risk in a closed portfolio of prepayable financial assets an amount of assets that is not expected to be prepaid, and thereby ignore prepayment risk in the measurement of the hedged item;
 8. eliminating the recognition of hedge ineffectiveness in earnings for qualifying cash flow and net investment hedges;
 9. relaxing the requirements for ongoing effectiveness testing by allowing qualitative testing after an initial quantitative effectiveness test;
 10. requiring presentation of hedge results in the same line item as the hedged item when the hedged item affects earnings for all qualifying hedges;
 11. changing the way that components of a hedging instrument that are excluded from hedge effectiveness assessments are handled, to allow the initial value of the excluded component to be amortized to earnings, while changes in the fair value of the excluded component may be either recognized in earnings or in OCI;
 12. allowing initial assessments of hedge effectiveness to be completed at any time before the first quarterly effectiveness testing date, instead of requiring such initial tests to be completed at hedge inception;
 13. allowing the application of the "critical terms match" method to hedges of forecasted transactions so long as the forecasted transactions are expected to occur within the same month or 31-day period as the derivative's maturity; and
 14. allowing an entity that uses the shortcut method of hedge accounting to designate a "backup" method of assessing effectiveness that it can use if the relationship is later determined not to have met the requirements for use of the shortcut method.

The changes to GAAP from ASU 2017-12 are mandatorily effective for fiscal years (including interim periods) beginning after December 15, 2018 for public business entities. Other entities need not adopt the changes until their annual financial statements for their fiscal year beginning after December 15, 2019. Early application is permitted in any interim or annual period. Transition to the new guidance requires a cumulative-effect adjustment to retained earnings and OCI to eliminate the effect on retained earnings of the recognition of ineffectiveness in existing cash flow and net investment hedges. Other effects of the changes are generally to be implemented prospectively, with several options provided to

alter hedge designation and documentation requirements for existing hedges to take advantage of the less stringent requirements. (ASC 815-20-65-3)

This chapter and other chapters within this edition are updated to reflect the new requirements arising from this new accounting standard. Readers should refer to prior editions for applicable accounting guidance in effect before the effective date of the new standard.

OVERVIEW

All derivatives must be carried at fair value in the balance sheet. However, for qualifying hedge transactions, gains and losses on derivatives may be recognized in earnings in a pattern that matches the hedged item. To qualify for hedge accounting, numerous criteria must be met.

1. The hedging relationship must be documented before hedge accounting can apply. This documentation must explain the risk being hedged, how the hedging instrument is effective in addressing that risk, and how hedge effectiveness will be assessed during the hedge period.
2. The hedged item must meet certain criteria. These criteria vary based upon the type of risk being hedged (fair value, cash flows, foreign currency, etc.). Certain items are ineligible to be hedged.
3. The hedging instrument must generally be a derivative (e.g., a forward or option), except for certain specific exceptions in which a cash instrument (e.g., a loan or debt security) may be utilized.
4. The hedge must be (and must be expected to be) highly effective in offsetting variability due to changes in the hedged risk. This must be confirmed through effectiveness assessments each period.

Each of these criteria is discussed in detail in this chapter. Hedge accounting is elective for transactions that meet all of the necessary criteria.

The mechanics of hedge accounting vary depending on whether the risk being hedged is fair value (price) risk, cash flow risk, or foreign currency risk. Generally:

- a. Fair value hedge accounting is accomplished by recognizing gains and losses on the hedged item related to the hedged risk in earnings along with changes in value of the derivative used to hedge the risk.
- b. Cash flow hedge accounting is accomplished by recognizing changes in value of the derivative used to hedge the cash flow risk in other comprehensive income (OCI) initially, and then reclassifying those gains and loss to earnings when the hedged transaction affects earnings.
- c. Hedges of the net investment in a foreign operation are recognized by recording gains and losses on the hedging instrument related to fluctuations in foreign exchange rates in OCI, in the same component in which translation gains and losses on the foreign investment are recognized.

These mechanics are also discussed in detail in this chapter.

BACKGROUND

ASC 815, *Derivatives and Hedging*, is the primary source of literature for hedge accounting. The original guidance, which was published in FAS-133, has been heavily interpreted and modified by several additional FASB standards, numerous EITF consensuses, and over 40 DIG issues addressing various aspects of hedge accounting. ASU 2017-12 made significant changes in the guidance, generally making hedge accounting easier to qualify for, document, and reflect in the financial statements.

The guidance for hedge accounting is extensive, in part because of the detailed requirements for an item or transaction to qualify for hedge accounting initially and on an ongoing basis. This chapter discusses the three types of hedging relationships that have specific methods of hedge accounting, the required criteria for hedge accounting, and reporting the results of hedge accounting in the financial statements.

Disclosures about derivatives and hedge accounting are discussed in Chapter 16, "Disclosures about Derivatives."

Description of Hedge Accounting

Hedge accounting is a special accounting practice that reflects certain situations when derivatives (or, in certain cases, other instruments) are used as part of a strategy to mitigate risks in other assets, liabilities, or contracts. Rather than applying the otherwise applicable U.S. GAAP to each component of the strategy, hedge accounting permits the reporting entity to override U.S. GAAP for one or both components and recognize the gains or losses on the instrument used to hedge the risk inherent in the hedged item in the same period as the income statement effect of the hedged item.

Because hedge accounting changes the timing of recognition of gains and losses in earnings, numerous conditions must be met both upfront and over the life of the hedging relationship; these are referred to as hedge criteria. The criteria differ depending on the nature of the risk being hedged, but are cumbersome in any event, even after the simplifications in ASU 2017-12. Despite the many criteria to qualify for hedge accounting and the complexity of actually determining the accounting entries in some instances, many entities elect to apply hedge accounting even though it is entirely optional—that is, even in a situation in which a company could qualify for hedge accounting, it may elect not to do so. Entities engaged in risk management strategies often desire hedge accounting, and therefore are willing to undertake the tasks necessary to achieve it, so that their reported net income reflects the effect of their derivative transactions in the same period as the item being hedged.

Different Types of Hedges

ASC 815 prescribes different methods of hedge accounting, depending on the type of risk being hedged. The FASB created three categories of hedging relationships. The categories share some common criteria, but each also has its own

unique criteria and different mechanics for achieving matching in the income statement. The three categories are:

1. **Fair Value Hedges** Hedges of changes in price or fair value of an existing asset, liability, or a *firm commitment* that has a fixed price. For example, the fair value of a fixed-rate bond changes as the general level of interest rates changes. That risk can be hedged with a receive-variable, pay-fixed interest swap. Another example is a firm commitment to buy grain at a fixed price (so long as the contract is not a derivative because it qualifies for the normal purchase exception (ASC 815-20-25-7 through 25-9), which becomes more or less valuable as the market price of grain rises and falls. That risk can be hedged with an option to sell grain at a fixed price. Fair value hedges essentially convert a fixed price item to a floating rate (then current price) item—the combined position now has cash flow risk (see below).
2. **Cash Flow Hedges** Hedges of variable cash flows from an existing asset or liability, or from a transaction expected to occur in the future whose price has not yet been set (known as a forecasted transaction). For example, floating-rate debt could require increased cash outflows if interest rates rise. That risk can be hedged with a receive-floating, pay-fixed interest rate swap. Another example is a projected sale of a commodity (so long as the contract is not a derivative because it qualifies for the normal sale exception (ASC 815-20-25-7 through 25-9)) whose terms have not yet been agreed upon, which could result in less cash if the market price of that commodity falls by the time a contract is struck. That risk can be hedged by selling a futures contract for settlement on approximately the same date as the commodity sale. Cash flow hedges essentially fix the cash flows for a transaction that previously had an uncertain amount of cash flow—the combined position now has price risk.
3. **Hedge of a Net Investment in a Foreign Operation** Hedges of the translation adjustment arising from remeasuring a company's net investment in the assets, liabilities, revenues, and expenses of a foreign subsidiary into the reporting currency of the investor under ASC 830. That risk can be hedged with a pay foreign currency, receive functional currency swap.

OBSERVATION: Fair value exposures and cash flow exposures are often mutually exclusive. By allowing hedges of both types of exposure, the FASB is permitting hedge accounting when one type of risk has been reduced in a transaction, even though hedging one risk creates (or increases) another.

Exhibit 15-1 summarizes how several common hedging transactions would be characterized under ASC 815.

**EXHIBIT 15-1
CHARACTERIZATION OF HEDGING STRATEGIES UNDER ASC 815**

| Strategy | Hedge Type under ASC 815 | Bottom-Line Effect on Income if Perfectly Effective |
|--|--------------------------------|--|
| 1. Swap interest rate from fixed to floating (same currency) | Fair value | Creates floating interest rate in interest income or expense |
| 2. Swap interest rate from floating to fixed (same currency) | Cash flow | Creates fixed interest rate in interest income or expense |
| 3. Lock in fixed interest rate on anticipated debt-offering with a futures contract | Cash flow | When debt is issued, creates desired fixed rate |
| 4. Lock in price of raw materials with a forward purchase contract (no purchase order exists). Assume same currency. | Cash flow | Cost of goods sold will reflect the locked in price of materials (ignoring any complications of inventory accounting). |
| 5. Lock in minimum selling price of finished goods with an option (no sale contract with a customer exists). Assume same currency. | Cash flow | Sales revenue will reflect a minimum selling price of inventory, less cost of option |
| 6. Lock in US\$ equivalent of a purchase of machinery from a foreign supplier (currency amount per contract) | Cash flow or fair value hedge | No effect until machine is depreciated, using the locked-in US\$-equivalent cost as its basis |
| 7. Monetizing a call option in a debt instrument (hedging an embedded option with an offsetting option) | Fair value | Creates effective interest rate for noncallable debt |
| 8. Swap interest rate from fixed to floating and swap currency from foreign currency to functional currency (say US\$) | Fair value | Creates floating US\$ interest rate in interest income or expense |
| 9. Swap interest rate from floating to fixed and swap currency from foreign currency to functional currency (say US\$) | Cash flow | Creates fixed US\$ interest rate in interest income or expense |
| 10. Lock in US\$ equivalent of a forecasted sale of goods by a foreign subsidiary | Cash flow | Sales revenue will reflect the US\$ equivalent of today's selling price of inventory |

The mechanics of hedge accounting vary for the three major categories of hedges. To provide context for this long and detailed chapter, Exhibit 15-2 provides an overview of the way hedge accounting works for the three categories.

**EXHIBIT 15-2
SUMMARY OF DERIVATIVES AND HEDGE ACCOUNTING**

| | No Hedge Accounting | Qualifying Fair Value Hedges | Qualifying Cash Flow Hedges | Qualifying Hedges of Net Investment In Foreign Subsidiary |
|-------------------------------------|-----------------------------------|--|---|---|
| Derivative: | | | | |
| Balance sheet | Fair value | Fair value | Fair value | Fair value |
| Treatment of gain or loss | Earnings | Earnings | First OCI, then earnings timed to match hedged item | CTA (part of other comprehensive income) |
| Treatment of hedged item: | | | | |
| Treatment of loss or gain | Not applicable | Earnings | Earnings (follow U.S. GAAP for hedged item) | CTA (other comprehensive income) |
| Balance sheet | Not applicable | Adjust for changes in fair value of hedged risk(s) | Follow U.S. GAAP for hedged item | Translate into reporting currency under ASC 830 |
| Bottom-line effect on income | Entire gain or loss on derivative | —Net effect is the ineffectiveness of the derivative (i.e., extent to which changes in fair value of the derivative do not exactly offset changes in the hedged risk)— | | |

QUALIFYING FOR HEDGE ACCOUNTING

To qualify for hedge accounting, all hedges must meet all of the following threshold criteria:

- Derivatives used as hedges must be linked to a specific transaction that affects earnings and that relationship must be documented at inception.
- Throughout the term of the hedge, the entity must expect the hedging instrument to be highly effective in offsetting changes in the fair value or cash flow of the hedged item, using reasonable methods that are appropriate in the circumstances.

These key qualifying conditions are described immediately below. Additional criteria that must be met for fair value hedges and cash flow hedges are then discussed under those section headings.

Documentation of the Hedging Relationship

At the inception of every hedging transaction, the entity must document the following information (ASC 815-20-25-3):

- Which instrument is the hedging instrument and which specific item it is hedging. Generally, long and short positions may not be hedged on a net basis. For example, an entity may not hedge its net interest rate gap

position or net income for a period. It must dig deeper and identify specific transactions to hedge.

- The nature of the risk being hedged (e.g., overall changes in fair value, interest rate risk, or foreign currency risk).
- The entity's risk management objective or strategy (e.g., to convert a floating-rate instrument to a fixed rate, or to hedge corn inventory from declines in the price of corn).
- The method the entity will use to assess and measure effectiveness (prospectively and retrospectively). Private companies that are not financial institutions and certain not-for-profit entities are not required to complete this part of the documentation until the date that the financial statements including the inception of the hedge relationship are available to be issued. (ASC 815-20-25-142 and 25-143)

PRACTICE POINTER: Documenting hedging relationships after the fact is not in accordance with U.S. GAAP and will disqualify a transaction for hedge accounting for the period prior to the designation.

REGULATORY ALERT: The SEC staff expects vigilant compliance with the documentation requirements of ASC 815, and the documentation should be contemporaneous with the designations of hedging relationships. For example, the SEC staff expects the documentation of the methods that will be used to assess effectiveness to be sufficiently detailed such that a third party could follow the documentation and make the assessment. Refer to the Current Accounting and Disclosure portion of the SEC website for additional information. The SEC has required registrants to restate their financial statements for failure to comply with the documentation requirements of ASC 815. (December 7, 1999, speech by Pascal Desroches, then a Professional Accounting Fellow at the SEC.)

In addition, in the March 2005 update of Current Accounting and Disclosure Issues in the Division of Corporate Finance, the SEC staff reiterated that it will challenge the application of hedge accounting in situations where a registrant has not contemporaneously complied with ASC 815-20's documentation requirements upon designation of a hedge. The SEC staff stresses that, for hedges of forecasted transactions, the documentation must include the estimated date, nature, and hedged amount of the forecasted transaction. The methodology used to assess hedge effectiveness must be reasonable and must be documented at inception.

At the December 2006 National Conference on Current SEC and PCAOB Developments, the SEC staff again addressed hedge documentation. The SEC staff reiterated that if a company fails to document its approach for assessing hedge effectiveness, then the hedge documentation is insufficient and hedge accounting would be inappropriate. The SEC staff also cited a situation involving cash flow hedges where a group of individual transactions are part of one hedging relationship. In that case, the documentation must be sufficiently clear that the group of hedged items share the same risk exposure. If the transactions have different characteristics (e.g., a group of forecasted sales of commodities that have different delivery locations) additional analysis may need to be done to

support the assertion that the group of hedged items share the same risk exposure. If there are changes in the composition of the group of transactions, the company may be required to update this analysis periodically throughout the life of the relationship. (Speech by Joseph D. McGrath, then a Professional Accounting Fellow, Office of the Chief Accountant of the SEC, at the December 2006 National Conference on Current SEC and PCAOB Developments)

Hedging Instruments

All or a proportion of a contract that meets the definition of a derivative in ASC 815 and is accounted for separately may be designated as a hedging instrument if the transaction qualifies for hedge accounting. Thus, both freestanding derivatives and embedded derivatives that are bifurcated from their host contract are eligible hedging instruments. In addition, two or more derivatives may be considered in combination and be jointly designated as a hedging instrument. (ASC 815-20-25-45) Common hedging instruments are options, forwards, swaps, and similar instruments.

Cash instruments, such as debt instruments, equity securities, short sale liabilities, and other contracts that do not meet the definition of a derivative, may not be designated as the hedging instrument, except for two specific types of foreign currency hedges involving unrecognized firm commitments and the net investment in a foreign operation. (ASC 815-20-25-71) This prohibition applies also to hybrid instruments that are accounted for on a *combined basis* at fair value. (ASC 815-15-35-1 and 35-2) (Refer to Chapter 14, "Embedded Derivatives," for more information.)

To enhance readability, this chapter uses the term "derivative" instead of hedging instrument, except in narrow circumstances where other types of instruments may be designated as hedging instruments. Those circumstances are specifically noted later in this chapter in the section on "Foreign Currency Hedges."

Designating Part of a Derivative in a Hedging Relationship

Either all or a *proportion* of a derivative may be designated as the hedging instrument. (ASC 815-20-25-45) The proportion must be expressed as a percentage of the *entire* derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. An entity may not separate a compound derivative into components representing different risks. For example, a \$100 million swap with an embedded option may not be divided into a swap and an option; however, an entity could choose to designate only \$50 million of the entire swap as a hedging instrument, provided the other hedge criteria are met. (Presumably, the hedged item would have an offsetting embedded option that was not accounted for separately.)

AUTHOR'S NOTE: For simplicity, when this chapter refers to a derivative as a hedging instrument, it includes the use of only a proportion of a derivative.

OBSERVATION: The restriction against separating derivatives into components is primarily to reduce complexity. Theoretically, it conflicts with other aspects of ASC 815 that allow/require split accounting for distinct risks.

Combining Derivatives

Two or more derivatives, or proportions thereof, may be designated together as a single hedging instrument. (ASC 815-20-25-45) For example, an entity could designate a swap and an option together as a hedge of the interest rate risk in callable debt (assuming other hedge criteria are met).

PRACTICE POINTER: Certain combinations of options are required to be accounted for as a single forward contract. Refer to Chapter 13, "Derivatives Accounting," for additional information.

Written Options

When a company writes an option, it takes on a potential obligation and gives the counterparty a potential right if the option goes in the money. The option writer's potential for gain is limited to the amount of premium received, but his potential for loss is much greater. Writing options is primarily a risk-taking activity and, as such, a written option is allowed to be used as a hedging instrument only in very narrow circumstances. A combination of a written option and a swap or forward contract (such as a swaption) should be considered a written option for purposes of applying the hedge accounting criteria. (ASC 815-20-25-88)

A written option may be designated as a hedging instrument of a recognized asset or liability or an unrecognized firm commitment only if the combination of instruments has at least as much potential for gains as exposure to loss (the symmetrical gain and loss test). For example, the following strategies could, on a combined basis, provide symmetrical opportunities for gain and loss, depending on the facts and circumstances:

- A written option that hedges callable debt.
- A collar (that is considered a net written option) that hedges a purchase of inventory in a foreign currency. (ASC 815-20-25-94)

However, a *covered call strategy* (i.e., a call option written against an asset held) would generally not meet the symmetrical gain and loss test, because the asset alone has upside and downside potential, but in the combined scenario, it only has downside potential.

The symmetrical gain and loss test should be applied only at the inception of the hedging relationship. (ASC 815-20-25-95) The time value of the written option may be excluded for the purpose of performing the symmetrical gain and loss test as long as that method is documented and consistent with the entity's risk management strategy. (ASC 815-20-25-96)

Collars

A combination of options (e.g., a collar) in which the strike price and the notional amount of both the written option component and the purchased option component remain constant would be considered a net written option unless all of the following three conditions are met (ASC 815-20-25-89):

1. No net premium is received, either in cash or as a favorable term, either at inception or over the life of the contract.
2. Each option is based on the same underlying and has the same maturity date.
3. The notional amount of the written option component is no greater than the notional amount of the purchased option component.

If the combination of options does not meet all of those conditions, it is subject to the symmetrical gain and loss test in ASC 815-20-25-95. For example, under this guidance, a combination of options having different underlying indices, such as a collar containing a written floor based on three-month Treasury rates and a purchased cap based on three-month LIBOR, must be considered a net written option even though those rates may be highly correlated. (ASC 815-20-25-90)

If either the written option component or the purchased option component has a strike price or notional amount that could fluctuate over the life of the contract, these conditions must be applied on each date that either the strike prices or the notional amounts change. (ASC 815-20-25-91)

If a collar is made up of a purchased option and a written option that have different notional amounts (but the notional amount of the written option is less than that of the purchased option), the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the put and call options. That is, the quantities of the asset designated as being hedged may be different based on those price ranges in which the collar goes in the money. (ASC 815-20-25-10)

AUTHOR'S NOTE: The Chicago Board Options Exchange has an excellent interactive education section on its website (www.cboe.com) that encourages scenario analysis with different strike prices, exercise dates, and other terms.

Limitations on Intercompany Derivatives

Large organizations often centralize their hedging functions for a variety of reasons, including (a) one department (or subsidiary) has expertise in derivatives markets (including a subsidiary that might actually be a derivatives dealer) or (b) it is more efficient for the company to monitor its exposures globally and enter into as few derivative transactions as possible. To document this transfer of risk between entities, "internal" or intercompany derivatives are written between the central treasury department and the subsidiary seeking to hedge its exposure (and then the central treasury department would enter into an offsetting contract with a derivatives dealer). Internal derivatives do not qualify for hedge account-

ing in consolidation, except in narrow circumstances involving foreign currency hedges, and numerous criteria must be met. (The specific circumstances are discussed later in the "Foreign Currency Hedges" section of this chapter.) A parent company may enter into a derivative with a third party and designate it as a hedge of a subsidiary's risk in consolidation; however, in situations involving foreign currency hedges, certain additional conditions must be met. (ASC 815-20-25-23 through 25-32)

To qualify for hedge accounting in the *separate company* financial statements of a hedging subsidiary, the subsidiary must be a party to the derivative, whether it is with a related party (e.g., a sister subsidiary or the parent company) or with a third party. (ASC 815-20-25-46A)

Hedged Items

ASC 815-20 permits an entity to hedge specific assets, liabilities, contracts, and other transactions that affect (or will affect) earnings. An entity may hedge either (1) the entire change in fair value (or cash flow) arising from a hedged item or (2) changes in fair value or cash flow arising from some but not all of the risks inherent in a hedged item, subject to certain limitations. (ASC 815-20-25-11 and 25-13) If the entire change in fair value is not designated as being hedged, two or more risks (interest rate risk, foreign exchange risk, and credit risk) simultaneously may be designated as being hedged. (ASC 815-20-25-15) ASC 815 uses the phrase, "change in fair value (or cash flow) attributable to the risk being hedged" in situations where only some designated risks have been hedged, as permitted. For example, a foreign-currency denominated bond would bear all of the following types of risk:

- Credit risk
- Interest rate risk (including prepayment risk)
- Foreign currency risk.

An entity is permitted to hedge one or more of those risks, provided that the derivative (or combination of derivatives) would be highly effective in offsetting changes from those designated risks. Perhaps the most common example of this practice is swapping the interest rate on a debt instrument. In such cases, *only* interest rate risk is being hedged. The swap offers no protection against changes in credit risk, so changes in credit quality do not affect hedge accounting (except when default becomes possible). ASC 815-20 imposes certain limits on what qualifies as a discretely hedgeable risk—the limits on interest rate risk are discussed below. Other limitations are discussed in the fair value and cash flow hedge accounting sections.

PRACTICE POINTER: This "bifurcation by risk" approach applies *only* to hedged items. A derivative (hedging instrument) may *not* be separated by risk, even if it is a compound derivative that has been bifurcated from a hybrid instrument. (ASC 815-20-25-71) Designations of selected risks and the methods of assessing effectiveness must be meticulously documented, to avoid second-guessing by auditors and regulators.

OBSERVATION: Although the bifurcation-by-risk approach seems unnecessarily complex at first glance, it was actually a concession by the FASB so that gains and losses from unhedged risks (such as credit) do not flow through earnings ASU 2017-12 provided additional refinements related to designation and measurement of interest rate risk hedges to better reflect the objective of hedging that risk in isolation.

Hedges of Interest Rate Risk

ASC 815-20 allows for hedge accounting for several kinds of hedges of interest rate risk, but there are still some types of interest rate hedges that do not qualify for hedge accounting.

If an entity seeks to hedge the interest rate risk of a hedged item in a fair value hedge (i.e., the entity wants to hedge the change in fair value of a fixed rate instrument due to changes in market interest rates), it must identify a *benchmark interest rate* inherent in (or explicitly stated in) that instrument. A benchmark interest rate is a widely quoted rate in an active market that is indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. Benchmark rates are determined on a market-by-market basis. In the United States, Treasury rates, the LIBOR swap rate, the Fed Funds Effective Swap Rate (also called the Overnight Index Swap or OIS Rate), and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate are the only acceptable benchmark rates. Any spread above the benchmark rate is considered a component of credit risk, not interest rate risk. (ASC 815-20-25-6A)

PRACTICE POINTER: The narrow definition of benchmark interest rates limits which fair value hedges of interest rate risk will result in the desired level of offset in the income statement. Later in this chapter, "shortcut methods" of assessing the effectiveness of interest rate swaps in certain hedges of interest rate risk are described that mitigate those concerns for a narrow subset of transactions.

If instead an entity wishes to hedge the risk of changes in cash flows due to changes in interest rates, ASC 815-20 allows for the designation of different hedged risks depending upon how the variability in cash flows is expected to arise. If the variability relates to interest payments or receipts under an existing variable rate financial instrument or a variable rate instrument that the entity expects to issue or purchase, the hedged risk could be the contractually specified interest rate in the instrument (e.g., LIBOR +2%, or the bank's prime rate + 1/2%). (ASC 815-20-25-15j and 815-20-25-19A) There is no requirement that the specified interest rate be (or be calculated in reference to) a benchmark interest rate.

Variability in cash flows due to interest rate risk can also exist in a situation in which an entity expects to issue or purchase a fixed-rate debt instrument, but the amount that it will pay to purchase or receive to issue the debt instrument will change based on changes in market interest rates before the purchase or