WHITEPAPER

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## Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20) – Premium Amortization on Purchased Callable Debt Securities

*FASB Accounting Standards Update No. 2017-08 (Issue Date: March 2017)*
*Link to Standard: Update No. 2017-08*

### Overview

The amendments in this Accounting Standards Update (ASU) shorten the amortization period for certain callable debt securities held at a premium. The guidance now requires the premium to be amortized to the earliest call date. Under prior guidance, entities generally amortized the premium as an adjustment of yield over the contractual life of the instrument. The new guidance does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity.

### Background

This guidance more closely aligns the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities. In most cases prior to this ASU, market participants priced securities to the call date that produces the worst yield when the coupon is above current market rates. Market participants priced securities to maturity when the coupon was below market rates in anticipation that the borrower would act in its economic best interest. By shortening the amortization period of premiums on these securities to the earliest call date, rather than maturity, the net interest income that is recognized will more accurately reflect the market expectation that the borrower will redeem these securities at the earliest call date.

Under the new guidance, premiums on callable debt securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates must be amortized to the earliest call date, rather than the maturity date. This ASU affects holders but not issuers of these securities. Although this ASU is not limited in scope to certain types of debt securities, municipal bond securities make up the majority, of the callable premium securities market.

A debt security is any security representing a creditor relationship with an entity, and includes all of the following:

- Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
- A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
- U.S. Treasury securities
- U.S. government agency securities

- Municipal securities
- Corporate bonds
- Convertible debt
- Commercial paper
- All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits

The term debt security **excludes** all of the following:

- Option contracts
- Financial futures contracts
- Forward contracts
- Lease contracts
- Receivables that do not meet the definition of security and, so, are not debt securities, for example:
  - Trade accounts receivable arising from sales on credit by industrial or commercial entities
  - Loans receivable arising from consumer, commercial and real estate lending activities of financial institutions

## Main Provisions

The main provisions of ASU 2017-08 are as follows:

- Holders of certain callable debt securities held at a premium must shorten the amortization period to the earliest call date.
- The scope of this ASU is limited to securities that have explicit, noncontingent call features that are callable at fixed prices and on preset dates.
- Further, for instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security is within the scope of the amendments in this ASU.
- There is no accounting change for securities held at a discount; the discount continues to be amortized to maturity.
- In the period of adoption, an entity is required to provide disclosures about a change in accounting principle.
- There are no new interest income disclosures required to split the effective yield between contractual interest and other adjustments.

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### Insights

Entities need to be acutely aware of the investment strategy and composition of its debt security portfolio. Premiums acquired by purchase or as deferred acquisition cost are within scope of this ASU; If an entity actively hedges interest rate risk on callable debt securities, then they should continue to follow its policies under Subtopic 815-25, Derivatives and Hedging – Fair Value Hedges, to account for hedge accounting basis adjustments. If the hedging relationship is discontinued and a hedge accounting basis adjustment remains, then any remaining premiums would fall within the scope of this ASU.

To reiterate FASB's insights, if the debt security with multiple call dates is not called on the earliest call date, the holder would reset the yield using the payment terms of the debt security and amortize any excess (the amortized cost basis compared to the amount repayable by the issuer) to the next call date.

Since International Financial Reporting Standards (IFRS) is largely principals based and U.S. GAAP is rules based, amortized cost of these debt securities may be different. Such differences would likely be due to the calculation of the effective interest rate. IFRS 9 – *Financial Instruments* calls for a methodology that incorporates management's expectations of cash flows during the instrument's expected life.

### Examples

**Example of 5-year amortization comparing this ASU vs. prior guidance.**

Assume 1/1/19 purchase of a 9% $100,000 bond with a $5,000 premium, which is callable at the end of year 2 and matures at the end of year 5.

Before the adoption of this ASU, the annual amortization of interest would be straight-line over the 5 years, or $1,800 per year. The journal entry in each of the 5 years to maturity would be:

| | | | |
|---|---|---|---|
| Dr. Cash or Interest Receivable | | $1,800 | |
| Cr. | Interest Income | | $ 800 |
| Cr. | Premium on Bond Receivable | | $1,000 |

At the end of year 1 the carry value of the bond would be $104,000 ($100,000 bond receivable and $4,000 unamortized premium on bond receivable).

After the adoption of this ASU, the bond is amortized to the earliest call date. The journal entry in each of the first 2 years would be:

| | | |
|---|---|---|
| Dr. Cash or Interest Receivable | $4,500 | |
| Cr. Interest Income | | $2,000 |
| Cr. Premium on Bond Receivable | | $2,500 |

At the end of year 1 the carry value of the bond would be $102,500 ($100,000 bond receivable and $2,500 unamortized premium on bond receivable).

**Example of journal entry for the initial adoption.**

Assume the same bond criteria as above, except the bond was purchased on 1/1/18. The journal entry in the period of adoption, let's use 1/1/2019, would be the difference in the carry value of the bond premium before and after adoption as follows:

| | | |
|---|---|---|
| 1/1/2019 | Dr. Premium on Bond Receivable | $1,500 |
| | Cr. Retained Earnings | $1,500 |

The carry value of the bond at 1/1/19 would be $102,500 ($100,000 bond receivable and $2,500 unamortized bond receivable). Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle.

## Final Thoughts

This new guidance shortens the amortization period from maturity to the earliest call date, only for callable debt securities held at a premium that have explicit, noncontingent call features that are callable at fixed prices and on preset dates.

| | Effective Date<br>Public Entity | All Other Entities |
|---|---|---|
| **Interim Periods** | Beginning after December 15, 2018 | Beginning after December 15, 2020 |

Early adoption is permitted, including adoption in an interim period. However, if an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning fiscal year that includes that interim period. The amendments in this ASU should be applied using a modified retrospective basis through a cumulative effect adjustment directly to retained earnings as of the beginning of the fiscal year that includes that interim period.

| | | |
|---|---|---|
| **Annual Periods** | Beginning after December 15, 2018 | Beginning after December 15, 2019 |

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Please look for future updates on other technical accounting matters at www.fidatopartners.com


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