University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

1-1-1989

Amortization of discounts on certain acquired loans; Practice bulletin, 06

American Institute of Certified Public Accountants. Accounting Standards Executive Committee;American Institute of Certified Public Accountants. Amortization of Discounts Task Force

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountants. Accounting Standards Executive Committee;American Institute of Certified Public Accountants. Amortization of Discounts Task Force, "Amortization of discounts on certain acquired loans; Practice bulletin, 06" (1989). *Guides, Handbooks and Manuals*. 193.
https://egrove.olemiss.edu/aicpa_guides/193

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Guides, Handbooks and Manuals by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Practice Bulletin 6
August 1989

Amortization of Discounts on Certain Acquired Loans

Accounting Standards Executive Committee
and
Amortization of Discounts Task Force

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

Copyright © 1989 by the
American Institute of Certified Public Accountants, Inc.
1211 Avenue of the Americas, New York, N.Y. 10036-8775

1 2 3 4 5 6 7 8 9 0 AccS 8 9

Practice Bulletin 6
Amortization of Discounts on Certain Acquired Loans

1. The Accounting Standards Executive Committee (AcSEC) has prepared the following guidance, based on existing authoritative literature, regarding amortization of discounts on certain acquired loans for which there is uncertainty as to the amounts or timing of future cash flows.

Scope

2. This practice bulletin addresses the accounting and reporting by purchasers of loans (1) that are acquired in a purchase business combination, bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest.

3. This practice bulletin applies to loans and other debt securities, such as corporate or governmental bonds, notes, and loan-backed securities, such as pass-through certificates, collateralized mortgage obligations, and other so-called securitized loans. For convenience, those other debt securities are hereinafter referred to as *loans*. It does not apply to loans that are carried at market values or at the lower of cost or market, nor does it apply to loans held by liquidating banks.[1] Enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan.

[1] Financial reporting by liquidating banks is dealt with in the minutes of the FASB's Emerging Issues Task Force for Issue 88-25, "Ongoing Accounting and Reporting for a Newly Created Liquidating Bank."

Accordingly, this practice bulletin does not apply to such transactions. SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and the February 10, 1986, notice to practitioners on ADC arrangements, reprinted in AcSEC Practice Bulletin 1, may be helpful in determining whether a loan was acquired for that purpose.

Background

4. Loans may be acquired at discounts from their face amounts. The discounts normally are amortized with corresponding increases in income over the estimated or contractual lives of the loans. APB Opinion 21, *Interest on Receivables and Payables*, describes the accounting for originated loans:

> *Note received or issued for cash*. The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As the Appendix to this Opinion demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note. (paragraph 6)

5. APB Opinion 16, *Business Combinations*, gives general guidance for assigning amounts to loans acquired in a purchase business combination:

> Receivables [should be recorded] at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. (paragraph 88[b])

6. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, describes the accounting for loans purchased at discounts:

> The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. (paragraph 15)
>
> Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest. (paragraph 17)
>
> Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. (paragraph 18)

7. The FASB's Emerging Issues Task Force's minutes for Issue 87–17 addressed accounting for spin-offs and other distributions of loans receivable to shareholders and relied in part on APB Opinion 29, *Accounting for Nonmonetary Transactions*:

> Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. (paragraph 23)

The Emerging Issues Task Force minutes state:

> An enterprise distributes loans receivable to its owners by forming a subsidiary and transferring those loans receivable to the subsidiary and then distributing the stock of that subsidiary to shareholders of the parent. If the book value of the loans receivable, which may be either the "recorded investment in the receivable" or the "carrying amount of the receivable," is in excess of their fair value, the accounting issue is whether the

enterprise should report the distribution at book value as a spin-off or at fair value as a dividend-in-kind and how the recipient should record the transaction.

> The Task Force reached a consensus that the assets should be reported at fair value by the enterprise and the recipient. Task Force members noted that the transaction is not a spin-off because the subsidiary is not an operating company. Rather, the transaction may be considered a dividend-in-kind. Under paragraph 23 of APB Opinion 29, *Accounting for Nonmonetary Transactions*, dividends-in-kind are nonreciprocal transfers of nonmonetary assets to owners that should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would clearly be realizable to the distributing entity in an outright sale at or near the time of distribution.

8. SEC Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*, states that the allowance for credit losses related to loans acquired by a bank in a purchase business combination should be the same as the allowance provided for those loans by the acquired bank unless the acquiring bank's plans for the ultimate recovery of those loans differ from the plans that served as the basis for the acquired bank's estimation of losses on those loans.

9. SAB No. 61 states that if the acquired bank's financial statements as of the acquisition date are not fairly stated because of an unreasonable allowance for credit losses, the acquired bank's preacquisition financial statements should be restated to reflect a reasonable allowance, with the resulting adjustment applied to the restated preacquisition income statement of the acquired bank; the allowance for credit losses may not be changed through a purchase accounting adjustment.

10. *Audits of Banks*, an AICPA industry audit guide, includes guidance on the suspension of the accrual of interest income on loans and the subsequent treatment of amounts received on those loans:

> Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or

collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt. (2d ed., pp. 51–52)

11. *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*, an AICPA industry audit and accounting guide, also includes guidance on the suspension of the accrual of interest income on loans:

A finance company's revenues from loans should be accrued over time in accordance with the terms of the contracts using the interest (actuarial) method. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is not probable, however, continuing to accrue income would not reflect economic substance. Accruals or amortization of discount and, in accordance with FASB Statement No. 91, paragraph 17, amortization of deferred net fees or costs should therefore be suspended if collectibility of interest or principal is not probable. The following are examples of events that could cause such uncertainty on consumer loans:

a. The borrower is in default under the terms of the loan agreement, and interest or principal payments are past due (often a stipulated number of days past due as established in company policies).

b. The ability of the borrower to repay is in doubt because of events such as a loss of employment or bankruptcy.

c. The loan terms have been renegotiated.

Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans, commercial loans usually lack homogeneous characteristics. In addition to the factors described above, considerations may include whether—

a. Significant unsecured balances are due from debtors suffering continued operating losses.

b. The financial condition of the debtor is weak.

c. The outlook for the debtor's industry is unfavorable.

d. The ratio of collateral values to loans has decreased because of changes in market conditions.

e. A portion of the unpaid principal or accrued interest has been written off.

When recognition of interest has been suspended, interest income that has accrued on such loans should not be reversed even though receipt of those amounts may not be forthcoming. The potential uncollectibility of such amounts should be taken into consideration in the computation of the allowance for losses.

Accrual of interest generally should not be resumed until future collectibility of the loan and accrued interest becomes probable. Determining future collectibility is a matter of judgment that depends on considerations such as—

- Whether the customer has resumed making regular payments for a certain number of installments.
- Whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur.
- Whether there are any other substantive indications of the customer's regaining an ability to repay the loan. (2d ed., rev., pp. 14–15)

12. Some entities have amortized the discounts, or portions of the discounts, on certain acquired loans, with corresponding increases in income, over the estimated or contractual lives of the loans. The effect of such amortization has been to produce higher reported rates of return on loans that, before acquisition, yielded lower reported rates of return or no reported returns, despite the fact that the acquisition had no effect on the quality of the loans. AcSEC has concluded that it should examine the accounting in such circumstances.

Accounting Guidance

Date of Acquisition

13. At the time of acquisition, the sum of the acquisition amount of the loan and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.[2] The discount on an acquired loan should be amortized over the period in which the payments are probable of collection only if the amounts and timing of collections, whether characterized as interest or principal, are reasonably estimable and the ultimate collectibility of the acquisition amount of the loan and the discount is probable. If these criteria are not satisfied, the loan should be accounted for using the cost-recovery method (see paragraphs 16 and 17).

14. If at the date of acquisition it is known that interest income on a particular loan is not being recognized by the seller because of concerns about the collectibility of the loan principal or interest, it should be presumed that the loan does not meet the criteria in paragraph 13. That presumption may be overcome if the acquirer's assessment of factors affecting collectibility, such as those discussed in paragraph 18, strongly indicate that collection of the acquisition amount and the discount is probable and the amounts and timing of collections are reasonably estimable. In accordance with FASB Statement No. 91, discounts should be amortized using the interest method.

Subsequent to the Date of Acquisition

15. Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon evaluation—

- The estimate of the total probable collections is increased or decreased but is still greater than the sum

[2] FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. Statement No. 91 provides accounting guidance for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. This practice bulletin addresses amortization of discounts on acquired loans that reflect impairment of the borrowers' credit.

of the acquisition amount less collections plus the discount amortized to date and it is probable that collection will occur, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.

- The estimate of amounts probable of collection is reduced and it is less than the acquisition amount less collections plus the discount amortized to date, amortization should cease, and either the loan should be written down or an allowance for uncollectibility relating to that loan should be recognized.
- It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph 17 below.
- It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized, and the cost-recovery method should be used as described in paragraph 17 below.
- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1.

Cost-Recovery Method

16. Application of the cost-recovery method requires that any amounts received be applied first against the recorded amount of the loan; when that amount has been reduced to zero, any additional amounts received are recognized as income.

17. The cost-recovery method should be used until it is determined that the amount and timing of collections are reasonably estimable and collection is probable. If the

remaining amount that is probable of collection is less than the sum of the acquisition amount less collections and the discount amortized to date, then either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized. If the remaining amount that is probable of collection is greater than that sum, then the difference between that sum and the revised amount that is probable of collection should be amortized on a prospective basis over the remaining life of the loan.

Collectibility

18. Whether the acquisition amount of an acquired loan less collections and the discount amortized to date are collectible is a matter of judgment. Some of the factors that should be considered in assessing collectibility include—

a. The financial condition of the borrower.

b. A substantial equity of the borrower in the collateral underlying the loan that is *not* funded by the lender. This may reflect, to some extent, the borrower's commitment to pay the loan.

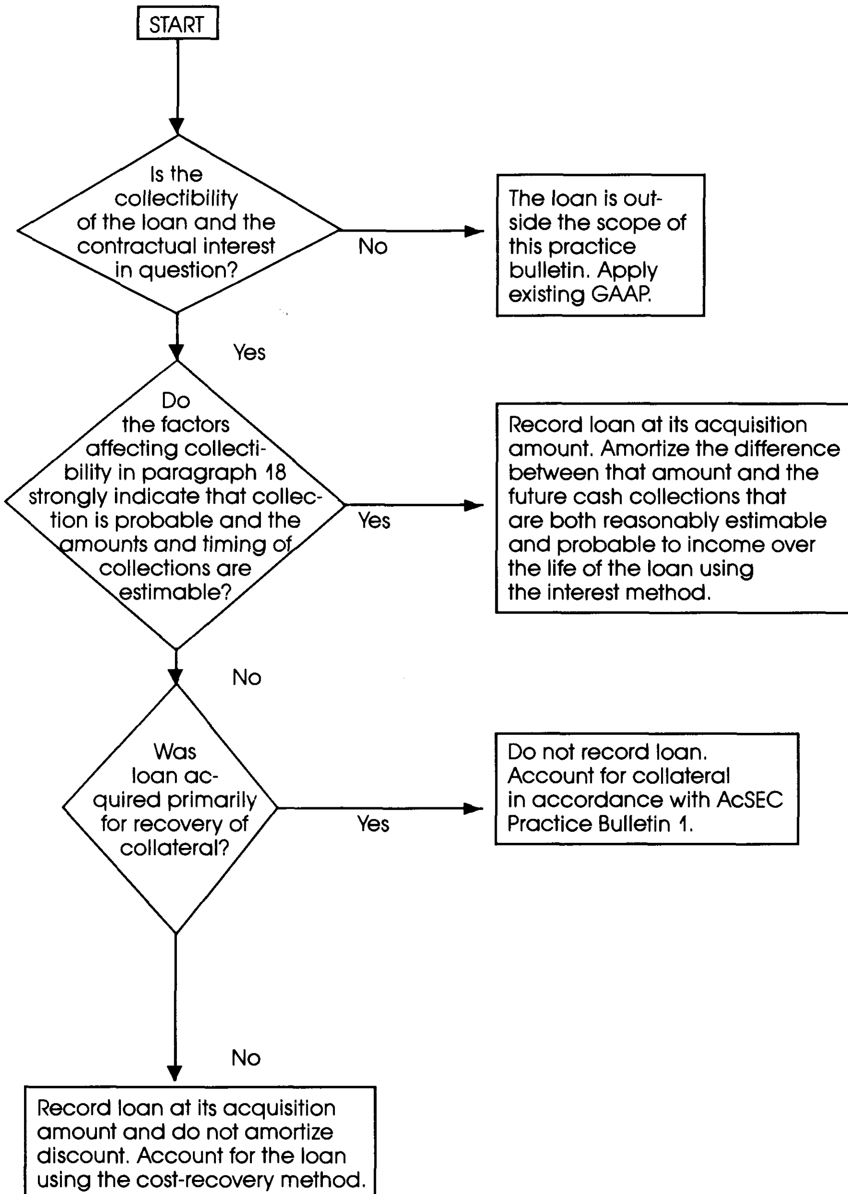
c. Historical cash flows from the acquired loan.

d. The prospect of near-term cash flows from the acquired loan.

e. Irrevocable letters of credit, enforceable personal guarantees, or takeout commitments from creditworthy parties. (The guidance on ADC arrangements in AcSEC Practice Bulletin 1 may be useful in evaluating these items.)

f. The nature of any asset underlying the loan and the probability that it will generate sufficient future cash flows to cover future principal and interest payments when due (for example, the forecasted earnings of a commercial property that are expected to cover future principal and interest payments on a loan).

Appendix A
Accounting at the Date of Acquisition



Appendix B
Illustrations of the Application of the Practice Bulletin

These illustrations are provided to assist in the interpretation of the principles set forth in this practice bulletin. They are not intended to provide guidance on whether the transactions should be accounted for as in-substance foreclosures.

Illustration 1

Z acquires a loan that is thirty days past due. Shortly after acquisition, the loan becomes current; collection of principal and interest is probable and the amounts and timing are reasonably estimable.

Task Force's Conclusion:

The discount should be amortized.

Illustration 2

Z acquires a loan that is thirty days past due. The loan is restructured with no loss recognized on the restructuring.

Additional Assumptions—A

The loan was restructured to pay no interest. Principal is to be paid in periodic installments, and it is probable that all of the principal will be collected.

Task Force's Conclusion:

The discount should be amortized, because the amount and timing of the cash flows that are probable of collection suggest that the presumption in paragraph 14 that the loan does not meet the criteria for amortization of discounts has been overcome.

Additional Assumptions—B

The loan was restructured to pay 4-percent interest, an amount less than the market rate and the original contractual rate. The original contractual principal payments continue to be made. The loan is not fully amortizing; that is, a substantial balloon payment will be required at maturity.

Task Force's Conclusion:

Due to the significance of the balloon payment, sole reliance on the payment as a basis for overcoming the presumption in paragraph 14 that the loan does not meet the criteria for amortization of discounts is not appropriate. Other evidence that supports the probability of collection would have to be assessed.

Additional Assumptions—C

Same assumptions as in **B**, except that the original contractual principal payments have been reduced and, consequently, a larger balloon payment will be required at maturity. (The new periodic payment is based on an amortization schedule longer than the term of the loan.)

Task Force's Conclusion:

The discount should not be amortized.

Additional Assumptions—D

The loan was restructured to pay no interest; principal is to be paid in a single amount at maturity.

Task Force's Conclusion:

The discount should not be amortized.

Illustration 3

Z acquires a loan that is thirty days past due at acquisition and begins to accrue interest income receivable and amortize the discount. The loan becomes ninety days past due, and Z stops accruing interest.

Task Force's Conclusion:

Amortization of the discount should stop.

Illustration 4

Z acquires a loan that is thirty days past due at acquisition. The amount and timing of the future payments are reasonably estimable, and the amount is probable of collection. Z begins to accrue interest income receivable and amortize the discount. The borrower makes all subsequent required payments but does not bring the loan current—that is, the borrower does not make the missed payment.

Task Force's Conclusion:

The discount should continue to be amortized.

Illustration 5

Z acquires a loan on which the borrower is making the contractual interest payments when due. The entire principal is due in a lump sum at maturity. Z believes repayment of some of the principal is probable, but repayment of the remainder is less than probable.

Task Force's Conclusion:

The discount, that is, the difference between the acquisition amount and the sum of the part of the principal and interest payments that are reasonably estimable and probable of collection, should be amortized to income over the life of the loan using the interest method. If the estimate of the amount that is probable of collection is revised, the periodic amortization should be adjusted accordingly.

Illustration 6

Y, an acquired bank, had a loan that originally paid 12-percent interest and that was secured by cash flows from a producing oil well. The well had proven reserves and the collateral coverage was 125 percent of the loan based on net cash flows ([oil produced X market price of oil] - cost to produce).

The price of oil subsequently decreased. Y agreed to accept reduced interest payments in a troubled debt restructuring, because estimates of cash flows at that time indicated that the loan principal plus 4-percent interest would be repaid. The borrower will continue to operate the well, and it is reasonably possible that cash flows of the borrower from additional sources would become available to the bank.

Z acquired Y in a purchase business combination and, in accordance with APB Opinion 16, recorded the loan "at present values of amounts to be received determined at appropriate current interest rates." Z believes that the amount and timing of the cash flows are reasonably estimable and the amount is probable of collection.

Task Force's Conclusion:

Z should amortize the discount because the cash flows are probable. However, amortization of the discount should stop if the price of oil drops further such that the probability of collection becomes uncertain.

Illustration 7

Acquiree bank has a $1,000,000 construction loan at 10-percent interest that was due on September 30, 1988. A takeout commitment on the loan was not honored, and the borrower continues to seek refinancing. The current market rate considering the creditworthiness of the borrower is 12 percent for a mortgage loan. Acquirer bank is acquiring Acquiree bank on December 31, 1988, at which time the loan is ninety days past due and interest is not being accrued. Acquirer bank is willing to renegotiate the loan so that it pays out. The borrower will operate the property, and it is reasonably possible that cash flows of the borrower from additional sources would become available to Acquirer bank.

Additional Assumptions—A

The property is leased under long-term leases. It is probable that the borrower will pay $10,000 a month from cash flow from the property. Over eighteen years and nine months that amount would repay all principal and contractual interest on the loan (approximately $2,250,000).

Task Force's Conclusion:

Acquirer bank should discount $2,250,000 at 12 percent and amortize the resulting discount to income, because the future cash collections are both reasonably estimable and probable.

Additional Assumptions—B

The property is 25 percent leased under long-term leases. It is probable that the borrower will pay $5,000 a month from cash flow from the property. Over twenty-five years (the estimated useful life of the property) that amount ($1,500,000) would not repay all principal and interest on the loan.

Task Force's Conclusion:

Acquirer bank should discount $1,500,000 at 12 percent and amortize the resulting discount to income, because the future cash collections totaling that amount are both reasonably estimable and probable.

Additional Assumptions—C

The property is not leased, and the borrower is unable to determine when payments can be made.

Task Force's Conclusion:

Acquirer bank would record the loan at the fair value of the note and account for it using the cost-recovery method. (If the Acquirer bank expects to obtain repayment of the loan through foreclosure of the underlying collateral, the collateral should be accounted for in accordance with AcSEC Practice Bulletin 1.)

Accounting Standards Executive Committee
(1987–1988)

WALTER SCHUETZE
Chairman
G. MICHAEL CROOCH
DAVID W. DUSENDSCHON
STUART H. HARDEN
WILLIAM W. HOLDER
WAYNE A. KOLINS
RAY L. KRAUSE
ALAN A. MCDONALD
CHARLES J. MCELROY
EDWARD J. MCGOWEN
JOHN J. ROBBINS
RICHARD B. SCHULTZ
D. GERALD SEARFOSS
NORMAN N. STRAUSS
ROGER W. TRUPIN

PAUL ROSENFIELD, *Director*
Accounting Standards

Amortization of Discounts Task Force

D. GERALD SEARFOSS
Chairman
ROBERT E. CREAGER
ARAM G. KOSTOGLIAN
COLEMAN D. ROSS
JOHN T. SHANAHAN, JR.
STEPHEN M. TODD

FREDERICK GILL,
Technical Manager
Accounting Standards

033150