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FASB Amends the Amortization Period for Certain Callable Debt Securities Purchased at a Premium

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On March 30, 2017, the FASB issued [ASU 2017-08](#),¹ which amends the amortization period for certain purchased callable debt securities held at a premium, shortening such period to the earliest call date.

Background and Key Provisions of the ASU

Under the current guidance in ASC 310-20,² entities generally amortize the premium on a callable debt security as an adjustment of yield over the contractual life (to maturity date) of the instrument.³ Accordingly, entities do not consider early payment of principal, and any unamortized premium is recorded as a loss in earnings upon the debtor's exercise of a call on a purchased callable debt security held at a premium.

¹ FASB Accounting Standards Update No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*.

² FASB Accounting Standards Codification Subtopic 310-20, *Receivables: Nonrefundable Fees and Other Costs*.

³ Under current GAAP, an entity that owns an individual purchased callable debt security held at a premium may not amortize that premium to the earliest call date even if the holder is certain that the borrower will repurchase the security on the call date. Under ASC 310-20-35-26, to consider estimates of future prepayments, an entity that applies the interest method must hold a large number of similar debt securities. If it satisfies that requirement, the entity may elect to include estimates of future prepayments in its application of the interest method.

Under the ASU, entities must amortize to the earliest call date the premium on certain purchased callable debt securities. Therefore, they will no longer recognize a loss in earnings upon the debtor's exercise of a call on a purchased callable debt security held at a premium. The ASU does not require any accounting change for debt securities held at a discount; the discount continues to be amortized as an adjustment of yield over the contractual life (to maturity) of the instrument.



Editor's Note

Constituents have noted that under current guidance, (1) the amortization of premiums does not reflect the economics of the underlying transaction and (2) the model for pricing securities in the United States includes consideration for calls. In addition, investors generally price a security to the call date when the security is trading at a premium.

The FASB states in the ASU that the amendments “more closely align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities” and that financial statement users indicated that “the amendment to the amortization period . . . will provide more decision-useful information.”

The only ASC 310-20 paragraph revised by the ASU is ASC 310-20-35-33, which states (as amended):

To the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the earliest call date, the excess (that is, the premium) shall be amortized to the earliest call date, unless the guidance in paragraph 310-20-35-26 is applied to consider estimated prepayments. After the earliest call date, if the call option is not exercised, the entity shall reset the effective yield using the payment terms of the debt security. Securities within the scope of this paragraph are those that have explicit, noncontingent call features that are callable at fixed prices and on preset dates.



Editor's Note

The amended guidance will not affect an entity that (1) applies ASC 310-20-35-26 to purchased callable debt securities and (2) estimates prepayments under the interest method, because the ASU does not affect an entity's ability to elect to estimate prepayments under ASC 310-20-35-26.

Furthermore, the ASU does not apply to any of the following:

- Loans and other financing receivables that do not meet the definition of a debt security.⁴
- Purchased debt securities held at a discount.
- Purchased debt securities held at a premium and for which the call date or call price is not known in advance, including debt securities with a prepayment feature whose prepayment date is not preset (i.e., immediately prepayable instruments). As a result, the following purchased debt securities held at a premium are not within the ASU's scope:
 - Debt securities callable at fair value.
 - Debt securities callable at an amount that includes a make-whole provision that is based on the present value of future interest payments.
 - Asset-backed debt securities, including mortgage-backed securities, in which early repayment is based on the prepayment of the assets underlying the securitization as opposed to the issuer's decision to prepay the debt security itself.

⁴ The ASU does not amend the definition of a debt security in ASC 310-20-20.

- Purchased debt securities held at a premium that are contingently callable.⁵

For purchased callable debt securities held at a premium that are within the ASU's scope, all purchase premiums should be amortized to the earliest call date, regardless of how they were generated (e.g., deferred acquisition costs and cumulative fair value hedge adjustments that increase the amortized cost basis of a callable security above par value⁶). As noted in paragraph BC11 of the ASU, "the [FASB] decided that the amortization period should apply to all premiums, regardless of how they were generated."

In situations in which an entity amortizes a premium to a call price greater than the par value of the debt security (because, e.g., the debt security is callable at a premium to par on the earliest call date), and the debt security is not called on the earliest call date, an entity resets the yield by using the payment terms of the debt security. If the security contains additional future call dates, the entity considers whether the amortized cost basis exceeds the amount repayable by the issuer on the next call date. If the entity determines that it does exceed the amount repayable, it amortizes the excess to the next call date.

Effective Date and Transition

The ASU is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted for all entities, including adoption in an interim period. If an entity early adopts the ASU in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period.

To apply the ASU, entities must use a modified retrospective approach, with the cumulative-effect adjustment recognized to retained earnings as of the beginning of the period of adoption. Entities are also required to provide disclosures about a change in accounting principle in the period of adoption.

⁵ Paragraph BC10 of the ASU notes that "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 [ASU]."

⁶ As noted in paragraph BC12 of the ASU, an entity must apply the ASU's guidance on fair value hedging adjustments only after the hedging relationship is discontinued.

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