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No. US2017-12
April 4, 2017

At a glance

Under new FASB guidance, the premiums on callable debt securities will be required to be amortized to the earliest call date.

Changes made to premium amortization period on callable debt securities

What happened?

On March 30, 2017, the FASB issued guidance[1] that requires certain premiums on callable debt securities to be amortized to the earliest call date. The amortization period for callable debt securities purchased at a discount will not be impacted.

Under current GAAP, premiums on callable debt securities are generally amortized over the contractual life of the security. Only when an entity has a large number of similar securities is it allowed to make an election to consider estimates of principal prepayments. Amortization of the premium over the contractual life of the instrument can result in losses being recorded for the unamortized premium if the issuer exercises a call feature prior to maturity.

When current market yields are below the coupon rate, callable debt securities often trade at a premium and market participants often assume exercise of the call feature at the earliest call date. The new guidance requires entities to amortize the premium on purchased callable debt securities to the earliest call date, which should better align interest income recognition with the manner in which market participants price these instruments.

If the debt security is not called at the earliest call date, the holder of the debt security would be required to "reset" the effective yield on the debt security based on the then current amortized cost basis and the future payment terms of the debt security.

Why is this important?

The new guidance will affect all entities that purchase callable debt securities at a premium, including investment companies. Securities within the scope of the new guidance are those with explicit, noncontingent call features that are callable at fixed prices on preset dates.

The accounting for the following is not affected by the new guidance:

- Securities that do not have explicit call features (such as asset backed securities with prepayment risk as a result of distribution of cash received on the underlying assets)
- Receivables, such as mortgage loans that do not meet the definition of a debt security

[1]Accounting Standards Update No. 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities*

- Basis adjustments as a result of the application of hedge accounting for active hedging relationships that are subject to existing policies established by the preparer

Certain financial institutions, such as retail and commercial banks, mutual funds and insurance companies, are likely to be most affected. Entities will need to ensure that their accounting systems are updated to amortize premiums on callable debt securities to the first call date, while continuing to amortize discounts on callable debt securities to the contractual maturity date.

What's next?

For public business entities with calendar year ends, the guidance is effective on January 1, 2019. All other entities have an additional year to adopt the guidance. Early adoption is permitted, including adoption in an interim period. If early adopted in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period.

Transition is on a modified retrospective basis via a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group.

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