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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

FASB

SUBJECT

FASB SHORTENS PREMIUM AMORTIZATION PERIOD FOR PURCHASED CALLABLE DEBT SECURITIES

SUMMARY

The FASB recently issued ASU 2017-08[1] (the "ASU" or "Update") to amend the amortization period to the earliest call date for purchased callable debt securities held at a premium. The ASU is available here, and becomes effective for public entities for fiscal years beginning after December 15, 2018, and for private entities one year later.

DETAILS

Background

Previous GAAP generally required an investor to amortize the premium on a callable debt security as a component of interest income over the contractual life of the instrument (i.e., yield-to-maturity amortization) even when the issuer was certain to exercise the call option at an earlier date. This resulted in the investor recording a loss equal to the unamortized premium when the call option was exercised by the issuer.

Main Provisions

The Update shortens the amortization period for premiums on purchased callable debt securities to the earliest call date (i.e., yield-to-earliest call amortization). This amortization method is expected to better align with expectations incorporated in market pricing on the underlying securities.

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[1] Premium Amortization on Purchased Callable Debt Securities

The amendments:

- Apply only to callable debt securities with explicit, noncontingent call features that are callable at fixed prices and on preset dates. If a security may be prepaid based upon prepayments of the underlying loans, not because the issuer exercised a date specific call option, it is excluded from the scope of the new standard. However, 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.
- Apply to all premiums on callable debt securities, regardless of how they were generated. For example, this includes initial purchase premium, deferred acquisition costs and cumulative fair value hedge adjustments that increase the amortized cost basis of a callable security over par value.
- Require companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. If the security has additional future call dates, any excess of the amortized cost basis over the amount repayable by the issuer at the next call date should be amortized to the next call date.
- Do not require an accounting change for securities held at a discount. The discount continues to be amortized to maturity.

Do not apply when the investor has already incorporated prepayments into the calculation of its effective yield under other GAAP.

EFFECTIVE DATE AND TRANSITION

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

An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle.