Accrued Interest Within a CECL Allowance Calculation

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Discounted cash flow calculations typically discount both principal and interest payments over the life of the loan based on prepayment and loss expectations. This can affect the overall allowance calculation, as the timing and amount of cash flows can impact the present value of the loan.

When calculating the amortized cost basis for a CECL calculation, the specific treatment of accrued interest can vary, there are two common approaches:

- **Including accrued interest:** Under this approach, accrued interest is added to the amortized cost basis of the loan. This means that the allowance calculation will be based on a higher carrying value of the loan.
- **Excluding accrued interest:** Under this approach, accrued interest is not included in the amortized cost basis of the loan. This means that the allowance calculation will be based on a lower carrying value of the loan. Additional disclosures are required

The choice of whether to include or exclude accrued interest in the amortized cost basis will affect the overall allowance calculation. If accrued interest is included, the allowance will generally be higher, as the carrying value of the loan will be higher. If accrued interest is excluded, the allowance will likely be lower, as the carrying value of the loan will be lower.

Example: Including Accrued Interest in Amortized Cost Basis

Scenario: A company has a loan with a principal balance of $100,000 and a 5% annual interest rate. The loan is outstanding for 1 months, during which time the company accrues $416 in interest.

- **Amortized Cost Basis (including accrued interest):** $100,000 (principal) + $416 (accrued interest) = $100,416
- **Allowance Calculation:** The allowance would be calculated based on the $100,416 carrying value.

Example: Excluding Accrued Interest in Amortized Cost Basis

Scenario: Using the same loan example, but excluding accrued interest.

- **Amortized Cost Basis (excluding accrued interest):** $100,000 (principal)
- **Allowance Calculation:** The allowance would be calculated based on the $100,000 carrying value.

Impact on the Provision for the Allowance

Under the first scenario the PV of the loans are the same, but the allowance would be higher when accrued interest is included. Under either method however, write-offs on accrued interest should be run through the allowance provision under the CECL standard. This means that when a company determines that it is unlikely to collect accrued interest, it should reduce the allowance for credit losses by the amount of the write-off. This ensures that the allowance accurately reflects the company's expected credit losses. The same would be for other ACB items such as Deferred fees and costs.

ARCSys' Responses to the CECL Standard Components

CECL Standard:	ARCSys Response:
BC56. Financial information for financial assets measured at amortized cost is presented on an amortized cost basis. Therefore, it would be inappropriate to base the estimate of expected credit losses solely on the unpaid principal balance when amortized cost amounts reported on the balance sheet may differ because of items such as deferred fees or costs, premium, or discount.	ARCSys bases our estimate on amortized cost, as well as disclosures.
BC57. The Board also considered current practice for financial assets measured at amortized cost and observed that while diversity exists, current practice generally records write-offs of amortized cost (including net deferred fees or costs, premium, or discount) through the allowance for credit losses. Therefore, historical data that are used as a basis for estimating credit losses frequently would already incorporate write-offs of these components of amortized cost.	ARCSys understands that not all institutions have complete historical write-off information. We have several models and multiple methods to build models in these cases.
BC58. As a result, the Board decided that the allowance for credit losses should be estimated and presented such that amortized cost net of the allowance for credit losses represents	ARCSys includes the amortized cost elements in the calculation.

the amount of amortized cost expected to be collected. Therefore, it would be inappropriate to limit the estimate of the allowance for credit losses by only considering the unpaid principal balance because that may not be the amount recognized for the financial assets.	
BC59. Consistent with the Board's intent not to prescribe specific methods or approaches and to facilitate the operability of the amendments in this Update where possible, the amendments allow entities to develop their estimate of expected credit loss on the amortized cost basis in two steps: by first estimating the expected credit losses on the unpaid principal balances, then by adjusting that estimated credit loss for the impact of other elements of the amortized cost basis not expected to be collected (including net deferred fees or costs, premium, or discount). Such an approach may help entities leverage historical loss information based on unpaid principal balances.	ARCSys models leverage historical data, as available.

The ARCSys Discounted Cash Flow (DCF) Process

To deal with the accounting issue of historical loss data not containing the losses due from write-offs of deferred fees/costs (premiums/discounts), ARCSys had to consider the data issues in developing models. Therefore, ARCSys developed the following ways to support the data discrepancies.

Deloitte's Discussion on Accrued Interest - An Element of Amortized Cost Basis and DCF Models

4.3.1.1.3 Effect of Accrued Interest on Historical Loss Information

An entity may have a nonaccrual policy under which it stops accruing interest if it believes the collection of interest is in doubt. This is generally the case when a borrower is in default for a specified period (e.g., 90 days past due). Many entities also reverse the previously accrued interest if the borrower remains in default for an extended period (e.g., 180 days). In those cases, historical loss information would not reflect any or all interest amounts that were not collected, because the entity had already decided to stop accruing interest on the asset and also may have reversed any interest that accrued before determining the ultimate amount of any loss on the asset.

Questions have arisen about whether historical loss information should be adjusted (increased) to reflect the amount of accrued interest that would have been charged off if the entity had not applied a nonaccrual accounting policy.[2] ASC 326-20-55-6(b) states that one of the judgments an entity uses in estimating credit losses is the following:

> The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off **and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest**. [Emphasis added]

In addition, as discussed in Section 4.4.5.1, ASC 326-20-30-5A states that "[a]n entity may make an accounting policy election . . . not to measure an allowance for credit losses for accrued interest receivables if the entity writes off the uncollectible accrued interest receivable balance in a timely manner."

Accordingly, we believe that an entity should adjust historical loss information if its loss data are not consistent with its accounting policy election related to whether an allowance is measured for losses on accrued interest. For example, if the entity does not elect to measure an allowance for credit losses on accrued interest receivables as permitted by ASC 326-2-30-5A, it should adjust the historical loss information to reflect the amount of accrued interest that would have been charged off if the entity had not applied a nonaccrual accounting policy.

4.4.5.1 Accrued Interest

ASU 2016-13 defines "amortized cost basis" as "the amount at which a financing receivable or investment is originated or acquired, adjusted for **applicable accrued interest**, accretion or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments" (emphasis added). The ASU's inclusion of accrued interest in the definition of amortized cost basis has three significant implications for financial statements with respect to the measurement, presentation, and disclosure of the amortized cost basis and the allowance for credit losses of financial assets:

- To measure an allowance for credit losses on the amortized cost basis of a financial asset, entities will be required to include an allowance for the applicable accrued interest of that asset.
- Entities will have to present the accrued interest amount in the amortized cost basis of the financial assets in the same line item on the balance sheet.
- Entities will be required to include accrued interest in their disclosures about the amortized cost basis by class of financing receivable and vintage in accordance with ASC 326-20-50-5 and 50-6, respectively.

Further, because accrued interest is included in the definition, the reversal of such interest will need to be written off in the same manner as the principal or other components of the amortized cost basis (see Section 4.5 for a discussion of write-offs). ASC 326-20-35-8 states that "[w]riteoffs of financial assets, which may be full or partial writeoffs, shall be **deducted from the allowance**" (emphasis added). In other words, all components of the amortized cost basis, including the accrued interest, must be written off through the allowance for credit losses.

After the issuance of ASU 2016-13, stakeholders raised concerns that the inclusion of accrued interest in the definition of amortized cost basis could be operationally burdensome because many loan systems are not able to track accrued interest on an individual loan level. Stakeholders have also expressed concerns about the conflict between existing nonaccrual policies, which generally follow regulatory instructions requiring the reversal of accrued interest as a debit to the interest income line item (at least in part), and the write-off guidance in ASC 326-20-35-8. Many stakeholders, primarily financial institutions, indicated that existing nonaccrual policies present a more accurate reflection of the earning potential of a loan and interest income than does the write-off guidance in ASC 326-20-35-8. Those stakeholders further maintained that any change from the existing nonaccrual policies would reduce the consistency and comparability of current-period financial statements, regulatory reports, and important interest-income-based metrics (e.g., net interest margin) with those of prior periods.

ASU 2019-04 addresses these concerns (which were originally discussed at the June 2018 TRG meeting). Specifically, ASU 2019-04 states that an entity would be *allowed* to:

a. Measure the allowance for credit losses on accrued interest receivable balances separately from other components of the amortized cost basis of associated financial assets.

b. Make an accounting policy election not to measure an allowance for credit losses on accrued interest receivable amounts if an entity writes off the uncollectible accrued interest receivable balance in a timely manner and makes certain disclosures.

c. Make an accounting policy election to write off accrued interest amounts by [either] reversing interest income or recognizing credit loss expense, or a combination of both. The entity also is required to make certain disclosures.

d. Make an accounting policy election to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheet. If the accrued interest receivable balances and the related allowance for credit losses are not presented as a separate line item on the balance sheet, an entity should disclose the amount of accrued interest receivable balances and the related allowance for credit losses and where the balance is presented.

e. Elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements.

4.4.6 Effect of Timing on Expected Credit Losses

The timing of defaults and prepayments (e.g., repayment of the financial asset, either partially or entirely, before its stated maturity according to its contractual terms) affects an entity's calculation of expected credit losses differently depending on the method used:

- *DCF method* — When a DCF method is applied to a pool of financial assets, the time value of money is explicitly incorporated (i.e., both the amount *and* timing of cash flows matter). For example, the timing of prepayments affects the timing of the recognition of discounts and premiums and the number of interest coupons to be received. These factors could increase or offset credit losses when a DCF method is applied to a pool of assets by using an overall EIR.

- *Measuring expected credit losses on the separate components of amortized cost (e.g., premiums, discounts) or on the asset's combined amortized cost basis* — Regardless of whether an entity estimates expected credit losses on the separate components of amortized cost or the combined amortized cost basis of the asset, an entity is permitted but not required to consider the timing of when credit losses will occur.[8] However, if an entity chooses to consider timing when estimating expected credit losses, the timing will affect the amount of amortized premiums, discounts, deferred fees and costs, etc. In addition, the entity would also need to estimate the acceleration of the amortization of the amounts resulting from prepayments.