

Statement of Financial Accounting Standards No. 118

[FAS118 Status Page](#)
[FAS118 Summary](#)

Accounting by Creditors for Impairment of a
Loan—Income Recognition and Disclosures

an amendment of FASB Statement No. 114

October 1994



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures

an amendment of FASB Statement No. 114

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CONTENTS

	Paragraph Numbers
Introduction and Background.....	1–5
Standards of Financial Accounting and Reporting:	
Amendments to Statement 114	6
Effective Date and Transition.....	7
Appendix A: Background Information and Basis for Conclusions.....	8–23
Appendix B: The Scope of the Disclosure Requirements in Paragraph 20(a) of Statement 114, as Amended.....	24

FAS 118: Accounting by Creditors for Impairment of a Loan— Income Recognition and Disclosures

an amendment of FASB Statement No. 114

FAS 118 Summary

This Statement amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, to allow a creditor to use existing methods for recognizing interest income on an impaired loan. To accomplish that, it eliminates the provisions in Statement 114 that described how a creditor should report income on an impaired loan (paragraphs 17-19).

This Statement does not change the provisions in Statement 114 that require a creditor to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent.

This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

This Statement is effective concurrent with the effective date of Statement 114, that is, for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

INTRODUCTION AND BACKGROUND

1. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was issued in May 1993 and addresses the accounting by creditors for impairment of certain loans. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994.
2. The Board received several requests to delay the effective date of Statement 114 and to clarify how that Statement should be implemented. A delay was requested to allow more time to resolve implementation questions about the application of the income recognition provisions in paragraphs 17-19 of Statement 114 and to make the necessary changes to accounting systems.
3. This Statement amends Statement 114 to allow a creditor to use existing methods for

recognizing interest income on impaired loans. To accomplish this, it eliminates the income recognition provisions in paragraphs 17-19 of Statement 114. As amended, Statement 114 does not address how a creditor should recognize, measure, or display interest income on an impaired loan. This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

4. Prior to the issuance of this Statement, Statement 114 provided for two alternative income recognition methods to be used to account for changes in the net carrying amount of an impaired loan subsequent to the initial measure of impairment. Under the first income recognition method, a creditor would accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense. Under the second income recognition method, a creditor would recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense. While those income recognition methods are no longer required, this Statement does not preclude a creditor from using either of those methods.

5. Statement 114 requires that a creditor recognize impairment of a loan *if* the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the impaired loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is equal to or greater than the recorded investment in the impaired loan, no impairment is recognized. This Statement does not change those requirements. When the net carrying amount of an impaired loan equals the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will affect only the *classification* of income (or expense) that results from changes in the measure of an impaired loan, not the total *amount* of income (or expense) recognized within a given reporting period. However, when a creditor's policies for recognizing interest income and for charging off loans result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will cause both the classification and the total amount of income (or expense) recognized within a given reporting period to be different from that which would have been determined in accordance with paragraphs 17-19 of Statement 114.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 114

6. Statement 114 is amended as follows:

a. The following sentence is added after the second sentence of paragraph 8:

For a loan that has been restructured in a troubled debt restructuring, *the contractual terms of the loan agreement* refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement.

b. In the first sentence of paragraph 11, *impaired loans* is replaced by *impairment of a loan*.

c. In the last sentence of paragraph 12, *those impaired loans* is replaced by *impairment of those loans*.

d. In the last sentence of paragraph 13, *measure of the impaired loan* is replaced by *present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral)*.

e. In the first sentence of paragraph 14, *measures an impaired loan using* is replaced by *bases its measure of loan impairment on*.

f. In the first sentence of paragraph 15, *measures an impaired loan using* is replaced by *bases its measure of loan impairment on*.

g. Paragraph 17 is replaced by the following:

This Statement does not address how a creditor should recognize, measure, or display interest income on an impaired loan. Some accounting methods for recognizing income may result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). In that case, while the loan would meet the definition of an impaired loan in paragraph 8, no additional impairment would be recognized. Those accounting methods include recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those methods. The recorded investment in an impaired loan also may be less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) because the creditor has charged off part of the loan.

h. Paragraphs 18 and 19 are deleted.

i. Paragraph 20 is replaced by the following paragraphs:

A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an

impaired loan in paragraph 8 of this Statement:

- a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement
- b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded
- c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20(a) and 20(c) in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20(a) and 20(c) to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and with this Statement.

- j. Paragraph 65 is deleted.

Effective Date and Transition

7. This Statement is effective concurrent with the effective date of Statement 114. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Leisenring and Swieringa dissented.

Messrs. Leisenring and Swieringa disagree that paragraphs 17-19 of Statement 114 should have been eliminated. Those paragraphs permitted a choice between two methods for recognizing income on impaired loans. They do not believe that those methods are complex or that complex guidance would have been necessary to implement those methods. The Board was aware that changes in accounting systems would be needed to implement those methods when it issued Statement 114 and that the accounting for impaired loans required by bank and thrift regulators was inconsistent with the income recognition provisions in paragraphs 17-19.

Messrs. Leisenring and Swieringa agree that the elimination of the income recognition provisions in Statement 114 will affect only the classification of income and not the total amount of income recognized within a given reporting period if the recorded investment in an impaired loan is equal to or greater than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). However, the accounting for impaired loans currently required by bank and thrift regulators includes recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those accounting methods. Those methods can result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). In that circumstance, income effects of the passage of time and changes in estimates, that otherwise would be recognized currently, are recognized in later periods. Messrs. Leisenring and Swieringa believe that that result is inconsistent with the fundamental premise in Statement 114 that loans should be carried at the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral).

The cost-recovery method is intended to address the uncertainty of expected future cash flows from impaired loans by delaying income recognition. The measure of impairment under Statement 114 takes into account the uncertainty of expected future cash flows. The Board concluded in Statement 114 that impairment of a loan should be based on the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) and that changes in estimates (or, alternatively, in market prices or fair values) should be recognized currently (paragraphs 40-43 and 58 of Statement 114). As a result, Messrs. Leisenring and Swieringa believe that the cost-recovery method is not acceptable under Statement 114, and they disagree with the amendment because it would permit the use of that method under that Statement.

Messrs. Leisenring and Swieringa are concerned that the amendment will allow the net carrying amount of a loan to be any amount as long as it does not exceed the present value of expected cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). They believe that paragraphs 17-19 of Statement 114 could have been amended

to eliminate inconsistencies in accounting for income on impaired loans by specifying a single method for recognizing interest income on an impaired loan. They would have delayed the effective date of Statement 114 if the Board needed time to develop a single method.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
James J. Leisenring
Robert H. Northcutt
Robert J. Swieringa

Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

8. This appendix summarizes considerations that were deemed significant by Board members in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

9. Statement 114 requires that a creditor measure impairment of a loan based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent. Prior to the issuance of this Statement, Statement 114 provided for two alternative income recognition methods to be used to account for changes in the net carrying amount of the loan subsequent to the initial measure of impairment. Under the first income recognition method, a creditor would accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense. Under the second income recognition method, a creditor would recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense. A creditor would have been precluded from using a cost-recovery or a cash-basis method of accounting. The two measurement methods that were allowed as practical expedients and the second income recognition method were not included in the Exposure Draft that resulted in Statement 114 and were added during the deliberations leading to that Statement because commentators said those provisions would facilitate implementation.

10. The Board received several requests to delay the effective date of Statement 114 and to clarify how that Statement should be implemented. The requests stated that more time was

needed to resolve implementation issues about the application of the income recognition provisions in paragraphs 17-19. The requests also stated that the accounting for impaired loans currently required by bank and thrift regulators is inconsistent with the provisions in those paragraphs. The requests stated that enterprises under the jurisdiction of those regulators would be required to make significant changes to their accounting systems to comply with the income recognition provisions in paragraphs 17-19 and that the implementation issues could not be resolved in time to make the necessary changes to accounting systems.

11. Statement 114 addresses the measurement of loan impairment. While income recognition was addressed in paragraphs 17-19 of Statement 114, the Board considered those provisions to be secondary in importance to the provisions that addressed measurement of loan impairment. The requests to delay the effective date were based on implementation issues related to those income recognition provisions, not on the measurement provisions.

12. An FASB Exposure Draft, *Accounting by Creditors for Impairment of a Loan—Income Recognition*, was issued on March 31, 1994. In the deliberations that preceded that Exposure Draft, the Board considered delaying the effective date of Statement 114 and issuing guidance for implementing the provisions in paragraphs 17-19 of Statement 114. The Board concluded that the implementation guidance would be complex and that constituents might be required to make costly changes to their accounting systems to implement that guidance; those systems changes could require further modifications if regulators issued accounting guidance in response to the provisions of Statement 114. Furthermore, implementation of the income recognition provisions in paragraphs 17-19 of Statement 114 would not have eliminated inconsistencies in the accounting for income on impaired loans because those provisions permitted a choice between two methods for recognizing income on impaired loans. Accordingly, the Board concluded that, to avoid a delay in the effective date of the measurement provisions of Statement 114, it would be preferable to allow creditors to use existing accounting methods for recognizing interest income and to eliminate the income recognition provisions.

13. The Board received 57 comment letters on the Exposure Draft. Some respondents to the Exposure Draft agreed that the income recognition provisions in paragraphs 17-19 of Statement 114 should be eliminated but gave other reasons for delaying the effective date. Some stated that the effective date should be delayed to give regulators time to resolve regulatory accounting and disclosure issues related to impaired loans. Some stated that a delay would give creditors time to modify accounting systems and policies. Some stated that more time would be needed to implement the disclosure requirements proposed in the Exposure Draft. After considering those comments, the Board concluded that the most significant implementation issues would be resolved by the elimination of paragraphs 17-19 of Statement 114 and by the simplification of certain disclosure requirements that were proposed in the Exposure Draft of this Statement. The Board also concluded that a creditor should implement Statement 114 for fiscal years beginning after December 15, 1994.

14. Some respondents asked whether the amendment to Statement 114 would allow a creditor

to use the methods for recognizing interest income that were described in paragraphs 17-19 of Statement 114. While those income recognition methods are no longer required by Statement 114, the Board concluded that a creditor should not be precluded from using those methods.

15. Some respondents said that the elimination of the income recognition provisions in paragraphs 17-19 of Statement 114 would result in inconsistent application of that Statement. Implementation of the income recognition provisions in paragraphs 17-19 would not have eliminated inconsistencies in income recognition on impaired loans, since the provisions in those paragraphs permitted a choice between two methods for recognizing income. Moreover, because not all impaired loans are within the scope of Statement 114, creditors could recognize interest income using existing accounting methods for some impaired loans. That is, a creditor could use a cost-recovery or cash-basis method of accounting for recognizing income on impaired loans that are excluded from the scope of Statement 114 because they are smaller-balance homogeneous loans that are collectively evaluated for impairment.

16. Statement 114, as amended by this Statement, does not address how a creditor should recognize, measure, or display interest income on an impaired loan. However, users of financial statements have told the Board that it is important to know how a creditor recognizes interest and records cash receipts related to impaired loans. The Board decided that a creditor should disclose its accounting policies for recognizing interest income on impaired loans, including its policy for recording cash receipts.

17. The Exposure Draft would have required that a creditor quantify and disclose the amount of interest income recognized, including the amount of cash receipts recorded as interest on an impaired loan and the amount of interest income that would have been recognized according to the contractual terms of the original loan agreement. Some respondents indicated that the information required to make those disclosures was not readily available and that it would be costly to develop accounting systems to gather that information. In response to those comments, the Board decided to simplify the disclosures that were proposed in the Exposure Draft by requiring that a creditor disclose the average recorded investment in the impaired loans during the reporting period and the related amount of interest income recognized during the time within that period that those loans were impaired. The Board believes that those disclosures will provide financial statement users with useful information about how a creditor recognized interest income on impaired loans. This Statement does not specify how a creditor should calculate the average recorded investment in the impaired loans during the reporting period. The Board believes that a creditor should develop an appropriate method and that averages based on month-end balances may be considered an appropriate method.

18. The Board believes that disclosure of the amount of interest income recognized on impaired loans using a cash-basis method of accounting also will provide financial statement users with valuable information about how cash receipts were recorded. The Board understands that this information generally is available and believes that a creditor should provide that information unless it is not practicable to do so.

19. Paragraph 20(a) of Statement 114 (prior to amendment) required that a creditor disclose the recorded investment in the loans for which impairment had been recognized in accordance with Statement 114 and the total allowance related to those impaired loans. Paragraph 65 of Statement 114 explained that if the creditor had written down a loan so that the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) was equal to or greater than the recorded investment in the loan, no impairment would be recognized. In those situations, the creditor would not have been required to disclose the recorded investment in the loan in years after the write-down. Respondents indicated that that disclosure would confuse financial statement users because information would not be provided about the total population of loans that meet the definition of an impaired loan in paragraph 8 of Statement 114. They said that information about the total population of impaired loans could be provided easily. This Statement eliminates paragraph 65 of Statement 114 and amends the disclosure provisions in paragraph 20 of that Statement to require that a creditor disclose the total recorded investment in loans that meet the definition of an impaired loan in paragraph 8 of Statement 114 at the end of the reporting period, the recorded investment in those impaired loans for which there is a related allowance for credit losses, and the recorded investment in those impaired loans for which there is no related allowance for credit losses. Those disclosures should be provided for impaired loans that have been charged off partially. Those disclosures cannot be provided for loans that have been charged off fully because both the recorded investment and the allowance for credit losses will equal zero.

20. A troubled debt restructuring need not be included in the disclosures required by paragraphs 20(a) and 20(c) of Statement 114 (as amended) if the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and the loan is not impaired based on the terms specified by the restructuring agreement. Although troubled debt restructurings meet the definition of an impaired loan in paragraph 8 of Statement 114, this treatment is consistent with the disclosure requirements (prior to amendment) in paragraph 40(a) of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, and should limit the cost of providing those disclosures.

21. Some respondents indicated that the scope of paragraph 20(b) of Statement 114 (prior to amendment) was unclear. Some stated that they believed that the intent of that paragraph was to require that a creditor provide information about the activity for the total allowance for credit losses, including amounts determined in accordance with Statement 5. Others stated that they believed that the scope of paragraph 20(b) was limited to the allowances determined in accordance with Statement 114. The Board believes that the creditor should provide information about the activity for the total allowance for credit losses, including amounts determined in accordance with Statement 5.

22. The Exposure Draft would have amended the scope of paragraph 20(c) of Statement 114 to apply to "loans that are impaired (or, alternatively, for all loans for which a creditor has credit

concerns)." The alternative scope for the disclosures was included in the Exposure Draft to help reduce the cost of implementing the disclosure requirements. However, some respondents stated that the alternative scope would not reduce the cost of implementation and would result in inconsistent disclosure practices. The Board decided to delete the phrase (*or, alternatively, for all loans for which a creditor has credit concerns*).

23. Some respondents asked whether a loan should be considered to meet the definition of an impaired loan in paragraph 8 of Statement 114 if it was restructured in a troubled debt restructuring and is not impaired based on the terms specified by the restructuring agreement. The Board concluded in Statement 114 that a loan restructured in a troubled debt restructuring is an impaired loan. It should not be accounted for as a new loan because a troubled debt restructuring is part of a creditors ongoing effort to recover its investment in the original loan. A loan usually will have been identified as impaired because the condition specified in paragraph 8 of Statement 114 will have existed before a formal restructuring. Although certain troubled debt restructurings may be excluded from the disclosures required by paragraphs 20(a) and 20(c) of Statement 114 (as amended), for a restructured loan that has not been excluded from the scope of Statement 114 because of the transition provisions in paragraph 27 of Statement 114, the measurement provisions of Statement 114 should be applied when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the *original* loan agreement. Likewise, a creditor should use existing accounting methods for recognizing interest income on impaired loans for that loan; the income recognition provisions (prior to amendment) in paragraph 30 of Statement 15, need not be applied.

Appendix B: THE SCOPE OF THE DISCLOSURE REQUIREMENTS IN PARAGRAPH 20(A) OF STATEMENT 114, AS AMENDED

24. The following table summarizes the scope of the disclosure requirements in paragraph 20(a) of Statement 114, as amended by this Statement.

Required Disclosures about the Recorded Investment in Loans That Meet the Definition of an Impaired Loan in Paragraph 8 of Statement 114			
(A)	(B)	(C)	
<u>Description of Loans</u>	<u>The Total Recorded Investment in the Impaired Loans</u>	<u>The Amount of the Recorded Investment in (A) for Which There Is a Related Allowance for Credit Losses</u>	<u>The Amount of the Recorded Investment in (A) for Which There Is No Related Allowance for Credit Losses</u>
1. Loans that meet the definition of an impaired loan in paragraph 8 of Statement 114 and that have <i>not</i> been charged off fully	Included. The amount disclosed in (A) must equal the sum of (B) and (C).	Included if there is a related allowance for credit losses.	Included if there is no related allowance for credit losses.
2. Loans that meet the definition of an impaired loan in paragraph 8 of Statement 114 and that have been charged off fully	Excluded. The recorded investment and allowance for credit losses are equal to zero.		

- | | |
|---|--|
| 3. Loans restructured in a troubled debt restructuring before the effective date of Statement 114 that are not impaired based on the terms specified by the restructuring agreement | Excluded. Disclosures should be provided in accordance with Statement 15. |
| 4. Loans restructured in a troubled debt restructuring before the effective date of Statement 114 that are impaired based on the terms specified by the restructuring agreement | Refer to items 1 and 2 above. |
| 5. Loans restructured in a troubled debt restructuring after the effective date of Statement 114 | May be excluded in years after the restructuring if (a) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new receivable with comparable risk and (b) the loan is not impaired based on the terms specified by the restructuring agreement. Otherwise, refer to items 1 and 2 above. |
| 6. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment and other loans that are excluded from the scope of Statement 114 as defined in paragraph 6 of that Statement | Excluded unless restructured in a troubled debt restructuring (refer to items 3-5 above and paragraph 9 of Statement 114 for requirements for a restructured loan). |