

Financial reporting considerations:
Evaluating accrued interest receivable on loan
deferrals/modifications

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In March 2020, the federal financial institution regulators issued an Interagency Statement (IAS) encouraging institutions to proactively and prudently work with their borrowers affected by COVID-19. That same month, the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act) was enacted. Section 4013 of the CARES Act allows financial institutions to temporarily suspend accounting principles related to troubled debt restructurings (TDRs) for loan modifications made in response to COVID-19.

In response to both the IAS and the CARES Act, institutions have worked to mitigate the adverse effects of COVID-19 on borrowers. Institutions have utilized a wide range of modification programs. Some of the more common approaches include:

- Converting amortizing loans to interest-only payments
- Deferring all principal and interest payments, but contractually stating that interest would continue to accrue during the deferral period
- Deferring all principal and interest payments for a period, and contractually stating that interest would not accrue during the deferral period (i.e., a payment holiday)
- Modifying loans in response to government-mandated forbearance programs

Practice note: At the April 8, 2020, board meeting, the Financial Accounting Standards Board (FASB) staff answered a technical inquiry specific to recognition of interest income on payment holiday modifications. The allowable views expressed by the staff in that inquiry may result in no interest income being recognized during the deferral period or interest income being recognized using an adjusted effective interest rate. While the nature of income recognition on these types of loans is beyond the scope of this document, institutions that have made these types of modifications are encouraged to refer to the minutes from the April 8 FASB board meeting. To provide clarification for loans with premiums, the AICPA issued Technical Question & Answer (TQA), Section 2130.41, "Loan Restructurings Resulting in Periods With Reduced Payments," on June 30, 2020.

For the third quarter, institutions are grappling with what, if any, steps they should take to evaluate the accrual status of loans still in deferral and to assess the collectibility of the accrued interest receivable (AIR) balances that might have ballooned to unusual levels as a result of the deferrals and modifications.

We offer the following observations, which could be used to develop an approach to this evaluation.

CARES Act versus Interagency Statement modifications

When it comes to determining accrual status and evaluating the collectibility of the AIR balance, we do not believe there is any distinction to be made for loans that were modified under the CARES Act versus loans modified under the IAS.

The CARES Act suspended TDR accounting set forth by FASB Accounting Standards Codification (ASC) 310-40, "Receivables – Troubled Debt Restructurings by Creditors." The CARES Act did not suspend or change any of the accounting or regulatory reporting considerations for accrued interest and accrual status.

Similarly, the IAS provides that short-term modifications made to borrowers on loans that were less than 30 days past due would not be indicative of a borrower experiencing financial difficulty that would be required for TDR classification. The IAS goes on to refer institutions to applicable regulatory reporting instructions and their internal accounting policies when evaluating accrual status, which we believe would be appropriate for modifications made under both programs.

Past due status

If a financial institution agrees to a payment deferral, the determination of whether and by how much a loan is past due would be based on the modified terms of the loan. The following example illustrates this consideration.

Facts: A borrower is contractually required to make monthly principal and interest payments on the first day of each month. In March, the financial institution and the borrower agree to defer principal and interest payments for five months. The loan is not past due at the time it is modified. This has the effect of deferring the April, May, June, July, and August payments. The borrower's next payment will be due Sept. 1. The agreement states that interest will continue to accrue during the deferral period and the maturity of the loan will be extended by five months.

Question: If the borrower does not make a payment during the month of September, how many days past due will the loan be at Sept. 30?

Answer: 29 days. The determination of whether a loan is past due is based on the modified terms of the contract. The borrower was contractually obligated to resume payments on Sept. 1. If no payment has been received by Sept. 30, the number of days past due is determined based on the contractual due date of Sept. 1.

The answer provided in the example does not differ from how the delinquency status would be calculated for a nonmodified loan. The amount of days past due is not based on the date of the last payment; rather, it is based on the date that the borrower was contractually obligated to make a payment.

Some institutions did not require borrowers to sign loan modification agreements but instead communicated unilaterally to certain borrowers that their payment due dates were being deferred without requiring any action on the part of the borrower. This action would have the same effect as a written loan modification signed by both the borrower and the lender in that it changes the contractual due date of the loan to the date stated in the written communication issued by the institution.¹ Thus, the answer to the example question would be no different for an institution that had a bilateral, executed loan modification from what it would be for an institution that initiated a unilateral loan modification with the borrower.

Accrual versus nonaccrual

GAAP does not address nonaccrual considerations. To determine if a loan should be reported as nonaccrual, the IAS directs financial institutions to the applicable regulatory reporting instructions as well as its internal accounting policies. The regulatory nonaccrual guidance generally prohibits the

¹ Refer to "[Frequently Asked Questions for Financial Institutions Affected by the Coronavirus Disease 2019 \(Referred to as COVID-19\)](#)," issued by the Federal Deposit Insurance Corp. on May 27, 2020.

accrual of interest on a loan that is over 90 days past due² or for which full payment of principal and interest is not expected.

The Interagency Statement stated that loans that were not past due over 30 days and were modified in response to COVID-19 using short-term arrangements (described as modifications for six months or less) generally should not be reported as nonaccrual, although it went on to observe that as more information becomes available indicating a specific loan will not be repaid, institutions should refer to the guidance in the instructions for the Consolidated Reports of Condition and Income.

For loans that were granted modifications extending up to six months, the end of the modification period is likely near. Additionally, more information might be available on these loans than was available at the time the modification was made. For loans that are expected to resume payments at the end of the modification period, the application of normal, delinquency-based nonaccrual policies may be appropriate. However, for loans that are now expected to require an extended or additional modification, or that are not expected to be able to resume contractual payments, institutions should evaluate whether or not the loans continue to meet the threshold of expecting full collection of principal and interest. Nonaccrual policies, which are largely based on the past due status of the borrower, may not be the appropriate determinant for whether the loan should be placed on nonaccrual. At the point at which the full collection of principal and interest is in doubt, an institution should place the loan on nonaccrual.

Similarly, for loans that were modified for periods extending longer than six months, delinquency-based nonaccrual triggers are also likely not appropriate to use as the sole indicator of when a loan should be placed on nonaccrual. Institutions should consider all available information at the end of the reporting period to determine if any individual loans should be placed on nonaccrual status.

The application of risk-based criteria to modified loans may facilitate such an analysis. Criteria such as length of modification, whether a second or extended modification has been requested, loan size, loan-to-value ratios, nature of the borrower's business, the borrower's geographic location, and the magnitude of the pandemic's disruption to that business or geography might provide useful funnels. An institution might be able to evaluate some loans in criteria-based pools but quite often might need to make such nonaccrual assessments at the loan level.

Collectibility of AIR

For modification programs that required the borrower to make interest-only payments during the deferral period, the AIR being carried on those loans might be minimal. For modification programs that allowed for the deferral of principal and interest payments for which interest still accrued during the deferral period, the balance of AIR at the end of the reporting period might be substantial.

For modified loans still on accrual status, there might be no individual indicators that full collection of principal and interest are in doubt; however, when assessed on a collective basis, the answer might be different. We believe institutions should assess the collectibility of their AIR balances and establish an allowance against the portion of the balance that is not expected to be collected (for current expected credit loss (CECL) adopters) or that is probable of not being collected (for non-CECL adopters).

² Regulatory guidance provides an exception to this general rule for consumer loans and loans secured by a one-to-four family residential property as well as purchased credit impaired loans accounted for in accordance with ASC 310-30 (or purchased credit deteriorated loans accounted for in accordance with ASC 326) if certain criteria are met. However, such loans should be subject to other alternative methods of evaluation to assure that the financial institution's net income is not materially overstated.

Allowance for credit losses (ACL) versus allowance for loan and lease losses (ALLL)

Although there are nuanced differences between ACL and ALLL as they pertain to the accounting for allowances on AIR balances, institutions should determine an appropriate allowance against these balances for amounts deemed uncollectible. The following table demonstrates the similarities and differences under the two methodologies.

Concept	ACL application (CECL methodology)	ALLL application (incurred loss methodology)
Recognition	ASC 326, "Financial Instruments: Credit Losses," requires an entity to estimate expected credit losses on the amortized cost basis of the loan, which includes applicable accrued interest, unless the following accounting policy election is made.	Under ASC 450-20, "Loss Contingencies," a loss must be recognized when it is both probable and estimable. Regulatory guidance requires an institution to evaluate the collectibility of any "recorded accrued and unpaid interest (i.e., not already reversed or charged off)."
Accounting policy elections	An accounting policy election can be made, at the class of financing receivable, to not measure an allowance for credit losses for AIR if the institution writes off the uncollectible AIR balance in a timely manner.	None
Establishing the allowance	A valuation allowance that is classified in the same line item as the AIR balance should be established with an offset to credit loss expense.	A valuation allowance that is classified in the same line item as the AIR balance should be established with an offset to credit loss expense.
Charging off/reversing accrued interest	ASC 326 allows an entity to make an accounting policy election to write off AIR by reversing interest income or recognizing credit loss expense or a combination of both. ³	In accordance with call report instructions, the reversal of AIR on a loan placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. One acceptable method is to reverse the AIR that has been accrued year-to-date through the interest income account in which the accrued interest was initially recorded. As AIR related to loan deferrals would have been recorded almost entirely, if not entirely, in the current calendar year, it is likely that none of the AIR would be reversed through the allowance that was established. Rather, provision expense would be reversed upon remeasurement of the allowance on AIR after the loan was placed on nonaccrual.

³ According to call report instructions, institutions that elect not to measure an ACL for AIR "should debit (i.e., reduce) the appropriate category of interest income on Schedule RI, 'Income Statement,' for the amount of uncollectible AIR being charged off." Institutions that opt to record an ACL for AIR "should measure an ACL on AIR and should charge off any uncollectible AIR against the ACL."

Many financial institutions have never carried an allowance on their AIR balances. However, particularly for institutions with interest payment deferral programs that continued to accrue interest, we believe that institutions should evaluate their AIR balances for collectibility to verify that assets and interest income are not overstated. Such an evaluation might result in an institution recording an allowance on its AIR.

CECL provides an accounting policy election to not measure an allowance on AIR if an entity writes off the uncollectible AIR balance in a timely manner. Accounting policies typically utilize number of days past due as a trigger for writing off uncollectible AIR. In the current environment, using past due status might not result in timely write-off of uncollectible AIR. Institutions using this election should evaluate the need for an allowance on AIR balances if write-offs are no longer timely.

Practice note: After the adoption of ASC 326, a class of financing receivable is defined as “A group of financing receivables determined on the basis of both of the following:

- "a) Risk characteristics of the financing receivable
- "b) An entity's method for monitoring and assessing credit risk.”

COVID-19-modified loans likely have distinct risk characteristics that cause them to be monitored and assessed for credit risk in a manner different from what is used for their unmodified counterparts. Thus, making a different accounting policy election as it pertains to measuring an ACL on AIR as a separate class of financing receivables would be allowable. This accounting policy election should be disclosed.

A natural follow-up question might be: “If an institution determines that COVID-19-modified loans are a separate class of financing receivable, must those loans be segmented differently for ACL determination and disclosure purposes?”

ACL determination: The ACL must be measured on a collective basis when similar risk characteristics exist. Institutions should evaluate whether COVID-19-modified loans continue to share similar risk characteristics with their current portfolio segments or whether they should be evaluated either in alternative segments or, to the extent they no longer share risk characteristics with any loans in the portfolio, individually. Even if COVID-19-modified loans constitute a separate class of financing receivable, as classes are generally a subset of the portfolio segment, we do not believe that they automatically would be required to be segmented separately.

Disclosure: ASC 326 requires disclosure of the amortized cost basis of the loan portfolio by credit quality indicators by class of financing receivable. For public business entities, these disclosures also must be made by year of origination (i.e., vintage). Institutions are also reminded to “determine, in light of facts and circumstances, how much detail [they] must provide to satisfy the disclosure requirements... An entity must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial assets and associated risks.”⁴

With this in mind, institutions should consider disclosing the volume and nature of COVID-19 loan modifications outstanding as of the reporting date, as this is likely decision-useful information to investors. When determining whether to disclose COVID-19-modified loans by credit quality indicators by vintage, an institution should evaluate whether this information would be excessive or whether it would provide decision-useful information to a financial statement user.

⁴ ASC 326-20-50-3.

Learn more

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