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# Accounting for nonrefundable fees of originating or acquiring loans and acquisition costs of loan and insurance activities; Issues paper (1983 September 20)

American Institute of Certified Public Accountants. Task Force on Accounting for Loan Origination Fees and Initial Direct Costs

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**American Institute of Certified Public Accountants**
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Telex: 70-3396

September 21, 1983

J. T. Ball, CPA
Financial Accounting
Standards Board
High Ridge Park
Box 3821
Stamford, CT 06905

Dear J.T.:

Enclosed for the FASB's consideration is an issues paper, "Accounting for Nonrefundable Fees of Originating or Acquiring Loans and Acquisition Costs of Loan and Insurance Activities," prepared by the Task Force on Accounting for Loan Origination Fees and Initial Direct Costs and approved by the Accounting Standards Executive Committee (AcSEC). Also, enclosed for your information is a letter from Thomas Asson, Chairman of the AICPA Banking Committee, that expresses that committee's views on certain issues.

The advisory conclusions of the task force are presented in paragraphs 106 to 114 of the issues paper. These are AcSEC's votes:

- AcSEC agreed (13 yes, 0 no, 2 absent) that accounting for loan origination fees should be based on the view that originating loans is integral to lending money and recognized as a yield adjustment over the loan period.

- AcSEC agreed (13 yes, 0 no, 2 absent) that if loan origination fees are required to be recognized as revenue when loans are originated, such fees should be recognized immediately only to the extent they equal loan acquisition costs that are charged as expense, with the excess, if any, recognized as a yield adjustment,

- Contrary to the views of the majority of the task force, AcSEC agreed (7 yes, 6 no, 2 absent) that making a loan commitment is integral to lending money. Based on that view, AcSEC agreed (7 yes, 6 no, 2 absent)

that a commitment fee should be recognized as a yield adjustment over the loan period only.

- AcSEC agreed (13 yes, 0 no, 2 absent) that a commitment fee should be recognized over the commitment period if a commitment is made with the expectation that the loan will not be made.

- AcSEC agreed (13 yes, 0 no, 2 absent) that acquisition costs of a loan or an insurance policy should be capitalized and amortized over the related loan period or insurance policy premium paying period.

- Both AcSEC and the task force believe that, for loans, capitalization and amortization of acquisition costs is conceptually preferable to immediate recognition of acquisition costs as expenses offset by equal amounts of revenue. However, as stated in its issues paper, the task force believes immediate recognition should nevertheless be an acceptable alternative, while AcSEC believes (8 yes, 5 no, 2 absent) that it should not be an acceptable alternative.

- AcSEC agreed (12 yes, 1 no, 2 absent) that capitalized acquisition costs of a loan or an insurance policy should be presented in the balance sheet as a separate asset that relates to future revenues to be generated from the loan or insurance policy.

- AcSEC agreed (11 yes, 2 no, 2 absent) that if acquisition costs of loans are required to be expensed when incurred, revenue equal to the costs should be recognized when the costs are incurred.

- AcSEC agreed (12 yes, 0 no, 1 abstain, 2 absent) that acquisition costs should be defined to include method B costs described in paragraph 99 of the issues paper, which

comprise costs of the same type as those incurred in manufacturing inventories.

Six of the seven members of the Task Force on Accounting for Loan Origination Fees and Initial Direct Costs were selected from AICPA industry committees and task forces that deal with particular types of financial institutions, namely, banks, S&Ls, credit unions, finance companies, mortgage bankers, and insurance companies. Representatives of the accounting standards division as well as members of the task force are available to discuss the issues raised in this paper with members of the Board or its staff at their convenience. We would appreciate being kept informed of the Board's action on this paper.

Sincerely,

Roger mej

Roger Cason
Chairman
Accounting Standards
Executive Committee

Mitchell mej

Mitchell M. Krasnoff
Chairman
Task Force on Accounting
for Loan Origination Fees
and Initial Direct Costs

RC/MMK:dw
Enclosure

File 3450
September 20, 1983

ISSUES PAPER

# Accounting for Nonrefundable Fees of Originating or Acquiring Loans and Acquisition Costs of Loan and Insurance Activities

Prepared by
Task Force on Accounting for Loan Origination Fees
and Initial Direct Costs
Accounting Standards Division
American Institute of Certified Public Accountants

830376

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# Introduction

1. The Accounting Standards Executive Committee's Task Force on Accounting for Loan Origination Fees and Initial Direct Costs has prepared this issues paper to address issues relating to accounting for loan origination and other nonrefundable fees and loan acquisition costs, which include costs of acquiring and originating loans. The issues need to be addressed because authoritative literature and current practice permit diverse accounting treatments of similar transactions by various types of financial institutions.

2. Diverse accounting treatments for similar transactions were not as apparent in the past when financial institutions tended to specialize in particular lending activities. The recent breakdown of traditional boundaries between the activities of various types of financial institutions has highlighted the problem. For example, savings and loan associations (S&Ls) traditionally confined their lending activities to residential real estate mortgages. However, new and proposed regulations contain provisions to permit S&Ls to make other types of loans, including real estate construction and development, consumer installment, and commercial loans.

3. The problem of diverse accounting treatments is highlighted further by the increased frequency of business acquisitions involving different types of financial institutions.

For example, a bank holding company may acquire a finance company. Although the bank and the finance company may make the same types of loans, bank and finance company accounting guidance may differ.

4. The approach used to develop this paper has been to consider the similarities and differences between various types of lending transactions and in accounting by different financial institutions for the same types of lending transactions. Those considerations included whether and to what extent accounting principles and practices pertaining to nonrefundable fees and acquisition costs should differ because of substantive differences in lending transactions. Based on those considerations, the objective of this paper is to consider accounting principles for nonrefundable fees and acquisition costs related to those transactions.

5. The task force considers a finance lease as defined in FASB Statement No. 13, Accounting for Leases, to be a lending transaction, the earning process of which is essentially identical to that of other lending transactions. The issues and advisory conclusions in this paper therefore also apply to activities concerning finance leases.

6. The task force also considered the nature of insurance transactions and concluded that an insurance contract is similar

to a loan in that both result in assumption of a short term or long term financial risk. An insurance contract involves assumption of a life, property, or casualty risk and a loan contract involves assumption of a credit risk. Further, the task force considered the nature of the activities and costs incurred to write insurance policies and believes that the nature of insurance policy acquisition costs is essentially the same as that of loan acquisition costs. Therefore, the task force concluded both types of costs are subject to the same conceptual considerations and accounting principles.

7. The task force believes there are no substantial unresolved accounting issues pertaining to refundable fees charged to customers. Therefore, this paper discusses only accounting for nonrefundable fees. Issues addressed in this paper are not relevant to insurance policy loans. Issues pertaining to credit losses, including whether the provision for credit losses is a loan acquisition cost, are not dealt with in this paper and are expected to be considered by the task force in a later project.

## Background

8. Business entities that have traditionally lent money include commercial and savings banks, S&Ls, credit unions, mortgage bankers, finance companies, and insurance companies.

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In recent years, other business entities have become increasingly involved in lending money. Loans generally are made in the forms listed in the appendix.

Activities Associated with Lending

9. An enterprise may originate new loans, including the refinancing or restructuring of the terms of existing loans, or acquire loans from other enterprises. An enterprise also may sell loans to other investors.

10. Originating or Acquiring Loans. An enterprise usually incurs a variety of types of costs, called acquisition costs, when it originates new loans, refinances or restructures the terms of existing loans, or acquires loans from other enterprises. Some of those costs are incremental and some are recurring. Incremental costs clearly associated with the production of new loans typically include costs of credit investigations and commissions or other fees incurred to originate or acquire loans. Recurring costs associated with the production of new loans may include, for example, the portion of an employee's salary applicable to time spend reviewing and approving loan applications. A portion of certain general and administrative costs also may be considered to be associated with the production of new loans.

11. An enterprise may charge its customers fees or designate portions of other charges as loan origination fees (including

points and refinancing or restructuring fees). Loan origination fees generally have been considered either additional revenue, often to reimburse certain loan acquisition costs, or adjustments to the effective yields of the loans. An enterprise may charge its customers other fees that are essentially identical to loan origination fees, though those other fees are not called loan origination fees.

12. The amount of a loan origination fee is often stated as a percentage of the loan principal. The amount may be negotiated with the borrower based on prevailing interest rates. Other factors may also affect the amount of the fee, for example, expected tax benefits and whether the loan is eligible for sale in the secondary market.

13. Another type of fee charged to customers is known as a commitment fee. Binding loan commitments are made to prospective borrowers to assure them that they will be given financing up to a specified amount for a specified period of time or on a specified date. A commitment may be to provide financing at an interest rate based on the market rate at the time the commitment is made (fixed rate commitment) or at the time the loan is to be drawn down or the loan purchase transaction settled (floating rate commitment). A commitment may be issued with little or no expectation of its eventual use. For example,

a customer may need a commitment only as an accommodation to transact business in a foreign market where the customer's credit standing is unknown. Another example involves a standby guarantee of repayment to a second lender. Commitment fees, in total or in part, are not always clearly distinguishable from other fees such as loan origination fees. An enterprise may include compensation for other related services in a single commitment fee. For example, in issuing a letter of credit on behalf of a customer, an enterprise may agree to process the payment of drafts drawn against the letter of credit as payments are collected. Compensation for such services may be included in the commitment fee rather than identified in a separate collection fee and may therefore be difficult to distinguish.

14. The amount of the commitment fee may be negotiated with the customer and may vary based on factors such as

- the creditworthiness of the customer,
- the perceived risk of adverse changes in interest rates or currency exchange rates during the term of the commitment,
- whether the transaction may give rise to reserve requirements under the Federal Reserve Act (for example, "ineligible" bankers' acceptances),

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- other related services to be provided by the enterprise, and
- the interest rate to be charged on a loan resulting from the commitment.

15. Selling Loans. Some enterprises, such as mortgage bankers, acquire loans to sell to other investors for profit. The sellers may retain the rights to service the loans and collect servicing fees from the other investors, typically a percentage of the outstanding principal balances.

Activities Associated With Writing Insurance Policies

16. Like the acquisition of loans, an enterprise usually incurs a variety of types of costs when it writes an insurance policy. Incremental direct costs, such as agents' or brokers' commissions and medical and inspection fees, are clearly associated with acquiring insurance contracts. Certain recurring costs, such as the portion of an employee's salary applicable to time spent reviewing and approving insurance applications, also may be considered associated with insurance contracts. In addition, a portion of certain general and administrative costs also may be considered to be associated with the sales of insurance contracts.

17. Enterprises historically have not charged customers nonrefundable fees when writing insurance policies. Therefore,

issues on recognizing nonrefundable fees are not relevant to insurance.

## Relevant Literature and Current Practice

18. The FASB and AICPA literature on accounting for nonrefundable fees and acquisition costs associated with lending and insurance activities includes the following:

FASB Pronouncements

- FASB Statement No. 13, Accounting for Leases.
- FASB Statement No. 17, Accounting for Leases - Initial Direct Costs.
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises.
- FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities.

AICPA SOPs, Guides, Proposed Guides, and Issues Papers.

- AICPA Statement of Position 75-2, Accounting Practices of Real Estate Investments Trusts.
- AICPA Audit and Accounting Guide, Audits of Savings and Loan Associations.
- AICPA Audit and Accounting Guide, Audits of Banks.

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- proposed AICPA Audit and Accounting Guide for Credit Unions.[1]
- issues paper, "Accounting for Installment Lending Activities of Finance Companies."[2]

FASB Statements No. 13 and 17 apply to leasing transactions by all business enterprises. The other literature generally applies to particular industries.

## Nonrefundable Fees

19. Loan origination fees, which include fees for refinancing and restructuring loans, and commitment fees are the two principal types of nonrefundable fees associated with lending transactions and are charged for various purposes, and present accounting for each type varies depending on the type of financial institution and the perceived nature and purpose of the charge. The revenue recognition principles and concepts that guide accounting for loan origination fees and commitment fees should also guide accounting for other types of nonrefundable fees that relate to originating or acquiring loans.

---

1 The proposed credit union audit guide defers consideration of accounting for nonrefundable fees and acquisition costs associated with lending activities pending completion of this issues paper.

2 Although an audit guide presently exists for finance companies, this issues paper relies on concepts in the finance companies issues paper.

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Loan Origination Fees

20. Diverse guidance on accounting for loan origination fees is provided in the accounting literature associated with lending activities.

21. S&Ls, Banks, and Mortgage Bankers. Guidance on accounting for loan origination fees is similar for S&Ls, banks, and mortgage bankers. Under that guidance, loan origination fees are recognized as income to the extent that they offset loan acquisition costs. The excess of the fees over costs, if any, is accounted for either as an element of interest income over the life of the loan (S&Ls and banks) or as related commitment fees (mortgage bankers).[3]

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[3] The guidance applicable to S&Ls is based on a presumption that amounts permitted to be recognized as income under FSLIC regulations before their amendment in 1979 are deemed not to exceed acquisition costs. The guidance applicable to mortgage bankers is based on the same presumption, that is, that amounts permitted to be recognized as income under FHA and VA rates are deemed not to exceed such costs. Accordingly, unless the circumstances rebut that presumption, the above regulatory amounts may be recognized as income for financial reporting purposes.

22. Loan acquisition costs generally include costs of underwriting the loan, processing the loan application, reviewing legal title to property, and other procedures. However, the definition of loan acquisition costs varies in the accounting guidance for banks, S&Ls, and mortgage bankers. The guidance for S&Ls and mortgage bankers define such costs to include all direct and indirect costs and an allocable portion of general and administrative costs; the guidance for banks does not provide such elaboration.

23. <u>Finance Companies</u>. The AICPA issues paper on installment lending activities of finance companies recommends that finance companies account for loan origination fees as an element of interest income and recognize the fees using the interest method over the life of the loan.

24. <u>Real Estate Investment Trusts (REITs)</u>. SOP 75-2 contains no accounting guidance for loan origination fees of real estate investment trusts.

25. <u>Insurance Companies</u>. The literature applicable to insurance companies provides no accounting guidance for loan origination fees.

<u>Commitment Fees</u>

26. Diverse guidance on accounting for commitment fees is provided in the accounting literature associated with lending activities.

27. S&Ls and Banks. Accounting guidance for S&L's and banks is similar in that both indicate that amounts designated as commitment fees may contain elements of interest that are adjustments of the yields on loans. Accordingly, both the S&L and bank audit guides state that "accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions." The guidance as to the nature of the underlying transactions is essentially the same; however, the specific guidance varies somewhat. The guidance in the S&L guide is somewhat more detailed than that in the bank audit guide. The underlying transactions that relate to making commitments are described in the S&L guide as including reimbursements of direct underwriting costs, compensation for earmarking funds or rendering services in issuing commitments, and assumption of the risks of adverse changes in market interest rates.

28. REITs. SOP 75-2, which applies only to the activities of real estate investment trusts, also recognizes the view that a commitment fee may contain several components but concludes that identifying the separate components is not practicable. The SOP therefore concludes that a commitment fee should be amortized over the combined commitment and loan period using the straight line method of amortization over the commitment period and the interest method for the remaining balance during the loan period.

29. Although the accounting may vary during the commitment period, the guidance requires that unamortized commitment fees remaining at the end of the commitment period be recognized as income if the loan is not funded.

30. Mortgage Bankers. FASB Statement No. 65 says that commitment and other loan fees collected by mortgage bankers represent compensation for a combination of services, which include all the elements of commitment fees identified in the S&L guide, the bank audit guide, and SOP 75-2. FASB Statement No. 65 requires mortgage bankers to account for loan fees in accordance with their primary purpose as follows:

| Types of Fees | Time of Recognition |
|---|---|
| Loan placement fees | When loan is placed and no significant obligations remain. |
| Loan commitment fees | On sale of loan to permanent investor. |
| Land acquisition, development, and construction loan fees | Over combined commitment and loan period. |
| Standby and gap commitment fees | Over combined commitment and loan period. |

31. Mortgage bankers also pay fees, such as placement and commitment fees, to be sure that funding will be available from permanent investors. Fees paid by mortgage bankers are recognized as charges to expense on the same basis as fees received are recognized as revenues.

32. Finance Companies. The issues paper on installment lending activities of finance companies recommends that all nonrefundable fees, including commitment fees, should be accounted for as an element of interest income.

33. Insurance Companies. FASB Statement No. 60 requires normal commitment fees received in connection with the placement of a mortgage loan (less direct costs) to be recognized as revenue over the commitment period. The excess of the fees over what is considered normal fees for making mortgage loan commitments is accounted for as an element of interest income over the life of the loan.

## Acquisition Costs

34. The accounting literature provides diverse guidance on accounting for acquisition costs of lending and insurance activities.

### Banks and S&Ls

35. The accounting guidance for banks and S&Ls addresses the issue of the types of costs that should be treated as loan acquisition costs or underwriting costs for purposes of fee recognition. Those considerations are discussed above in the section on loan origination fees. Banks and S&Ls generally charge all such costs to expense when incurred, though banks sometimes defer and amortize uncommonly large or unusual costs over the life of the loan.

<u>Finance Companies</u>

36. The issues paper on installment lending activities of finance companies identifies two main issues pertaining to loan acquisition costs:

- What types of costs should be treated as loan acquisition costs?
- What method should be used to recognize loan acquisition costs as expense?

The advisory conclusion in the issues paper recommends narrowly defining loan acquisition costs as "initial direct costs" including "...costs directly associated with the production of new loans... that <u>clearly</u> vary directly with the production of new loans."

37. The advisory conclusion further states that internal costs should be excluded from the definition because there is rarely a direct cause and effect relationship between those costs and activities associated with producing new loans. Paragraph 121 of the issues paper says that

> Certain costs such as advertising, marketing, and data processing development, will affect or be affected by the volume of new business. However, the intent of the narrow definition of initial direct costs is to exclude such costs because it is difficult to demonstrate that such costs clearly vary directly with the production of new loans.

The definition of loan acquisition costs as initial direct costs is based on the view that there is a clear relationship

of those costs to specific loans. Because all revenues are deferred as yield adjustments and the costs are directly associated with specific revenues, recognition of loan acquisition costs in income should be deferred and amounts should be amortized to income by the interest method over the shorter of the expected lives and the contractual terms of the loans.

<u>Mortgage Bankers</u>

38. FASB Statement No. 65 requires costs associated with loan applications received directly from borrowers, called in-house originations, to be expensed as incurred. FASB Statement No. 65 extracted the accounting principles in SOP 76-2, <u>Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry</u>, but not all the background information and reasons for conclusions stated in the SOP. SOP 76-2 considered whether mortgage bankers should defer the excess, if any, of acquisition costs over origination fees. The SOP concluded that all acquisition costs should be recognized as expenses when incurred because of the difficulty of identifying costs of originating specific loans and the practices followed by other industries with similar activities.

39. Mortgage bankers purchase existing mortgages from various sources to sell the mortgages to permanent investors. They do not earn interest income because they do not keep the

mortgages. FASB Statement No. 65 considers a portion of the cost of purchasing existing mortgages to be the cost of acquiring rights to receive future servicing revenue. Mortgage bankers frequently retain the servicing rights to the mortgages they sell and collect fees for servicing those mortgages. FASB Statement No. 65 requires a portion of the purchase price of existing mortgages to be deferred and amortized over the mortgage service period and prohibits immediate recognition in income.

REITs

40. SOP 75-2 provides no accounting guidance for loan acquisition costs of real estate investment trusts.

Insurance Companies

41. FASB Statement No. 60 provides no accounting guidance for loan acquisition costs. For insurance policy acquisition costs, FASB Statement No. 60 requires costs that vary with and are primarily related to writing new and renewal insurance contracts to be deferred and amortized to income as the related premiums are earned. Typically costs include commissions, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees.

Leases

42. FASB Statement No. 13, Accounting for Leases, prescribes accounting treatment for all lease transactions. It requires

lessors to charge initial direct costs of direct financing leases to expense when incurred. A portion of unearned income equal to the initial direct costs is recognized as revenue in the same period. For operating leases, FASB Statement No. 13 requires initial direct costs to be deferred and amortized to expense over the lease terms; however, such costs are usually expensed when incurred because their amounts are immaterial.

43. The Statement defines initial direct costs as "those incremental direct costs incurred by the lessor in negotiating and consummating leasing transactions." In FASB Statement No. 17, Accounting for Leases-Initial Direct Costs, issued because of requests to clarify the meaning of "incremental direct costs," the FASB redefined initial direct costs to include

> [t]hose costs...directly associated with negotiating and consumating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of sales persons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of sales persons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expense or other indirect expense, such as rent and facilities costs shall be included in initial direct costs.

Thus, FASB Statement No. 17 eliminates the requirement that initial direct costs be incremental but limits such costs to only those incurred for completed leasing transactions.

## Scope

44. This paper is limited to the following issues pertaining to accounting for applicable lending and insuring activities by business enterprises that regularly engage in such activities:

- methods of recognizing loan origination fees,
- methods of accounting for other nonrefundable fees that relate to acquiring and placing loans, such as commitment fees, and
- methods of recognizing acquisition costs related to making loans and writing insurance, including consideration of how acquisition costs should be defined.

## Recognizing Nonrefundable Fees

45. The designation of nonrefundable fees charged when a commitment is made, at the inception of a loan or when a loan is refinanced or restructured, may not describe their substance. Accounting for nonrefundable fees should be based on the substance of the transactions to which the fees relate and not simply on their designation.

46. In paragraph 63 of Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises, the FASB defines revenue as

> ...inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. (emphasis added)

47. The FASB is expected to consider the timing of recognition of revenues in its conceptual framework project on accounting recognition. Existing guidance is found in APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. Paragraph 148 of APB Statement 4 says that revenue under generally accepted accounting principles may be derived, among other sources, from "rendering services and permitting others to use enterprise resources, which results in interest, rent, royalties, fees, and the like...." Paragraph 150 states this realization principle:

> Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

Paragraph 151 applies that realization principle to revenue generating activities and states that

> Revenue from services rendered is recognized under this principle when services have been performed and are billable.

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> Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used.

Thus, each activity for which nonrefundable fees are received must be analyzed to consider whether the activity provides services that constitute a separate earning process or are an integral part of the entity's central operations. The key question in determining sound accounting for nonrefundable fees is whether the accounting should be based on the view that the related activity for which the fee is charged is a separate revenue generating activity or the view that it is integral to that of lending money or acquiring loans for sale.

Issues on Accounting for Loan Origination Fees

48. The activities associated with originating loans lead to this issue:

> Should accounting for loan origination fees be based on the view that originating loans is integral to lending money or the view that it is a separate revenue generating activity?

49. If accounting for loan origination fees is based on the view that originating loans is integral to lending money, the

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fees would be accounted for as adjustments to the yields of the loans. Some support that accounting treatment because originating loans is a necessary part of lending money.

50. They believe that origination fees are not distinguishable from revenues earned by permitting others to use enterprise resources and, therefore, the fees are simply an element of interest. They point out that, in many instances, the amount designated as an origination fee may be negotiated with the borrower, with an offsetting adjustment to the stated interest rate. They argue that the fees are functions of the net amounts of resources provided, the periods over which they are provided, and the effective interest rates. They contend that recognizing loan origination fees as adjustments to the yields of loans results in a better presentation of the substance of the lending transaction. That view underlies the advisory conclusions in the issues paper on installment lending activities of finance companies, which recommends accounting for all nonrefundable fees as adjustments to the yields of loans.

51. These proponents believe that if origination fees are recognized as yield adjustments, an enterprise should be required to account for fees on a loan by loan basis over the life of each loan. The unamortized portion of a fee would be recognized as an adjustment to income if a loan is paid off before

the end of its contractual period. They further believe that to avoid tracking loans individually, an enterprise may recognize origination fees as yield adjustments over the average expected loan repayment period if such periods can reasonably be determined based on the enterprise's experience. If an enterprise lacks such experience, for example, when it first begins operations, the enterprise may base its calculations of average expected loan repayment periods on the experience of other enterprises with similar loans in the same geographical area.

52. Under such a composite method using an average expected loan repayment period, as with composite depreciation methods, adjustments would not be made to income when loans are paid off prior to contractual maturity. The resulting amount of income recognized in each accounting period should approximate what would have been recognized on a loan by loan basis. Use of a composite method would require determination of expected repayment periods for each significant loan category. For example, the expected repayment period for conventional residential mortgage loans should be calculated separately from the expected repayment period for consumer installment loans.

53. Others believe that originating loans is one of the entity's separate business activities and the services provided in originating loans differ from those allowing borrowers to use

enterprise resources over time. They note that if the costs of originating loans increase, the amounts of loan origination fees may also increase. For example, loan origination fees are generally higher when properties collateralizing loans are large, unusual, or involve other complexities, because more processing costs are incurred. Proponents of that view argue that the services of originating loans are complete once money is lent. They believe costs are better matched with revenues by recognizing in income all or a portion of loan origination fees when loans are made.

54. Some, however, reject the argument that costs are better matched with revenue if the fees are recognized as loans are made. They believe the pattern in which the enterprise incurs costs should not determine the amount and timing of revenue recognition. They note that costs can still be matched with revenues to the extent deemed necessary by cost capitalization and amortization.[4]

55. The conclusion on the first issue pertaining to loan origination fees may lead to the following issue:

> <u>If accounting for loan origination fees should be based on the view that originat-</u>

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[4] Issues on matching and cost capitalization are explored in paragraphs 82 to 85 on loan acquisition costs.

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ating loans is a separate revenue generating activity, should loan origination fees be recognized in income

- in total immediately,
- to the extent fees equal costs of originating or acquiring loans and profits from a separate revenue generating activity, with the excess, if any, recognized over the loan period, or
- to the extent fees equal costs of originating or acquiring loans, with the excess, if any, recognized over the loan period?

56. Some of those who believe accounting for loan origination fees should be based on the view that originating loans is a separate revenue generating activity argue for immediate recognition in income of entire amounts designated as loan origination fees. Their position is based on the belief that once loans are made, the earning process of originating loans is complete because no further services are required and, therefore, all of the associated fees should then be recognized in income.

57. Others note that calling fees loan origination fees does not always indicate their true purpose. They believe that allowing immediate recognition in income of any amounts designated as loan origination fees would emphasize accounting for the form of transactions over their substance. Such accounting may encourage entities to label various fees loan origination fees. Some of those who disagree with that approach argue that amounts designated as loan origination fees should be recognized in income to the extent the fees equal loan acquisition costs and reasonable profit margins from a separate revenue generating activity, with the excesses, if any, recognized over the loan periods or in accordance with their purposes.

58. Still others who disagree with immediate recognition in income of total amounts designated as loan origination fees believe the fees are essentially reimbursements of acquisition costs. Therefore, they believe the fees should be recognized in income to the extent of those costs when loans are made. Amounts in excess of acquisition costs are either adjustments to interest yields on loans, to be recognized in income over the loan period using the interest method or, for loans intended for sale to other investors, may represent commitment fees.[5]

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[5] Commitment fees, as discussed in the following section, may also be considered reimbursements of acquisition costs to the extent such costs are not covered by loan origination fees.

Proponents of that view contend that the primary purpose of loan origination fees is to generate sufficient revenues to reimburse lenders for acquisition costs, and recognizing the fees in income to the extent of acquisition costs improves matching of costs and revenues. That view underlies the positions on loan origination fees in the S&L guide, the bank guide, and FASB Statement No. 65.

Issues on Accounting for Commitment Fees

59. A commitment generally involves an enterprise's contractual obligation under which it promises to permit others to use its resources at a future date. Some commitments may be issued with an expectation that loans will not be made, such as when a customer needs a credit guarantee to engage in certain transactions but does not expect to draw loans on the guarantee. Other commitments may be issued with varying degrees of probability of their eventual use.

60. The activities associated with extending binding loan commitments lead to this issue:

> Should accounting for commitment fees be based on the view that making loan commitments is integral to lending money or is a separate revenue generating activity?

61. Some believe that extending binding loan commitments is an integral part of an entity's ongoing activity of lending

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money. They support the view that if the basic earning activity of an enterprise consists of permitting others to use enterprise resources or selling loans to other investors, all related activities should be accounted for as part of that central earning process. Under that view, all nonrefundable fees are simply an element of interest income to be accrued while the enterprise's resources are held by others. They believe the principle of recognizing revenue as it is earned requires ignoring the effects of the timing of payments at the inception of loans and their designations as commitment fees.

62. Accounting for commitment fees as part of the basic earning activity of an enterprise results in recognizing the entire amounts of the fees as adjustments to the yields of loans or as adjustments to the gains on sales of loans. Commitment fees on loans held would increase the effective interest rates of the loans and thereby relate the risks inherent in making commitments to the overall risks associated with lending money. That would, for example, produce effective yields higher than the market rates of interest for loans made under floating rate commitments, by reflecting over the lives of the related loans the risks associated with the commitments.

63. Others believe that extending binding commitments is an activity separate from lending money. They argue that

issuing a commitment is a separate negotiated transaction that precedes a loan transaction. They argue that, depending on the type of commitment, the enterprise incurs various types of costs. The prospective borrower is usually charged a commitment fee, which is intended for reimbursement of costs incurred and compensation for services rendered, such as assuming the risk of adverse changes in market interest rates or providing a take out or standby commitment to assure another party of repayment. In the lender's financial management strategy, the need for liquid assets to meet significant commitments may result in a decision to forego certain long term investment opportunities. Earnings that may be foregone over the commitment period are not determinable but may influence the amount of commitment fees.[6] For those reasons, they believe compensation should be recognized over the commitment period.

64. In addition, they believe that fees charged by an enterprise for services separate from its lending activities should not be recognized as a yield adjustment. For example, they believe certain fees charged for services performed in connection with the syndication of a loan, in which several banks

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[6] An enterprise may establish compensating balance requirements that also influence the amount of commitment fees. Issues on accounting for compensating balances are not addressed in this paper.

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participate, may represent only remuneration for services rendered in performing the syndication and should be recognized when the syndication is complete. They also believe fees charged to enterprises that purchase a participation in a loan may represent, in part or in total, compensation to the seller for the origination of the loan and should be recognized when the participation is sold.

65. Those who believe that making loan commitments is not integral to lending money recognize that while some commitment fees may represent only remuneration for services rendered in making the commitments, other commitment fees may also include a component that represents a yield adjustment. Under that view, if a commitment fee relates solely to making a commitment and related services, it should be recognized over the commitment period. However, the inclusion of a yield adjustment component in the commitment fee leads to this issue:

> If accounting for commitment fees should be based on the view that extending binding commitments for loans is a separate revenue generating activity, should commitment fees that contain both components be accounted for in the commitment period only or over the combined commitment and loan periods?

66. Some believe that the entire amount of the fees should be recognized as income during the commitment period. They consider that treatment to be a practical approach that reflects the services rendered over the commitment period such as assumption of risk of adverse changes in market interest rates. Those risks would not be reflected in interest earned on loans or in the gain recognized when loans are sold.

67. Others believe that recognizing the entire amounts of fees over the commitment period overstates remuneration for services rendered in making commitments. They contend that the two components of commitment fees should be identified and accounted for separately. The first component, which relates to the commitment, should be recognized over the commitment period. The other component, which relates to the loan, should be recognized as a yield adjustment.

68. Determining whether there are two components to the fee and, if so, the amount of each component to be associated with each period to which it relates should be based on a thorough analysis of the terms of the commitment. Accordingly, those proponents believe consideration should be given to such factors as the reasonableness of

- income from commitment fees in relation to direct costs of making the commitment and

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- the interest yield on the loan in relation to market conditions.

However, they would require that the method of accounting to ensure that income representing part of the loan yield be deferred until the loan is made and then amortized as a yield adjustment.

69. Those who support accounting for commitment fees based on their dual characteristics recognize that determining the amount of each component may be difficult. However, they believe that if the separate components of the fees cannot be reasonably identified, a practical solution is to recognize the total fees over the combined commitment and loan periods. They believe the straight line method of amortization should be used during the commitment period using, as the denominator, the combined time span for the loan and commitment period. At the time the loan is made, the method should be changed so that the remaining unamortized commitment fee is amortized as a yield adjustment. Unamortized commitment fees remaining when commitments expire without loans being made should be recognized in income at that time. The recommended accounting treatment in the bank guide, FASB Statement No. 65, and SOP 75-2 is based on that view. The S&L guide reflects a variation of that view, which allows recognition of revenue at the commitment date in

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amounts equal to costs of issuing the commitment and allows an adjustment of revenue when the loan is made based on market interest rates at that time.

70. Some loan commitments are made with the expectation that loans will not be eventually made. For example, a customer may require a credit guarantee to do business in a market in which he lacks established credit. The customer may obtain a standby letter of credit from a financial institution but never intend to use the credit line to borrow money. SOP 75-2 acknowledges the possibility of distinguishing between commitments that are expected to be funded and those that are not. The S&L guide also acknowledges the existence of such commitment fees and specifically identifies "a fee paid to obtain a take-out commitment, guaranteed by a commitment letter, with little expectation that the loan committed will be funded by the issuer of the letter." FASB Statement No. 65 similarly defines a standby commitment fee as "a commitment to lend money with the understanding that the loan probably will not be made unless permanent financing cannot be obtained from another source."

71. Present accounting guidance generally requires amounts designated as commitment fees to be accounted for over the combined commitment and loan period. Accounting guidance is vague regarding commitment fees charged if the probability of

making loans is remote. In setting forth criteria for recognizing commitment fees, the S&L guide says, among other things, that "unamortized commitment fees should be recognized at the end of the commitment period if the loan is not funded." FASB Statement No. 65 states the same criterion and requires that "if a loan commitment expires without the loan being made ... any related unrecognized fees shall be recognized as revenue or expense at that time." However, the S&L guide also says "amounts representing compensation...for a service rendered in issuing the commitment should be deferred and amortized over the commitment period using the straight line method." That statement may be interpreted to mean that if issuance of commitments with the expectation that loans will not be made is considered services rendered, the associated fees should be recognized in income ratably over the commitment period. FASB Statement No. 65 provides for no such interpretation. The guidance in the bank guide is more general than either the S&L guide or FASB Statement No. 65 and requires that "accounting for recognition of income from commitment fees ... [to] be based on the nature and substance of the transactions...a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized ...."

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72. If a fee is charged for making a commitment with little or no expectation that the loan will be made, it can be presumed that the commitment fee does not have a component that relates to the yield of the loan. The entire fee therefore consists of only one component that relates to services rendered in making the commitment and the following issue is raised:

> How should commitment fees be accounted for if they relate to commitments that are made with the expectation that loans will not be eventually made?

The issue applies only to the types of commitments described in paragraph 70, as long as no other loan is made to the same party that obtained the commitment or to a related borrower. The issue does not pertain to the more general expectation based on historical experience that a certain percentage of all commitments will not result in loans being made.

73. Some believe commitment fees should be recognized as income when the commitment is made if the probability of making a loan under the commitment is remote. Although that treatment may differ from how other commitment fees are accounted for, they believe the circumstances under which such commitments are made justify the difference. They argue that the earning process is substantially complete when such commitments are

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1 made, because no additional services are required during the 2 commitment period or at its expiration. They contend that prior 3 experience and existing circumstances at the time commitments 4 are made enable management to judge the probability that a loan 5 will not be made.

6 74. Others believe that accounting for commitment fees for 7 commitments made with expectation of loans not being made should 8 be the same as for other commitment fees. They consider the 9 earning process to extend over the commitment period, requiring 10 the fees to be recognized in some manner over that period. They 11 note that the assumption of risk and other services are provided 12 over the commitment period regardless of whether the loan is ex- 13 pected ultimately to be made and therefore believe no special 14 accounting for such commitment fees is warranted. They consider 15 such commitment fee revenue analogous to property and liability 16 insurance premium revenue and note that generally accepted 17 accounting principles require such premium revenue to be recog- 18 nized over the period at risk. In their view, parallel account- 19 ing treatment therefore should exist for commitment fees if com- 20 mitments are provided with the expectation that loans will not 21 be made. Some of those also argue that the impracticality of 22 determining with certainty whether loans will be made precludes 23 unique accounting treatment for such fees. 24

75. Still others believe the commitment fees should be recognized as income at the end of the commitment period regardless of whether there is expectation that the loan will not be made. They consider the earning process to be complete only when unused commitments expire.

## Recognizing Acquisition Costs

76. The types of activities needed to make loans or write insurance policies have basic similarities and require a number of processing steps. Marketing may be used to attract prospective customers; such efforts may be directed at an individual customer, at the general public, or at other parties such as real estate and insurance brokers. The information in a loan or insurance application is reviewed for accuracy. To determine the degree of risk involved, a prospective borrower's credit status, which may be checked with third parties, is evaluated. Similarly, a prospective insurance customer's relevant history, such as medical records or casualty experience, also is evaluated and verified to assess the degree of risk. A loan or insurance file is established, which includes the applications, information about the borrower's credit and financial position or the insured's relevant history, and other pertinent documents. If the loan is secured by collateral or if high value property is being insured, the property may be inspected, its ownership

1 verified, and its value estimated, sometimes with the assistance
2 of independent appraisers. Once the loan or insurance policy is
3 approved based on an evaluation of the risk assumed, accounting
4 records for the loan or policy are set up. Other activities may
5 be associated with more complex transactions. For example, ori-
6 ginating certain loans may entail arranging participation agree-
7 ments. Similarly, large insurance risks may involve reinsuring
8 part of the policy with other companies to limit the risk
9 assumed by individual insurers.

10 77. The types of costs of those activities vary. Some are
11 clearly incremental and vary directly with specific loans or in-
12 surance policies, for example, costs of independent appraisals
13 of collateral or insured property or commissions paid to brokers
14 or employers. Other types of costs, such as the portion of an
15 employee's salary applicable to time spent reviewing and approv-
16 ing loan or insurance applications, may be identifiable with
17 specific loans or policies; however, a method of allocation is
18 necessary to make such an association for this category of costs.

19 78. Enterprises that make loans or issue insurance originate
20 various types of loans and insurance policies. The common ele-
21 ments of the activities necessary to originate all types of
22 loans and insurance policies and the costs of those activities
23 are sufficiently similar to consider accounting concepts for
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those acquisition costs together. Conclusions should apply equally, for example, to mortgage loans or consumer installment loans as well as to insurance.

79. There are few substantive differences between activities to originate loans and those to extend binding commitments. In both cases, the activities essentially are similar in that the enterprise reviews potential risks to assess its financial exposure. Accordingly, each of the following issues dealing with acquisition costs also pertains to costs of extending commitments. Issues on costs of extending commitments are therefore not addressed in this paper.

Issues on Accounting for Acquisition Costs

80. FASB Statement of Financial Accounting Concepts No. 3, paragraph 19, defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The incurrence of costs does not establish the existence of an asset; rather, the essential feature of an asset is it will probably result in a future economic benefit. An asset may produce benefits by being

- exchanged for cash or other goods or services
- used to produce or otherwise increase the values of other assets
- used to settle liabilities

81. APB Statement No. 4, paragraphs 157 to 160, discusses three pervasive expense recognition principles, which specify the bases for recognizing costs as expenses:

- Associating cause and effect. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

- Systematic and rational allocation. In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided.

- Immediate recognition. Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Because diverse expense recognition principles exists, the following issue is stated:

> Should acquisition costs be recognized as expense when they are incurred or should they be capitalized as assets and amortized over the loan period or premium paying period of the insurance policy?

82. One view is that costs associated with originating loans and insurance policies are ordinary and necessary costs of doing business and should be recognized as expenses when incurred.

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Those who hold that view reject capitalization of acquisition costs as assets because they contend the costs provide no discernible future benefits and therefore do not meet the definition of assets in FASB Statement of Financial Accounting Concepts No. 3. They argue that a direct relationship between most acquisition costs and revenues from loans and insurance policies cannot be established. They further argue that systematic allocation of acquisition costs to future periods would be arbitrary and, accordingly, the preferability of a particular method of allocation could not be proved. Some also prefer recognizing acquisition costs as expense when incurred because that treatment is more conservative than deferring recognition of costs to future periods. However, some of those who hold that view believe that insurance policy acquisition costs should continue to be capitalized in accordance with the present accounting literature because such practice has been commonly accepted for a considerable period.

83. Others believe that costs associated with originating loans and writing insurance should be identified, capitalized as assets, and amortized over the loan or policy periods in relation to revenue earned. Under that view, loan acquisition costs would be amortized as yield adjustments over the lives of loans and insurance policy acquisition costs would be charged to

expense in proportion to premium revenue earned. In their opinion, capitalized acquisition costs meet the definition of an asset under FASB Statement of Financial Accounting Concepts No. 3 because they are used to produce other benefits, namely, revenue to be generated from loans or insurance policies. FASB Statment of Financial Accounting Concepts No. 3, paragraph 108, states "[i]f research or development activities result in an enterprise's acquiring future economic benefit, that future economic benefit qualifies as an asset...." Barring uncertainty as to whether those activities will produce future economic benefit, their costs would conceivably be recognized as assets. Loan and insurance policy acqusition activities also result in an enterprise's acquiring future economic benefits but without the uncertainties inherent in research and development activities. Therefore, some hold analogously that the costs of loan and insurance policy acquisition activities should be capitalized as assets and amortized over the future periods benefitted.

84. Those proponents believe that capitalized acquisition costs meet the definition of an asset under FASB Statement of Financial Accounting Concepts No. 3 because the loan or insurance contract will generate future revenues and the acquisition costs were incurred to negotiate that contract. They note that such costs are already accounted for as assets under FASB

Statement No. 13 for operating leases and under FASB Statement No. 45, Accounting for Franchise Fee Revenue, for franchise contracts. They believe further support for that view exists in FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation. Paragraph 9 of that statement requires capitalizing costs that are included in allowable costs for ratemaking purposes if future revenue is expected to equal and provide recovery for those particular costs, rather than similar future costs. According to paragraph 58 of FASB Statement No. 71, that probable additional revenue meets the criterion of probable future economic benefits needed to account for the costs as assets.

85. Proponents of that view believe that a cause and effect relationship exists between the costs of and revenues derived from lending money. The costs should therefore be considered as one factor in establishing the yields of the loans to recognize that relationship. Similar treatment for debt issue costs is suggested in FASB Statement of Financial Accounting Concepts No. 3, paragraph 161, which states that "debt issue cost in effect reduces the proceeds of borrowing and increases the effective interest rate [of the related debt]..." Since activities necessary to borrow money may thus be viewed as integral to the overall borrowing activity, activities necessary

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to lend money should be viewed as part of the overall lending activity and accounted for as such. Capitalizing the acquisition costs and amortizing them over future periods best reflects their relationship to yields on loans and is necessary to satisfactorily match costs incurred with revenues earned.

86. Capitalizing acquisition costs as an asset to be amortized over the loan period or premium paying period of the insurance policy leads to the following issue:

> If acquisition costs should be capitalized and amortized, how should the related asset be presented in the balance sheet?

87. Some believe that capitalized loan acquisition costs should be presented in loans receivable because of the relationship between the costs and the loans. They note that loan acquisition costs are incurred to produce revenue earning assets and therefore should be reflected as part of the reported amount of those assets. They believe that presentation reflects the lower effective interest rate produced by amortizing acquisition cost as a yield adjustment. They also believe that capitalized insurance policy acquisition costs should be offset against unearned premiums as a contraliability. Those proponents consider such treatment of acquisition costs to be consistent with that suggested for debt issuance costs in paragraph 161 of FASB Statement of Financial Accounting Concepts No. 3.

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88. Others contend that all capitalized acquisition costs (loan and insurance) should be presented as a separate asset that relates to future revenues to be generated from the agreements. They note that current accounting principles incorporate a similar view for initial direct costs of certain executory contracts, such as operating leases and franchise agreements. The capitalized costs of those contracts relate to the future revenues to be generated from the executory contracts, because the revenue generating assets, the lease and franchise agreements, are not recognized under current accounting principles. Those proponents hold that capitalized acquisition costs should be subject to the same principles even though the revenue generating asset, the loan receivable and unearned premiums on an insurance policy, are recognized in the financial statements.

89. If loan acquisition costs are recognized as expenses when incurred, the substance of lending transactions may require special recognition of revenue to offset the costs. Therefore, the following issue is stated:

> <u>Should a portion of the revenue associated with the loan, such as loan origination fees or a portion of unearned revenue equal to the amounts of acquisition costs, be recognized in income when the costs are incurred?</u>[7]

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7 This issue is not relevant to insurance contracts because no such revenue comparable to loan origination fees exists.

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90. An enterprise incurs costs, in addition to the interest cost of obtaining the money to lend, at the inception of loans and, accordingly, before revenues are recognized. Though balance sheet results may differ, the same amounts of net income for each period result if loan origination fees or unearned revenues are accounted for as offsets to loan acquisition costs or if loan acquisition costs are capitalized and all revenues associated with loans are deferred and amortized over the lives of loans.

91. Some believe that if those loan acquisition costs are recognized as expenses when incurred, loan origination fees or a portion of unearned revenue equal to loan acquisition costs should be accounted for as offsets to the costs in the same period. They believe that accounting treatment provides the necessary matching of related costs and revenues.

92. Others argue that it would be undesirable to allow revenue to be recognized at the inception of a loan, merely because costs have been incurred. In their view, a proper matching of costs and revenues involves determination of expense recognition based on revenue recognition. They hold that the pattern in which an enterprise incurs costs should not determine the amount and timing of revenue recognition. Furthermore, such accounting tends to obscure the amount of acquisition costs incurred.

93. Some of those who believe revenue should not be recognized at the inception of the loan contend that capitalizing loan acquisition costs and recognizing them as a yield adjustment is a better alternative for matching of costs with revenues than recognizing revenue at the inception of a loan equal to acquisition costs. They note that net income amounts do not differ under either approach. They also observe that identifying loan acquisition costs is necessary for either alternative and, therefore, neither method is more difficult to apply than the other. They conclude that a cost capitalization method should be used because it is conceptually preferable to early recognition of revenue.

94. Those who prefer to recognize revenue equal to loan acquisition costs at the inception of a loan believe there is no evidence that such current practice produces undesirable reported financial results. They therefore believe that the additional cost of precisely identifying capitalizable loan acquisition costs is not justified. They argue that, in the absence of a comprehensive cost accounting system for determining loan acquisition costs to be capitalized, current practice is acceptable if the reasonableness of the amount of revenue in relation to estimated costs currently recognized can be demonstrated. For example, the bank audit guide refers to reasonableness of com-

mitment fees in terms of their relationships to direct costs and reasonableness of the interest yield on the loans in relation to market conditions. It does not require the specific identification of costs that would be necessary under a cost capitalization approach to matching.

95. Those who believe that a portion of revenue associated with loans should be recognized in income when the costs are incurred do not agree on how much revenue should be recognized. Some believe that revenue recognized should be limited to costs incurred. Others believe that originating loans is a separate revenue generating activity and, therefore, sufficient revenue should be recognized in excess of costs to establish a reasonable profit in addition to recovery of costs incurred. Such issues are explored in paragraphs 45 to 58 on nonrefundable fees.

96. Views vary on which costs should be considered acquisition costs. If such costs are to be treated other than as expenses of the periods in which they are incurred, their definitions need to be made clear. Similarly, if loan origination fees or unearned revenues should be accounted for in relation to loan acquisition costs, the definition of those costs is essential to determine amounts of revenue recognition.

The following issue is therefore raised:

> <u>If acquisition costs should be either capitalized or, for loans, offset by revenue, what costs should be treated as acquisition costs</u>?

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97. There are three methods to defining acquisition costs. For expediency, those methods are referred to as Method A, Method B, and Method C in this paper.

98. Under Method A, acquisition costs comprise only incremental costs that clearly vary with the production of loans and insurance policies. Thus, commissions paid for new business would be included in acquisition costs regardless of whether the commissions are paid to employees or to third parties. However, salaries paid to employees are a recurring rather than an incremental cost and therefore would be excluded from acquisition costs. Also, costs associated with unsuccessful efforts to make loans or sell insurance contracts would be excluded from acquisition costs.

99. Under Method B, acquisition costs comprise both incremental costs as well as other costs considered to be related to the production of loans and insurance policies. That definition encompasses costs similar to those that would be capitalized as part of inventory in manufacturing operations. For example, an allocable portion of salaries of employees engaged in processing loan or insurance applications, together with an allocable portion of occupancy and other similar overhead costs, would be included in acquisition costs. Also, this allocation would include costs of a normal level of unsuccessful activities for producing loans and insurance policies because of the impracticality of isolating costs of unsuccessful activities from the allocation. In that respect, the results would be similar to inventory costing, which includes an amount for normal spoilage.

100. Under Method C, acquisition costs comprise a broad range of costs. In addition to incremental costs and other costs that would be capitalized in manufacturing operations under Method B, certain selling, general, and administrative costs would be included in acquisition costs. For example, advertising costs and a portion of an executive officer's salary, if considered related to the production of loans or insurance policies, would be allocated and included in acquisition costs. That definition is similar to the definition presently followed by the S&L industry.

101. Method A proponents believe that only incremental costs should be treated as acquisition costs to be associated with revenues earned. They believe a direct relationship with revenues earned cannot be established for other costs and contend that accounting based on a relationship between indirect costs and revenues would rely on arbitrary allocations, which should be avoided. They believe their view is reflected in FASB Statement No. 45, Accounting for Franchise Fee Revenue, which requires deferral of direct incremental costs until the related revenue from franchise sales is recognized; other regular and recurring costs are expensed as incurred. They also believe that the broader cost capitalization concepts applied to inventories of manufacturers are not appropriate for financial institutions because of public and lender expectations for conservative capitalization and liquidity.

102. Method B proponents believe that both incremental costs and other costs related to the production of loans and insurance contracts should be associated with revenues by a systematic and rational manner of allocation. They note that systematic and rational allocation of costs is common in accounting. Furthermore, they consider such an association of costs with revenues to be similar to accounting for manufacturing operations, in which depreciation and other overhead costs are charged to manufactured inventories. For example, APB Statement No. 4, paragraph 184, states that "costs assigned to products and services provided are those costs of manufacturing products and providing services that are considered productive, including direct costs and indirect costs (absorbed overhead)." Therefore, they would include as acquisition costs, for example, portions of salaries applicable to personnel who originate loans or insurance policies, related fringe benefits, data processing loan or insurance set up charges, costs of loan or insurance file documents, and costs of appraisals and site inspections.

103. Method C proponents believe that the definition of allocable acquisition costs should not be so limited. They would capitalize a portion of general and administrative costs, in addition to the costs that Method B proponents would capitalize, because they believe those additional costs can be demonstrated to be related to the production of loans or insurance policies.

104. The purpose of this paper is, in part, to readdress accounting for acquisition costs as required in FASB Statements No. 17 and 60. The definition of such costs in FASB Statement No. 17 is similar to Method B. However, costs incurred in negotiating leases that are not consummated are excluded from the definition. FASB Statement No. 60, paragraph 66, defines acquisition costs to include "costs that vary with and are primarily related to the acquisition of insurance contracts." Whether that definition falls under Method A or B is unclear. Some enterprises have interpreted the definition to include only Method A costs; other enterprises have interpreted it more broadly to include Method B costs.

## Advisory Conclusions

105. Paragraphs 106 to 114 present the advisory conclusions of the Task Force on Accounting for Loan Origination Fees and Initial Direct Costs on the issues raised in this paper. The votes of the task force are presented following each advisory conclusion.[8]

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[8] AcSEC's votes on the advisory conclusions, which are not identical to the votes of the task force, are presented in a separate letter that was sent to the FASB with this paper.

## Accounting for Loan Origination Fees

106. Accounting for loan origination fees should be based on the view that originating loans is integral to lending money. Income from lending money and permitting others to use enterprise resources should be recognized when it accrues. Therefore, origination fees represent yield adjustments, which should be recognized using the interest method as described in paragraphs 51 and 52. (Vote: 7 to 0)

107. However, if loan origination fees are required to be recognized as revenue when loans are originated, such fees should be recognized immediately as revenue only to the extent they equal loan acquisition costs that are charged as expense with the excess, if any, recognized as yield adjustments as described in paragagraphs 51 and 52. (Vote: 7 to 0). The composition of costs of acquiring loans is considered in paragraph 114.

## Accounting for Commitment Fees

108. Making a loan commitment is a separate transaction that provides distinct services to customers for which the lending instititution is entitled to compensation. Accounting for commitment fees should therefore be based on the view that making loan commitments is a separate revenue generating activity from which remuneration may be provided for services rendered. (Vote: 5 to 2)

109. Those five task force members who voted yes for paragraph 108 and believe making a loan commitment is a separate transaction also believe an amount designated as a commitment fee may have two components: one relating to making commitments and one related to lending money. If so, the components should be separately identified and accounted for. The component relating to making a commitment should be recognized over the commitment period and the component relating to lending money should be accounted for as a yield adjustment as described in paragraphs 51 and 52. If a commitment fee has both components, but the components cannot be readily identified, the commitment fee should be recognized over the combined commitment and loan periods as described in paragraph 69 and not over the commitment period alone. The two task force members who voted no for paragraph 108 believe that making a loan commitment with expectation that the loan will be made is integral to lending money and therefore the total commitment fee should be accounted for as a yield adjustment as described in paragraphs 51 and 52.

110. The task force believes that a commitment fee is earned and should be recognized over the commitment period if a commitment is made with expectation that the loan will not be made and that no other loan is made to the same or a related borrower. (Vote: 7 to 0)

Accounting for Acquisition Costs

111. Acquisition costs should be capitalized as an asset and amortized over the related loan period or the premium paying period of the related insurance policy. Loan acquisition costs should be amortized as yield adjustments as described in paragraphs 51 and 52 and insurance policy acquisition costs should be charged to expense in proportion to premium revenues earned. Acquisition costs related to loan commitments and other services should be capitalized and charged to expense in proportion to related revenues as they are recognized in income. (Vote: 6 to 1). In addition, for loans, a less conceptually preferable but acceptable alternative would be to permit immediate recognition of acquisition costs offset by equal amounts of revenue. (Vote: 5 to 2).

112. A majority of the task force believes capitalized acquisition costs should be presented in the balance sheet as a separate asset that relates to future revenues to be generated from the agreements. A minority of the task force believes capitalized acquisition costs should be included in the loan receivable balance or offset against unearned insurance premiums. (Vote: 4 to 3)

113. The task force believes acquisition costs should not be required to be expensed when incurred. However, for loans, if

acquisition costs are required to be expensed when incurred instead of deferred and amortized, revenue equal to the costs should be recognized when the costs are incurred. (Vote: 7 to 0)

114. Acquisition costs should be defined as incremental costs and allocable costs related to or identifiable with loans or policies, which would exclude general and administrative costs and comprise the same types of costs associated with accounting for manufacturing inventories (Method B). (Vote: 5 to 2) The minority view is split. One member of the task force believes acquisition costs should be defined to include only incremental costs of making loans or writing insurance policies (Method A). Another member of the task force believes acquisition costs should be defined to include a portion of general and administrative costs considered related to the production of loans or insurance policies (Method C).

## Appendix A

Loans generally take the following forms:

- Consumer installment loans - interest bearing or discount loans made directly to consumers, usually payable in equal installments. The loans may be either unsecured or collateralized by durable goods, a savings account, the cash value of a life insurance policy, or some other form of collateral.
- Retail contracts - loans to consumers that originate when dealers or manufacturers finance customers' purchases and sell the contracts to financial institutions, often at a discount.
- Commercial installment loans - loans to businesses, usually collateralized by various types of assets such as accounts receivable, inventories, or property and equipment.
- Real estate mortgage loans - loans collateralized by real estate (conventional loans, Federal Housing Authority (FHA) insured loans, or Veterans Administration

(VA) guaranteed loans), generally payable in installments.[9]

- Construction loans - loans made to finance construction during the construction period.[9]

- Credit card programs - agreements under which consumers are issued credit cards and obtain lines of credit for unsecured borrowings to purchase goods or services from participating merchants or to obtain cash advances.

- Finance leases - lease agreements that meet the definition of a finance lease under the provisions of FASB Statement No. 13.

- Time and demand loans - loans that are payable on demand or that may contain provisions for maturity or renewal for periods such as 90 or 180 days from the dates the loans were made. Time and demand loans may be made to consumers or businesses and may or may not be collateralized.

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[9] Real estate mortgage loans and construction loans may be originated simultaneously as a package.

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24

## APPENDIX B

This appendix provides a summary by industry of accounting principles for loan origination and commitment fees. The summary is a simplification of the requirements set forth in the accounting literature. To be fully understood, the summary should be read in conjunction with the authoritative literature listed in paragraph 18 of this issues paper and with the discussions of current practice under that literature in paragraphs 19 to 44 of this paper.

No chart on the definition of acquisiton costs has been provided in this appendix, primarily for two reasons. First, the definition of such costs varies in the accounting literature applicable to each type of financial institution, as well as the literature applicable to leasing. Second, the various definitions use general descriptions that require judgment in application.

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24

## Loan Origination Fees

| | Banks | S&Ls | Finance Cos. | Mortgage Bankers |
|---|---|---|---|---|
| Recognize as revenue amounts necessary to offset acquisition costs charged to expense with the remainder deferred as yield adjustments. | X | X | | X |
| Defer in total and recognize as yield adjustments with simultaneous deferral and amortization of acquisition costs. | | | X | |

## Commitment Fees

| | Banks | S&Ls | Mortgage Bankers | Finance Cos. | REITS | Insurance Cos. |
|---|---|---|---|---|---|---|
| Recognize over the combined commitment and loan periods or on sale of loans to other enterprises.[1] | X | X | X | | X | X[2] |
| Defer in total and recognize as yield adjustments. | | | | X | | |

1 The manner in which the accounting literature requires commitment fees to be recognized over the combined commitment and loan periods varies for various industries. Guidance is vague on when to recognize fees relating to commitments made with the expectation that the loans will not be made.

2 The literature for insurance companies addresses only normal commitment fees on mortgage loans.