
Example 1

Measuring Impairment: Present Value of Expected Future Cash Flows Method (Unsecured Loan)

Management terms out an annually renewing, unsecured revolving line of credit due to the borrower's financial difficulties. The loan will now amortize and mature in 5 years because this produces a payment the borrower can afford based on current financial information. The original note rate of 6%, which is the loan's effective interest rate, was not changed. Management has determined that the loan modification constitutes a TDR. The bank's loss experience on unsecured loans classified Substandard is 25%.

Since there is no collateral, what cash flows and discount rate should be used to calculate the present value of expected future cash flows used to measure impairment?

- A. Expected future cash flows: 5 years of monthly payments at the modified contractual amount.
Discount rate: 6%
- B. Expected future cash flows: 5 years of monthly payments at the modified contractual amount.
Discount rate: The market rate for debt of similar risk, estimated at 20%
- C. Expected future cash flows: 5 years of monthly payments at the modified contractual amount reduced by 25%. Discount rate: 6%

The best answer is C.

Answer C is the best answer because the estimate of expected future cash flows takes default assumptions into consideration. The resulting present value is subtracted from the loan balance to derive the impairment amount. The allocated impairment amount is included in the ALLL and reviewed quarterly to determine the need for any adjustments.

Answer A does not consider default assumptions in the estimate of expected future cash flows on the loan; therefore, it would result in no impairment despite the loan being unsecured and the borrower being in financial distress.

Answer B uses an incorrect discount rate. ASC 310 requires the discount rate to be the loan's original effective interest rate, not the market rate of interest. Additionally, the expected future cash flows have not been adjusted for default assumptions.