Alert – New Credit Impairment Standard Issued

On June 16, 2016, the Financial Accounting Standards Board (FASB) released the long-awaited standard updating the guidance on recognition and measurement of credit losses for financial assets. Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326)—Measurement of Credit Losses on Financial Instruments,* supersedes today's guidance and applies to all entities holding financial assets not measured at fair value (FV) through net income. The new requirements, known as the current expected credit loss model (CECL), replace today's incurred loss model. At acquisition and each reporting date, entities will recognize an allowance for lifetime expected credit losses for instruments within the ASU's scope. Credit losses will be immediately recognized through net income; the amount recognized will be based on the current estimate of contractual cash flows not expected to be collected over the financial asset's contractual term. Entities will have flexibility to develop methods to estimate and measure expected credit losses, as long as the methods are consistently applied and reflect the ASU's key elements.

The new model will significantly impact financial institutions, although all entities will need to evaluate the impact of the new standard—including not-for-profits (NFP) with programmatic loans and companies with long-dated trade receivables.

Scope

The ASU applies all financial assets measured at amortized cost, including certain debt securities, trade receivables, loans, net investments in leases, off-balance sheet credit exposures and reinsurance receivables. Debt securities classified as available-for-sale (AFS) are excluded from the scope of the CECL model and will follow a modified other-than-temporary impairment (OTTI) model. In addition, trading securities and loans held for sale are excluded from the scope of the ASU.

CECL Model

Currently, depending on the nature of the financial asset, a credit loss must either be probable or other than temporary before recognition. The ASU eliminates a recognition threshold on credit losses. An entity would recognize a **Day 1** impairment allowance for its current estimate of contractual cash flows not expected to be collected on financial assets. Entities are permitted to develop credit loss estimates on an individual or pooled basis when similar risk characteristics exist. The allowance for credit losses may be determined using various methods, *e.g.*, discounted cash flow (DCF), loss rate, roll rate, probability of default or methods that use an aging schedule. Entities should consider relevant internal or external information relative to assessing the collectability of cash flows. An entity should consider expected prepayments in estimating future contractual cash flows. Only an entity reasonably expecting to execute a troubled debt restructuring (TDR) would consider extensions, renewals or modifications.

Small banks may not need complex models; however, they will need to make changes to current systems for data collection and analysis.

Range of Information

FASB has broadened the information an entity will be required to consider in developing its credit loss estimate. Under current GAAP, an entity generally considers past events and current conditions in measuring credit losses. The ASU requires the loss estimate to include relevant information about past events, current conditions **and** reasonable, supportable forecasts. To estimate expected credit losses, an entity need only consider relevant qualitative and quantitative factors reasonably available without undue cost and effort, which may be based on internal or external information. An entity may find that using its internal information is sufficient in determining collectibility. For periods beyond which an entity is able to make a reasonable forecast, entities would revert to unadjusted historical credit loss experience.

Modified OTTI

For AFS debt securities, an allowance approach would be used, permitting an entity to recognize reversals of credit losses. Entities no longer will be required to consider the length of time the FV of the AFS debt security has been less than its amortized cost basis when estimating whether a credit loss exists. Entities no longer will be required to consider historical and implied volatility or recoveries or declines in FV for AFS debt securities after the balance sheet date when determining whether a credit loss exists.

Purchased Credit-Impaired Financial Assets

The ASU modifies the definition of what were previously known as purchased credit-impaired (PCI) assets. FASB defines purchased financial assets with credit deterioration (PCD) as an acquired financial asset or acquired groups of financial assets with similar risk characteristics that have experienced a more-than-insignificant deterioration in credit quality since origination, based on the buyer's assessment. PCD assets would follow the same approach as originated assets for purposes of credit impairment; upon acquisition and at each reporting date, an entity would recognize a credit impairment allowance for its current estimate of the contractual cash flows not expected to be collected. At acquisition, both the financial asset and allowance for credit losses would be recorded gross, and the allowance for credit losses would be added to the purchase price to determine the initial amortized cost basis. The result is no accretion into interest income of the credit-related discount. The difference between the amortized cost basis and par amount of the debt will be recognized as a noncredit discount or premium and accreted into interest income over the remaining life of the asset. Subsequent changes in expected cash flows would be recorded as gains and losses through the credit loss provision. Recognition of interest income would be accounted for under existing guidance in *Receivables* (Topic 310). The following example is from FASB.

***Example:** Recognition of Purchased Financial Asset with Credit Deterioration*

Assume that Bank ABC pays $750,000 for a bond with a par amount of $1 million. The bond is measured at amortized cost basis. At purchase, the allowance for credit loss on the unpaid principal balance is estimated at $175,000. At acquisition, the balance sheet would reflect an amortized cost basis for the financial asset of $925,000—the amount paid plus the allowance for credit loss—and an associated allowance for credit losses of $175,000. The difference between par of $1 million and the amortized cost of $925,000 is a noncredit-related discount. The acquisition-date journal entry is as follows:

Loan—par amount:	*$1,000,000*
Loan—noncredit discount:	*$75,000*
Allowance for credit losses:	*$175,000*
Cash:	*$750,000*

The $75,000 noncredit discount would be accreted into interest income over the bond's life, consistent with other Topics. The $175,000 credit loss allowance should be updated in subsequent periods for any changes in expected cash flows, with changes in the allowance for credit losses on the unpaid principal balance immediately reported in the statement of financial performance as a credit loss expense.

TDRs

The ASU does not change the definition or derecognition guidelines for TDRs, but rather changes the impairment recognized on restructuring. Credit losses for TDRs now will be measured using the CECL model. The ASU eliminates the current GAAP requirement to use a DCF technique. Credit losses, including concessions given to a borrower under a TDR, will be recognized through an allowance account.

The discount embedded in the purchase price attributable to expected credit losses would not be recognized as interest income, as is the current practice.

New Disclosures

The ASU carries forward certain disclosure requirements of ASU No. 2010-20, *Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, such as quantitative and qualitative information about credit risk, credit losses and credit quality, including the amount of recorded investment by credit quality indicator. The ASU requires a rollforward of the allowance for expected credit losses as well as comprehensive disclosures including, but not limited to, the allowance for expected credit losses, past-due and nonaccrual status, PCI financial assets and collateralized financial assets.

Effective Date

FASB created a new subgroup of public business entities for the purpose of providing a delayed effective date for the credit impairment standard. This subgroup of smaller public business entities, which do not meet the definition of a Securities and Exchange Commission (SEC) filer, would have an additional year to adopt the standard for both annual and interim periods; this group would include many community banks. All other entities would have a one-year deferral for annual financial statements and two years for interim financial statements.

The new guidance will be effective for public business entities that are SEC filers for fiscal years beginning after December 15, 2019, including interim periods, *i.e.*, 2020 for calendar year-end companies. The effective date for smaller public business entities, which do not meet definition of an SEC filer, would be fiscal years beginning after December 15, 2020, including interim periods. For all other entities, including NFP entities and employee benefit plans, the new guidance would be effective for fiscal years beginning after December 15, 2020, and for interim financial statements for fiscal years beginning after December 15, 2020. Early application is permitted for fiscal years beginning after December 15, 2018, including interim periods.

Transition

Transition would be on a modified retrospective transition basis. An entity will apply the guidance to all outstanding financial assets as of the beginning of the first reporting period the guidance is effective. Entities will reflect the cumulative effect of the change related to periods before the ASU's effective date in the carrying amount of assets as of the effective date, with an offsetting adjustment to the opening balance of retained earnings. Financial statements for each individual prior period presented would not be adjusted.

OTTI Debt Securities

For debt securities with a previous charge due to OTTI, transition would be on a **prospective basis** as of the effective date. The amortized cost basis of the debt security would be unchanged on the adoption date. Amounts previously recognized in accumulated other comprehensive income as of the adoption date that relate to improvements in cash flows would continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. The effective interest rate on a security will remain unchanged as a result of the adoption. After adoption, recoveries of amounts previously written off due to improvements in cash flows would be recorded as a reduction in allowance for credit losses in the period received.

PCD Assets

An entity will classify assets accounted for under Subtopic 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality,* as PCD assets at the adoption date, including those acquired assets for which Subtopic 310-30 has been applied by analogy. At adoption, an entity will not need to reassess whether an instrument meets the PCI definition. Entities will be required to adjust the amortized cost basis of the financial asset and allowance for expected credit losses. The noncredit discount or premium—after the adjustment for credit losses—will be accreted to interest income using the effective interest rate at the adoption date.

Conclusion

Although the effective date may seem a long time away, there are some areas to focus on immediately. The CECL model may require operational and system changes to ensure compliance with the new requirements and to satisfy auditors and banking regulators.

Considerations include:

- Collecting and retaining data
- Tracking loans from origination
- Forecasting economic and other qualitative factors
- Preparing for enhanced disclosure requirements

BKD has prepared several papers on the financial instruments projects and will continue to monitor updates. Visit our Hot Topics page to access these resources. For more information, contact your BKD advisor.

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