AN ALERT FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

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## NEW GUIDANCE ON ACCOUNTING FOR CREDIT LOSSES CALLED 'BIGGEST CHANGE TO BANK ACCOUNTING EVER'

On June 16, The Financial Accounting Standards Board (FASB) issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326).

The final current expected credit loss (CECL) standard marks a significant shift in the way credit losses on many financial assets, especially loans, are recorded. The ASU will require that banks estimate and record credit losses on loans and other assets (e.g., HTM debt securities) within the scope of the CECL model based on expected loss over the contractual life of the loan (considering prepayments). The goal of the new standard is to improve investor and financial statement user access to more timely information about credit losses and likely would require banks to record losses sooner than under current GAAP.

The standard will apply to all banks, savings associations, credit unions and financial institution holding companies, regardless of asset size.

The American Bankers Association has called the standard "the biggest change to bank accounting ever."

### SUMMARY

The new CECL standard updates and replaces credit loss accounting standards that have been in place for many years. FASB notes that the current "incurred loss" methodology, which delays recognition until there is a probable loss, has been criticized for restricting the ability to record expected credit losses that do not yet meet the "probable threshold," and this concern was underscored by the financial crisis.

The new guidance requires that banks measure all expected credit losses for financial assets within the scope of the CECL model based on historical experience, current conditions and—for the first time—will require financial institutions to use forward-looking, reasonable and supportable forecasts to make informed credit loss estimates. For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity should revert to historical loss information that is reflective of the contractual term (considering prepayments) of the financial asset. In addition, the ASU:

- "Eliminates the probable initial recognition threshold in current GAAP and, instead, reflects an organization's

Read more

### HOW DO I GET MORE INFORMATION?

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current estimate of all expected credit losses over the contractual term

- Increases usefulness of the financial statements by requiring timely inclusion of forecast information in forming expectations of credit losses

- Increases comparability of purchased financial assets with credit deterioration (PCD assets), [which will replace the current purchased credit impaired (PCI) model, with originated and non-PCD assets. The threshold for meeting PCD criteria, that is, occurrence of more-than insignificant amount of credit deterioration since origination, is different than meeting PCI criteria under the existing standards]

- Increases users' understanding of underwriting standards by requiring additional information about credit quality indicators by year of origination (vintage)

- For available-for-sale debt securities, aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses (and subsequent reversals) through an allowance rather than a write-down

*Source: FASB in Focus*

The new accounting standard provides high-level guidance, but does not specify a single method for measuring expected credit losses. According to the FASB, "Institutions should use judgment to develop estimation methods that are well documented, applied consistently over time and faithfully estimate the collectability of financial assets by applying the principles in the new accounting standard."

CECL is the result of a project the FASB began in 2008, and has included stakeholder outreach, meetings and workshops, and more than 3,000 comment letters. Effective dates are as follows:

- **Public companies that are SEC filers:** Fiscal years beginning after Dec. 15, 2019, including interim periods within those fiscal years

- **Public companies that are non-SEC filers:** Fiscal years beginning after Dec. 15, 2020, including interim periods within those fiscal years

- **Non-public companies:** Fiscal years beginning after Dec. 15, 2020, and interim periods beginning after Dec. 15, 2021

For all institutions, early application of the new standard is permitted for fiscal years beginning after Dec. 15, 2018, including interim periods within those fiscal years.

## BDO INSIGHTS

While banks have until 2020 or 2021 to implement CECL, the time to begin planning for adoption is now. Most banks do not currently collect the level of disaggregated data that will be required to calculate the life of loan estimate and should promptly begin exploring the right measurement method and new processes for their organization. Significant judgment will be required in forecasting, and while the FASB has set up a transition resource group and may provide additional implementation guidance, banks should begin speaking with advisors and planning immediately. Bank executives should also start educating their finance executives, investors and stakeholders about the new standard and how it will change their metrics and integrate with budgeting and planning.

BDO's dedicated Financial Institutions & Specialty Finance practice serves community and regional banks all over the country, and our professionals are available to discuss and advise on your organization's unique needs. As further transition and implementation resources arise, we will continue to provide timely updates and insights.

For more information on the new standard, see the FASB ASU as well as the announcement and "In Focus" publication on the new standard here. Also available for reference are the joint statement from the four federal financial institution regulatory agencies and BDO's Flash Report on the topic.