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SUBJECT
FASB ISSUES ASU ON CREDIT LOSSES ON FINANCIAL INSTRUMENTS

SUMMARY
The FASB recently issued ASU 2016-13[1] (the "Update"), which (i) significantly changes the impairment model for most financial assets that are measured at amortized cost and certain other instruments from an incurred loss model to an expected loss model; and (ii) provides for recording credit losses on available-for-sale (AFS) debt securities through an allowance account. The Update also requires certain incremental disclosures. The Update takes effect in 2020 for SEC filers and in 2021 for all other entities including public business entities other than SEC filers. Early adoption is permitted for all entities beginning after December 15, 2018, including interim periods within those fiscal years. The ASU is available here.

DETAILS
Expected Credit Loss Model
The Update requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. In contrast, current US GAAP is based on an incurred loss model that delays recognition of credit losses until it is probable the loss has been incurred. Accordingly, it is anticipated that credit losses will be recognized earlier under the CECL model than under the incurred loss model.

CONTACT:
NATIONAL ASSURANCE

GAUTAM GOSWAMI
National Assurance Partner
(312) 616-4631 / ggoswami@bdo.com

ADAM BROWN
National Director of Accounting
(214) 665-0673 / abrown@bdo.com

CHRIS SMITH
Accounting and Audit Professional Practice Leader
(310) 557-8549 / chsmith@bdo.com

[1] Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

The following are within the scope of the CECL methodology:

- financial assets measured at amortized cost basis (such as loan receivables, held-to-maturity debt securities, reinsurance receivables, trade and certain other receivables)
- net investment in leases that are not accounted for at fair value through net income
- certain off-balance sheet credit exposures (such as loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815 on derivatives and hedging)

The CECL model does not apply to financial assets measured at fair value through net income, available-for-sale debt securities, loans made to participants by defined contribution employee benefit plans, policy loan receivables of an insurance entity, promises to give (pledges receivable) of a not-for-profit entity and loans and receivables between entities under common control.

BDO Observation: As noted, the CECL model applies to trade receivables from revenue transactions in the ordinary course of operations. ASC 326-20-55-38 through 55-40 (Example 5) illustrates that application of the CECL model may result in an entity recognizing expected credit losses even for trade receivables that are not past due.

The expected credit loss is recorded as an allowance for credit losses, adjusted for management's current estimate as updated at each reporting date. The initial measurement of expected credit losses, as well as subsequent changes in the estimate of expected credit losses is recorded as a credit loss expense (or reversal) in the current period income statement.

When measuring credit losses, financial assets that share similar risk characteristics (e.g. risk rating, effective interest rate, type, size, term, etc.) should be evaluated on a collective (pool) basis, while financial assets that do not have similar risk characteristics must be evaluated individually. The Update does not prescribe the methodology for measuring the allowance for expected credit losses. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or other methods. However, the Update does require that an entity base its estimate on available and relevant internal and/or external information about past events (e.g., historical loss experience with similar assets), current conditions, and reasonable and supportable forecasts that affect the expected collectability of the reported amount of financial assets. 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, with straight-line or immediate reversion both being acceptable methods. Further, life of loan losses must be considered even if the risk of loss is remote; however if a pool of assets has never historically incurred losses and current conditions and supportable forecasts show zero risk of nonpayment, then no allowance is required.

BDO Observation: Entities will likely need to obtain and maintain loss information for the life of financial assets on a disaggregated basis, not just annual loss data. This information will not only aid in developing loss estimates but also the credit quality disclosures. Entities should anticipate updating their systems and data collection procedures to (i) obtain disaggregated historical loss and credit quality data (risk rating changes, credit scores, etc.) and ensure appropriate future collection and retention of this data and (ii) adjust historical loss and credit quality data for current conditions and reasonable and supportable forward-looking information.

The Update also replaces the current accounting model for purchased credit impaired loans and debt securities ("PCI"). The Update provides that allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination ("PCD assets"), as newly defined,[2] should be determined in a similar manner to

[2] Purchased Financial Assets with Credit Deterioration - Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.

other financial assets measured at amortized cost basis. However, upon initial recognition, the allowance for credit losses is added to the purchase price ("gross up approach") to determine the initial amortized cost basis. That is, the initial allowance for credit losses is added to the purchase price rather than being reported as a credit loss expense. The subsequent accounting for PCD financial assets is the same expected loss model described above. Interest income for PCD assets would be recognized based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition. The new PCD model is expected to be easier to implement than the previous PCI model which has been criticized as being overly complex.

The Update retains many of the currently required disclosures. However, incremental disclosures are required on how the entity developed its estimates, including changes in the factors that influenced management's estimate and the reason for those changes including a discussion on the reversion method applied for periods beyond the reasonable and supportable forecast period. Also, disclosures of credit quality indicators must be further disaggregated by year of origination (optional for entities that are not public business entities).

AFS Debt Security Credit Loss (Impairment) Model

The Update made certain targeted amendments to the existing impairment model for AFS debt securities. For an AFS debt security for which there is neither an intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a write-down of the amortized cost basis. As a result, entities will be able to record reversals of credit losses in current period income as they occur, which is prohibited under current GAAP. Additionally, the allowance is limited by the amount that the fair value is less than the amortized cost basis, considering that an entity can sell its investment at fair value to avoid realization of credit losses. An entity should not consider the length of time that the security has been in an unrealized loss position to avoid recording a credit loss. Further, in determining whether a credit loss exists, the historical and implied volatility and recoveries or additional declines in the fair value after the balance sheet date should no longer be considered. Changes in the allowance will be recorded in the period of the change as credit loss expense (or reversal of credit loss expense). The Update requires new disclosures, including a rollforward of the allowance for credit losses by major security type.

EFFECTIVE DATE AND TRANSITION

The Update has tiered effective dates as follows:

- For public business entities that are SEC filers, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- For all other public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.
- For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

All entities may elect to early adopt the amendments in this Update as of the fiscal year beginning after December 15, 2018, including interim periods within the fiscal year.

An entity must apply the amendments in this Update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach), except as noted below.

A prospective transition approach is required for debt securities for which an other-than-temporary impairment had been recognized before the effective date. Amounts previously recognized in accumulated other comprehensive income as of the date of adoption that relate to improvements in cash flows expected to be collected should continue to be accreted into income over the remaining life of the asset. Any improvements in cash flows because of improvements in credit after the adoption date are recorded in the income statement in the period they are received. If cash flows are expected to decrease because of deterioration in credit expectations, an allowance should be recorded based on the amendments in this Update.

A prospective transition approach is required for assets previously accounted for as PCI. Upon adoption, the amortized cost basis should be adjusted to reflect the addition of the allowance for credit losses on the transition date. The remaining noncredit discount or premium will continue to accrete or amortize at the effective interest rate at the date of adoption. The same transition requirements should be applied to beneficial interests that previously applied the PCI model or have a significant difference between contractual cash flows and expected cash flows.

INTERNATIONAL CONVERGENCE

The credit losses project began as a joint project with the IASB, but the Boards determined in 2012 that convergence was not possible. The IASB issued IFRS 9, Financial Instruments, in July 2014. While both the Update and IFRS 9 are considered to be expected credit loss models, the primary difference relates to the timing of recognition of expected losses. The Update requires that the full amount of expected credit losses be recorded for all financial assets measured at amortized cost, whereas IFRS 9 requires an allowance for credit losses equal to 12 months of expected credit losses until there is a significant increase in credit risk, at which point lifetime expected losses are recorded.

ON THE HORIZON

The FASB has established a transition resource group that is designed to inform the Board about interpretive issues that have or are likely to arise as implementation efforts commence. Interested parties are encouraged to monitor the resource group's deliberations.