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To the Point

FASB — proposed guidance

FASB poised to make significant changes to credit impairment model

Entities would be required to recognize lifetime expected credit losses rather than incurred losses.

What you need to know

- The FASB substantially completed redeliberations on credit impairment and plans to issue a final standard that would apply to all entities, not just those in financial services.
- An entity would recognize an allowance for management's current estimate of lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Today's other-than-temporary impairment model for available-for-sale debt securities would be modified to require an allowance for credit impairment rather than a direct write-down, among other things.
- Entities would be required to make disclosures about the credit quality of certain financing receivables by year of origination (i.e., vintage). This would significantly expand the volume of disclosures.
- The Board will decide on an effective date after the staff prepares a draft of the final standard. We expect the FASB to issue a final standard in the second half of 2015.

Overview

The Financial Accounting Standards Board (FASB or the Board) has substantially completed redeliberations on new guidance that would significantly change how entities measure and recognize credit impairment for certain financial assets. Today's incurred loss model would be replaced with one that requires management to estimate all contractual cash flows that it does not expect to collect over the lives of loans and other debt instruments measured at amortized cost.

The FASB also decided to change today's other-than-temporary impairment (OTTI) model[1] for available-for-sale (AFS) debt securities. Entities would no longer be required to consider certain factors when determining whether an impairment should be recognized. They also would be required to recognize an allowance for credit impairment rather than a direct reduction of a security's cost basis. As a result, entities could reverse credit impairments.

The FASB has been working on ways to improve the accounting for credit impairment since the financial crisis in 2008. Today's guidance was criticized for delaying recognition of credit impairments of financial assets and for providing multiple models that were too complex. The FASB initially worked with the International Accounting Standards Board (IASB) to develop new guidance but the Boards ultimately were unable reach a converged solution. The FASB's decisions on credit impairment differ significantly from the three-stage impairment model the IASB finalized as part of IFRS 9.[2]

This publication summarizes the FASB's tentative decisions to date. We expect the FASB to issue a final standard in the second half of 2015. The FASB hasn't yet decided on an effective date.

Summary of proposed amendments

Financial assets measured at amortized cost

An entity would apply what the FASB calls the "current expected credit loss" (CECL) model to most financial assets measured at amortized cost as well as certain other items.

Illustration 1 — Scope of FASB's CECL model

Items in scope	Items out of scope
‣ Loans, including those made to meet a not-for-profit entity's mission (e.g., programmatic loans) ‣ Held-to-maturity (HTM) debt securities ‣ Trade, lease and reinsurance receivables ‣ Loan commitments ‣ Financial guarantees that are not accounted for as insurance or at fair value through net income	‣ Related party loans and receivables between entities under common control ‣ Loans made to participants by defined contribution employee benefit plans ‣ Policy loan receivables of an insurance entity ‣ A not-for-profit entity's pledges receivable (i.e., promises donors have made)

Under the CECL model, an entity would reserve for all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit. The estimate of expected credit losses would consider all contractual cash flows over the life of the asset. The estimate would be developed based on historical loss experience for similar assets as well as management's assessment of current conditions and reasonable and supportable forecasts about the future.

Further, the FASB tentatively decided that an entity's estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. As a result, there would only be limited circumstances in which a reserve of zero would be appropriate.

The final standard would also eliminate the guidance in Accounting Standards Codification (ASC) 310-30[3] that applies to purchased credit-impaired (PCI) financial assets. Under the new model, an entity would recognize a CECL allowance for expected credit losses on a PCI asset it acquires (based on an estimate of expected contractual shortfalls, as described above), and the initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition. The subsequent accounting for PCI assets would be the same as for originated loans.

The final standard is also expected to include guidance addressing:

- Information that management would consider in determining expected credit losses
- How expected prepayments, extensions, renewals and modifications should be considered
- Estimation on a collective (pool) basis and estimation on an individual basis
- Reversion to historical averages for periods beyond which management is able to make or obtain a reasonable and supportable forecast about the future
- Collateral-based practical expedients for estimating expected credit losses
- Cost-basis adjustments resulting from troubled debt restructurings

How we see it

While the concept of the CECL model is relatively simple, entities may face significant implementation challenges, including:

- Obtaining historical lifetime credit loss data and developing appropriate models and methodologies to aggregate and analyze such information
- Developing reasonable and supportable forecasts about the future and determining how to adjust historical data to reflect this information

Once a final standard is issued, we would expect the FASB, the American Institute of Certified Public Accountants, US banking regulators and industry associations to be involved with efforts to try to help entities, particularly smaller ones, manage the complexity of implementation. We believe it is critical that broad consensus be reached about reasonable ways of implementing the standard before entities spend time and resources designing and implementing new methods and models.

Entities may face significant implementation challenges.

Available-for-sale debt securities

The FASB tentatively decided not to apply the CECL model to AFS debt securities. Instead, the FASB decided to modify the existing OTTI model in ASC 320-10. Under today's guidance, an entity first determines whether a security is impaired (i.e., whether its fair value is less than its amortized cost basis). An entity then evaluates whether an impairment is other- than-temporary based on whether (1) the entity intends to sell the security, (2) it is more likely than not that the entity will be required to sell the security before recovering its cost basis or (3) the entity does not expect to recover the entire amortized cost basis of the security by collecting all contractual cash flows (i.e., whether a credit loss exists).

Under the new guidance, an entity evaluating whether a credit loss exists would no longer be required to consider (1) the length of time that the fair value of the security has been less than its amortized cost or (2) recoveries or additional declines in the fair value after the balance sheet date.

How we see it

It's unclear whether the FASB intends to preclude an entity from considering either of these two factors when evaluating whether a credit loss exists or whether an entity would still be permitted to consider them. We expect the final standard to provide clarity on this point.

Further, the FASB decided that entities would recognize an allowance for OTTI credit losses rather than reduce their cost basis as they do today. The new approach would allow an entity to recognize reversals of OTTI credit losses, which would immediately reduce the provision for credit losses. Today, a recovery of an OTTI credit loss is recognized as interest income over time.

Disclosures

For AFS debt securities, the existing OTTI disclosure requirements would be retained, but they would be updated to reflect the Board's other decisions about AFS debt securities (e.g., the change to an allowance approach that permits reversals).

For financial assets measured at amortized cost, an entity would disclose information about its method for developing its allowance as well as changes in the factors that influenced management's estimate of expected credit losses and the reasons for those changes (e.g., change in loss severity). This would be consistent with what the FASB proposed in December 2012.[4]

For financing receivables[5] measured at amortized cost (excluding revolving lines of credit such as credit cards), disclosures about credit risk would be expanded significantly. Specifically, an entity would be required to disaggregate each credit quality indicator by year of the asset's origination (i.e., vintage) for as many as five annual periods. The FASB has directed its staff to perform outreach on the operability and usefulness of the vintage disclosures while the staff prepares a draft of the final standard. The FASB may reconsider the requirement based on this feedback.

Transition and effective date

An entity would apply the guidance by recording a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. The final standard would also include transition provisions for PCI assets and debt securities. The Board hasn't decided on an effective date but plans to do so after the staff prepares a draft of the final standard and addresses any issues that arise as a result.

Endnotes:

1. ASC 320-10, *Investments — Debt and Equity Securities.*
2. IFRS 9, *Financial Instruments,* July 2014.
3. ASC 310-30, *Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality.*
4. FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses (Subtopic 825-15),* issued 20 December 2012.
5. ASC 310-10, *Receivables*, defines a financing receivable generally as a financing arrangement that is both a contractual right to receive money (on demand or on fixed or determinable dates) and is recognized as an asset on the balance sheet, with certain exceptions.

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