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To the Point

FASB — proposed guidance

Preparing for the new credit impairment standard

Now that the FASB has set effective dates for the new credit impairment standard, entities should start planning for implementation.

What you need to know

- The FASB set effective dates for the new credit impairment standard starting in the first quarter of 2019 for calendar-year entities.
- Because implementing the new credit impairment standard will likely require significant effort, entities should begin planning now. The standard would require them to estimate and recognize an allowance for lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Implementing the new credit impairment standard will likely require changes in processes, systems and controls for financial institutions and other entities. Public companies also will need to consider disclosures they would have to make about the new standard and its effects.
- If they haven't yet done so, entities should establish a governance structure for implementation.

Overview

With more than three years before the first effective date of the new credit impairment standard, entities may think they have ample time to implement the standard the Financial Accounting Standards Board (FASB or Board) plans to issue in the first quarter of 2016. But financial institutions and other entities should be taking steps now to prepare for the potentially significant changes they would need to make.

Building a better working world

The first steps for management are developing a governance structure for implementation and performing a preliminary assessment of how much work will be necessary. Implementing the standard will likely require significant adjustments to processes, systems and controls, especially for financial institutions.

Entities should also develop plans to communicate with investors and other stakeholders, including making disclosures about the effects of new standards discussed in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 11.M.[1]

Background

The new impairment standard would supersede today's guidance and would apply to all entities that hold financial assets that are not measured at fair value through net income. The guidance would address the recognition and measurement of credit losses on debt securities, trade receivables, loans, net investments in leases, off-balance sheet credit exposures, reinsurance receivables and other financial assets that represent the contractual right to receive cash.

For available-for-sale (AFS) debt securities, the FASB has decided to modify today's other-than-temporary impairment (OTTI) model to no longer require entities to consider certain factors when determining whether a credit loss should be recognized. The FASB also has decided to require entities to recognize credit losses through an allowance for credit impairment (rather than a direct reduction of a security's cost basis), thereby allowing for the reversal of credit impairments in later periods.

Now is the time for preparers to begin developing a plan to implement the credit impairment standard.

For all other affected financial assets, the FASB has decided to replace today's "incurred loss model" with an "expected credit loss model." This change would require entities to make more estimates of future losses, which would require more judgment.

Key considerations

The FASB decided on the following effective dates for the credit impairment standard:

- For public business entities (PBEs) that meet the definition of an SEC filer, the standard would be effective for annual periods beginning after 15 December 2018, and interim periods therein. That means calendar-year SEC filers would begin applying it in the first quarter of 2019.
- For other PBEs, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods therein. That means calendar-year PBEs that are not SEC filers would begin applying it in the first quarter of 2020.
- For all other entities, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. That means these entities that have calendar years would begin applying it in their annual financial statements for 2020 and in interim statements in 2021.

All entities would be allowed to adopt the guidance as of the effective date for PBEs that are SEC filers.

In making their decision on effective dates, the FASB discussed the difficulty of implementing several major new standards, including those involving classification and measurement of financial instruments, revenue recognition and accounting for leases, over the next several years.

While the effective dates of the impairment standard may seem distant, entities should take steps to prepare for implementation once it is issued. This graphic depicts the steps an entity might take to meet the first effective date.

Illustration 1: Implementation plan to meet the first effective date

2015	2016		2017 - 2018
Stage 1: Mobilize	**Stage 2: Design**	**Stage 3: Build**	**Stage 4: Test and deploy**
▸ Establish governance structure ▸ Assess current models and data availability ▸ Educate individuals from credit risk management, finance, information technology and the disclosure committee about the new standard	▸ Perform gap analysis and highlight changes required ▸ Design or modify models and allowance methodology ▸ Design or modify data flows, processes and controls ▸ Document proposed accounting policies or changes to existing policies	▸ Implement organizational changes ▸ Build, adjust and calibrate models ▸ Build or enhance data warehouse(s) ▸ Monitor and validate reporting changes	▸ Validate and deploy allowance models ▸ Validate and deploy data flows ▸ Monitor and validate process and control changes ▸ Run old and new systems at the same time and prepare to go live

A good place to start is putting in place a governance structure for implementation that brings together multiple disciplines. For example, a financial institution that expects to be significantly affected may consider a governance structure that includes individuals from accounting policy, credit risk management, information technology, treasury, finance, accounting controllership, investor relations, regulatory reporting, internal control and internal audit.

The next step is typically identifying key actions that need to be taken during the implementation phase. A preliminary assessment of the current state and future state required by the standard can be used to identify key actions that need to be taken to implement the new standard.

For example, entities will need to decide how to change their credit risk models to estimate lifetime expected credit losses. As a result, entities may need to:

- Compile additional historical loss data to transform today's historical loss estimate from an incurred loss to an estimate of lifetime losses
- Identify information (internal or external) that can be used to develop what the FASB is calling a "reasonable and supportable" forecast of the future
- Consider how to adjust their historical lifetime loss statistics for these reasonable and supportable forecasts, including developing the necessary processes and controls.

In addition, entities with trade receivables will need to think about changing their processes and documentation to meet the requirements of the standard, even though in many cases the standard won't significantly change their results.

Entities also will need to start planning for new disclosures because the standard is expected to require significantly more interim and annual disclosures than current US GAAP. Entities will need to assess whether they currently collect the information they will need to satisfy the new requirements or whether they will need to adjust their processes and controls or put new ones in place to gather the information and make sure it is accurate.

Implementing the standard also will be challenging because industry groups, regulators and implementation groups will be addressing questions that arise over time, and an entity's understanding of the new requirements will likely evolve. In addition to industry groups and banking regulators, we expect the staff of the SEC, the American Institute of Certified Public Accountants and the FASB's Transition Resource Group on Credit Impairment to all weigh in.

Questions to consider now

As entities develop their implementation plans, management should consider the following questions:

- What governance structure will be used to oversee and coordinate implementation? How will this effort be communicated and agreed to by the Board of Directors?
- What is the plan for a preliminary assessment of the standard's effect on the entity? When will it be complete?
- If the entity is an SEC registrant, what is the plan for making the disclosures under SAB Topic 11.M about the effect of a new accounting standard?
- What process has the entity put in place to monitor interpretations by the various organizations that are likely to interpret the standard?

Endnote:

[1] Refer to SEC Staff Accounting Bulletin Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In a Future Period.*