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March 2015, No. 15-9

FASB Makes Impairment Transition and Disclosure Decisions

At two recent meetings, the FASB reached decisions on transition methods and disclosures for the proposed standard on financial instruments impairment (proposed ASU).[1] The FASB directed its staff to draft the final standard, and plans to discuss the effective date at a later meeting.

Key Facts

- The FASB provided the transition method for purchased-credit impaired (PCI) financial assets and other-than-temporarily impaired (OTTI) debt securities at the adoption date.
- The disclosure requirements for debt securities classified as available-for-sale (AFS) will be retained and updated for the proposed ASU's general credit risk disclosure principles.[2]
- A period-to-period rollforward of the amortized cost for financial assets measured at amortized cost and at fair value through other comprehensive income (FVOCI) will not be required.
- Disclosures of credit quality indicators for financing receivables will be disaggregated by the year of the asset's origination.

Key Impacts

- Entities may need to evaluate the new disclosure requirements, particularly credit quality indicators disaggregated by vintage year, and assess their impact on systems, processes, and controls.
- The transition method for OTTI debt securities and PCI financial assets is likely to be less burdensome for entities to implement than the original proposal.

Contents

[1] FASB Proposed Accounting Standards Update, Financial Instruments – Credit Losses, December 20, 2012, available at www.fasb.org.

[2] FASB ASC Subtopic 320-10, Investments – Debt and Equity Securities, available at www.fasb.org.

Impairment Project Timeline

- 2010 – Exposure Draft
- December 2012 – Revised Exposure Draft
- April 2013 – Comment Period Ended
- 2013 to Present – Redeliberations
- 2015 – Final Standard Expected

Purchased-Credit Impaired Financial Assets

The Board decided that an entity will account for PCI financial assets upon transition as follows:

- All loans and debt securities acquired with deteriorated credit quality for which an entity applies Subtopic 310-30 (including by analogy) will be classified as PCI financial assets at the date of adoption.[3]
- Entities will not be permitted to perform further assessments at the adoption date to determine whether other previously acquired assets meet the new definition of PCI assets.
- Entities will be required to gross up the allowance for lifetime expected credit losses at the date of adoption with a corresponding adjustment to the carrying value of the assets.
- Interest income will be recognized based on the yield as of the adoption date.

The Board also decided that subsequent increases and decreases in lifetime expected credit losses will be recorded through the allowance for expected credit losses with a corresponding adjustment to the current-period provision for credit losses.

Background. The current PCI definition in Subtopic 310-30 is not the same as the proposed definition. Also, some entities have applied Subtopic 310-30 by analogy to other purchased loans. Respondents questioned whether loans purchased before the effective date of the proposed ASU would need to be reevaluated under the new PCI definition, and if so, whether the determination would be made as of the date of adoption or the date the assets were acquired.

Currently for PCI financial assets, the excess of expected cash flows at acquisition over the acquirer's initial investment in the assets is recognized as interest income on a level-yield basis over the remaining life of the assets. If there is a subsequent significant increase in estimated future cash flows, that change is recognized prospectively by increasing the yield. The Board decided entities will continue to recognize interest income on these assets based on their yield as of the adoption date.

OTTI Debt Securities

The Board decided that entities will adopt the provisions of the ASU related to OTTI debt securities prospectively as of the adoption date.

- Amounts previously recognized in accumulated other comprehensive income (AOCI) as of the date of adoption that relate to significant improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis.
- Any improvements in cash flows due to improving credit after the adoption date will be recorded through the provision for credit losses in the income statement.

[3] FASB ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality, available at www.fasb.org.

Background. At a previous meeting, the Board decided that debt securities classified as AFS would be excluded from the scope of the lifetime expected credit-loss model. Instead, the impairment amount would be recognized through an allowance account that would allow reversals of previously recognized credit losses. Under current U.S. GAAP, credit losses on debt securities are recognized in earnings through an adjustment to the amortized cost basis, and the amortized cost basis is not adjusted for improvements.

The proposed ASU would have required a cumulative-effect adjustment to the carrying amount of the debt securities at the adoption date with an offsetting adjustment to the opening balance of retained earnings or other appropriate components of equity. Respondents to the proposal requested additional guidance on transition for OTTI debt securities and specifically highlighted these two issues:

- Hindsight may be required to determine how much of the allowance initially recognized would have been written off.
- Accounting for a debt security that has had a significant improvement in cash flows following the initial impairment. Under current GAAP, subsequent improvements are recognized prospectively as an adjustment to yield.

Disclosures

An entity will be required to disclose a period-to-period rollforward of the allowance for expected credit losses for financial assets measured at amortized cost and at FVOCI. The Board decided not to require the amortized cost rollforward disclosures. However, entities will be required to disaggregate the credit quality indicators for all classes of financing receivables (excluding revolving lines of credit such as credit cards) that are disclosed under current GAAP by the year of the asset's origination (i.e., vintage year).[4] Some of the key requirements are:

- Disaggregation by vintage year will be for a specified minimum number of annual reporting periods, and any financing receivable originated prior to that will be disclosed in an aggregate column;
- Entities will apply current GAAP to determine if a loan refinancing or restructuring is a new loan or a loan modification;[5] and
- Revolving lines of credit will not be subject to the vintage year disclosure, but will still need to be disaggregated by credit quality indicators.

Background and Observations. The proposed ASU would have retained current U.S. GAAP requirements to disclose a rollforward of the allowance for credit losses and introduced an amortized cost rollforward of financial assets measured at amortized cost and FVOCI. Financial statement users generally supported this requirement while preparers believed implementation would be difficult.

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[4] A financing receivable is a defined as a financing arrangement that: (1) represents a contractual right to receive money either on demand or on fixed or determinable dates, and (2) is recognized as an asset in the entity's statement of financial position. Financing receivables include, but are not limited to, loans, trade accounts receivables, and notes receivable.

[5] ASC Paragraphs 310-20-35-9 through 35-12, available at www.fasb.org.

Transition Disclosures

The Board affirmed the transition disclosure requirements included in the proposed ASU, which are listed below:

(a) The nature of the change in accounting principles, including an explanation of the newly adopted accounting principles.

(b) The method of applying the change.

(c) The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.

(d) The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

(e) An entity that issues interim financial statements must provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statements of the period of change.

Next Steps

The Board directed the staff to draft the final standard. During the drafting process, the staff will perform outreach with preparers and users on the disclosure requirement to disaggregate credit quality disclosure by vintage year, any remaining issues identified, and the effective date. The Board will meet with the staff to discuss any remaining issues, the cost-benefit and complexity of the decisions reached to date, and the effective date.

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