In depth
A look at current financial reporting issues

pwc

No. US 2016-07
July 11, 2016

What's inside:

The FASB's new financial instruments impairment model

Accounting and disclosure considerations

At a glance

The FASB issued Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326),* (the "ASU") on June 16, 2016. The ASU introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU will apply to: (1) loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost, (2) loan commitments and certain other off-balance sheet credit exposures, (3) debt securities and other financial assets measured at fair value through other comprehensive income, and (4) beneficial interests in securitized financial assets.

Given the broad scope of the new guidance, both financial services and non-financial service entities will be affected. The ASU will be effective for public business entities (PBEs) that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Non-PBEs (including certain not-for-profit entities and employee benefit plans) are not required to adopt the guidance for interim periods until fiscal years beginning after December 15, 2021. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Background

.1 Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326)*, represents the completion of a major component of the FASB's financial instruments project. The other major components are (1) recognition and measurement guidance for financial instruments, which was finalized in January 2016[1] as ASU 2016-01, *Financial Instruments – Overall*, and (2) targeted amendments to the hedge accounting guidance, which are expected to be exposed for public comment in the third quarter of 2016.

.2 Following the financial crisis of 2008-2009, the FASB was tasked with revisiting the accounting models for the impairment of financial assets to address stakeholder concerns regarding the delayed recognition of credit losses under the current incurred loss model. The FASB began the initiative working jointly with the IASB with the hopes of developing a converged standard. The initial converged model proposed that the recognition of the full expected credit loss be delayed until there was a significant deterioration in credit

[1] See PwC In depth US2016-01, *New guidance on recognition and measurement to impact financial instruments*

risk. However, based on US constituent feedback, the FASB decided to adopt the current expected credit losses (CECL) model, which generally calls for the immediate recognition of all expected credit losses. As a result, the impairment models for financial assets under US GAAP and IFRS will not be converged.

Key provisions

.3 The ASU introduces new accounting models for expected credit losses on financial instruments and applies to: (1) loans, accounts receivable, trade receivables and other financial assets measured at amortized cost, (2) loan commitments and certain other off-balance sheet credit exposures, (3) debt securities and other financial assets measured at fair value through OCI, and (4) beneficial interests in securitized financial assets.

The CECL model

Scope

.4 The CECL model will apply to: (1) financial assets measured at amortized cost, and (2) certain off-balance sheet credit exposures. Examples of instruments subject to the CECL model include loans, held-to-maturity (HTM) debt securities (including corporate bonds, mortgage backed securities, municipal bonds and other fixed income instruments), loan commitments (including lines of credit), financial guarantees accounted for under ASC 460, *Guarantees*, and net investments in leases, as well as reinsurance and trade receivables.

PwC observation:

The scope of the new guidance is broad; while financial service entities will be significantly impacted, all entities will need to assess the impact of the CECL model. For example, application of the model to trade and lease receivables will likely impact most non-financial service entities.

Incurred versus expected credit losses

.5 The CECL model is designed to capture expected credit losses through the establishment of an allowance account, which will be presented as an offset to the amortized cost basis of the related financial asset or as a separate liability, in the case of off-balance sheet exposures. The resulting allowance for loan and lease losses (ALLL) is designed to be a valuation account that is deducted from the amortized cost basis of an instrument to present the net amount expected to be collected.

.6 The CECL model requires an estimate of the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and the reasonable and supportable forecasts of future events and circumstances, as well as estimates of prepayments. Financial instruments with similar risk characteristics should be grouped together when estimating ECL. The ASU does not prescribe a specific method to estimate credit losses, so its application will require significant judgment.

PwC observation:

The CECL model is designed to improve the current impairment model. It removes the current threshold that delayed the recognition of a credit loss until it was "probable" a loss event was "incurred." Under the new model, there is no trigger event before booking ECL. By requiring the consideration of reasonable and supportable forecasts of future events, the CECL model accelerates the recognition of credit losses as compared to current GAAP. Reporting entities will now need to record credit losses they "see coming" but are not yet incurred. These changes will likely require significant effort to develop new processes and controls for estimating expected credit losses, and their application will require considerable judgment.

Initial recognition of life-time expected credit losses

.7 The CECL model requires the recognition of ECL upon initial recognition of a financial asset. With the exception of certain purchased assets with credit deterioration (PCD), this day-one recognition of the ALLL will be recorded with an offset to current earnings. Subsequently, the ECL will need to be assessed each period, and both negative and positive changes to the estimate will be recognized through an adjustment to the ALLL and earnings.

PwC observation:

The day-one recognition of expected credit losses in current earnings for most instruments is one of the most controversial provisions of the new guidance. The FASB understands that financial assets that are originated or purchased will include compensation for credit risk in the yield or investment return of the assets. The recognition of the effective yield of the instrument (including compensation for credit risk) will occur over time through the application of the interest income models under US GAAP. As day-one estimated credit losses will be recognized in earnings, this creates a mismatch in the timing of the recognition of ECL and the recognition of the compensation for credit risk.

.8 The guidance requires that the ALLL be determined based on the amortized cost of the financial asset, which includes all premiums, discounts, deferred origination costs/fees, foreign exchange adjustments, and fair value hedge accounting adjustments. The use of some approaches to estimating the ECL already require consideration of amortized cost. For example, the discounted cash flow (DCF) approach compares the amortized cost of the financial asset and the present value of the expected cash flows. However, other approaches, such as a loss rate approach, which may be based on an analysis of historical losses as compared to the par value of the instrument, will not meet this requirement. In situations where the estimate of the ECL is not based on the amortized cost of the financial asset, an adjustment will need to be made to incorporate premiums and discounts, etc.

PwC observation:

The FASB's outreach to stakeholders on how loss rates are currently derived indicated diversity in practice. Some entities determine loss rates by dividing amounts charged off by the amortized cost basis of the instrument. Others calculate loss rates based on the amount of principal/par amount of an instrument that was charged off. One of the FASB's goals was to permit entities to leverage existing processes and data to the extent possible when adopting the CECL model. As a result, the FASB decided to permit entities to continue to applying loss rates to the unpaid principal balance and then adjust the credit losses for the impact of the other elements of the amortized cost basis (e.g., premiums or discounts) separately.

The ASU provides limited guidance regarding how an entity should incorporate premiums/discounts into the allowance estimate and therefore, doing so may be challenging and will require judgment. It would generally not be appropriate to just assume there is no expected credit loss or partial reduction of expected credit loss for a financial asset that was purchased at a discount (i.e., the ALLL cannot be reduced by the amount of the discount), and a premium may have different credit risks than the unpaid principal value. Given the complexity of the guidance, judgment will be needed to determine the ALLL when an entity is using an approach other than one based on discounted cash flows.

Pooling of financial assets with similar risk characteristics

.9 When estimating CECL, reporting entities will be required to calculate the ECL on a "pooled" approach when instruments have similar risk characteristics. If a financial instrument does not share similar risk characteristics with other financial instruments, the ECL would be calculated on an individual basis. An entity will reassess whether financial instruments share similar risk characteristics at each reporting date. If a financial instrument no longer shares similar risk characteristics with the pool in which it is grouped, it should be removed from the pool for the purposes of calculating ECL. Such an instrument may then be grouped with another pool of instruments with shared risk characteristics or if there are none, the ECL will be calculated on an individual basis, but may be based on expected loss assumptions from groups of similar assets.

.10 Risk characteristics used as a basis for pooling may include past due status, collateral type, borrower's FICO score, internal and external credit ratings, maturity (term), industry of the borrower, subordination, origination vintage, geographical location of the borrower, or other factors. Reporting entities should carefully consider the attributes utilized to create pools of similar risk characteristics and consider what inputs drive the credit risk measurement used in credit loss modelling.

Measurement of expected credit losses

.11 The CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of ECL should consider historical information, current conditions, and reasonable and supportable forecasts, as well as estimates of prepayments. Adjusting historical information to reflect current conditions and expectations about the future will require significant judgment, as the ASU does not prescribe a specific method to make the estimate.

.12 For periods beyond which an entity can develop a reasonable and supportable forecast, an entity should revert to historical loss information that reflects the contractual term of the financial instrument (or group of financial instruments). The reversion to historical loss information may be immediate, on a straight-line basis, or on another rational and systematic basis. For example, if an entity can only reasonably forecast ECL for the first 4 years of a 10-year loan, it should consider historic loss information reflective of the contractual term of the loan to determine the expected credit losses relating to the period beyond the 4 years it can forecast.

PwC observation:

The CECL model does not provide prescriptive guidance regarding how to develop an estimate of expected credit losses. Although the ASU acknowledges that a DCF model may be used, it does not require its use. There is a high degree of judgment involved in estimating ECL and different methodologies may result in a range of acceptable outcomes. The selection of a modelling methodology is therefore one of the key decisions in adopting the CECL model.

Because the ASU does not provide a definition, different institutions may have different views on what constitutes a reasonable and supportable forecast.

.13 The estimate of expected credit loss should consider the contractual term of the financial asset and a borrower's prepayment behavior. Renewals, modifications, or extensions should generally not be considered.

.14 In making the estimate, credit risk mitigation strategies that may be pursued in the event of a default should be considered, not only as it relates to the amount of the ultimate credit loss, but also as to how it may impact the term of the instrument. For example, when there is a reasonable expectation that the reporting entity will execute a troubled debt restructuring (TDR) with the borrower, the estimate of ECL should consider if the TDR will result in an extension of the term of the financial asset. The FASB concluded that similar to today's guidance, the completion of a TDR does not create a new instrument, rather it is the continuation of the original instrument.

.15 Credit enhancements, such as guarantees or insurance contracts, should also be considered in the estimate of expected credit losses unless they are freestanding contracts. A credit enhancement deemed to be a freestanding contract should not be considered in the estimate of ECL. For example, if a bank originates a loan and then separately enters into a credit default swap (CDS) agreement with another entity as a credit enhancement for the loan, the CDS agreement should be accounted for separately and not considered in the estimate of expected credit losses.

.16 Although credit enhancements are good credit risk mitigation tools, the ASU does not permit an entity to consider them in the estimate of credit loss if the credit enhancement is not embedded in the asset origination or purchase of the financial asset.

.17 If financial assets are secured by collateral, the ECL should consider the impact the collateral will have in reducing credit losses. The estimate of ECL should not only consider current collateral value, but also consider the nature of the collateral, potential future changes in its value, and historical loss information for financial assets secured with similar collateral. A reporting entity generally cannot assume that no credit loss exists simply because the instrument is collateralized. The ASU provides a number of specific provisions and practical expedients relating to collateralized instruments, including:

- An entity should estimate the ECL based on the fair value of the collateral when an entity determines foreclosure is probable (consistent with current US GAAP).

- If the borrower is experiencing significant financial difficulty and repayment of the loan is expected to be provided substantively through the operation or the sale of the collateral, an entity may estimate the ECL based on the fair value of the collateral (if operating the collateral for repayment of the financial asset), or the fair value of the collateral less costs to sell (if selling the collateral for repayment of the financial asset).

- For certain financial assets that provide for collateral to be replenished as necessary, the fair value of collateral may be compared to the amortized cost basis to estimate ECL. If the contract requires the collateral to be continually replenished to an amount that always equals or exceeds the amortized cost basis of the instrument, an entity may be able to conclude that the ECL on the instrument is zero.

PwC observation:

The ASU provides limited guidance on the application of the practical expedient related to instruments with collateral replenishment provisions. Areas of consideration may include which party controls the collateral, the legal terms of the arrangement, how often the collateral is replenished, and whether the collateral is liquid. Careful consideration and judgment is needed to assess whether it is appropriate for an entity to apply this practical expedient.

Off balance sheet credit exposures

.18 The CECL model also applies to off-balance sheet credit exposures such as unfunded revolving lines of credit, non-derivative financial guarantees, and other unfunded loan commitments. Because they are often legally binding agreements to extend credit under certain terms and conditions, loan commitments can expose an entity to credit losses.

.19 For unfunded loan commitments, a reporting entity should first determine whether the commitment can be unconditionally (i.e., unilaterally and irrevocably) cancelled by the issuer. If this is the case, then no estimate of expected credit losses is required for the unused or undrawn portion of the commitment. Where the issuer does not have the unconditional right to cancel the commitment, an estimate of credit losses is required for the unfunded portion. The estimate of credit losses would include a determination of the likelihood that funding will occur, and if funded, the related expected credit losses under the CECL model. The estimate of ECL for an unfunded commitment is recorded as a liability.

.20 For the funded portion of a loan commitment, the methodology and principles of calculating impairment under the CECL model should be consistent with the approach used for similar receivables.

PwC observation:

When an unfunded commitment becomes funded, the ECL for the liability should be reclassified as the ALLL for the funded loan. An entity should first reassess whether the amount of the ALLL is appropriate, as the initial estimate of ECL for the unfunded loan would have considered the probability of the commitment not being funded in the loss estimate. The same consideration is not necessary for a funded loan.

.21 Loan commitments can be either revolving (in which the amount of the overall commitment is re-established upon repayment of previously drawn amounts) or non-revolving (in which the amount of the overall commitment is not re-established upon repayment of previously drawn amounts). For revolving commitments, the estimate of expected credit losses is more complex, as the provider of the commitment will need to consider the probability of future draws and repayments.

Expectations of non-payment are zero

.22 Generally, the ASU requires an entity to estimate expected credit losses for a financial asset, even when the risk of loss is remote. However, the CECL model provides a practical expedient when an expectation of nonpayment of the amortized cost basis is zero (i.e., where the risk of default may be greater than zero, but the amount of the expected loss is zero) based on historical loss information, adjusted for current conditions and reasonable and supportable forecasts. As mentioned above, the existence of collateral, in and of itself, does not necessarily lead to an assumption of no loss of the amortized cost basis.

PwC observation:

Limited guidance is provided on the application of this practical expedient to "credit risk-free" financial assets. Therefore, an entity should exercise careful judgment and ensure their use of the practical expedient is well supported and documented. The illustration in the ASU (Example 8) sets a high bar for the application of this practical expedient, describing US Treasury securities as a financial asset that may qualify for this practical expedient.

Write-offs and recoveries

.23 Reporting entities are required to write-off financial assets (or a portion thereof) in the period in which a determination is made that the financial asset (or portion) is uncollectible. This generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted. Factors an entity may consider include (1) significant changes in the borrower's financial position such that they can no longer pay the obligation or (2) whether the proceeds from collateral will be sufficient to repay the loan. Certain regulatory agencies have provided guidance to financial institutions with respect to when write-offs are appropriate or required. Recoveries of financial instruments should be recorded when received.

PwC observation:

The threshold for when write-offs should occur under the CECL model is consistent with the threshold in current GAAP. This was a conscious decision by the FASB in an effort to permit companies to leverage existing policies and procedures to the extent possible. However, the term "uncollectible" is not defined and continues to require the application of judgment. It is likely that regulatory agencies will continue to heavily influence write-off policies for institutions subject to their oversight.

Troubled debt restructurings

.24 According to the ASU, "*restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.*" This description of TDRs is consistent with current US GAAP. In addition, similar to today's GAAP, a loan that has been restructured through a TDR is not considered to be a new loan, but instead the continuation of the original loan. In a departure from current GAAP, loans subject to a TDR will be assessed for impairment using the CECL model.

.25 In measuring an impairment on an instrument that has been restructured through a TDR, the value of certain concessions made by the creditor should be reflected in the ALLL. When using a discounted cash flow approach, the value of the concession will be captured in the ALLL estimate. If an entity uses a model other than a discounted cash flow approach, the entity will need to determine an approach to incorporate the concession in the ALLL estimate. When using a discounted cash flow approach, the pre-modification effective interest rate should be used.

.26 As noted in paragraph .14, if a TDR is reasonably expected to occur, the expected life of a financial asset should consider any extensions that may result from the TDR.

Available-for-sale debt securities

Scope

.27 Available-for-sale (AFS) debt securities are not within the scope of the CECL model. Debt securities classified as AFS will apply a new impairment model with some important changes from today's model. The AFS debt security impairment model will apply to all debt securities classified as AFS (including corporate bonds, mortgage backed securities, municipal bonds, and other fixed income instruments). As a result of the differences between the CECL and AFS debt security impairment models, the timing and recognition of impairment will be different.

PwC observation:

AFS debt securities and HTM debt securities were previously assessed for impairment using the same model. The FASB concluded that a security available to be sold should be assessed for impairment differently than an amortized cost asset being held to collect cash flows. Accordingly, the new model will apply to AFS debt securities while HTM debt securities will be assessed for impairment using the CECL model.

Equity instruments are not with the scope of the ASU and should be accounted for under ASU 2016-1: *Recognition and Measurement of Financial Assets and Financial Liabilities* (other than those that result in consolidation or the application of the equity method). ASU 2016-01 includes a specific impairment model for certain equity investments.

Available-for-sale debt securities impairment model

.28 Similar to current GAAP, the impairment model for AFS debt securities will require an estimate of ECL only when the fair value is below the amortized cost of the asset. One of the key changes to the model includes the removal of the requirement to consider the length of time the fair value of an AFS debt security has been below the amortized cost when determining whether a credit loss exists. In addition, recoveries or subsequent declines in fair value after the balance sheet date should not be considered in determining the estimate of expected credit losses. As a result of these changes, the AFS impairment model is no longer based on an impairment being "other-than-temporary."

.29 Unlike the CECL model, the impairment model for AFS debt securities does not permit pooling of securities (i.e., the ALLL must be calculated on an individual security level but may use assumptions consistent with expectations of credit losses for a group of similar securities) and requires an entity use present value of expected cash flows when estimating the ECLs. The key steps under this impairment analysis are:

a. Assess if the investment is considered impaired (i.e., is the fair value less than amortized cost). If fair value is greater than amortized cost, then the investment is not considered impaired as of the reporting date and no allowance is required.

b. Similar to current GAAP, if the asset is impaired, consider whether management has: (i) the intent to sell, or (ii) will more-likely-than-not be required to sell the impaired security before recovery of its amortized cost basis. If either of these requirements are met, the reporting entity should record the entire impairment loss (i.e., the difference between fair value and amortized cost) in earnings. This impairment (inclusive of any ALLL) must be written off against the amortized cost basis of the security. Subsequent to this write-off, the difference between the amortized cost basis and the cash flows expected to be collected should be accreted as interest income.

c. If neither of the conditions in (b) apply, determine if the decline in fair value below the amortized cost of the security is credit or non-credit related. An ALLL is only required for credit-related losses. To determine the portion of a decline in fair value that is credit related, an entity should compare the present value of expected cash flows of the security with the amortized cost basis of the security. A reporting entity should recognize the credit loss through earnings by recording an ALLL. However, the ALLL should be limited to the difference between fair value and the amortized cost of the security (a provision known as "the fair value floor"). Any difference between the fair value of the security and the amortized cost basis, less the ALLL will be reported in other comprehensive income.

PwC observation:

The AFS debt security impairment model requires consideration of the time value of money, and therefore, a DCF calculation must be performed. It does not provide the same modelling flexibility as the CECL model for estimating expected credit losses.

The AFS debt security impairment model for instruments described in paragraph .29(c) differs from the one applied to instruments that meet one of the criteria in paragraph .29(b). If one of the requirements in paragraph .29(b) are met, the asset should be written-down to its fair value through current earnings (i.e., a basis adjustment). This basis adjustment includes the credit and non-credit related losses. If neither of the requirements in paragraph .29(b) are met, only credit-related losses are recorded through an allowance and current earnings.

.30 The ALLL should be assessed each reporting period. Improvements in expected cash flows due to improvements in credit should be recognized through a reversal of the ALLL. However, a reversal of the ALLL should not be greater than the allowance recognized.

PwC observation:

The requirement to recognize expected credit losses through an ALLL for these instruments is a significant change from the current model for AFS debt securities. The current model requires that increases in credit loss estimates be recognized as basis adjustments, and improvements in credit loss estimates be recognized as an adjustment to the effective yield of the security. The new AFS impairment model may require significant changes to systems, processes, and controls.

.31 Write-offs and recoveries related to credit losses will follow the same guidance as the CECL model (see CECL guidance at paragraph .23 for more details).

Purchased financial assets with credit deterioration

Purchased financial assets with credit deterioration impairment model

.32 A different model is applied to certain purchased financial assets. Purchased financial assets with credit deterioration (PCD assets) are "*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*." PCD assets can be loans or debt securities (HTM or AFS). Beneficial interests can meet the definition of a PCD asset or would also be subject to the PCD asset model if there is a significant difference between their expected cash flows and contractual cash flows at the date of initial recognition.

PwC observation:

The FASB intended the definition of PCD assets to be broader and encompass more instruments than currently meet the definition of purchased credit impaired assets under ASC 310-30. Under today's guidance, a purchased credit impaired asset is one for which it is probable that not all contractual cash flows will be collected and that has experienced a deterioration in credit quality. The new model does not require an assessment of probability, but focuses only on whether there has been a more-than-insignificant deterioration in credit quality.

The ASU also does not define what is considered a more-than-insignificant deterioration in credit quality since origination. The determination will require judgment.

.33 For PCD assets, an investor will need to recognize an ALLL on initial recognition by estimating the expected credit losses of the purchased assets. Unlike the CECL model for financial assets that are not considered PCD, an entity should not recognize the initial estimate of ECL through current earnings, but through an adjustment to the amortized cost basis of the related financial asset at acquisition (i.e., a balance sheet gross-up). A similar gross up should be recorded for AFS instruments that are deemed to be PCD assets. Specifically, both the recorded asset balance (i.e., the purchase price) and the ALLL should be increased by the amount of the expected credit losses at acquisition. For example, if an entity purchases a PCD loan for $70 (with a par of $100) and estimates the ECL for the asset to be $15, then the entity should add $15 to the purchase price of $70, record an initial cost basis of $85, and recognize an ALLL of $15. The ASU prohibits extending PCD accounting to other financial assets with the exception of certain beneficial interests. See paragraph .38 for more details.

.34 If a discounted cash flow method is used to estimate expected credit losses, the initial ALLL should be calculated by discounting expected credit losses (i.e., the difference between contractual and expected cash flows) by the effective interest rate. The effective interest rate is the discount rate that makes the present value of the asset's expected cash flows equal the purchase price.

.35 If an entity uses a non-discounted cash flow method to estimate expected credit losses, such as a loss rate approach, the initial estimate of expected credit losses would be based on the unpaid principal balance. Under a loss rate approach, the loss rate would be applied to the par amount at initial recognition to determine the ALLL.

.36 Subsequently, the accounting for PCD assets will follow the CECL model or AFS debt security impairment model (as appropriate) with all adjustments to the ALLL recognized through current earnings.

.37 Interest income for a PCD asset should be recognized by accreting the amortized cost basis of the instrument to the contractual cash flows of the instrument. Under the PCD asset model, the discount related to estimated credit losses will not be accreted into interest income; only the non-credit related discount will be accreted. This results from the increase to the cost basis recorded in connection with the day-one allowance for PCD instruments. The accretable yield may be different for ALLLs estimated using a DCF model versus a non-discounted cash flow model.

PwC observation:

The new guidance is intended to simplify the accounting for PCD asset from today's purchased credit impaired asset model in ASC 310-30. It is designed to eliminate some of the asymmetrical treatment between credit losses and credit recoveries observed under today's model, as well as to simplify the calculation of interest income for these instruments. The PCD model is also meant to more closely align the accounting in periods subsequent to acquisition for these instruments with the accounting for originated assets.

Beneficial interests

Beneficial interests impairment model

.38 The ASU updates the accounting guidance in ASC 325-40, *Beneficial Interests in Securitized Financial Assets*. Upon initial recognition, beneficial interests classified as either held-to-maturity or AFS will apply the PCD asset guidance (i.e., initial recognition of an ALLL and an offsetting entry to the amortized cost basis) if either of the following conditions are met: (i) the beneficial interest meets the definition of a PCD asset or (ii) there is a significant difference between contractual cash flows and expected cash flows at the date of recognition.

.39 When expected cash flows change from the estimate of expected cash flows previously projected, an entity should first apply the CECL or AFS impairment model, depending on whether the beneficial interest is classified as HTM or AFS, respectively. For any changes in expected cash flows not accounted for under the CECL or AFS impairment model (i.e., increases or decreases in credit losses), the effective yield should be adjusted prospectively. The accretable yield for the beneficial interest should be recalculated as the excess of cash flows expected to be collected over the beneficial interest's reference amount. The reference amount is equal to the initial investment (or amortized cost basis if the PCD model was applied) minus cash received and write-offs recorded to date plus the yield accreted to date.

PwC observation:

A key change under the new model for beneficial interests is that favorable and adverse changes in cash flows that relate to credit will be recorded through the ALLL and current earnings. This is different than today's GAAP that requires a direct write-down (if there is an impairment) or a prospective yield adjustment if credit loss estimates decline. Given the change to the accounting model, entities will likely need to make a number of changes to systems, processes, and controls.

.40 Beneficial interests that are recorded at fair value through net income or where an entity has elected to apply the fair value option are not addressed by the new impairment guidance. However, other GAAP (e.g., investment company GAAP) may require or permit interest income to be recognized separately from the rest of the change in fair value of a beneficial interest. To determine the interest income for those beneficial interests and the appropriate accretable yield, an entity will need to consider the new guidance in this ASU.

Interest income recognition

.41 Although not addressed directly, the recognition of interest income will be impacted as a result of the changes introduced by the new ASU that affect the amortized cost basis of certain instruments. The ASU also eliminates the interest income model that existed for purchased credit impaired assets within ASC 310-30.

.42 Similar to current GAAP, the ASU does not provide proscriptive guidance for when an entity should put an instrument on non-accrual status, but it does permit existing non-accrual practices to continue. The ASU allows a creditor to use existing methods for recording payments received on non-accrual assets, including a cash basis method, a cost recovery method, or some combination of both.

Disclosures

.43 The new guidance requires a number of disclosures, some of which are incremental to what is required by current US GAAP. The disclosures are intended to enable users of the financial statements to understand (i) the credit risk inherent in the portfolio and how management monitors credit quality, (ii) management's models, inputs, and assumptions in estimating expected credit losses, and (iii) changes in the estimate of expected credit losses that have taken place during the period. The ASU includes examples of the required disclosures.

.44 One of the more significant changes to disclosures is the ASU's requirement for public business entities to disclose the amortized cost basis within each credit quality indicator (CQI) by vintage year of origination for financing receivables and the net investment in leases.

PwC observation:

The ASU provides a phase-in approach for applying the vintage disclosure requirements for public business entities that are not SEC filers. Specifically, each of the most recent three years of CQIs will be required at adoption. Subsequently, an incremental year of CQI disclosures will be required for every fiscal year thereafter until five separate fiscal years are disclosed. Public business entities that are SEC filers will need to present separately five fiscal years of CQI disclosures. For instruments originated prior to the fifth separately presented fiscal year, public business entities may present CQI disclosures in the aggregate.

Transition

.45 In general, the new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, prospective application of the ASU is required for PCD assets previously accounted for under ASC 310-30 (the current PCI guidance) and for debt securities for which an other-than-temporary impairment was recognized prior to the date of adoption. The transition guidance provides other special provisions for instruments that will be considered PCD assets. Reporting entities should carefully consider the transition provisions relating to PCD assets and debt securities.

What's next?

.46 The new guidance will be effective for:

- Public business entities (PBEs) that meet the definition of an SEC filer for annual and interim periods beginning after December 15, 2019;

- Other PBEs that do not meet the definition of an SEC filer for annual and interim periods beginning after December 15, 2020; and

- All other entities, including certain not-for-profit organizations and employee benefit plans, for annual periods beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021.

.47 Early adoption is permitted for all entities for annual and interim periods beginning after December 15, 2018.

.48 Given the complexities of the new impairment guidance, implementation issues will likely arise between now and the effective dates. The FASB has formed a Transition Resource Group (TRG) that may meet periodically to discuss these implementation issues as they arise. Reporting entities should monitor the related FASB and TRG communications.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

Authored by:

John Althoff
Partner
Phone: 1-973-236-7021
Email: john.althoff@pwc.com

Edward Lee
Director
Phone: 1-973-236-4478
Email: edward.x.lee@pwc.com

Chip Currie
Partner
Phone: 1-973-236-5331
Email: frederick.currie@pwc.com