June 16, 2016

FASB In Focus

Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326)

On June 16, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations.

The ASU requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates.

Why Did the FASB Embark on a Project to Improve Financial Reporting of Credit Losses on Financial Instruments?

Current GAAP requires an "incurred loss" methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. This model has been criticized for restricting an organization's ability to record credit losses that are expected, but do not yet meet the "probable" threshold.

The global financial crisis underscored those concerns.

In the lead-up to the financial crisis, financial statement users were making estimates of expected credit losses using forward-looking information and devaluing financial institutions before accounting losses were recognized. This highlighted that the information needs of users differ from what GAAP has required.

Similarly, preparers expressed frustration during this period because they could not record credit losses that they were expecting due to the fact that the probable threshold had not been met.

In 2008, the FASB and the International Accounting Standards Board (IASB) established a Financial Crisis Advisory Group (FCAG) to advise the Boards on improvements in financial reporting in response to the financial crisis. The FCAG recommended exploring more forward-looking alternatives to the incurred loss methodology.

With this feedback in mind, the FASB embarked on a project focused on the objective of better aligning the financial reporting for credit losses with the informational needs of financial statement users. Over the course of the project, the FASB solicited feedback on various approaches to meet this objective by issuing three due process documents, which resulted in the consideration of various expected credit loss models and feedback from 3,360 comment letters.

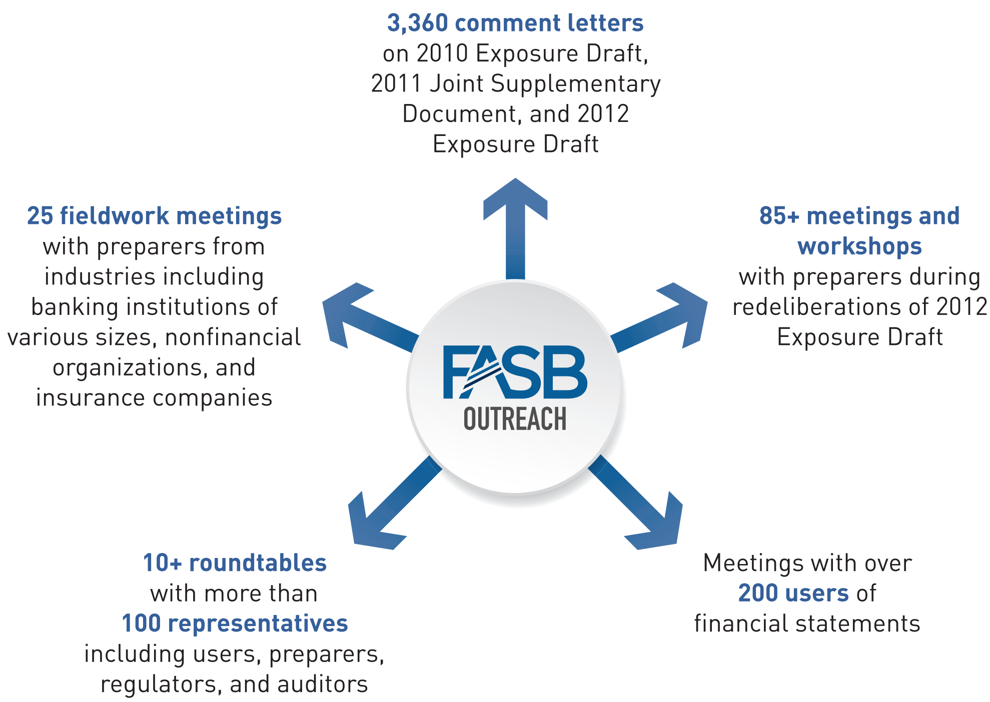
In redeliberations, the FASB emphasized the scalability of the standard and considered feedback from organizations of all sizes, including community banks and credit unions.

What Kind of Outreach Did the FASB Undertake When Developing the ASU?

When developing the ASU, the FASB participated in extensive outreach activities and received significant input from a wide variety of stakeholders. Outreach activities are summarized on page 2.

How Will the ASU Improve Accounting for Credit Losses on Financial Instruments?

The new standard requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience,



current conditions, and reasonable and supportable forecasts.

The standard requires organizations to immediately record the full amount of credit losses that are expected in their loan portfolios, resulting in more timely and relevant information that better meets the needs of investors and other users of financial statements.

Under the new standard, many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances.

The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements.

What Does the New Guidance Do?

Assets Measured at Amortized Cost

Under the new guidance, the allowance for credit losses is a valuation account that is deducted from the amortized cost of the financial asset to present the net amount expected to be collected.

The income statement reflects the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period.

The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The standard does not require a specific credit loss method, allowing an organization to use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances.

Most organizations should be able to leverage existing systems and processes to comply with the new standard, and organizations will not need to forecast economic conditions over the entire contractual life of long-dated financial assets if those forecasts are not supportable.

The standard does not require a specific credit loss method, allowing an organization to use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances.

The allowance for credit losses for PCD assets that are measured at amortized cost is determined in a similar manner to other financial assets measured at amortized cost; however, the initial allowance for credit losses is added to the purchase price rather than being created through credit loss expense.

The ASU. . .

- Eliminates the probable initial recognition threshold in current GAAP and, instead, reflects an organization's current estimate of all expected credit losses over the contractual term
- Broadens the information considered when measuring credit losses to include forward-looking information
- Increases usefulness of the financial statements by requiring timely inclusion of forcasted information in forming expectations of credit losses
- Increases comparability of purchased financial assets with credit deterioration (PCD assets) with originated and non-PCD assets
- Increases users' understanding of underwriting standards by requiring additional information about credit quality indicators by year of origination (vintage)
- For available-for-sale debt securities, aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses (and subsequent reversals) through an allowance rather than a write-down.

The ASU also will expand upon the current credit quality disclosures by further disaggregating the reported amounts by their year of origination. This increased transparency will help investors and other financial statement users better understand the credit quality trends of asset portfolios.

Available-for-Sale Debt Securities

As previously indicated, credit losses for available-for-sale debt securities should be measured in a manner similar to current GAAP. However, the ASU will require that credit losses be recorded through an allowance for credit losses, which will allow subsequent reversals in credit loss estimates to be recognized in current income. In addition, the allowance on available-for-sale debt securities will be limited by the amount the fair value is less than the amortized cost.

Who Will Be Affected by the New Guidance?

The amendments affect organizations that hold financial assets and net investment in leases that are not accounted for at fair value with changes in fair value reported in net income.

The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

Does the FASB's New ASU Differ from IFRS?

The credit losses project began as a joint project with the IASB, but the Boards determined that convergence was not possible in 2012 due to the differing needs of their respective stakeholder groups.

The IASB issued International Financial Reporting Standards (IFRS) 9, *Financial Instruments*, in July 2014. The FASB and the IASB both sought to respond to concerns identified by the FCAG pertaining to the delayed recognition of credit losses; however, the IASB's stakeholders strongly preferred an impairment model that uses a dual measurement approach, while U.S. stakeholders strongly preferred the current expected credit loss model.

The main difference between this ASU and IFRS 9 relates to the timing of recognition of expected losses.

This ASU 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 recognized.

Consequently, the allowance for credit losses as measured and recorded under the guidance in the ASU will be accounted for differently under GAAP than under IFRS and will have a different effect on the financial statements.

When Will the ASU Be Effective?

For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Thus, for a calendar-year company, it would be effective January 1, 2020.

For public business entities that are not SEC filers, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.

For all other organizations, the ASU is effective for fiscal years beginning after December 15, 2020, and for interim periods within fiscal years beginning after December 15, 2021.

Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

What about Transition?

The ASU requires organizations to apply the amendments 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). For certain assets (such as debt securities for which an other-than-temporary impairment has been recognized before the effective date and PCD assets), a prospective transition approach is required.

Additionally, there is transition relief related to credit quality disclosures for public business entities that do not meet the definition of an SEC filer in the first three years of application. These companies may phase-in the disclosure of credit quality indicators by year of origination by presenting only the three most recent origination years in the year of adoption, and in each subsequent fiscal year adding the then-current origination year to the disclosure until a total of five origination years are presented.

For more information about the project, please visit the FASB's website at www.fasb.org.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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