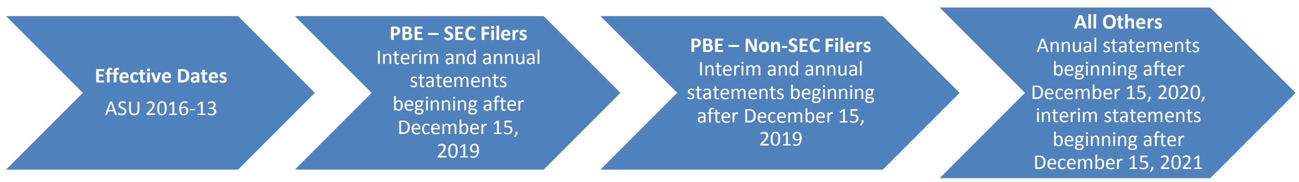
Additional CECL Clarifications

The effective date is drawing nearer for the new credit impairment standard, Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments*, commonly referred to as current expected credit loss (CECL). Large banks and IT vendors have begun initial project scoping and have generated detailed questions on how the model will work. At the Financial Accounting Standards Board (FASB) meeting on December 13, 2017, members discussed and concluded on several technical inquiries, which are summarized below. In addition, U.S. Securities and Exchange Commission (SEC) officials who spoke at the December 2017 American Institute of CPAs conference provided insights on two consultations on CECL-related topics. While the SEC conclusions are only applicable for public companies, these decisions sometimes become industrywide practices that nonpublic companies follow by analogy.



FASB

Troubled Debt Restructurings

FASB created a transition resource group (TRG) to solicit, analyze and discuss stakeholder issues arising from implementation of the new guidance. At the June 2017 TRG meeting, members supported the creation of an accounting policy election to use an effective interest rate (EIR) adjusted for prepayment expectations when using a discounted cash flow (DCF) method to determine the allowance for credit losses. The TRG meeting summary notes, "after the troubled debt restructuring (TDR) event, the EIR used should **not** be periodically updated for prepayment expectations." Therefore, if an entity makes the policy election to use a prepayment-adjusted EIR, the rate the entity should use for measurement of credit losses on TDRs is the prepayment-adjusted EIR **before** the date the TDR takes place.

Some banks have indicated it would be very difficult to adopt a prepayment-adjusted EIR for DCF measurement of credit losses for pre-existing TDRs. Determining the prepayment-adjusted EIR for these financial assets would be extremely difficult from an operability standpoint because to properly recalculate a prepayment-adjusted EIR as of the historical TDR date of each loan, they would have to restore the economic assumptions and models that were appropriate for each TDR date to project cash flows.

FASB agreed transition relief was warranted to allow entities that elect to use a prepayment-adjusted EIR in a DCF approach to measure credit losses using the prepayment-adjusted EIR as of the **adoption date** for existing loans accounted for as TDRs. The TRG minutes will be amended to clarify this issue. Because the ASU is silent on this point, additional standard setting is not required.

Variable-Rate Financial Assets

The CECL model allows an entity to use a DCF method when determining the estimated expected credit losses for assets measured at amortized cost. Existing guidance in Accounting Standards Codification 310, *Receivables*, lays out the application of a DCF method to variable-rate loans.

ASU 2016-13 amended the guidance to cover both loans and debt securities carried at amortized cost: "If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, that financial asset's effective interest rate (used to discount expected cash flows) shall be calculated based on the factor as it changes over the life of the financial asset. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows."

Stakeholders have interpreted the prohibition in the second sentence to preclude the consideration of how changes in interest rates might affect the prepayments and defaults for variable-rate financial assets, which could result in an inaccurate measurement of credit losses if a DCF method is used. This is because prepayments and defaults can be significantly affected by a change in the contractual interest rate. The prohibition also could create inconsistencies in measurement across variable and fixed-rate instruments.

FASB voted to remove the prohibition from using projections and allow—but not require—entities to determine prepayments and defaults using their expectations of future rate environments. Such projections should be reasonable and supportable. This change will be made in the next round of technical corrections scheduled for the second quarter of 2018.

Subsequent Events

ASU 2016-13 amended the subsequent events guidance in Topic 855. Some preparers questioned whether information obtained during the period after the measurement date—but before financial statements are issued or available to be issued—should be considered for the purposes of measuring estimated credit losses.

FASB clarified its intent on the updates to the subsequent events guidance—when determining an estimate of credit losses, an entity should **not** recognize in the financial statements the effects of any events that occur during the subsequent event period unless an error correction is necessary under Topic 250, *Accounting Changes and Error Corrections*. Disclosure of subsequent events affecting estimated credit loss may be appropriate, but recognition is prohibited. FASB felt the standard's wording was clear and, therefore, no standard-setting activity will result. The clarification on this point will be reflected in the amended meeting minutes.

SEC

General Expected Credit Losses Approach Versus Collateral-Dependent Loan Approaches

For collateral-dependent financial assets where foreclosure is probable, a company is **required** to measure expected credit losses based on the collateral's fair value. However, if a company determines the asset is collateral-dependent but foreclosure is not probable, it can elect to apply a practical expedient to measure expected credit losses based on the collateral's fair value.

A registrant sought SEC guidance on the application of the general expected credit losses approach to a portfolio of consumer loans where the registrant received notice of the borrowers' bankruptcies, but foreclosure was not probable. The registrant anticipated that it would not apply the practical expedient and would apply the general expected credit losses approach to that portfolio. The registrant concluded that in applying the general expected credit losses approach, it would incorporate all relevant information about expectations of future cash flows, *e.g.*, payment history of similar loans and delinquency status, when determining the allowance for credit losses (and not measure credit losses based on the collateral's fair value). The staff did not object to the registrant's conclusion.

Scopes of PCI Loans & PCD Financial Assets

ASU 2016-13 modified the definition of what were previously known as purchased credit-impaired (PCI) assets. FASB defines purchased financial assets with credit deterioration (PCD) as an acquired financial asset or acquired groups of financial assets with similar risk characteristics that have experienced a more than insignificant deterioration in credit quality since origination, based on the buyer's assessment. This differs from current U.S.

generally accepted accounting principles (GAAP), which include assets with contractual cash flows that, at acquisition, are probable of not being collected.

Under existing GAAP, the SEC staff has not objected to the application of the PCI model by analogy in certain circumstances in the absence of further standard setting.

The SEC staff was consulted on the scope of the PCD model. A registrant inquired whether consumer installment loans that the registrant purchases immediately after they are originated by a retailer in connection with the sale of goods would qualify for the PCD model. The staff **objected** to the view that these loans would qualify for the PCD model because there was no credit deterioration associated with the loans at the date of initial recognition, particularly since the loans were purchased shortly after origination. The staff also considered whether loans that the registrant originates to retailers and are collateralized by consumer installment loans made by the retailers in connection with the sale of goods would qualify for the PCD model. The staff concluded that application of the PCD model would not be appropriate in that fact pattern because the loans made to the retailers are originated rather than purchased.

BKD will continue to monitor this project. If you want to learn more about the CECL standard or how BKD can help your institution with CECL implementation, contact your trusted BKD advisor. Visit BKD's Hot Topics page to learn more.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com