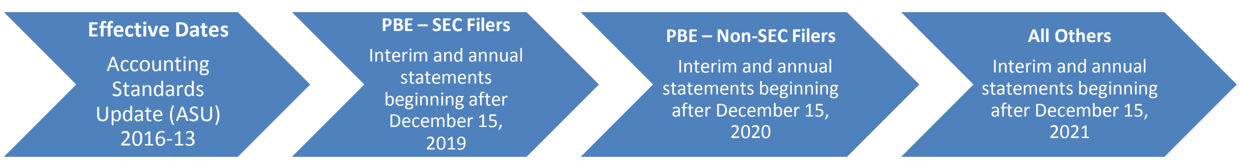
New CECL FAQs & FASB to Consider New Alternative

An overhaul of major accounting guidance always raises operational and implementation challenges. As the adoption date of the new credit impairment standard—commonly called the current expected credit loss (CECL) model—draws nearer, the number of concerns is rapidly increasing. The Financial Accounting Standards Board (FASB) is doing its best to address issues in a timely manner.

FASB recently issued a Staff Q&A covering the weighted-average remaining maturity (WARM) method of estimating expected credit losses. This method could be less complicated and less costly for smaller, less complex pools of assets.

A second public roundtable is scheduled for January 28, 2019, to gather additional views on the credit loss standard. Participants will include representatives of banks of various sizes, regulators and other stakeholders. Agenda topics will include FASB staff's research on credit losses agenda requests, including a proposal submitted by a group of regional banks to consider an alternative to the income statement effect of the CECL model. At the November 2018 transition resource group meeting, FASB caused concern in the industry by clarifying its intention that gross write-offs and recoveries were a required part of the vintage disclosure, rather than just an illustrative format. Most large financial institutions had not included this in their project scope or parallel testing now underway. This disclosure, as well as other transition issues, will be a key discussion point. The first roundtable in February 2016 resulted in several significant changes to the final standard, especially for smaller banks and credit unions. The roundtable will be audio webcast and archived.

BKD will continue to monitor all CECL developments.



WARM Method

The WARM method uses an average annual charge-off rate as a foundation for estimating the credit losses for the remaining balances, *e.g.*, expected credit losses through the end of the contractual term, of financial assets in a pool at the balance sheet date. The Staff Q&A addresses five questions, summarized below.

- **Is the WARM method an acceptable method to estimate allowances for credit losses under Subtopic 326-20?** Yes. FASB has permitted entities using various methods because it believes entities manage credit risk differently and should have flexibility to best report their expectations.
- **What factors should an entity consider when determining whether to use the WARM method?** If an entity is using a loss rate-based method today, that entity may be able to continue with a comparable method, including the WARM method. However, compared with the method it uses today to estimate incurred losses, the entity's assumptions and inputs will need to change to arrive at an estimate for expected credit losses that contemplates the contractual term of the financial assets adjusted for prepayments, as well as reasonable and supportable forecasts.
- **How can an entity estimate the allowance for credit losses using a WARM method?** A detailed example is provided that also was discussed at a February 2018 webinar hosted by bank regulators.

- **Are there other ways to perform the WARM estimation?** Yes, there may be other acceptable ways for estimating the allowance for credit losses using the WARM method. A second comprehensive example is provided.
- **When an entity implements CECL using a loss rate method such as the WARM method, is it acceptable to adjust historical loss information for current conditions and the reasonable and supportable forecasts through a qualitative approach as was done in the example rather than a quantitative approach?** Yes, if adjustments to historical loss information are appropriate, an entity could use a qualitative approach to adjust its historical data for current conditions and reasonable and supportable forecasts. ASU 2016-13 does not require a quantitative analysis. Nevertheless, an entity should maintain appropriate documentation, commensurate with its complexity and sophistication to support its qualitative adjustments and the effect of the relevant qualitative factors on the measurement of expected credit losses.

Alternative Proposal

In November 2018, a group of 21 banks submitted an alternative proposal to FASB, which will be discussed at the upcoming public roundtable. The approach would retain the CECL methodology's intent of establishing a balance sheet allowance for lifetime credit losses, but the income statement provision would be recognized in three parts:

- Nonimpaired financial assets – Loss expectations within the first year would be recorded to provision for losses in the income statement
- Nonimpaired financial assets – Loss expectations beyond the first year would be recorded to accumulated other comprehensive income
- Impaired financial assets – Lifetime expected credit losses would be recognized entirely in earnings

The adoption of CECL will be complex and likely will require significant hours to implement correctly. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance complying with the CECL standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this topic. Visit our website to learn more.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com