FASB Understanding Costs and Benefits

ASU: Credit Losses (Topic 326)

This document summarizes how the Financial Accounting Standards Board (FASB) considered the expected benefits and costs of its new Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326),* and the process the FASB undertook in concluding that the expected benefits of the amendments in the ASU justify the anticipated costs.

The FASB issues new financial accounting and reporting standards only when the benefits of a standard—which include improvements in the relevance and neutrality of reported financial information—justify the costs it imposes on financial statement preparers to implement the new standard, and on users to consider and respond to the new information.

The FASB concluded that the expected benefits of the amendments in this ASU justify the anticipated costs.

Both users and preparers have previously raised concerns about the delayed recognition of credit losses on financial assets measured at amortized cost. To address these concerns, the new standard measures all expected credit losses over the life of the financial assets. Enhanced disclosures will facilitate users' assessment of management's initial credit loss estimate for newly originated financial assets, as well as subsequent changes to those estimates.

Organizations are likely to incur costs associated with implementing the new requirements; however, the FASB has sought to minimize the cost of implementation and complexity based on preparer feedback. Additionally, the new requirements will provide users of financial statements with more useful information about expected credit losses.

Organizations applying the new standard will be able to leverage many of their existing financial reporting processes. This is because specific estimation methods are not prescribed, and while forward-looking information must be considered, an organization may revert to historical loss information in periods where a reasonable and supportable forecast cannot be obtained.

The new standard affects all organizations that hold financial assets and net investments in leases that are not accounted for at fair value with changes in fair value reported in net income.

The ASU on credit losses will take effect for calendar year-end SEC filers in 2020. For other calendar year-end organizations, the ASU on credit losses will take effect in 2021.

Early application will be permitted in 2019 for all organizations.

BACKGROUND

Today in Generally Accepted Accounting Principles (GAAP), organizations are required to use an "incurred loss" methodology when recognizing credit losses on financial assets measured at amortized cost. This approach delays recognition until it is probable a loss has been incurred, which has been criticized by both preparers and users. The Financial Crisis Advisory Group (FCAG) also cited the delayed recognition of credit losses as a weakness in GAAP.

The Credit Losses project was added to the FASB's agenda based on feedback from preparers, users, and the FCAG. Several different impairment models were evaluated before the FASB ultimately decided on the current expected credit loss (CECL) model. The CECL model was developed in response to feedback that previously proposed models were complex and/or inoperable.

The main objective of the new standard is to provide financial statement users with more useful information about expected credit losses. This objective is achieved by:

- Removing the probable threshold in current GAAP
- Broadening the range of information that is considered in determining expected credit losses, and
- Providing enhanced disclosures.

Overview of Costs and Benefits of the New Credit Losses Standard

BENEFITS	COSTS
More timely reporting of credit losses Measurement using forward-looking information Greater transparency on • The extent of expected credit losses • Changes in expected credit losses • Credit quality indicators • Portfolio composition Enhance comparability through a single measurement objective Decrease in costs for users because credit losses will now be reported based on expectations and forward-looking information, consistent with the analysis performed by users.	Implementation costs • Gathering data • Incorporating new inputs into processes • Review and audit of new estimates • Personnel costs for process changes and education • Investor costs for education on the transition impact from the incurred loss methodology to expected credit loss methodology Once implementation activities are complete and an organization's processes have been fully updated, the ongoing costs associated with preparing the allowance for credit losses are similar to those in current GAAP. This is because many of the same estimation methods will be permitted (for example, loss rate methods, probability of default methods, discounted cash flow methods, and aging schedules), although the data used as inputs will be different than what is used today.

The credit losses measured under this approach will be better aligned with the forward-looking information considered by users. Additionally, the CECL model aligns the accounting for credit losses with underwriting decisions because expected losses (rather than only incurred losses) generally are considered when underwriting a loan or other financial asset.

The standard changes the accounting for purchased financial assets with credit deterioration (PCD assets). The allowance for credit losses for PCD assets 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 recorded as credit loss expense. This approach excludes credit-related discounts from interest income on a prospective basis, which results in enhanced comparability between PCD assets and non-PCD assets.

The accounting for credit losses on available-for-sale debt securities is similar to current GAAP; however, the new standard will require credit losses to 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 for credit losses on available-for-sale debt securities will be limited by the amount the fair value is less than amortized cost.

OUTREACH WITH STAKEHOLDERS

Since the project's inception in 2008, the FASB has requested and received significant input from stakeholders on the application of the proposed guidance. This input includes stakeholder responses to the proposed amendments in three public documents:

1. The 2010 Exposure Draft (2010 ED)
2. The 2011 Joint Supplementary Document (2011 JSD), and
3. The 2012 Exposure Draft (2012 ED).

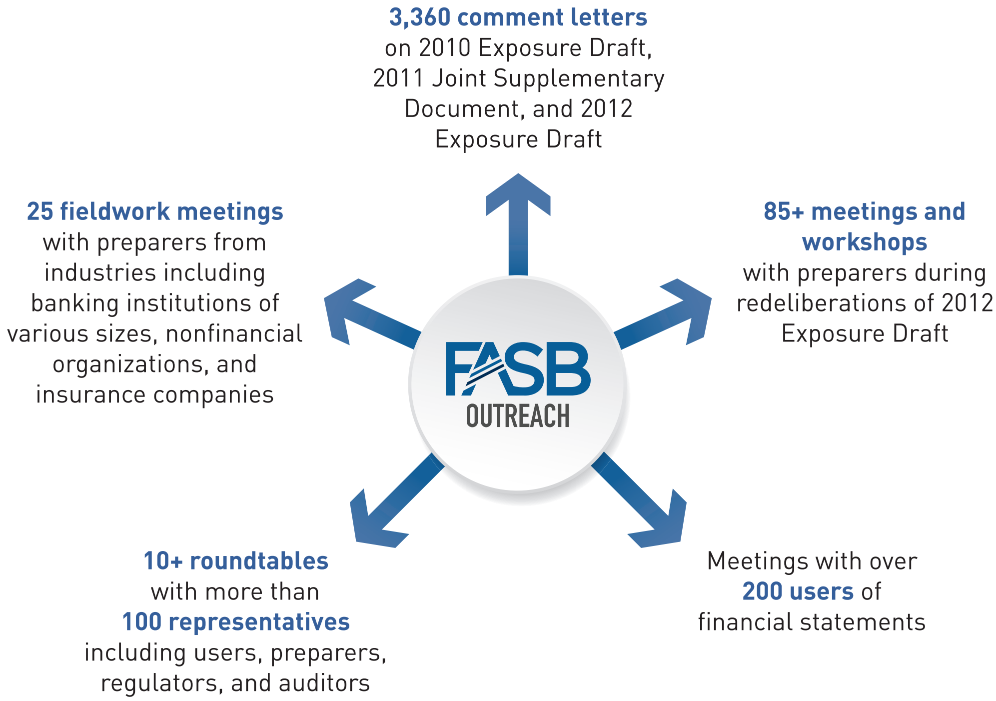
A significant amount of input on the 2012 ED was received and considered in redeliberation meetings in 2013 through 2016.

During that time period, stakeholder feedback, including feedback from community banks and credit unions, prompted various changes to the CECL model to reduce cost and complexity.

Additional outreach was performed in the final stages of redeliberations to confirm the operability of the standard, and the feedback received indicated that the changes made have reduced costs and complexity.

STAKEHOLDER CONCERNS

The FASB considered various credit loss models before moving forward with CECL. There was initially strong opposition to each of the previous models based on complexity or operability concerns. The Board has considered the feedback received throughout the



project and believes CECL most appropriately addresses the concerns of stakeholders. In connection with the feedback received, the following key changes were made during the development of CECL:

- Eliminated the "probable threshold" in current GAAP
- Eliminated a good book/bad book methodology, multi-stage methodology, or other credit deterioration methodology because of operability concerns addressed by stakeholders
- Allowed various estimation methods because of the emphasis placed on the importance of a scalable approach for institutions of all sizes
- Incorporated forward-looking information into the estimate, but will allow for use of historical loss information in periods where a reasonable and supportable forecast is not available
- Kept separate accounting for interest income and credit losses
- Retained current practices for nonaccrual assets
- Excluded available-for-sale (AFS) debt securities from the CECL model, and improved the existing AFS impairment model
- Reduced the complexity in accounting for purchased credit-deteriorated assets
- Disaggregated credit quality indicators by vintage, which is operationally easier than the previously proposed roll-forward of amortized cost basis
- Added a phase-in approach for vintage disclosures for smaller financial institutions
- Tiered effective dates to provide more implementation time for smaller financial institutions.

COSTS: APPLYING THE NEW ASU

The FASB understands that reporting organizations will incur additional costs as a result of the new ASU.

For example, organizations will, in general, incur initial costs to educate employees about how to apply the new requirements and to explain to users the effects of the changes in accounting for credit losses on the organization's financial statements.

In addition, many organizations may need to consider changes to processes and controls to ensure that they are measuring credit losses in accordance with the new standard. Organizations may also need to gather and/or obtain incremental data relevant to the expected credit loss method that they believe is appropriate for their type of assets and sophistication level.

However, once these implementation activities are complete and an organization's processes have been

Costs of Applying the New ASU:

- Personnel costs to change processes and controls to apply the new requirements
- Costs to educate stakeholders about new reporting requirements
- Costs to obtain incremental data related to expected credit loss method.

fully updated, the ongoing costs for most organizations of preparing the allowance for credit losses under the new ASU should not be significantly above the costs of complying with the accounting model in current GAAP. This is because many of the same estimation methods will be permitted (for example, loss rate methods, probability of default methods, discounted cash flow methods, and aging schedules).

The FASB concluded that, based on substantial outreach with preparers of financial statements, many organizations will be able to apply the requirements of the new ASU using similar systems and processes to what they used before to meet current GAAP reporting and disclosure requirements.

BENEFITS: APPLYING THE NEW ASU

The FASB observed that the new ASU will provide benefits to many investors and other users of financial statements by increasing the transparency of information provided on credit losses. More specifically, the new ASU accomplishes the following:

- Results in more timely reporting of credit losses
- Results in greater transparency about the extent of expected credit losses on financial assets held at the reporting date
- Improves a user's ability to understand changes in expected credit losses that have taken place during the period
- Allows preparers to consider forward-looking information rather than limiting consideration to current and past events
- Improves a user's ability to compare purchased financial assets with credit deterioration with originated financial assets
- Enhances consistency when credit losses are measured at the individual asset level, as compared with the portfolio level, because the credit losses that are expected will be recorded for all assets
- Provides greater transparency to the user in assessing the credit quality indicators of a loan portfolio and changes in composition of the loan portfolio over time.

Benefits of Applying the New ASU:

- More timely reporting of credit losses
- Increased transparency about the extent of expected credit losses for users
- Consistency in measurement between assets.

CONCLUSION

The FASB's assessment of the costs and benefits of issuing this ASU is unavoidably more qualitative than quantitative because there is no identified method to objectively quantify all costs to implement the new guidance or to quantify the value of improved information in financial statements.

Overall, the FASB concluded that the expected benefits of the amendments in the new ASU justify the anticipated costs.

More information on the ASU, including a press release, *FASB in Focus,* and a video, can be found on the FASB website.

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