FASB Releases Financial Instruments – Credit Losses Standard

On June 16, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments – Credit Losses (Topic 326). The issuance will change fundamentally how companies recognize credit losses by moving from an incurred loss model to and expected loss model. The ASU:

- Eliminates the probable recognition threshold to allow for current estimate of credit losses over the instruments contractual term
- Allows entities to consider forward looking information
- Increases usefulness by requiring more timely inclusion of forecasted information in developing loss estimates
- Increased comparability of purchased financial assets with credit deterioration (PCD) with originated and non PCD assets
- Increases users' understanding of underwriting standards by requiring additional disclosures about credit quality indicators by year of origination
- For available for sale debt securities, aligns the income statement recognition of credit loses with the reporting period in which changes occur by recording credit losses (and subsequent reversals) through an allowance rather than a write-down.

The amendment will affect entities that hold financial assets and net investment in leases that are not account for at fair value with changes in fair value reported in net income, such as:

- Debt securities
- Trade receivables
- Off balance sheet credit exposures
- Reinsurance receivables
- Any other financial assets not excluded from the scope that have the contractual right to receive cash.

Historically, an entity would estimate credit losses based of events that have already incurred, whether specifically known or not, as of a reporting date. To meet the threshold, the loss had to be both probable that it had incurred and reasonably estimable. There were several models prescribed in the accounting literature to measuring impairment. The accounting model used was determined based on the characteristics of the specific instrument (debt instrument, individual impairment, collective (pooling) impairment, troubled debt, etc.). The ASU seeks to reduce this complexity by requiring one model for estimating credit impairment. However, the ASU does not prescribe a specific credit loss method to be followed to derive the estimates.

In addition, the incurred loss methodology delayed recognition of credit losses because entities could only take into consideration known or historical data to estimate credit losses. This method was heavily criticized during the financial crisis because entities were restricted to only record losses that was estimated to have already incurred. They were precluded from reserving for the losses they could foresee in the horizon because the probability of occurrence as of the reporting date threshold had not been met.

Effective date and transition

The ASU becomes effective for public business entities that are S.EC filers in 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. Thus, for a calendar year company it would be effective January 1, 2021.

For all other organizations, the ASU is effective for fiscal years beginning after December 15, 2021. Thus, for a calendar year company it would be effective January 1, 2022.

Entities adopting the standard will do so using a cumulative effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). Early adoption is permitted. However the FASB did allow for transition relief related to credit quality disclosures for public entities that do not meet the definition of an SEC filer in the first three years of application. These companies can phase in the disclosure of credit quality indicators by year of origin by presenting on 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.

Implementation Issues

The FASB has formed a Transition Resource Group (TRG) to solicit, analyze and discuss stakeholder issues arising from the implementation of the new credit impairment guidance. The TRG does not have the authority to issue guidance. Rather, the TRG will share their views and recommendations with the FASB to take action. Two meeting were held prior to the final issuance of the ASU. No meetings have been scheduled since issuance.