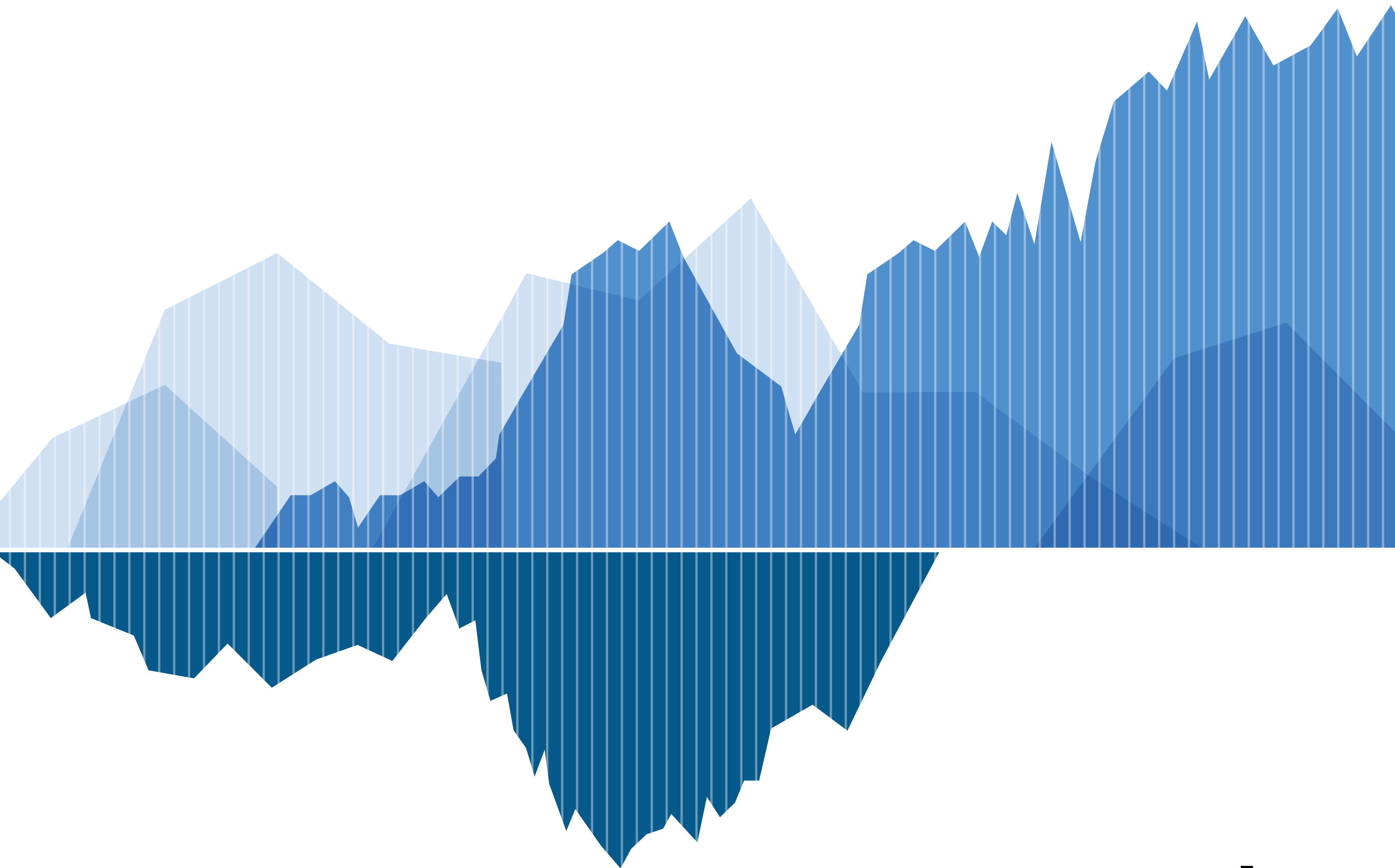
WHITEPAPER

CECL Standard: Abridged.

ASU 326—Financial Instruments—Credit losses



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ASU 326-FINANCIAL INSTRUMENTS-CREDIT LOSSES

The Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 326 provides the guidance by which the current expected credit losses methodology (CECL) for estimating allowances for credit losses will be applied. The allowance will be reported as a valuation account, or the difference between the financial assets' amortized cost basis and the net amount expected to be collected.

The new accounting standard does not change the existing write-off principle in U.S. GAAP or current nonaccrual practices.

WHO/WHAT IS AFFECTED BY THE AMENDMENTS IN THIS UPDATE? (ASU 326-20-15-2)

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.

On the effective date, institutions will apply the new accounting standard based on the characteristics of financial assets as follows:

Financial Assets Carried at Amortized Cost

The amendments in this Update require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented as the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s).

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.

Financial assets that are measured at amortized cost basis are as follows:

- Financing receivables
- Held-to-maturity debt securities
- Receivables that result from revenue transactions within the scope of Topic 605 on revenue recognition, Topic 606 on revenue from contracts with customers and Topic 610 on other income
- Reinsurance receivables that result from insurance transactions within the scope of Topic 944 on insurance
- Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860:
    - *Net investments in leases recognized by a lessor in accordance with Topic 842 on leases*
    - *Off-balance-sheet credit exposures not accounted for as insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments*

Full FASB CECL Standard Text

ASU citations in this document refer to the full standard text issued by FASB. Access the full Accounting Standards Update, finalized on June 16, 2016.

ACCESS CECL TEXT

Purchased Credit-deteriorated Assets

Financial assets classified as purchased credit-impaired assets prior to the effective date will be classified as purchased credit-deteriorated assets as of the effective date. For all purchased-credit deteriorated assets, institutions will be required to gross-up the amount of the financial asset for its allowance for expected credit losses as of the effective date and should continue to recognize the noncredit discount or premium as interest income, if appropriate, based on the effective yield on such assets determined after the gross-up for the allowance.

Available-for-sale and Held-to-maturity Debt Securities

Debt securities on which other-than-temporary impairment had been recognized prior to the effective date will transition to the new guidance prospectively (i.e., with no change in the amortized cost basis of these securities).

INITIAL MEASUREMENT (326-20-30-1 THROUGH 15)

The new accounting standard does not specify a single method for measuring expected credit losses. Institutions should use judgment to develop estimation methods that are well documented, applied consistently over time and faithfully estimate the collectability of financial assets by applying the principles in the new accounting standard.

The initial measurement should be applied with a modified-retrospective approach that will require a cumulative-effect adjustment to the opening retained earnings in the statement of financial position as of the date of adoption. For more implementation guidance and illustrations see section 326-20-55.

Determining Proper Segmentation (326-20-30-2)

Segmentations or pools should have similar risk characteristics. These pools should be as granular as possible while maintaining statistical significance. Management will need to evaluate pools on an ongoing basis to ensure that the underlying assets continue to exhibit similar risk behavior.

Determining the Expected Life of Each Segment (326-20-30-6)

Entities are required to estimate expected credit losses over the contractual term of the financial asset(s). Prepayments will need to be considered as a separate input or embedded in the credit loss experience.

Expected life is a critical component of all methodologies used to determine loss experience. Prepayment and/or mortality rates will provide for increased flexibility and defensibility.

Interagency Joint Statement

Shortly after the FASB issued the final CECL standard, the four regulatory agencies issued a joint statement on CECL implementation.

READ THE STATEMENT

Calculating Historical Loss Experience (326-20-30-3, 7 Through 8)

When developing an estimate of expected credit losses on financial asset(s), entities are required to consider available information relevant to assessing the collectability of cash flows. Also, entities need to consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates.

Understanding and documenting how each segment or pool reacts using various methodologies will yield more accurate reserve levels and provide management, auditors and regulators with confidence that proper due diligence was performed. Additionally, quantifying loss experience throughout economic cycles is a component of the calculation that requires an iterative process over multiple periods.

Adjusting Historical Loss Experience for Current and Forecasted Conditions (326-20-30-7 Through 9)

Management will need to evaluate current and forecasted environments and adjust the utilization of historical loss experience. Reversion to historical loss experience only is an available option that will require documentation regarding the application of sections **326-20-30-7 through 8**.

SUBSEQUENT MEASUREMENT (326-20-35)

At each reporting date, entities (including purchased financial assets with credit deterioration) will compare their current estimate of expected credit losses with the estimate of expected credit losses previously recorded. Entities will then report in net income (as a credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

The method applied to initially measure expected credit losses for the assets should be applied consistently over time.

Evaluate Pool Characteristics (326-20-35-2)

Management will need to evaluate, upon subsequent measurement periods, whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in the pool.

Expected Foreclosure (326-20-35-4)

Regardless of the initial measurement method, an entity is required to measure expected credit losses based on the fair value of the collateral when the entity determines that foreclosure is probable. This method may also be used when it is determined that the primary source of repayment is expected substantially through the sale of the collateral when the borrower is experiencing financial difficulty as of the reporting date.

FASB CECL News Release

Read the news released shared by the FASB on June 16, announcing the issuance of CECL. This release contains links to additional resources.

READ NEWS RELEASE

CONSIDERATIONS FOR OFF-BALANCE-SHEET CREDIT EXPOSURE (326-20-30-11)

Entities are required to estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic will be established/adjusted. The estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life.

Entities should present the estimate of expected credit losses on the statement of financial position as a liability. The liability for credit losses for off-balance-sheet financial instruments will need to be deducted from the liability for credit losses in the period in which the off-balance-sheet financial instruments expire, result in the recognition of a financial asset or are otherwise settled.

CONSIDERATIONS FOR PURCHASED LOANS/ PURCHASED FINANCIAL ASSETS WITH CREDIT DETERIORATION (326-20-30-13)

Entities are required to add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated.

For assets that do not have a more-than-insignificant deterioration, entities shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets.

At acquisition, entities will provide the following reconciliation:

- The purchase price
- The allowance for credit losses at the acquisition date based on the acquirer's assessment
- The discount (or premium) attributable to other factors
- The par value

CECL Prep Kit

Access our collection of resources to help your institution prepare for CECL. This complimentary toolkit includes links, videos, on-demand webinars and guides on data and implementation.

ACCESS PREP KIT

DISCLOSURE GUIDANCE (326-20-50)

General (326-50-1 Through 3)

Entities must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses. The disclosure guidance in this Section should enable a user of the financial statements to understand:

- The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio
- Management's estimate of expected credit losses
- Changes in the estimate of expected credit losses that have taken place during the period

Credit Quality Information (326-20-50-4 Through 9)

An entity shall provide information that enables a financial statement user to do both of the following:

- Understand how management monitors the credit quality of its financial assets
- Assess the quantitative and qualitative risks arising from the credit quality of its financial assets

Entities shall provide quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets (excluding off-balance-sheet credit exposures), including all of the following:

- A description of the credit quality indicator(s)
    - **326-20-50-7:**
      If an entity discloses internal risk ratings, then the entity shall provide qualitative information on how those internal risk ratings relate to the likelihood of loss
- The amortized cost basis, by credit quality indicator
- For each credit quality indicator, the date or range of dates in which the information was last updated for that credit quality indicator
- **Vintage Disclosure Requirement (326-20-50-6):**
  Entities are required to present the amortized cost basis within each credit quality indicator by year of origination (that is, vintage year). For purchased financing receivables and net investment in leases an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition. For origination years before the fifth annual period, an entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate. For interim period disclosures, the current year-to-date originations in the current

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UPCOMING WEBINARS

reporting period are considered to be the current-period originations. The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for an entity that is not a public business entity.

Allowance For Credit Losses

An entity shall provide information that enables a financial statement user to do the following:

- Understand management's method for developing its allowance for credit losses
- Understand the information that management used in developing its current estimate of expected credit losses
- Understand the circumstances that caused changes to the allowance for credit losses

Entities are required to disclose all of the following by portfolio segment and major security type:

- A description of how expected loss estimates are developed
- A description of the entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
    1. *Past events*
    2. Current conditions
    3. Reasonable and supportable forecasts about the future
- A discussion of risk characteristics relevant to each portfolio segment
- A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes
- Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, its rationale for those changes, and the quantitative effect of those changes
- Reasons for significant changes in the amount of writeoffs, if applicable
- A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period
- The amount of any significant purchases of financial assets during each reporting period
- The amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period

Sageworks CECL Solution

Sageworks ALLL is the most trusted reserve automation solution in banking. Learn how Sageworks can help your institution navigate the transition to CECL.

CECL SOLUTION

ABOUT SAGEWORKS

Sageworks (www.sageworks.com) is a financial information company working with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Thousands of bankers rely on Sageworks' credit risk management solutions to streamline credit analysis, risk rating, portfolio stress testing, loan administration and ALLL calculation. Sageworks is also an industry thought leader, regularly publishing whitepapers and hosting webinars on topics important to bankers.

Sageworks ALLL is the premiere automated solution for estimating a financial institution's reserve. It helps bankers automate their ALLL process and increase consistency in their methodology, making it defensible to auditors and examiners. Sageworks' risk management consultants also assist clients with the implementation of their ALLL models and guidance interpretation. To find out more, visit www.sageworksanalyst.com.

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Neekis Hammond is a senior risk management consultant at Sageworks. He provides financial institutions with advisory services, leads thought leadership, develops market strategies and consults with product development on solution requirements and accuracy.

He specializes in the ALLL; CECL preparation and methodology; acquired loan accounting and valuation—ASC 310-20, ASC 310-30, and ASC 820; stress testing, and various portfolio analysis topics—PD, LGD, migration, vintage, prepayment, utilization, pricing, risk rating, etc. Neekis has also facilitated multiple FDIC Assisted Acquisitions. Prior to joining Sageworks, he held a key role within Elliott Davis Decosimo's FIG Consulting division, where he provided valuation, accounting, and loan analysis services. Preceding Elliott Davis Decosimo, he was with a multi-billion dollar financial institution, where he worked on acquisitions ranging in size from $130MM to $2 billion, and worked as an auditor with a regional CPA firm.