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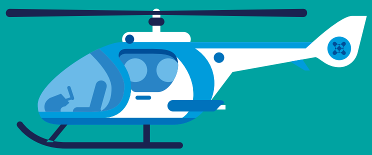

Defining Issues®

FASB Transition Resource Group discusses potential changes to the credit losses standard

June 12, 2018

KPMG reports on the TRG's discussion about estimating credit losses, including accrued interest and the timing of recognition of recoveries.[1]

Applicability

Companies affected by the implementation of the credit losses standard.[2]

Key facts

Some of the main points that TRG members generally agreed on are listed in the chart. Certain of these decisions will require changes to the standard, which would be issued as a proposed codification amendment and subject to due process.

Topic	TRG discussion
Capitalized interest	The allowance for credit losses would not consider unearned interest income that will be capitalized when using a measurement method other than discounted cash flows.
Accrued interest	Accrued interest is included in the amortized cost basis of a financial asset on which the allowance is determined. However, companies should be given options to present accrued interest separately on the balance sheet, and apply disclosure approaches that require less disaggregation than what is currently required. In addition, depending on whether a company applies a nonaccrual policy, the accrued interest on nonaccrual loans would be either reversed through interest income, or treated as a writeoff of amounts deemed uncollectible. This approach would require an amendment to the standard.

1 ASU 2016-13, Measurement of Credit Losses of Financial Instruments. The Transition Resource Group for Credit Losses (TRG) discussed implementation issues on June 11, 2018.

2 ASC 326, Financial Instruments—Credit Losses

Topic	TRG discussion
Transfer of loans and debt securities	On transfer of a loan from held-for-sale to held-for-investment, or on transfer of a credit impaired debt security from available-for-sale to held-to-maturity, a company would reverse any outstanding valuation allowance or allowance for credit losses and establish a new allowance for credit losses. This approach would require an amendment to the standard.
Timing of recognition of recoveries	Expected recoveries on financial assets that have been previously written off could be included in the estimate of the allowance for credit losses. There was mixed feedback from TRG members on whether the inclusion of expected recoveries should be an option or a requirement. This approach would require an amendment to the standard.
Refinancing	When estimating the contractual term for a financial asset, a company is permitted, but not required, to use the framework in US GAAP related to whether a refinancing is a modification of the original loan or a new loan to determine whether an expected refinancing would be considered a prepayment.

Capitalized interest

What is the issue?

For measurement methods other than discounted cash flows, the allowance for credit losses reflects a company's expected credit losses of the amortized cost basis.

The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, and is adjusted for applicable accrued interest, accretion or amortization of premiums, discounts, net deferred fees or costs, collection of cash, writeoffs, foreign exchange and fair value hedge accounting adjustments. Unearned interest income that will be capitalized is not a component of the amortized cost basis.

The TRG discussed how a company should consider interest income that will be capitalized when estimating expected credit losses.

TRG's recommendation

The TRG generally agreed with the FASB staff recommendation that the allowance for credit losses would be calculated based on the current amortized cost basis. Therefore, the allowance would not consider unearned interest income that will be capitalized.

Certain items raised by the TRG members that the FASB staff indicated it will consider include:

— clarifying how a company should apply the general guidance in the standard for considering premiums and discounts when estimating the allowance for credit losses; and

— articulating the rationale for applying an approach for capitalized interest that is different from the guidance for premiums and discounts.

Accrued interest

What is the issue?

Many companies currently present accrued interest receivable as part of 'other assets' on the balance sheet. The standard includes accrued interest in the definition of amortized cost basis, and requires the estimate of the allowance to be deducted from the assets' amortized cost basis to present the net amount expected to be collected.

Stakeholders noted that the inclusion of accrued interest in the estimate of expected credit losses and related disclosures is expected to be operationally burdensome and costly. In addition, regulated financial institutions that follow regulatory nonaccrual policies currently record the reversal of accrued interest in interest income when loans are placed on nonaccrual status. Stakeholders were concerned that these policies would be precluded under the standard.

The TRG discussed:

- whether accrued interest should be included in the definition of amortized cost basis; and
- the reversal of accrued interest on nonaccrual loans.

TRG's recommendation

The TRG generally agreed with the FASB staff recommendation that accrued interest should continue to be included in the definition of the amortized cost basis of a financial asset on which the allowance is determined. However, companies should be given options to:

- compute the allowance on accrued interest separately from other components of amortized cost;
- present accrued interest receivable separately from the loan balance on the balance sheet (however, a company electing this option would disclose the accrued interest receivable amount and its location on the balance sheet); and
- disclose the total amount of accrued interest receivable as part of the vintage disclosures.

In addition, the TRG generally agreed that:

- for regulated companies that apply a nonaccrual policy and nonregulated companies that apply a nonaccrual policy similar to regulated companies, accrued interest on nonaccrual loans should be reversed through interest income, and an allowance for credit losses should not be recognized on accrued interest; and
- when a company does not apply a nonaccrual policy, it should consider accrued interest when estimating the allowance for credit losses, and any reversal of accrued interest should be treated as a writeoff and deducted from the allowance.

Certain items raised by the TRG that the FASB staff indicated it will consider include:

- how the guidance should be applied by companies that do not apply nonaccrual policies for credit cards and other consumer loans but currently reverse accrued interest to interest income when those loans are written off (typically when past due for a specified number of days); and
- how to determine if a nonregulated company has a nonaccrual policy similar to regulated companies.

Transfer of loans and debt securities

What is the issue?

Held-for-sale loans are reported at the lower of the amortized cost basis or fair value. These loans are not in the scope of the standard. Instead, a valuation allowance is recorded for the amount by which the amortized cost basis exceeds the fair value.

When a loan is transferred from held-for-sale to held-for-investment, it is recorded at the lower of the amortized cost or fair value on the transfer date, which establishes a new cost basis. Held-for-investment loans are in the scope of the standard.

If an available-for-sale debt security is impaired (i.e. the security's fair value is less than amortized cost) and a credit loss exists, an allowance for credit losses is recorded. The allowance is limited to the difference between the amortized cost and the fair value.

When a security is transferred from available-for-sale to held-to-maturity it is recorded at fair value on the transfer date, which establishes a new cost basis. Lifetime expected credit losses are recognized for held-to-maturity debt securities.

The TRG discussed whether an allowance for credit losses should be recorded on transfer if a valuation allowance (loans) or allowance for credit losses (securities) had been recognized before transfer.

TRG's recommendation

The TRG generally agreed with the FASB staff recommendation that on transfer of a loan from held-for-sale to held-for-investment, or transfer of a credit impaired debt security from available-for-sale to held-to-maturity, a company would reverse any outstanding allowance or allowances for credit losses and establish a new allowance for credit losses based on the guidance in the standard.

For the income statement, the TRG generally agreed that a company would not be permitted to net the related income statement amounts. The approach agreed to by the TRG would require changes to the standard, which would be issued as a proposed codification amendment and subject to due process.

Example: Loan transferred from held-for-sale to held-for-investment		
Company A purchases a loan for par of $1,000,000 and classifies it as held-for-sale. Subsequently, the fair value declines to $900,000 and a valuation allowance of $100,000 is recorded. At the end of year 1, as a result of a change in management's intention, the loan is transferred from held-for-sale to held-for-investment. On the transfer date, Company A estimates expected credit losses for the held-for-investment loan would be $80,000. Company A records the following entries on transfer.		
	Debit	*Credit*
Loans – held-for-investment	1,000,000	
Loans – held-for-sale		1,000,000
Valuation allowance (lower of cost or market)	100,000	
Other expense		100,000
Credit loss expense	80,000	
Allowance for credit losses		80,000

Timing of recognition of recoveries

What's the issue?

The standard requires a company to:

- deduct the allowance for credit losses from the amortized cost basis of financial assets to present the net amount expected to be collected on the financial assets;
- recognize writeoffs of financial assets in the period in which the financial assets are deemed uncollectible; and
- recognize recoveries of financial assets previously written off when they are received.

The TRG discussed whether expected recoveries from assets that have been written off should be considered when estimating the allowance for credit losses.

TRG recommendation

The TRG generally agreed that expected recoveries on financial assets that had previously been written off could be included in the estimate of the allowance for credit losses.

Certain items raised by the TRG members that the FASB staff indicated it will consider include:

- whether the inclusion of expected recoveries in estimating the allowance for credit losses should be an option or a requirement; and
- whether the expected recoveries of amounts that had been previously written off should be presented as an asset (and not an offset to the allowance for credit losses).

Refinancing

What's the issue?

The standard requires a company to estimate expected credit losses over a financial asset's contractual term, adjusted for prepayments. The standard does not provide guidance about how to define prepayments when estimating expected credit losses.

The TRG discussed whether a company is required to use the US GAAP guidance[3] related to determining whether a refinancing is a modification of the original loan or a new loan to decide whether a prepayment exists when estimating expected credit losses. If a company applied the guidance in current US GAAP and a refinancing was not expected to be considered a new loan, the expected refinancing would not be considered when determining the term over which to estimate expected credit losses.

Alternatively, if the refinancing was expected to be considered a new loan, it would be considered as an expected prepayment when estimating expected credit losses.

TRG's recommendation

The TRG generally agreed with the FASB staff recommendation that the standard should not provide specific guidance about how to consider

[3] ASC 310-20-35-9 - 35-12

prepayments when estimating expected credit losses. The TRG clarified that a company is permitted, but not required, to use the framework in US GAAP related to whether a refinancing is a modification of the original loan or a new loan.

Because a company would be permitted to apply judgment when determining how to consider prepayment, different approaches may be applied for different loan types – e.g. consumer loans versus commercial and industrial loans. A company would also need to provide support for those judgments. The approach agreed to by the TRG would not require the standard to be amended.

Technical inquiries

The FASB staff summarized its responses to recent technical inquiries for which it had determined that no additional work or amendments to the standard were required.

— **Loans and receivables between entities under common control.** The FASB staff clarified that these loans and receivables are outside the scope of the standard for all stand-alone reporting levels – i.e. parent and subsidiary.

— **Gains and losses on subsequent disposition of leased assets.** When estimating expected credit losses for a portfolio of leases, both expected gains and expected losses on dispositions of residual assets would be included in the estimate of expected credit losses.

In response to feedback from stakeholders, the FASB staff indicated that the Board has agreed to discuss the following issues at a future meeting. The FASB staff indicated that some issues may be discussed in July.

— **Fair value option.** Whether to allow a one-time election to apply the fair value option to existing financial assets on adoption of the standard.

— **Effective date for nonpublic business entities.** Whether nonpublic business entities should be given additional transition relief.

— **Operating lease receivables.** Whether billed operating lease receivables are within the scope of the standard.

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KPMG's Financial Reporting View

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