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2009 financial crisis regarding the delayed recognition of credit losses. The new model removes the current GAAP threshold that delays the recognition of a credit loss ...

Aug. 08, 2016

In June, the FASB issued its long-awaited financial instruments impairment standard. The scope of the standard is broad, so while financial services companies will experience the biggest impact, all companies, in all sectors, will need to apply aspects of the new standard. For example, industrial companies will need to apply the new model to their trade receivables.

The impairment guidance will apply to:

- accounts receivable, trade receivables, loans and other financial assets measured at amortized cost,
- loan commitments and certain other off-balance sheet credit exposures,
- debt securities and other financial assets measured at fair value through other comprehensive income, and
- beneficial interests in securitized financial assets.

FASB's objective was to address stakeholder concerns that arose during the 2008-2009 financial crisis regarding the delayed recognition of credit losses. The new model removes the current GAAP threshold that delays the recognition of a credit loss until it is "probable" a loss event has been "incurred," (i.e., the "incurred loss" model), and replaces it with a forward-looking "expected" loss model. This new model is referred to as the current expected credit loss or "CECL" model.

Under the new model, there is no trigger event before booking expected credit losses; rather, they are recognized on day one. This day-one recognition of expected credit losses is likely the most controversial provision of the new guidance.

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losses and subsequent changes to the estimate will be recorded in the P&L.

The new guidance also modifies the impairment model for available-for-sale (AFS) debt securities. It requires an estimate of expected credit losses only when the fair value is below the amortized cost of the asset and credit losses will be limited to the difference between the security's amortized cost basis and its fair value. The length of time the fair value of an AFS debt security has been below the amortized cost will no longer impact the determination of whether a credit loss exists; it is no longer an other-than-temporary model. The AFS debt security model will also require the use of an allowance to record estimated credit losses (and subsequent recoveries). This is a significant change from the current model.

Need for new process and controls

These changes will likely require companies to expend significant effort to develop new processes and controls for estimating expected credit losses, and their application will require considerable judgment as the standard does not prescribe the use of a specific method to make the estimate.

The new impairment model will also impact the accounting for purchased assets with credit deterioration, the definition of which differs from what are called credit impaired assets today, and the impairment model for beneficial interests. The standard will be effective for SEC filers in fiscal years beginning after December 15, 2019.

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