FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout
Codification Improvements—Financial Instruments
November 7, 2018

Meeting Purpose

1. The purpose of this decision-making Board meeting is to discuss feedback received at the November 1, 2018 Credit Losses Transition Resource Group (TRG) meeting and the staff's analysis and recommendations. The Board will address the following implementation issues that were discussed at that meeting:
   (a) Issue 1—Recoveries
   (b) Issue 2—Negative Allowance
   (c) Issue 3A—Vintage Disclosures: Gross Writeoffs and Gross Recoveries
   (d) Issue 3B—Vintage Disclosures: Revolving Loans
   (e) Issue 4—Contractual Extensions
   (f) Issue 5—Discounting Cash Flows When Using a Method Other Than a Discounted Cash Flow (DCF) Method.

2. The Board also will discuss cost-benefit analysis and ask for permission to proceed with drafting a proposed Accounting Standards Update for vote by written ballot.

Questions for the Board
Issue 1: Recoveries
(1) Does the Board believe that Alternative A is appropriate based on the feedback received from the Credit Losses TRG and the staff's analysis?
Issue 2: Negative Allowances
(2) Does the Board believe that an entity should be able to record a negative allowance on financial asset(s), so long as the amount of the negative allowance does not exceed the aggregate amount of previous or expected writeoffs of the financial asset(s)?
Issue 3A: Vintage Disclosures: Gross Writeoffs and Gross Recoveries

(3) Does the Board believe that the credit quality disclosure requirements should be clarified to require an entity to present gross recoveries and gross writeoffs by origination year?

Issue 3B: Vintage Disclosures: Revolving Loans

(4) Does the Board believe that an entity should be required to disclose amounts of line-of-credit arrangements that are converted to term loans by origination year when an additional credit decision was made by the entity?

(5) Does the Board believe that an entity should not be required to disclose amounts of line-of-credit arrangements that are converted to term loans by origination year if no additional credit decision was made by the lender—and, instead, disclose those line-of-credit arrangements in a separate column?

Issue 4: Contractual Extensions

(6) Does the Board believe that an entity should consider unilateral extension or renewal options within the control of the borrower that are included in the original or modified contract when determining the contractual term over which to estimate expected credit losses on a financial asset(s)?

Issue 5: Discounting Cash Flows When Using a Method Other Than a DCF Method

(7) Does the Board believe that further clarifications in the guidance are needed with respect to the role of discounting when using a method other than a DCF?

Cost and Benefits, Permission to Ballot, and Comment Period

Given the additional proposed amendments resulting from the November 1, 2018 TRG meeting:

(8) Does the Board reaffirm that the expected benefits of the changes justify the expected costs of the changes? If not, is there additional information that the Board needs to make that determination?

(9) Does the Board authorize the staff to proceed to draft a proposed Update for vote by written ballot?

(10) Does the Board reaffirm the 30-day comment period previously voted on? If not, what comment period does the Board prefer for the amendments in this proposed Update?

Issue 1—Recoveries

3. Before the TRG meeting on June 11, 2018, stakeholders informed the staff that there was diversity in views on whether future expected cash flows (expected recoveries) from a financial asset that had been written off, or may be written off in the future, should be included in the calculation of expected credit losses under the amendments in Accounting Standards

Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. For a complete background on the Board's decisions and additional stakeholder feedback received leading up to the November 2018 TRG Meeting, please see TRG Memo No. 17, "Recoveries", linked here.

4. Overall, many TRG members stated that the guidance is clear as written (outside of minor changes mentioned in the staff's analysis) and that stakeholders should continue to leverage current practices and historical data regarding recoveries to use as an input for the expected credit losses calculation. Observers and certain TRG members stated that they preferred that the Board prescribe more guidance about which recoveries should be considered in the determination of the allowance for credit losses, including additional examples in the implementation guidance. In response to observers and those TRG members who suggested that the Board amend the guidance in Update 2016-13 to clarify which recoveries should be considered when measuring the allowance, some TRG members stated that providing additional guidance about the scope of recoveries would not be consistent with the intent of the guidance to provide flexibility and scalability in the allowance determination.

5. On the basis of the feedback received from outreach on the questionnaire document and from the November 1, 2018 TRG meeting, the staff believes that the Board should consider two alternative paths forward with respect to issues related to recoveries and the previous tentative Board decisions made at the August 29, 2018 Board meeting. Both alternatives would require the Board to reaffirm its previous decision that an entity is required to consider expected recoveries in the determination of an allowance for credit losses.

   (a) **Alternative A**: Reverse the limitation that recoveries are only from the borrower.

   (b) **Alternative B**: Clarify which recoveries can and cannot be considered.

Issue 2—Negative Allowance

6. At the June 2018 TRG meeting, the staff clarified that an entity could record a negative allowance when measuring expected credit losses. Subsequent to the TRG meeting, stakeholders pointed to the guidance for collateral-dependent financial assets in paragraphs 326-20-35-4 through 35-5 and asked whether entities could have a negative allowance when an entity measures the allowance for credit losses using the fair value of the underlying collateral. This memo addresses the feedback received at the November 1, 2018 Credit Losses TRG meeting related to the issues raised about a negative allowance and the staff's analysis and recommendations for the Board, which are based on that feedback. For a complete background and additional stakeholder feedback solicited, please see TRG Memo No. 17, "Recoveries", linked here.

7. All TRG members and observers stated that an entity should be permitted to record a negative allowance when measuring the expected credit losses for financial asset(s), as long as the negative allowance does not exceed the aggregate amount of previous or expected writeoffs of the financial asset(s). Those TRG members and observers asked for clarification in the guidance to allow an entity to record such a negative allowance when using the fair value of collateral to determine the allowance for credit losses in accordance with paragraphs 326-20-35-4 through 35-5 and when measuring the allowance for credit losses when following the guidance in paragraphs 326-20-30-1 through 30-5.

8. Two TRG members and an observer maintained that a negative allowance arising from an asset previously written off should be presented as a separate asset from the amortized cost basis or the allowance for credit losses. Those TRG members and observers noted that certain financial ratios, such as the coverage ratio, may be skewed if the negative allowance amount is left to offset the allowance for credit losses balance. Other TRG members and observers suggested that an entity could provide clarity to its investors about negative allowances through robust disclosures. In addition, TRG members noted that the financial ratios that would be affected by permitting negative allowances are currently imperfect and that negative allowances would not significantly dilute the usefulness of that financial information.

Issue 3A—Vintage Disclosures: Gross Writeoffs and Gross Recoveries

9. At the November 1, 2018 Credit Losses TRG meeting, the staff discussed with TRG members and observers two issues related to the vintage disclosure table. The first issue included in TRG Memo No. 14, "Cover Memo" was related to a recent technical inquiry. The amendments in Update 2016-13 require entities to disclose the amortized cost basis of their financial assets by class of financing receivable (or major security type), credit-quality indicator, and year of origination. Example 15 in the implementation guidance of Update 2016-13 illustrates gross writeoffs and gross recoveries presented by origination year. A stakeholder asked if gross writeoffs and gross recoveries must be presented by origination year in the vintage disclosure. For a complete background, additional stakeholder feedback received, and staff analysis leading up to the November 1, 2018 Credit Losses TRG meeting, please see the TRG Memo No. 14, "Cover Memo", linked here.

10. The TRG members had mixed views on requiring the disclosure of gross writeoffs and gross recoveries by origination year. Those supporting the disclosure requirement noted that the information is critical to users' understanding of management's ability to estimate expected credit losses over time. Specifically, one TRG member noted that the credit quality disclosures, specifically the vintage disclosure in paragraph 326-20-50-6, becomes significantly less decision useful without the gross writeoffs and gross recoveries by

origination year because a user will not be able to determine the cause of the change in the amortized cost basis of any particular origination year (that is, whether the loans in that origination year were paid down or written off).

11. Many preparers on the TRG noted that the disclosure requirement would be operationally burdensome because the information on gross writeoffs and gross recoveries by origination year is not readily available in their financial reporting systems. Those TRG members stated that their current implementation plans do not include obtaining that data and that the requirement would add significant implementation costs because that type of information may not exist in the form needed for the disclosure or the information exists in a loan system that has not been integrated with the financial reporting system.

12. Overall, all TRG members and observers stated that the disclosure requirement would need to be clarified through a Codification improvement because the guidance as written currently does not require disclosure of gross writeoffs and gross recoveries by origination year. Instead, those TRG members stated that Example 15 in paragraph 326-20-50-79, which includes gross writeoffs and gross recoveries by origination year, depicts one way in which entities may meet the credit quality disclosure requirements in paragraphs 326-20-50-4 through 50-9 rather than prescribing a requirement to disclose particular information.

Issue 3B—Vintage Disclosures: Revolving Loans

13. Stakeholders questioned how an entity should present revolving loans that convert to term loans. Certain revolving loans are converted into a fixed term loan, and stakeholders recommended numerous ways to present this information within the vintage disclosure tables. For a complete background, additional stakeholder feedback received, and staff analysis leading up to the November 1, 2018 Credit Losses TRG meeting, please see the TRG Memo No. 16, "Vintage Disclosures for Revolving Loans", linked here.

14. TRG Memo No. 16, "Vintage Disclosures for Revolving Loans" provided the following views with respect to the issue raised:

    (a) View A: The loans should always be included in the revolving loan totals, even after conversion to a term loan.

    (b) View B: The loans should be presented in the vintage year that corresponds with the start date of the term loan (the conversion date).

    (c) View C: The loans should be presented in the vintage year that corresponds with origination date of the original revolving credit arrangement.

    (d) View D: Lenders should make and disclose a policy election by class of receivable and apply one of View A, B, or C.

(e) View E—Alternative View Raised During Outreach: Term loans should be presented in the vintage year that corresponds with lender's most recent credit decision.

15. In addition, the staff presented a View F in which an entity would be required to disclose amounts of revolving loans that have been converted to term loans in a separate column in the vintage disclosure table.

16. The TRG members and observers agreed with the staff's analysis that View A would not be appropriate. The majority of TRG members and observers expressed support for Views E and F. Those supporting View E noted the conceptual merit of requiring an entity to disclose amounts of revolvers converted to term loans in the origination year corresponding with the most recent credit decision because that disclosure would provide the most useful information to investors. However, some TRG members had concerns about amounts of certain longer duration loans that automatically convert to term loans. Those loans would be presented in the "prior" column in the vintage disclosure table and that would not provide adequate insight into those amounts. Supporters of View F noted that the addition of a column for amounts of revolvers converted to term loans provides an operational approach for disclosing those transactions.

17. On the basis of the feedback at the meeting, the staff suggested another alternative that would combine both Views E and F. That is, an entity would be required to disclose conversions line-of-credit arrangements to term loans within the origination year that corresponds with the entity's most recent credit decision (View E). However, for those conversions from line-of-credit arrangements to term that do not include a credit decision by the entity, the entity would disclose those amounts of line-of-credit arrangements converted to term loans in a separate column on the vintage disclosure table (View F). The staff's suggested alternative was generally agreed to by the TRG members and observers as an appropriate disclosure for those amounts, while also providing an operational way for preparers to disclose such information.

Issue 4—Contractual Extensions

18. At the November 1, 2018 Credit Losses TRG meeting, the staff discussed with TRG members and observers an issue raised by stakeholders regarding the interpretation of contractual term and the explicit guidance that prohibits an entity from extending the contractual term of a financial asset unless there is a reasonable expectation of a troubled debt restructuring (TDR).

19. Stakeholders provided the following scenarios to consider when determining how to clarify existing guidance in Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost:

(a) Scenario A: The financial instrument does not have explicit extension options; however, the lender may have a past practice of renewing or extending the term of the loan.

(b) Scenario B: The financial instrument contains a contractual extension option that provides the borrower with a unilateral right to extend the term of the lending arrangement.

(c) Scenario C: The financial instrument contains a contractual extension option that provides the borrower with a conditional right to extend the term of the lending arrangement. The conditional right may or may not be within the control of the borrower.

(d) Scenario D: The financial instrument contains a contractual extension option that provides the lender with the right to extend the life of the lending relationship.

20. For a complete background and additional stakeholder feedback solicited, please see TRG Memo No. 15, "Contractual Term: Extensions and Measurement Inputs", linked here.

21. Overall, the majority of the TRG members and observers agreed with the staff's analysis that an entity should not consider extensions such as those in Scenarios A and D. Additionally, the majority of the TRG members and observers stated that an entity should consider the contractual extension options that are in the control of the borrower, such as those in Scenarios B and C from TRG Memo No. 15. Some TRG members noted the operational challenges with Scenario C to acquiring the data and performing a probability analysis of (a) whether the contingent event will occur and (b) whether the borrower will exercise those options. Some TRG members also noted that contractual extensions not in the control of the borrower (for example, market-based options, such as the results of the S&P 500 index) would not be considered in determining the contractual term of the financial asset.

Issue 5—Discounting Cash Flows When Using a Method Other Than A Discounted Cash Flow Method

22. At the November 1, 2018 Credit Losses TRG meeting, the staff discussed with TRG members and observers two related issues with respect to the role of discounting when estimating the amount of expected credit losses. Specifically, the TRG discussed whether an entity estimating expected credit losses would be permitted to (a) discount cash flows to a date other than the reporting date (also known as partial discounting) and (b) discount some, but not all, of the expected cash flows when using a method other than a DCF method. For a complete background and additional stakeholder feedback solicited, please see TRG Memo No. 14, "Cover Memo", linked here.

23. In the initial submission to the FASB, stakeholders noted that certain regulatory guidance requires entities to discount certain cash flows to a date other than the reporting date. These stakeholders noted that aligning credit loss estimation data for accounting purposes with regulatory requirements would reduce costs for preparers and ease the burden of adopting the amendments in Update 2016-13.

24. Most TRG members agreed that partially discounting cash flows to a date other than the reporting date should not be permitted, even if this methodology is used for regulatory reporting purposes. Many of the TRG members noted that it would be difficult to support partial discounting on a conceptual basis. Some preparers noted that allowing partial discounting would ease the cost and operational burden of adopting the amendments in Update 2016-13 because their loss-given-default data already includes partial discounting. Also, a representative from a credit union noted that, where possible, it would be preferred to align the accounting and regulatory guidance.

25. Much of the discussion at the TRG meeting also centered on how much flexibility the Board intended to provide with respect to the method of estimating expected credit losses. Some TRG members interpreted paragraphs 326-20-30-4 through 30-5 to provide entities with the choice of using either a DCF method or a method that does not employ any discounting while other stakeholders interpreted those paragraphs to allow for either a DCF method or other methods, which may or may not include the effects of discounting.