WILARY WINN LLC

# Recent Developments Related to the Accounting for Acquired Assets

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As many participants in the financial institution industry are aware, the current expected credit loss ("CECL") model under Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, became effective for all private entities on December 15, 2022, after becoming effective for most public entities on December 15, 2019. This new accounting standard requires companies to record estimated lifetime credit losses for all financial instruments rather than incurred losses, which was the previous requirement under the old standard. Among other amendments, CECL also amended certain parts of the codification related to *Business Combinations (Topic 805)*, that sets forth the purchase accounting rules which requires that all acquired assets and assumed liabilities be reported at their respective fair values. More specifically, CECL initially required that institutions apply separate accounting treatment to any acquired financial assets that "have experienced more-than-insignificant deterioration in credit quality since origination." This separate accounting treatment for acquired financial assets under CECL was called the purchase credit deteriorated ("PCD") framework. However, as discussed in a recent blog post, FASB recently tentatively eliminated the distinction between PCD and non-PCD assets, thus all acquired financial assets are required to be accounted for using the separate framework under CECL.

Additional developments continue to occur related to clarifying the interaction between CECL and purchase accounting. On October 12, 2022, FASB tentatively decided to change the term from PCD to purchased financial assets ("PFA") when referencing the accounting framework for acquired financial assets under CECL. In addition, FASB tentatively decided that seasoning should be defined through a principles-based approach that considers the acquirer's involvement with the purchased financial assets prior to acquisition. This decision comes after FASB decided that seasoning should be incorporated in determining whether an acquired financial asset falls under the PFA framework. In addition, FASB tentatively decided that revolving loan types, such as credit cards and home equity lines of credit, should be included under the PFA framework.

**Ultimately, FASB tentatively decided that all financial assets acquired in a business combination or asset purchase are presumed seasoned. Thus, generally all loans acquired in these types of transactions must be accounted for using PFA accounting.**

One of the main objectives of CECL was to provide stakeholders with more decision-useful information about the expected credit losses of financial assets using a single measurement model. This single model approach contrasts with the incurred loss methodology, which was the previous accounting framework for estimating credit losses. Under this methodology, there were five different impairment models for various types of financial assets. These numerous impairment models burdened institutions with added intricacies when determining their loan loss reserve estimates, which prompted FASB to look for ways to simplify the reserve estimation process while still enhancing decision-usefulness. One of these impairment models that was ripe for replacement was the relatively complex purchase credit impaired ("PCI") model, which FASB supplanted with the PFA framework.

As discussed in a previous blog post, CECL accounting for acquired loans under the PFA framework requires institutions to bifurcate the discount rate component and credit component from the purchase discount. The discount rate portion will be allocated to each PFA loan and recognized on a level yield basis over the life of the loan. The credit component will not be accreted into interest income; instead, it will be added to the PFA loan's purchase price with the offset included in the allowance for credit losses. This accounting treatment for PFA loans provides a two-fold benefit to institutions. First, initial recognition of measurement of the acquired financial assets is simplified due to institutions no longer needing to account separately for acquired financial assets with lower credit quality, as was the case with the PCI model. Additionally, the ongoing accounting is also simplified due to the alignment of PFA accounting with CECL. More specifically, the credit portion of these PFA loans will be included in the institution's allowance for credit losses on day one with any increase or decrease in expected credit losses being reflected through provisioning or releasing the reserve in the same manner as originated assets.

**The change in accounting simplifies the day one and ongoing accounting for acquired loans, as compared to the previous PCI accounting. All acquired loans, regardless of credit quality, now fall under the PFA framework, with institutions now recording any portion of the discount related to expected credit losses as an increase to basis with the difference being booked to the ACL. Then on an ongoing basis, any increases in expected credit losses will be booked to the ACL as well, while continuing to accrete the interest rate portion of the purchase discount into interest income on a level yield basis. Conversely, any future improvements in expected credit losses will flow directly through income as a reduction to the ACL.**

Ultimately, these decisions by FASB related to the PFA framework have yet to be finalized as amendments to the CECL standard as of the date of this blog. These tentative decisions from FASB are provided for the information and convenience of stakeholders who want to follow the FASB's deliberations. FASB decisions become final only after a formal written ballot to issue a final Accounting Standards Update. We encourage institutions to collaborate with their auditors in order to determine how they will account for acquired financial assets upon CECL adoption in the interim period prior to a final decision from FASB.

**These changes are not yet finalized, but FASB has stated that it will continue to deliberate the accounting framework at future meetings. Now that CECL has become effective for all financial institutions, we hope that FASB will issue final decisions in the near future, as these changes are rather significant. We currently encourage institutions to work with their auditors when accounting for acquired financial assets while we await a final decision from FASB.**

Finally, we recognize that the PFA framework represents a significant change for how institutions will account for acquired loans; however, we note that our discounted cash flow models have always separated the interest rate component from the credit component in our detailed loan valuations. Thus, we believe our experience performing these loan valuations positions us very well to aid our clients as they navigate PFA accounting, as well as overall CECL adoption. For additional information regarding CECL and the services we offer, please visit our website at https://wilwinn.com/services-overview/cecl-alm/credit-risk/.