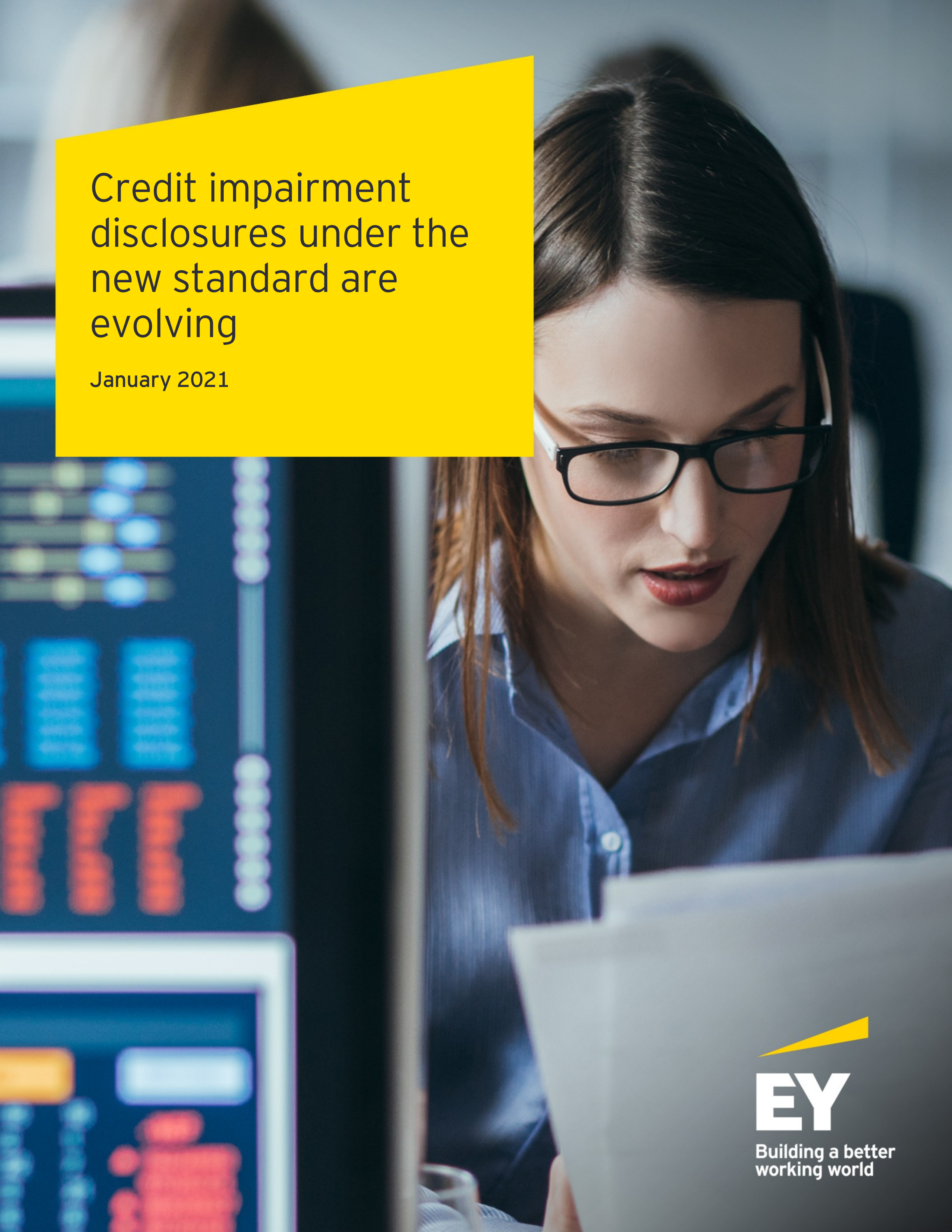

Credit impairment disclosures under the new standard are evolving

January 2021

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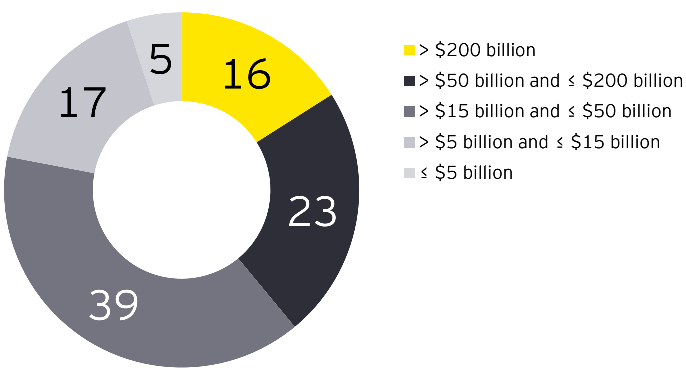
Overview

In our review of third-quarter credit impairment disclosures made by 100 companies that extend significant amounts of credit, we did not find significant changes from the first disclosures the companies made under the new standard. However, the companies in our sample made more disclosures about loan deferrals and modifications related to the impact of COVID-19 on economic conditions, and we expect disclosures to continue to evolve as the needs of users and the views of regulators become clearer.

This publication updates our *Review of the first wave of credit impairment disclosures under the new standard* that we issued in June 2020. That publication focused on the disclosures calendar-year Securities and Exchange Commission (SEC) filers that adopted the new credit impairment standard[1] on 1 January 2020 made under the new standard in SEC filings for the first quarter of 2020.

In this publication, we summarize the findings of our review of third-quarter disclosures made by the same 100 companies. Our sample included the top 25 banks measured by assets, 69 other banks of varying sizes and six other companies with long-term financing receivables.

Number of entities in our sample, by total assets in Q3 2020



More disclosures on loan deferrals and modifications due to the pandemic

Many entities provided disclosures about loan modifications, deferrals and forbearances they made due to the deterioration in economic conditions in the US and worldwide caused by the COVID-19 pandemic.

In many cases, the companies did not classify these modifications as troubled debt restructurings (TDRs) due to the relief provided in Section 4013 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the clarification provided in the 7 April 2020 *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working With Customers Affected by the Coronavirus (revised)* and, therefore, didn't include them in the required disclosures on TDRs.

However, many companies disclosed details of their modification programs and quantified their impact. These disclosures were located both in the Management's Discussion and Analysis (MD&A) and footnote sections of filings. Because the CARES Act relief related to TDRs was extended by the Consolidated Appropriations Act, 2021, we expect most loan modifications made through the end of 2021 to not be classified as TDRs.

SEC officials have been encouraging companies to make clear disclosures about the impact of COVID-19 on their operations, which for companies that extend significant amounts of credit would include disclosures about loan modifications and their allowance for loan losses (ALL). Therefore, we expect some companies might expand their disclosures about their modification programs in future filings. Below is an example of the more expansive disclosures certain entities in our sample made in the third quarter:

Example disclosure about modification programs

Loan portfolio segment	No. of loans modified	$ balance modified (in thousands)	% of loan segment	Description of modification program	% Now out of program and current	% on 2nd modification
Commercial — Geography A	10,100	500,600	3.1%	3-month forbearance of interest, due at end of term	85%	12%
Commercial — Geography B	4,800	365,800	4.2%	No payments (P+I) for 4 months, due at end of deferral period	82%	10%
Consumer — Mortgages	15,070	800,900	5.1%	3-month forbearance of interest, due at end of deferral period	75%	16%
Consumer — Other	22,350	613,200	1.8%	No payments (P+I) for 6 months, due at end of term	91%	5%

EY observation

While companies are not required to make the extensive disclosures required for TDRs if they don't classify loan modifications as TDRs, they should continue to evaluate whether additional disclosure is necessary for modification programs available to borrowers that have been impacted by COVID-19. Information regarding the credit performance of the portfolio is important to users of the financial statements.

Non-accrual policies

Given the high volume of loans that have been modified to defer principal and interest payments due to COVID-19, banks have had to reconsider their policies for when to put loans on non-accrual status. That is, management has had to evaluate whether it expects to collect all contractual principal and interest for loans that have been modified but aren't classified as TDRs. This may be a change from historic practice, when banks typically applied a bright-line policy such as putting any loan past due for more than 90 days on non-accrual status.

In the third quarter, some companies provided details about their non-accrual policies for loans in COVID-19 modification programs, but others were silent. For example, some companies disclosed a policy that loans that were performing before the modification continue to accrue interest during the deferral period. Companies that did not make disclosures about their non-accrual policy for COVID-19-related modified loans should consider doing so in future reporting periods.

Forecasts

The new credit impairment guidance in Accounting Standards Codification (ASC) 326 requires an entity to incorporate reasonable and supportable forecasts of future economic conditions into the estimate of expected credit losses, considering factors that would affect the borrowers. Entities are required to provide a discussion of the factors that influenced management's current estimate of expected credit losses, including past events, current conditions and reasonable and supportable forecasts of future economic conditions.

Most entities described the macroeconomic factors they used in their forecasts. The types of macroeconomic factors (e.g., unemployment rates, gross domestic product) disclosed by companies in our sample did not significantly change from the first quarter to the third quarter. There were also no significant changes to the number of entities that disclosed the use of a third-party forecast or the use of multiple economic scenarios.

However, more companies in our sample quantified at least some of the key macroeconomic inputs they used in the third quarter. Some entities provided macroeconomic factors from the base case scenario, while others provided the inputs for multiple scenarios.

34% Q3

Quantified macroeconomic inputs used in their forecasts

23% Q1

Quantified macroeconomic inputs used in their forecasts

Based on our discussions with certain preparers, we understand that it could be difficult for entities to quantify the macroeconomic inputs they used in their reasonable and supportable forecast. That is because many companies adjust their allowance estimate to incorporate a weighting of multiple economic scenarios, either in their reasonable and supportable forecast or through a qualitative adjustment to the ALL estimate. Users of financial statements should understand that disclosures may not be comparable between companies for this reason.

EY observation

The guidance requires a reasonable and supportable forecast of future economic conditions to be based on management's forecast, not a market-consensus view. Therefore, it is important for entities to provide disclosures that allow users to understand management's view of future economic conditions. This is even more important when management's view differs from the consensus and when economic conditions are changing quickly.

Reasonable and supportable (R&S) period and reversion

Most companies in our sample continued to disclose the period covered by their reasonable and supportable forecasts.

Based on our conversations with certain preparers, we understand that some companies considered changing their reasonable and supportable forecast period due to the higher level of uncertainty in the economic conditions. However, most companies in our sample continued to indicate that they used the same forecast period in the third quarter as they did in the first quarter. Most companies also indicated that they used the same forecast period across all of their segments and classes of loans.

The new standard states that, for periods for which an entity is no longer able to forecast economic conditions, the entity cannot estimate zero credit losses. It also states that, when the reasonable and supportable forecast is no longer a better estimate of expected credit losses than using historical loss information, entities should revert to historical loss information for the remaining contractual term of the financial asset. Most entities in our sample that disclosed a reversion method in their third-quarter filings said they would use a straight-line reversion method to go from their forecast to historical loss information, as they did in their first-quarter filings. A few entities said they would use an immediate reversion technique.

As a reminder, the R&S forecast period and reversion methodology are not accounting policy elections and should be changed as part of the allowance estimate.

Sensitivity

Small changes to key assumptions can result in significant changes to the ALL. The new standard doesn't require entities to make disclosures about sensitivity analyses they perform, but 10% of the companies in our sample chose to disclose (either in MD&A or the notes to the financial statements) how those changes would impact their ALL. The number of companies making this disclosure was the same as in the first quarter.

Some of the companies in our sample illustrated sensitivity by disclosing the impact of changes in economic variables and risk ratings on their ALL. Other entities shared regulatory stress testing results to help users understand how the ALL would change if economic conditions deteriorated further.

10%

Disclosed quantitative sensitivity analyses
(No change from Q1 2020)

Pooling considerations

Disclosures about pools of loans with similar risk characteristics continued to be limited, and only a few companies made disclosures about changes in how they pooled financial assets that shared similar risk characteristics, what risk characteristics drive risk of loss and other pooling considerations.

As a reminder, ASC 326 requires financial assets that share similar risk characteristics to be pooled for purposes of calculating an allowance. This pooling is meant to be dynamic, meaning it should change as the characteristics of assets change.

Companies should consider whether they need to adjust their pools as the economic environment changes. Additionally, if they make changes, companies should consider whether it is appropriate to disclose the changes.

Looking ahead to next quarter

As part of its post-implementation review process, the Financial Accounting Standards Board (FASB) performed outreach to stakeholders on the credit impairment standard. At a FASB meeting in December 2020, the FASB staff summarized this feedback, saying in part that users expressed a desire for more quantitative disclosures and were concerned about the lack of comparability between entities' disclosures. Based on this feedback, the FASB may perform more outreach and may consider whether enhanced disclosure requirements are needed. We encourage entities to monitor developments.

The staff also cited feedback questioning whether the special accounting for TDRs is necessary now that companies have to estimate lifetime current expected credit losses under ASC 326. Companies should also monitor developments on this topic. With the extension of the TDR relief provided in Section 4013 of the CARES Act, we expect disclosures about TDRs and reasonably expected TDRs to be minimal.

The effects of all executed modifications should be reflected in the allowance estimate. In addition, companies that identify a reasonably expected TDR should make sure they reflect all effects of the reasonably expected TDR in the ALL.

Additionally, with the extension of TDR relief, disclosures about non-accrual policies for COVID-19-related modified loans will continue to be relevant.

For a majority of entities, implementing ASC 326 involved significant effort and required enhancements to processes and controls. The timing of the COVID-19 pandemic complicated their accounting and disclosures. We expect disclosures to continue to evolve, as the needs of users and the views of regulators become clearer.

Endnotes:

[1] Issued as Accounting Standards Update 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* and codified as ASC 326.

The standard was effective for SEC filers, other than smaller reporting companies, for annual periods beginning after 15 December 2019. For all other entities, the standard is effective for annual periods beginning after 15 December 2022. The CARES Act provided optional temporary relief from adopting ASU 2016-13. From the date of enactment of the CARES Act to the earlier of 1 January 2022 or the first date of the fiscal year that begins after the date on which the COVID-19 national emergency terminates, an insured depository institution, bank holding company or affiliate thereof can choose not to comply with ASU 2016-13.

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