

To the Point

FASB – proposed guidance

FASB proposes expanding the gross-up approach in ASC 326 to almost all acquired financial assets

The proposal addresses stakeholder concerns raised in the Board's post-implementation review of its credit losses standard.

What you need to know

- ▶ The FASB proposed requiring entities to apply the gross-up approach in ASC 326 to all financial assets acquired in a business combination and those acquired in an asset acquisition or recognized through the consolidation of a variable interest entity that is not a business, if they meet certain seasoning criteria, with limited exceptions. Today, the approach is applied only to purchased financial assets with credit deterioration.
- ▶ To be considered seasoned, financial assets would have to be acquired in an asset acquisition or recognized through the consolidation of a variable interest entity that is not a business (with limited exceptions) more than 90 days after the origination date and if the entity was not involved with the origination.
- ▶ The model would apply to acquired credit cards and other revolving credit arrangements, trade accounts receivable, contract assets, and sales-type and direct financing leases. However, it would not apply to available-for-sale debt securities.
- ▶ The proposal would be applied on a modified retrospective basis to all prior periods presented in financial statements for which an entity has adopted ASU 2016-13.
- ▶ Comments are due by 28 August 2023.

Overview

The Financial Accounting Standards Board (FASB or Board) **proposed**¹ amendments to Accounting Standards Codification (ASC) 326,² *Financial Instruments – Credit Losses*, that would eliminate the criterion limiting the use of the gross-up approach to purchased financial

assets with credit deterioration (PCD). Instead, an entity would apply the gross-up approach to all assets acquired in a business combination and to those acquired in an asset acquisition or recognized through the consolidation of a variable interest entity (VIE) that is not a business, if they meet certain seasoning criteria.

The proposal is aimed at addressing concerns stakeholders raised during the FASB's post-implementation review of the credit losses standard about the complexity of applying the current guidance and the lack of comparability in the accounting for PCD and non-PCD assets.

Under current GAAP, a financial asset acquired in a business combination, acquired in an asset acquisition or recognized through the consolidation of a VIE that is not a business is accounted for using the gross-up approach only if the asset has experienced a more-than-insignificant deterioration in credit quality since origination. The gross-up approach requires an entity to record an allowance for credit losses at the acquisition date and an offsetting entry as an addition to the amortized cost basis of the PCD asset (i.e., the initial amortized cost basis is the sum of the purchase price and allowance for credit losses). In contrast, the allowance for credit losses of a non-PCD asset is separately recorded through a credit loss expense at the acquisition date.

Stakeholders said the existence of two accounting approaches (PCD and non-PCD) causes complexity and impacts comparability, and the non-PCD accounting that results in a Day 1 credit loss expense for non-PCD assets (i.e., acquired assets that have experienced insignificant credit deterioration or credit improvement since origination) is not intuitive.

The FASB said a uniform approach for purchased financial assets would provide better financial information, respond to investors' concerns about comparability and be more in line with its intent when it created the credit losses guidance with Accounting Standards Update (ASU) 2016-13.³

The proposal would not change measurement, presentation or disclosure requirements for acquired financial assets that are accounted for using the gross-up approach.

Key considerations

Scope

The gross-up approach would apply to all acquired financial assets (with limited exceptions) in the scope of ASC 326-20⁴ that are deemed "seasoned" (see discussion below). Acquired financial assets would include credit cards and other revolving credit arrangements, trade accounts receivable, contract assets, sales-type lease receivables and direct financing lease receivables. The Board noted that stakeholders have expressed concern about the operational complexities in applying the gross-up approach to credit cards and other revolving credit arrangements.

The approach would not apply to available-for-sale (AFS) debt securities, including beneficial interests classified as AFS.

Seasoning criteria

The proposal would require acquired financial assets that are "seasoned" to be accounted for using the gross-up approach. The Board concluded that financial assets acquired in a business combination would be presumed seasoned, and therefore, the gross-up approach would apply to them.

For financial assets acquired in an asset acquisition or recognized through the consolidation of a VIE that is not a business, the proposal would require entities to apply seasoning criteria to identify those assets that are economically similar to originated assets and, therefore, would not qualify for the gross-up approach. The seasoning criteria would include a bright-line time-based threshold of 90 days and a qualitative assessment by the entity of its involvement with the origination of the financial asset.

The 90-day bright line is intended to identify financial assets that do not have sufficient historical performance to allow an entity to objectively assess any fundamental change in the characteristics of the assets since origination. Financial assets acquired within 90 days of origination would be accounted for in a manner similar to those originated by the acquirer. Financial assets acquired more than 90 days after origination would be deemed seasoned and, therefore, would be accounted for using the gross-up approach, if the acquirer was not involved with the origination of the assets.

The proposal includes examples of factors an acquirer should consider in assessing its involvement in the origination of an acquired financial asset, such as:

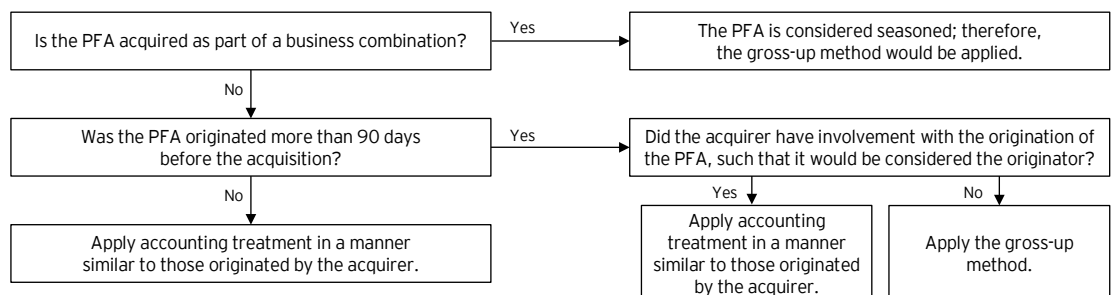
- ▶ The acquirer’s direct or indirect exposure to economic risks and rewards of ownership before the acquisition
- ▶ The nature of the relationships between transacting entities and the acquirer’s ability to influence the originator’s underwriting standards
- ▶ The contractual terms of the transaction
- ▶ The existence of funding arrangements between the acquirer and the originator
- ▶ The existence of a loss-sharing arrangement where the acquirer shares principal loss incurred by the originator before acquiring the financial asset
- ▶ The existence of a make-whole arrangement where the acquirer is obligated to reimburse the originator upon termination of its purchase of the financial asset

How we see it

While the 90-day threshold would make it simpler to determine whether an acquired financial asset is seasoned, the qualitative assessment by the acquirer of its involvement with the origination of financial assets acquired after the 90-day period would require judgment and consideration of all relevant facts and circumstances.

Transactions between related parties or entities under common control would likely not meet the seasoning criteria and, therefore, would not qualify for the gross-up approach.

The following decision tree shows how an entity would determine whether a purchased financial asset (PFA) should be accounted for using the gross-up approach under the proposed amendments.



Transition and effective date

For entities that have adopted ASU 2016-13, an effective date will be determined after the Board considers stakeholder feedback. For entities that have not yet adopted ASU 2016-13, any final amendments would have the same effective dates as ASU 2016-13.

Entities would apply the proposed amendments on a modified retrospective basis to all prior periods presented in the financial statements for which an entity has adopted ASU 2016-13. If necessary, a cumulative adjustment would be recorded as of the later of (1) the beginning of the reporting period the entity adopted ASU 2016-13 or (2) the beginning of the earliest period presented in the financial statements.

How we see it

Depending on the effective date of any final guidance, it may be difficult for entities that have completed business combinations or asset acquisitions or have consolidated VIEs that are not businesses after adopting ASU 2016-13 to perform the calculations necessary to apply the proposed guidance on a modified retrospective basis.

Endnotes:

- ¹ [Proposed Accounting Standards Update, *Financial Instruments – Credit Losses \(Topic 326\): Purchased Financial Assets*](#).
- ² ASC 326, *Financial Instruments – Credit Losses*.
- ³ ASU 2016-13, *Financial Instruments – Credit Losses*.
- ⁴ ASC 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*.

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