Missouri Independent Bankers Association
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# Key Year-End Accounting and Tax Issues for Financial Institutions

## *From CECL to Information Reporting, Financial Institutions Face Major Changes*

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On Nov. 3, 2015, RSM held our annual Financial Institutions Accounting and Tax Update. Following is an overview of key issues covered. **For more detail, you can listen to the recorded webcast.**

1. **Upcoming Financial Accounting Standards Board (FASB) guidance on accounting for financial instruments—classification and measurement**

Final guidance on this issue is expected from the FASB very soon, possibly by the end of 2015. One of the biggest changes from current rules will be the requirement that virtually all equity securities must be carried at fair value through net income. There is a practicality exception for certain securities for which a fair value cannot be readily determined. Those will be measured at cost less any impairment and adjusted as necessary for observable changes in price. Other changes include:

- The treatment of deferred tax assets (DTAs) is changed. Available-for-sale DTAs must now be evaluated in conjunction with all other DTAs. They can no longer be isolated and considered separately.
- When using the fair value option, any change in fair value caused by instrument-specific credit risk, which is currently reported as part of net income, will now be reported as part of other comprehensive income (OCI) and transferred to earnings if settled before maturity.
- Changes to disclosure requirements:
  - Financial assets face new disclosure requirements by measurement category and form.
  - Public business entities (PBEs) will be required to disclose the fair value of any amortized-cost financial instruments computed in accordance with FASB Accounting Standards Codification 820 (ASC 820). This will not be required for short-term receivables, payables or demand deposit liabilities. This may be a significant change for entities that have not previously prepared these disclosures using an exit price model. Non-PBEs will be exempt from this disclosure requirement.

In a significant change from the original exposure draft, the existing guidance for classification and measurement remains unchanged for many categories of financial instruments, including:

- Loans
- Debt securities
- Hybrid financial instruments and embedded derivatives
- Fair value option (with some modifications)
- Loan commitments
- Revolving lines of credit
- Commercial letters of credit
- Foreign currency gains and losses on debt securities classified as available for sale (AFS)

Financial institutions should assess the impact of the changes in classification and measurement of financial instruments in three key areas:

- First, determine the extent to which the changes regarding equity securities will result in income statement volatility.
- Second, check whether revised treatment of DTAs may affect your future analysis.
- Third, if you are a PBE, develop an exit-price model for financial instruments measured at amortized cost in accordance with ASC 820.

2. **Accounting for credit impairment**

Final guidance on accounting for credit impairment is expected from FASB in the first quarter of 2016 and will mark a substantial change for financial institutions. FASB's proposed Current Expected Credit Loss (CECL) guidance will present significant new financial reporting and accounting challenges, and require financial institutions to re-think the way they measure and reserve for credit losses. CECL is likely to result in a significant increase in the allowance for loan losses for many financial institutions, many current estimates indicate an increase of perhaps as much as 20 to 50 percent.

Financial institutions will need to apply CECL to virtually all financial assets measured at amortized cost, including:

- Loans and loan commitments
- Lease receivables
- Held-to-maturity debt securities (The current other-than-temporary-impairment (OTTI) model, with some modifications, will be retained for available-for-sale debt securities.)

Under CECL, financial institutions must estimate losses based on a current estimate of contractual cash flows that are not expected to be collected over the life of the asset. There is no threshold for recognition—all losses will be recorded, even if the likelihood of that loss is remote. Financial institutions will have to estimate a loss for virtually all assets in scope of this guidance.

Determining the life of the loan will be a critical part of the process as it sets the timeframe over which losses must be estimated. The life of the loan should be the contractual term reduced for estimated prepayments. Extensions or renewals should only be considered if the lender expects to modify the loan through a troubled debt restructuring.

Financial institutions should start with historical life-of-asset loss rates, including:

- Decide how to group assets with similar risk characteristics
- Define the appropriate historical period to use with each asset group
- Determine how to weight historical experience

Lenders will then need to consider how current and forecasted conditions will differ from those during the historical period and adjust their loss estimates accordingly.

Vintage analysis may be a valuable approach, but is not required. Lenders can choose from a variety of methods, including cash-flow, loss-rate and probability-of-default methods, among others. Approaches can vary by portfolio segment. For example, an institution may elect to use vintage analysis for the consumer loan portfolios, and a probability of default model for the commercial operating line portfolio.

Because of the scope of this change, financial institutions should be preparing now to address it. Start by gathering data by asset type, including:

- Lifetime historical loss information
- Prepayment and average life data
- Correlation of historical losses to economic and underwriting conditions

Financial institution boards should understand and track management's plans to address CECL. They may wish to consider whether changes in lending philosophy are warranted, especially concerning loan duration and pricing. Because CECL also applies to held-to-market investments, boards may also wish to consider changes to their investment approach and the potential impact CECL may have on capital planning.

**For more information on how to respond to CECL, see our white paper, Financial institutions need to think about CECL now to plan effectively.**

3. **Are you a PBE?**

Financial institutions that are PBEs face a variety of issues. They:

- Cannot adopt FASB Private Company Council standards
- May face earlier effective dates for new standards
- May have expanded disclosure requirements

Whether your institution is a PBE may not be as cut-and-dried as you think, especially when it comes to criteria d and e of FASB's Definition of a Public Business Entity. Criteria d states that an entity is a PBE if "It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market." For financial institutions, such securities could include:

- Over-the-counter stock
- Debt
- Negotiable CDs
- Any instrument involving a broker

Criteria e states that an entity is a PBE if "It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion."

**4. Tax concerns**

Following are four tax issues financial institutions should consider now:

**A.** Favorable guidance on bad debt charge-offs

IRS Large Business and International Directive 04-1014-008 gave guidance that is very favorable to financial institutions regarding bad debt. Per this directive, financial institutions can take an approach in full conformity with GAAP/RAP when addressing bad debt, eligible debt securities and other real estate owned (OREO). This offers a variety of potential tax benefits:

- It allows for the concept of the credit impairment element that discounts future cash flow estimates and then re-establishes the debt as an earning asset using its original yield.
- It allows for the including estimated selling costs when arriving at the charge-off amount.
- While the guidance does not address nonaccrual interest, many believe it is covered since interest accrued forms part of a loan's tax basis.

Financial institutions that did not consider these issues can retroactively realize tax benefits by amending their 2014 tax returns.

**B.** Information reporting issues

There is no change by the Department of the Treasury in the status of proposed regulations issued in October 2014 that would eliminate the 36-month nonpayment testing period as a triggering event requiring information reporting for discharge of indebtedness. Do not change your systems or protocols for 1099-C reporting. Be sure to continue to check the box on Form 1099-C indicating that you are still pursuing collection.

There is an open question as to whether lenders should report interest capitalized to a new or modified loan with the same lender should be reported on Form 1098.

Penalties for unfiled or erroneous information returns will double for returns due after Dec. 31, 2015. (**See our tax alert for more information.**)

**C.** Three key tax risks

Be careful to track any "book-tax" differences, especially with respect to mergers and acquisition. This is a key area of focus with the IRS.

The IRS is also paying close attention to fiduciary returns (e.g., corporate and individual trust tax returns).

As mentioned above, fines are doubling for late or unfiled information returns.

**D.** Tax best practices

Consider an independent review of the adequacy of any FASB Interpretation No. 48 reserves, including those for state tax exposure.

Involve internal audit when appropriate, especially with respect to items such as third-party information returns and unclaimed property.

Consider holding annual or more frequent state of the tax function meetings with the board as a whole, or with an appropriate committee, such as the audit committee.

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