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Banks Must Brace for Potential Change to Credit Loss Accounting

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A contentious piece of the accounting framework concerning credit losses, known as Topic 326, is on the cusp of creating a significant shift following a decision by the Financial Accounting Standards Board in February.

Despite reservations from the accounting sector, FASB advanced its proposal to revise accounting for purchased financial assets—a more unified approach that came after investment analysts and accountants called for changes to the existing rules.

FASB says the proposal would simplify accounting for acquired financial assets by modifying the "gross-up approach." This would uniformly apply the gross-up method to most all assets in a business combination and eliminate the requirement to assess assets for "more-than-insignificant" credit decline since origination.

As FASB mulls the proposal, it's an excellent time to take a close look at its biggest potential impacts.

Alignment of acquisition methods. The amendment seeks to unify the accounting process for all acquired financial assets. The current approach differentiates between purchased financial assets with credit deterioration, or PCD, and those without, requiring distinct accounting treatments for each.

The proposed change would eliminate this distinction, alleviating complexities in the initial measurement and ongoing accounting for credit losses—all assets would uniformly be accounted for at fair value, with credit losses recognized similarly over time.

Gross-up approach extension. The proposed change would extend the gross-up approach, which has applied only to PCD assets, to all acquired financial assets. This means companies would recognize an allowance for expected credit losses and adjust the asset's amortized cost basis, regardless of the asset's credit quality at acquisition.

Simplification of criteria. The amendment would eliminate subjective criteria for determining significant credit quality deterioration. This change likely would reduce complexity and make applying current expected credit losses, or CECL, methodology more intuitive.

Increased comparability and transparency. By adopting a single method for handling the initial measurement of acquired financial assets, the comparability of financial statements likely would improve, enhancing investors' understanding of a company's financial health by clarifying credit risk management.

Impact on financial reporting. Adopting the proposed changes could cause noticeable shifts in reported earnings following an acquisition. By standardizing the accounting for all acquired financial assets, the proposed amendments would lead to consistent treatment for initially recognizing credit losses and the subsequent interest income, which may differ from existing disparate treatment for PCD and non-PCD assets.

That could impact key financial metrics and ratios that analysts and investors use to assess a company's performance. These alterations would require careful consideration by companies as they report financial results and by stakeholders as they interpret these results.

Regulatory concerns. Certain regulatory bodies, notably the Office of the Comptroller of the Currency and the Federal Reserve, cautioned against the proposed modifications to the CECL standards. They highlight risks associated with postponed loss recognition in bank mergers, which could affect the overall safety and soundness of the banking system. For accounting professionals, this regulatory focus requires heightened awareness and adaptation to potential changes in the reporting of expected credit losses.

Implementation challenges. Large financial institutions such as Bank of America Corp. and J.P. Morgan Chase & Co. raised concerns that changing the accounting for acquired financial assets could be both costly and time-intensive to implement. They've highlighted the difficulties of adapting current systems to the broad scope of the new rules, which are expected to encompass an array of purchased assets, including complex and diverse portfolios like those of credit cards.

This expansion to a uniform treatment poses significant operational challenges, from system upgrades to increased demands on staff training and compliance. These changes could impact institutions' risk management, financial reporting, and overall market perception, with potential implications for their operational efficiency and regulatory standing.

Market perception and clarity. Some financial institutions supported the proposed changes, saying they would address the current "uneconomic" issue of double counting credit marks on performing assets, offering clearer insights to investors. Others in the industry suggest the existing accounting treatment is both confusing and fails to reflect economic reality.

In response, FASB is contemplating ways to enhance the proposal's acceptance among detractors. This could involve carving out exceptions for specific acquisition types, such as credit card portfolios, in the new accounting rules. Such adjustments likely would influence both the transparency and complexity of financial reporting, with potential ripple effects on investor trust, and the overall market's interpretation of financial institutions' health and performance.

Enhanced M&A efficiency. By eliminating the need to differentiate between PCD and non-PCD assets, banks could integrate the financial assets of acquired entities more efficiently. The uniform accounting treatment for all acquired financial assets might lead to quicker assessments and faster post-acquisition integration, increasing the pace of mergers and acquisitions. This could encourage more deals as the complexity and time involved in the accounting aspects of due diligence and financial integration are reduced.

However, it's essential to monitor for any regulatory guidance on how this change would intersect with banks' capital requirements and regulatory frameworks to ensure that the simplified accounting doesn't obscure actual financial risk associated with acquisitions.

Reassessment of risk management strategies. The upcoming amendments to Topic 326 are poised to transform the methodology for calculating and disclosing credit losses, so financial institutions must undertake a comprehensive review of their risk management frameworks. This reassessment will likely span across several core areas, such as loan origination practices, which may need adjustment to accommodate more granular and forward-looking credit assessments.

Likewise, underwriting standards could be revised to integrate new predictive indicators of creditworthiness, and asset portfolio management might evolve to enhance dynamic monitoring and active management of credit risk concentration.

With a clearer view of expected credit losses mandated by the new accounting guidance, banks are expected to harness advanced data analytics, implement more robust stress-testing, and perhaps explore machine learning applications to forecast credit risk more accurately.

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Author Information

Marc Giampaola is partner at Marcum and New England co-leader for its financial institutions services group.

Michael Schoff is a director at Marcum's financial accounting and advisory services practice.

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To contact the editors responsible for this story: Melanie Cohen at mcohen@bloombergindustry.com; Rebecca Baker at