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CONSUMER FINANCE

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About Navigant's Financial Services Consulting Practice

Navigant (NYSE: NCI) provides a wide range of services, spanning from consulting and compliance to litigation and investigative support, to help highly-regulated industry organizations address their most critical business issues. Our Financial Services consulting practice works collaboratively with banking, insurance, and investment management clients to achieve their business objectives by improving operational effectiveness and mitigating compliance risks. Our comprehensive service offering focuses on our clients' key opportunities and challenges including core business operations, technology, human capital, regulatory compliance, strategic transformations, customer service, and business process outsourcing (BPO). We bring deep industry, consulting and technical expertise, and are known for partnering with our clients to realize their business objectives.

FASB ISSUES NEW GUIDANCE ON ACCOUNTING FOR CREDIT LOSSES

INTRODUCTION

On June 16, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-13, Financial Instruments – Credit Losses, which is listed as Topic 326 within the Accounting Standards Codification (ASC) (the Standard). This highly anticipated guidance has been under development since 2010, incorporating feedback from over 3,000 comment letters on two exposure drafts from 2010 and 2012. The Standard affects entities holding financial assets and net investment leases not accounted for at fair value through net income.

Current accounting requires that credit losses are recognized when it is probable that a loss has been incurred. This delayed recognition of credit losses that were expected by an entity, but that had not yet met the probability threshold. ASC 326 replaces the incurred loss methodology with a framework that requires recognition of financial assets as the amount expected to be collected through the measurement of currently expected credit losses.

Among the provisions of ASC 326 are new accounting models that require consideration of expected credit losses for the following instruments:

1. Assets Measured at Amortized Cost and Certain Off-Balance Sheet Credit Exposures (CECL Model)
2. Available-for-Sale (AFS) Debt Securities
3. Purchased Financial Assets with Credit Deterioration (PCD)
4. Beneficial Interests in Securitized Financial Assets Proportionate procedures

THE CECL MODEL

ASC 326 introduces the Current Expected Credit Loss (CECL) model. The CECL model results in reflecting expected credit losses as of the reporting period date through the establishment of an allowance account with changes in expected credit losses as of the reporting period date generally recognized in current period earnings.

Key provisions in applying the CECL model include:

- Financial Instrument Scope: The CECL model applies to financial instruments measured at amortized cost and certain off-balance sheet credit exposures. Among the instruments for which CECL is applicable include loans, held-to-maturity debt securities, net investments in leases, loan commitments, trade receivables, reinsurance receivables, and certain financial guarantees.
- Financial Asset Aggregation: For the purpose of measuring expected credit losses under CECL, financial assets that share similar risk characteristics should be pooled. If a financial asset does not share similar risk characteristics, it is to be measured individually.
- Expected Loss Measurement: At the end of each reporting period, entities will be required to make a reasonable estimate of credit losses generally over the contractual life of the asset. ASC 326 does not prescribe any specific estimation method citing alternatives such as discounted cash flow, loss-rate, roll-rate, probability-of-default, or aging schedule methods. Regardless of the method chosen to estimate credit losses, the loss estimation measurement should consider historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the financial asset.
- Financial Statement Presentation: An allowance for credit loss valuation account should be recorded as an offset to the amortized cost basis of the financial asset to present the net amount expected to be collected. Net income should be recognized to adjust the allowance for credit loss to reflect management's current estimate of expected credit losses.

AVAILABLE-FOR-SALE DEBT SECURITIES

While Available-for-Sale (AFS) Debt Securities are not within the scope of the CECL model, ASC 326 does introduce a separate impairment model. Similar to current accounting, the impairment model per ASC 326 requires the measurement of expected credit losses only when the fair value of the financial asset is less than its amortized cost. The new impairment model also does not require consideration of the length of time that the fair value has been less than the amortized cost in assessing credit losses. The impairment model is summarized as follows:

a. Assess whether the fair value of the financial asset is less than its amortized cost as of the reporting period;
b. If fair value is less than amortized cost, consider whether management intends to sell, or is more than likely going to be required to sell, before recovery of the amortized cost basis. If this condition is met, recognize the difference between fair value and amortized cost in current period earnings; and,
c. If the condition mentioned in b. above is not met, calculate the amount of the impairment related to credit versus non-credit. The amount related to the credit should be recognized as an allowance with an offset to current period earnings with the allowance limited to the difference between the fair value and amortized cost. To the extent that the amortized cost adjusted for the allowance exceeds fair value, the amount of impairment related to non-credit would be reported in Other Comprehensive Income.

PURCHASED FINANCIAL ASSETS WITH CREDIT DETERIORATION

ASC 326 also amends the accounting for Purchased Financial Assets with Credit Deterioration (PCDs). PCDs can be Held-for-Sale or AFS loans or debt securities and are defined as acquired financial assets that as of the date of acquisition have experienced a more than insignificant deterioration in credit quality since origination. At acquisition, the PCD is initially recognized at the purchase price plus an allowance for credit loss based on the expected losses. Unlike the CECL model which could result in a Day 1 loss, the offset to the allowance at acquisition is an adjustment to the amortized cost basis of the financial asset rather than being recognized in net income. Subsequent accounting for PCDs will follow the CECL or AFS Debt Security model, as applicable, with changes in the allowance recognized in net income. In addition, interest income should be recognized based on accreting the amortized cost basis of the instrument to its expected cash flows.

BENEFICIAL INTERESTS IN SECURITIZED FINANCIAL ASSETS

Beneficial interests classified as either AFS or held-to-maturity will apply the guidance discussed above for PCD instruments if: (i) the beneficial interest meets the definition of a PCD asset; or, (ii) as of the date of recognition, there is a significant difference between contractual and expected cash flows. Subsequent accounting as expected cash flows change will follow the CECL or AFS Debt Security impairment model depending on the instrument's classification. Beneficial interests accounted for at fair value are not within the scope of the ASC 326 impairment guidance.

DISCLOSURE REQUIREMENTS

The Standard creates enhanced disclosure requirements in an effort to help users understand the credit risk inherent in an entity's portfolio, how management monitors portfolio credit quality, expected loss estimation methods, and the change in expected credit losses during the reporting period. Entities will be required to provide the required disclosures based upon portfolio segment, class of receivable, credit quality indicators, and vintage year of origination, as applicable.

Generally, entities will transition to the Standard by applying a modified retrospective approach to outstanding instruments through a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period. For Purchase Credit Impaired (PCI) instruments accounted for under ASC 310-30 (SOP 03-3) prior to the date of adoption, the new guidance will be applied prospectively. The prospective application will result in an adjustment to the amortized cost basis of the financial asset to reflect the addition of the allowance for credit losses at adoption date. For debt securities where an other-than-temporary impairment had been recognized prior to the adoption date, the new guidance will be applied prospectively such that the amortized costs basis and effective interest rate remains unchanged.

TRANSITION REQUIREMENTS

ASC 326 EFFECTIVE DATES

Fiscal years beginning after December 15, 2019, including interim periods

- For public business entities filing with the Securities and Exchange Commission (SEC)

Fiscal years beginning after December 15, 2020, including interim periods

- For all other public business entities

Fiscal years beginning after December 15, 2020, and interim periods for fiscal years beginning after December 15, 2021

- All other entities, including not-for-profit and employee benefit plans

Fiscal years beginning after December 15, 2018, including interim periods

- Early adoption of the Standard is permitted

RECOMMENDATIONS

Adopting the requirements of ASC 326 will have vast impacts throughout the organization. In considering adopting ASC 326, Navigant recommends the following:

RECOMMENDATIONS FOR ADOPTION

DEVELOP IMPLEMENTATION PLAN

- Once the adoption date has been determined, all parts of the entity should work in a cohesive way to ensure the entity is able to effectively transition to the new Standard.
- The regulators have expressed an expectation that companies should be in the process of developing an ASC 326 implementation plan.

DEVELOP ACCOUNTING POLICY AND PROCEDURES

- Entities will need to inventory the financial instruments that are within the scope of ASC 326 and determine the appropriate accounting model.
- The accounting policy and procedures should be drafted to outline applicable impairment models, the supporting time period for which expected credit losses can be reasonably estimated, pooling criteria, accretion methods, etc.

ASSESS DATA AVAILABILITY AND MODELING CAPABILITIES

- Although the implementation date may seem far away, entities should begin to assess whether their current infrastructure is adequate to comply with the Standard, including maintaining accurate historical data in order to perform an accurate lookback analysis and make a cumulative adjustment in the first year of adoption.
- Institutions should consider impacts to related processes such as stress testing projections and examine existing models and forecasts across business groups to determine if the proper infrastructure exists to develop supportable and reasonable estimations of expected credit losses.

DEVELOP AND IMPLEMENT NECESSARY PROCESSES, SYSTEMS AND CONTROLS

- The adoption process will not only concern the CFO and financial reporting departments of a company, but will require involvement from all departments, including governance.
- A robust framework will have to be in place to ensure the integrity of the data used as inputs during the estimation process, and proper estimation and accounting treatment of credit losses.
- Companies should assess and enhance existing Internal Controls over Financial Reporting (ICFR) to ensure that they address all facets of the new process, including supporting models.

NAVIGANT SERVICE OFFERINGS

Navigant is a leading expert in providing accounting and financial reporting solutions. Our staff of professionals includes CPAs, CIAs, CFEs, former controllers and other finance professionals, forensic specialists, MBAs, PhD economists, lean six sigma, former regulators, information management specialists and computer systems professionals. On average our staff is more seasoned, possessing significant industry and/or consulting experience and requiring little on the job training, relative to our competitors who rely on more entry level resources. Our qualifications well position Navigant to support your adoption efforts, including, but not limited to, the following:

PROJECT MOBILIZATION AND SCOPING	• Assisting with development of project governance and adoption support structure • Performing initial analysis of financial instrument ASC 326 classification and determining applicable accounting models • Analyzing the downstream impact of the new Standard on all aspects of the business, including credit, data, and modeling functions • Developing and executing project management function and management reporting • Providing staff augmentation to support adoption efforts and/or accounting close process
ACCOUNTING POLICY AND OPERATIONS	• Performing a review of existing accounting policies and supporting processes to identify gaps • Developing accounting policies and procedures • Evaluating existing chart of accounts and recommending modifications • Preparing financial reporting and related financial statement disclosures • Assessing existing processes and the design and effectiveness of controls and developing a Target Operating Model pursuant to ASC 326 • Updating SOX/internal controls documentation to reflect ASC 326 accounting policy and procedures
TECHNOLOGY	• Assessing existing system capabilities to satisfy requirements of ASC 326 and performing gap analysis • Identifying requirements for enhancing proprietary systems and/or third party vendor solution alternatives • Assisting with system selection, RFP process, and implementation • Evaluating system control environment
DATA AND MODELING	• Assessing and/or developing loss estimation methodologies • Executing data and model readiness assessments • Coordinating across business areas to enhance data management and integrity • Building and testing loss estimation models • Evaluating model governance program and executing model validation

About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at navigant.com.