2020 FAR CPA Exam Changes
CHANGES HAPPENING IN FAR 2020 EXAM

Financial Instruments – Credit Losses (ASUs 2016-13, 2018-19, 2019-05)
— The credit loss (i.e., bad debt) changes are pervasive and complicated. These changes remove more bright-line rules that accountants are used to and require more judgment, and in some cases data analytics, to develop expectations for credit losses.

Here’s some of the basics:

- This represents a switch from an incurred credit loss model to a current expected credit loss (CECL) model to reflect economic downturns in the financial statements faster (i.e., earlier recognition).
- The new model estimates expected credit losses over the lifetime of the asset for more credit risk transparency.
- Estimates can be based on historical information, current conditions or reasonable and supportable forecasts (e.g., predictive data analytics).
- The new guidance applies to assets measured at amortized cost (e.g., receivables and held-to-maturity debt securities) and available-for-sale (AFS) debt securities, as well as finance leases and off-balance-sheet credit exposures (e.g., financial guarantees).
- When expected credit losses increase, an allowance for credit losses (i.e., a contra-account) is booked at the reporting date to adjust the value of the asset, and credit loss expense is recognized on the income statement.
- When expected credit losses decrease, the allowance for credit losses is decreased, and a credit loss expense is reversed on the income statement.
- Such assets are written off when they are entirely uncollectible.
Goodwill (ASU 2017-04)
- The second step in the goodwill impairment test (i.e., calculating the implied fair value of goodwill) has been eliminated for simplification purposes.
- Now you basically just compare the fair value of the reporting unit with its carrying value. If fair value is less than carrying value, then goodwill is impaired, and a loss should be recognized.

Intangibles (ASU 2018-15)
- Aligns the accounting treatment of implementation costs incurred in a cloud computing arrangement that is treated as a service contract with the requirements to capitalize implementation costs incurred with respect to internal-use software.

Variable interest entities (ASU 2018-17)
- Expands the private company accounting alternative for variable interest entities (VIEs) to provide an election not to apply the regular VIE GAAP guidance when certain criteria are met.

GASB Updates
- Statement No. 87 provides a single model for lease accounting (i.e., all leases are essentially finance leases, with limited exceptions).
- Statement No. 89 provides clarification on accounting for interest cost incurred before the end of a construction period.
Further Breakdown of Changes

Expected Credit Loss Model (ASC 326-20)

What assets will be affected by this change?

- Accounts receivable (A/R), financing receivables, finance leases, held-to-maturity (HTM) debt securities, available-for-sale (AFS) debt securities, and other off-balance sheet credit exposures (e.g., financial guarantees).

How is each type of asset affected by the change?

- A/R, HTM debt securities, & finance leases:
  - Estimate losses over life of asset with pools of assets that have similar risk profile assumptions to capture risk, even if the risk is remote.
  - Management should have a reasonable forecast of economic conditions and documentation to support this.
  - For assets that are purchased having a significant credit deterioration since issuance, an allowance needs to be recorded at acquisition.
  - Significant new disclosures will be required in statements.

- AFS debt securities:
  - No longer consider the length of time an instrument has been impaired in model.
  - Record an allowance for credit losses instead of a reduction in amortized cost basis.
  - Limit credit losses to excess of amortized cost over fair value.
  - Reduce allowance for credit risk improvements and reverse credit loss expense in the income statement.
How will it affect the financial statements?

- Credit losses are recognized earlier than they would have been under current GAAP.
- Income becomes more volatile as credit loss expense is recognized.
- More processes and controls need to be implemented by management to consistently pool assets and determine conditions that affect their model. Even if management doesn’t expect the allowance to change significantly, they need to have a repeatable and understandable process to how they came to that conclusion. Documentation in the notes to financials will be required.
- More data will need to be collected and included in the model to help management decide how to identify information that can be used in developing the reasonable and supportable forecast, whether internal or external, to estimate the expected credit losses.

What are the key differences between the old incurred loss model and the new expected credit loss model?

- Instead of reporting losses that have been incurred as of the balance sheet date, credit loss expense is now recognized for credit losses that are expected over the life of the asset. Since this recognition of losses will now flow through the income statement, earnings will likely become more volatile.
- Pooling of assets that share a common risk profile is required with the new model, whereas current GAAP permits but doesn’t require this. Management discretion on what assets to pool together comes into play. This also means that where a single asset may not have had any expected credit losses, the pool of similar assets could.
Economic conditions are considered in both current GAAP and the new model. The new model also includes management’s expectations of future economic conditions. This is another area where more judgment is required.

The result of the new model should show up on the balance sheet as what management thinks is the net amount that will be collected on the asset.

Implementation considerations for the expected credit loss model:

- Components of amortized cost include unpaid principal balance, accrued interest, unamortized discounts / premiums, foreign exchange adjustments, and fair value hedge accounting adjustments.
- Limited historical loss information may be available for amortized cost other than unpaid principal balance.
- Processes and controls will need to be developed for gathering data for the components of amortized cost that haven’t been historically captured.
- Pools of similar assets based on risk profile will need to be reviewed at each measurement date to confirm they still share risk attributes and belong to the same pool. This review and any changes will need to be documented.
- Losses need to be reflected over the asset’s contractual life.
  - Included: expected prepayments and contractual extensions.
  - Excluded: expected extensions, renewals and modifications.
- It may be hard to determine contractual life on assets that have no stated maturity like A/R and credit card receivables. Management will also need to determine if a loan refinance with the same lender would be considered a prepayment.
Management judgment will be required to determine:

- The method that is most appropriate for determining credit losses. A variety of methods may be used, including the discounted cash flow method, loss-rate methods, roll-rate methods, probability-of-default method, and aging schedules.
- Designation of pools of assets with similar risk profiles. Risk of default is understandable but may also include specific asset risks for the company or the company's appetite for risk based on its individual tolerance.
- Key economic variables used in model.
- Selection of reasonable and supportable forecast period.
- Determination of how to select the estimate used—is it a single most likely outcome or a weighted average outcome based on probability.
- Support adjustments to historical loss information and reversion methodology to the historical loss model past the reasonable and supportable forecast period of the expected loss model.
- Is it worth managing all this data or can an external source of data be used?

Reference article:
Goodwill (ASU 2017-04)

Additional comments:

- The only step in determining goodwill impairment will be the current 1st step of the impairment determination: comparing the fair value of a reporting unit with the carrying amount. If the cost is greater than fair value, the goodwill impairment charge equals the difference up to the amount of goodwill allocated.
- The primary goal of the standard is simplification and providing cost savings to all entities.
- Any loss recognized should not exceed the total amount of goodwill allocated to that reporting unit.
- Impairment losses on goodwill can’t be reversed once recognized.

Reference article:  
Intangibles (ASU 2018-15)

The point of this guidance is to reduce diversity in practice for the costs of implementing cloud computing arrangements or hosting arrangements that are service contracts. Entities that historically capitalized implementation costs for internal use software projects should apply their existing policies and procedures to implementation costs incurred in hosting arrangements that are service contracts.

Customers should apply ASC 350-40 to determine whether to capitalize implementation costs of the cloud computing arrangement or expense them as incurred.

- Only qualifying costs incurred during application development stage can be capitalized. Examples: costs of integrating the hosting arrangement with software on site, coding, configuring, customization, compensation and benefits for employees for time spent on application development activities, and interest costs incurred while implementing the hosting arrangement.
- Other costs are required to be expensed like costs of project planning, training, maintenance after implementation, and data conversion. Overhead costs (general and administrative) and training costs not related to software development or implementing the hosting arrangement can’t be capitalized.
- For multiple element arrangements like training, hosting, maintenance, data conversion, etc. bundled together, companies need to allocate the costs to each element on the relative standalone price for each part of the contract.
Companies implementing hosting arrangements with multiple modules should accumulate costs and amortization records at the module level so that they can begin amortization at the appropriate time for that module. Documentation of modules, costs, obsolescence, and impairment or abandonment are required.


Variable interest entities (ASU 2018-17)

This standard applies to all entities except for public entities, non-for-profit entities, and employee benefit plans qualifying common control arrangements. It creates an alternative accounting policy election to not apply VIE guidance to legal entities under common control. All the following criteria must be met for this election:

- Reporting entity and legal entity are under common control.
- Reporting entity and legal entity are not under common control of a public entity.
- Legal entity under common control is not a public entity.
- Reporting entity doesn’t have a direct or indirect controlling financial interest in the legal entity.

Additional disclosures are required related to the reporting entity’s involvement and exposure to entities with this election. While it doesn’t require consolidation, a combined financial statement presentation is still an option to show combined results for entities under common control. Early adoption is allowed, and entities are required to apply the amendments retrospectively.

The rule change will make GASB lease accounting like FASB lease accounting where substantially all leases will be required to be reported on the balance sheet. Distinctions between operating and finance leases, however, are eliminated.

For Lessees:

- Lease liabilities will be considered long-term debt.
- Lease payments will be financing outflows on the cash flow statement.
- For operating-type leases, rent expense will no longer be reported in the activity statement. Instead, interest expense on the liability and amortization expense related to the asset will be reported.

For Lessors:

- Lessor accounting will mirror lessee accounting—this is different from FASB and IASB.
- Lessor will recognize a lease receivable and a corresponding deferred inflow while still reporting the asset underlying the lease.
- Interest income from the receivable will be recognized using the effective interest method.
- Lease revenue will be recognized through amortizing the deferred inflow over the lease term.
- New rules exclude leases associated with investment assets carried at fair value like investment rental property. This accounting doesn’t change from current treatment.
FURTHER BREAKDOWN OF CHANGES CONTINUED

GASB vs. FASB Differences

- Right-of-use assets may amortize more quickly than liabilities in GASB, which will negatively impact net position. FASB’s treatment has the asset and liability at roughly the same amount.
- FASB reports lease liabilities as long-term operating payables. GASB has them as long-term debt. This could impact compliance with debt covenants.
- FASB reports straight-line rent expense, and GASB reports interest expense on the liability and amortization expense on the asset. This speed up expense recognition.


GASB Statement No. 89

This statement requires state and local government agencies, including public housing authorities, to expense interest during the construction period instead of capitalizing the interest and including it in the asset’s value. The change was made to simplify reporting and show the true cost of borrowing. The benefit of expensing interest has an immediate impact on the income statement instead of amortizing over several years.