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PCD assets post-CECL: The real-world implications of an accounting change

Even before its official publication in 2016, the Financial Accounting Standards Board (FASB) standard ASC 326, better known as Current Expected Credit Losses (CECL), has been a topic of great discussion and debate. As we approach the initial implementations of the new standard, much of the discussion has shifted to post-transition concerns. While there are many potential impacts that may result from CECL, one of the concerns is the effect on acquisition activity. I plan to focus here on the implications of a revised definition within the standard that deals with the classification of acquired assets.

One benefit CECL will bring to the accounting space is moving away from the complicated and burdensome accounting for Purchase Credit Impaired (PCI) assets. Since the economic downturn began more than 10 years ago, the challenges that PCI brought to the mergers & acquisitions (M&A) space were numerous. They could require significant investment in accounting processes or software to handle post-acquisition. As promised, CECL is moving away from PCI accounting and will shift to new requirements under the name Purchase Credit Deteriorated (PCD) assets.

While heralded, and in my opinion a change for the better, there are still implications beyond accounting that are important, and that everyone in the financial services industry should understand. I will examine a couple of these implications.

Definition

As stated, the name of the assets that fall under this accounting has changed from PCI to PCD. With this name change, there is also a change in the definition of what assets should receive this classification (and thus, accounting). PCI assets were defined as having "evidence of deterioration" at acquisition. This language led to a relatively consistent application across the industry that if a loan was impaired when acquired, it was PCI. In contrast, PCD is defined as having experienced a "more-than-insignificant deterioration" in credit quality since origination. What might not be obvious to people outside of the accounting profession is that the FASB clearly intended for this definition to give more flexibility. They have stated these intentions publicly as well. They wanted to offer companies the ability to include more assets into the classification than previous accounting rules allowed.

That flexibility does bring challenges in comparability between companies' financial statements. After CECL is implemented, company policy will dictate how a PCD asset is determined, which means that separate companies might classify the same purchase differently. For example, assume that a bank acquisition is forthcoming with two potential acquirers. Analysts would have to know each acquirer's policy for determining PCD assets to know the level of potential classifications for each. This makes predictability of M&A activity a bit more challenging. Analysts will need to understand how a company considers this definition to understand the future results post-acquisition. For reasons I will explain below, this classification could alter the long-term results of the acquisition. It will not only make the classification of a similar transaction among companies different, but the actual financial result as well.

Income recognition

There are several changes to the accounting for these assets under CECL as we move from PCI to PCD. One of the changes that may have considerable implications is the way that income recognition will now work. The accounting for PCI assets was performed where income was recognized based on a combination of cash received and the updated outlook for future payments. In other words, the current activity for a particular asset (or pool of assets) would drive a constant ebb-and-flow to the accounting and the income recognized. As projections improved, you would recognize more of the discount through yield adjustments and interest income. As projections worsened, overall income would diminish due to allowance adjustments. Without getting into the full details and previously mentioned complications, the key takeaway was that income recognition would move based on asset performance.

PCD accounting, while far more simplified, will have less of the ebb-and-flow and be more tied to the purchase date expectations. Under PCD accounting, on that purchase date an allowance for future losses will be established and a purchase discount (or premium) will be recorded. From that point forward, if the asset performs, the discount will accrete into interest income. Then, adjustments in the allowance will flow through the provision on the income statement. This process is far more simplified and consistent with non-PCD assets, both of which are great benefits. However, an asset that performs beyond expectation will no longer see that benefit in net interest income as it had before, but instead through the provision.

To complicate this matter further is a difference between PCD and purchased non-PCD assets that are established within the CECL guidance. PCD assets differ in their accounting from non-PCD assets in that the initial allowance established on purchase date does not affect profit & loss (P&L). Instead, the allowance is recorded as part of the difference between the purchase price of the asset and the par amount remaining. For example, let's assume a bank buys a singular PCD loan for $65 with a remaining principal balance of $100. If the allowance for potential future losses for this loan under CECL is $25, the journal entry would appear as follows:

Loan	$100
Cash	$(65)
Allowance	$(25)
Discount	$(10)

What is clearly missing from this entry is the P&L impact of the allowance, which would be present for a non-PCD asset. Both this impact and the changes to income recognition after purchase date can have significant implications to the deal's income recognition. These implications could lead to material changes in the overall results if the acquisition is significant enough. The importance of this change should be considered with the definition change and flexibility a company has in how it defines and recognizes a PCD asset.

Overall, as an accountant who has worked extensively in this space, I view the accounting change moving from the PCI to PCD framework to be positive. However, I also understand the importance of recognizing the implications of such a change. In particular, how analysts will be able to understand and predict the financial statement impacts that an acquisition may have. There is also curiosity within the market about what these changes could mean to M&A activity. I do not believe it will play a role in the amount of activity seen in the market. However, I do think it could alter some of the timing and participants. For example, some companies have already discussed not getting involved in acquisitions until some of the nuances in the accounting can be better understood. This is especially true given the overall questions from analysts and the market about whether PCD treatment is preferred or not in the end. A second example that could affect both timing and participants is the acquisition of banks that have not yet adopted CECL. Say that the acquired bank has not yet done so and is not prepared with an estimate of the impact. It may be difficult to assess the portfolio without due diligence. Above all, the main point from this discussion is that the added flexibility and simplification will task financial statement users. It will also place more burden on companies to articulate the results within the footnotes and qualitative discussion. The added flexibility will be helpful for people who operationally must deal with the accounting. However, it will also drive challenges in comparability among industry participants. The real impact of these challenges is yet to be seen.