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Heads Up

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We've Been Expecting You

FASB Finalizing Credit Impairment Guidance

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The FASB is currently finalizing amendments to its guidance on the impairment of financial instruments. The proposed amendments would introduce a new impairment model[1] based on expected losses rather than incurred losses. Under this current expected credit loss (CECL) model, an entity would recognize as an allowance its estimate of the contractual cash flows not *expected* to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.[2]

This *Heads Up* provides a comprehensive summary of the FASB's proposed changes to the credit impairment guidance under current U.S. GAAP, which are reflected in the Board's December 2012 proposed ASU[3] and subsequent tentative decisions.[4] In addition, this newsletter contains several appendixes. Appendix A compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and the IASB's recently amended IFRS 9, respectively. Appendix B gives an overview of the existing impairment models under U.S. GAAP for loans and debt securities. Appendix C and Appendix D provide illustrative examples of how an entity might apply the CECL model to purchased credit-impaired (PCI) assets and trade receivables, respectively.

Editor's Note: Although the FASB has completed nearly all significant redeliberations and its staff has begun drafting a final ASU, the Board has yet to discuss the effective date of its proposed amendments to the current guidance on accounting for credit losses. A final standard is likely to be issued in the second half of this year.

The CECL Model

Scope

The CECL model would apply to most[5] debt instruments (other than those measured at fair value through net income (FVTNI)), trade receivables, lease receivables, reinsurance receivables that result from

[1] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[2] Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B for a tabular summary of those models.

[3] FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses*.

[4] Decisions are as of the FASB's March 11, 2015, meeting. Although the Board has nearly completed its deliberations in the project, the guidance in the final ASU may differ from that in the tentative decisions as a result of changes made during the finalization process.

[5] The CECL model would not apply to the following debt instruments:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

insurance transactions, financial guarantee contracts,[6] and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320[7] (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible would be written off in a manner consistent with existing U.S. GAAP.

Editor's Note: Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero."[8] U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

Measurement of Expected Credit Losses

Under the proposed amendments, an entity's estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects that it will execute a troubled debt restructuring with the borrower."[9]

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity would be able to use historical charge-off rates as a starting point in determining expected credit losses, it would have to evaluate how conditions that existed during the historical charge-off period differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

Editor's Note: Measuring expected credit losses will most likely be a significant challenge for all entities, particularly financial institutions. As a result of moving to an expected loss model, entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

[6] The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.

[7] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[8] Quoted text is from the FASB's summary of tentative Board decisions reached at the joint meeting of the FASB and IASB on September 17, 2013.

[9] Quoted text is from the FASB's summary of tentative Board decisions reached at its September 3, 2014, meeting.

Unit of Account

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

Editor's Note: The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling PCI assets on the basis of "common risk characteristics." Entities may need to make changes to systems and processes to capture loss data at more granular levels depending on the expectations of market participants such as standard setters, regulators, and auditors.

Practical Expedients for Measuring Expected Credit Losses

The FASB tentatively decided to permit entities to use practical expedients when measuring expected credit losses for two types of financial assets:

- *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, when applicable).
- *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Write-Offs

Under the proposed ASU, an entity would write off a financial asset if it determines that it has no reasonable expectation of future recovery. However, in light of stakeholders' concerns that the proposed requirement could conflict with regulatory guidance and may result in entities' recognizing write-offs significantly later than under current practice, the FASB tentatively agreed to retain the write-off requirements in existing U.S. GAAP. That is, an entity would write off the carrying amount of a financial asset when the asset is deemed uncollectible. The Board also tentatively decided that this write-off guidance would apply to AFS debt securities.

AFS Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, during redeliberations, the FASB tentatively decided not to include AFS debt securities within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Editor's Note: The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in other comprehensive income (OCI). However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The FASB's tentative decisions to revise the impairment model in ASC 320 could result in earlier recognition of impairment.

PCI Assets

For PCI assets as defined[10] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCI asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Consequently, any subsequent changes to the entity's estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows. See Appendix C for an illustrative example on how to apply the proposed guidance to PCI assets.

Editor's Note: Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. However, in a manner consistent with current practice, the CECL model precludes an entity from recognizing as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows as a result of deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

[10] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Certain Beneficial Interests Within the Scope of ASC 325-40

The FASB tentatively decided that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit should be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would not be included in interest income)."[11]

Editor's Note: Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Modified Financial Assets

In a manner consistent with the proposed ASU, the FASB decided not to comprehensively reconsider the accounting for modifications during redeliberations (e.g., when a modification results in derecognition or what constitutes a troubled debt restructuring (TDR)). However, the Board affirmed its previous decision that the CECL model would apply to modified debt instruments.

For non-TDR modifications that do not result in derecognition, an entity would measure expected credit losses on the basis of the cash flows expected after the modification, discounted at the post-modification effective interest rate. However, as stated in the proposed ASU, when an entity executes a TDR, "the cost basis of the modified asset shall be adjusted . . . so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of contractual cash flows. The basis adjustment . . . would be determined as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate)." The basis adjustment that reflects a *decrease* in cash flows post-modification would be recognized as a credit loss with a corresponding reduction to the amortized cost basis of the instrument. The basis adjustment that reflects an *increase* in cash flows post-modification would be recognized as an increase to the instrument's amortized cost basis with a corresponding increase in the allowance for expected credit losses.

Loan Commitments

Off-balance-sheet arrangements such as commitments to extend credit, guarantees, and standby letters of credit that are not considered derivatives under the guidance in ASC 815 are subject to credit risk and are therefore within the scope of the CECL model. In a manner consistent with the proposed ASU, the FASB tentatively decided that the estimate of expected credit losses on the *funded* portion of a loan commitment should be determined similarly to how the estimate is determined for other loans. For an *unfunded* portion of a loan commitment, the Board tentatively decided to retain the guidance in the proposed ASU that would require an entity to "estimate [expected] credit losses over the full contractual period over which the entity is exposed to credit risk [under an unconditional] present legal obligation to extend credit." Such an estimate would take into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.

Editor's Note: An entity's estimate of expected credit losses on unfunded loan commitments (e.g., credit card receivables) will most likely depend on (1) whether the entity has the unconditional ability to cancel the commitment to extend credit and, if so, (2) the time it takes for the cancellation to become effective.

[11] Quoted text is from the FASB's summary of tentative Board decisions reached at its June 11, 2014, meeting.

Disclosures

Many of the disclosures that would be required under the proposed ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20.[12] Accordingly, entities would be required to disclose information related to:

- Credit quality.[13]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

In addition, the FASB affirmed the provision in the proposed ASU that would require an entity to provide a rollforward of its allowance for expected credit losses for assets measured at amortized cost and AFS debt securities. However, in a change from the proposed ASU, an entity would not be required to provide rollforward disclosures of the amortized cost balances of its debt instruments. Instead, an entity would be required to disclose credit-quality indicators for each asset class, disaggregated by vintage, for a period not to exceed five years (although upon transition, the entity would be required to provide this disclosure only for the current and prior-year amortized cost balances). The disclosure would be required for annual and interim periods and would not be required for an entity's revolving lines of credit.

Editor's Note: The FASB's decision not to require the amortized cost rollforward disclosure is in response to the concerns raised by financial statement preparers about the operational challenges in providing such information. The FASB believes that disclosing credit-quality information disaggregated by asset class and by vintage would be operationally easier for financial statement preparers and would provide financial statement users with information similar to that provided in a rollforward of the amortized cost balance. Because the FASB's tentative decision to require this new disclosure has not been exposed for public comment, the Board directed its staff to conduct significant outreach activities to obtain feedback from financial statement users, preparers, and other stakeholders on the proposed requirement.

Transition

Approach

For most debt instruments, the amendments would require entities to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, the Board tentatively decided on the following instrument-specific transition provisions:

- *Other-than-temporarily impaired debt securities* — An entity would be required to apply (1) the CECL model prospectively to HTM debt securities and (2) the changes to ASC 320 prospectively to AFS debt securities. As a result, previous write-downs of a debt security's amortized cost basis would not be reversed; rather, only changes in the estimate of expected cash flows of the debt security occurring on or after the effective date of the guidance would be reflected as an allowance for credit losses. Upon adoption of the new guidance, any impairment previously recognized in OCI would be accounted for as a prospective adjustment to the accretable yield of the debt instrument.
- *PCI assets* — An entity would be required to apply the changes to PCI assets prospectively. That is, the change in the definition of a PCI asset would apply only to assets acquired on or after the effective date of the guidance. For debt instruments accounted for under ASC 310-30, an entity would apply the gross-up approach as of the transition date (i.e., establish an allowance for expected credit losses with a corresponding adjustment to the debt instrument's cost basis).

[12] FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

[13] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

In addition, any post-adoption changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement as impairment expense (or reduction of expense). Accordingly, the yield on a PCI asset as of the date of adoption would be "locked" and would not be affected by subsequent changes in the entity's estimate of expected credit losses.

- *Certain beneficial interests within the scope of ASC 325-40* — Entities holding such interests would need to comply with the same transition requirements as those that apply to PCI assets.

Disclosures

The FASB tentatively decided to retain the following transition disclosure guidance in ASC 825-15-65-1(d) and 65-1(e) of the proposed ASU:

> d. An entity shall provide the following disclosures in the period that the entity adopts [the new guidance]:
>
> 1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
> 2. The method of applying the change.
> 3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
> 4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.
>
> e. An entity that issues interim financial statements shall provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

Next Steps

An effective date for the final guidance has not yet been proposed but will be determined at a future FASB meeting. The FASB directed its staff to prepare a draft of the final ASU for distribution to stakeholders (including financial statement users, preparers, and auditors) to obtain feedback on the proposed amendments ("fatal flaw review").

Appendix A — Comparison of Impairment Models

The table below compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and IFRS 9 (2014), respectively.

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Scope	Applicable to: • Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment. • Loans identified for individual evaluation. • Loans acquired with deteriorated credit quality. • Debt securities (including beneficial interests in securitized financial assets).	Applicable to: • Most debt instruments (other than those measured at FVTNI). • Lease receivables. • Reinsurance receivables from insurance transactions. • Financial guarantee contracts. • Loan commitments. AFS debt securities are excluded.	Applicable to: • Financial assets measured at amortized cost. • Financial assets mandatorily measured at fair value through OCI. • Loan commitments when there is a present obligation to extend credit (except for those measured at fair value through profit or loss (FVTPL) under IFRS 9 (2014)). • Financial guarantee contracts to which IFRS 9 applies (except for those measured at FVTPL). • Lease receivables within the scope of IAS 17.[1] • Contract assets within the scope of IFRS 15.[2]
Recognition threshold	Depending on the nature of the financial asset, credit losses must be either probable or other-than-temporary before recognition.	None. Impairment is based on expected (rather than incurred) credit losses.	None. Impairment is based on expected (rather than incurred) credit losses.
Measurement	Varies depending on the nature of the financial asset and unit of account. Approaches used in practice include: • Fair value measurement. • Present value of expected cash flows. • Fair value of underlying collateral.	Single-measurement approach: current expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect).	Dual-measurement approach: • For assets in the first category, 12-month expected credit losses. • For assets in the second category, lifetime expected credit losses.
Transfer criteria between measurement categories	Not applicable under existing U.S. GAAP models.	Not applicable under CECL model. Only one measurement category.	Transfer to lifetime expected credit losses when there has been significant deterioration in credit quality since initial recognition unless credit risk is low. Transfer back to 12-month expected credit losses when transfer criteria are no longer satisfied.
Trade receivables	No specific guidance or applicable simplified approach.	No specific guidance or applicable simplified approach.	For trade receivables with a significant financing component, the three-bucket impairment model or a simplified model with an allowance of lifetime expected losses could be used.
PCI assets	Credit impairment is recognized when, on the basis of current information and events, it is probable that an investor will be unable to collect (1) all cash flows expected at acquisition plus (2) additional cash flows expected to be collected that arise from changes in post-acquisition estimates. Significant increases in the estimate of expected cash flows expected to be collected at acquisition are recognized as prospective yield adjustments.	The allowance for PCI assets is the current expected credit losses. Interest income recognition is based on purchase price plus the initial allowance accreting to the contractual cash flows. The non-credit-related discount or premium that results from acquiring a pool of PCI assets is allocated to each individual financial asset.	The allowance for PCI assets is based on the cumulative change (from the original expectation at acquisition) in lifetime expected credit losses. Interest income recognition is based on applying the credit-adjusted effective interest rate to the amortized cost of the financial asset (rather than contractual cash flows).

[1] IAS 17, *Leases*.

[2] IFRS 15, *Revenue From Contracts With Customers*.

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Nonaccrual accounting	No applicable guidance.	No applicable guidance.	IFRSs do not permit nonaccrual of interest. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.
Write-offs	An entity writes off a financial asset in the period in which the financial asset is deemed *uncollectible*.	Same as under current U.S. GAAP.	An entity writes off the carrying amount of a financial asset if it ultimately determines that it has no reasonable expectation of future recovery.

Appendix B — Impairment Models Under U.S. GAAP

The table below highlights several impairment models under current U.S. GAAP for loans and debt securities.

Impairment Models for Loans and Debt Securities		
Guidance	**Scope**	**Measurement Objective**
ASC 450-20	Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.	All probable and reasonably estimable losses.
ASC 310-10-35	Loans that are identified for individual evaluation.	If it is probable that all of the contractual cash flows will not be collected, the difference between the carrying amount and the present value of the expected future cash flows discounted at the original effective interest rate. Certain practical expedients exist.
ASC 310-30	Loans acquired with deteriorated credit quality.	See ASC 310-10-35 or ASC 450-20, as applicable (as discussed in ASC 310-30-35-10). Or, for a loan accounted for as a debt security, see ASC 320-10-35 (as discussed in ASC 310-30-35-8). Recoveries (i.e., reversals of impairments) are not permitted for a loan accounted for as a debt security.
ASC 320-10-35 ASC 325-40-15	Debt securities (including beneficial interests in securitized financial assets).	If the investor intends to sell a debt security or it is more likely than not the investor will be required to sell the security before recovery of its amortized cost basis, impairment is deemed to be other than temporary and the difference between the amortized cost and fair value of the security is recognized in earnings. However if (1) the investor does not intend to sell, (2) it is not more likely than not that the investor will be required to sell the security before recovery, and (3) the investor does not expect to recover the entire cost basis of the security, the security is other than temporarily impaired and only the credit-related component of the impairment loss is recognized in earnings, and the noncredit portion is recorded in OCI. Credit losses might be measured in accordance with ASC 310-10-35, ASC 325-40, or ASC 310-30 depending on the circumstances. Recoveries are not permitted for debt securities.

Appendix C — Application of the CECL Model to PCI Assets

The example below, which is reproduced from ASC 825-15-55-40 through 55-42 of the proposed ASU, illustrates the application of the proposed guidance to PCI assets.

> Entity E is a bank that records [PCI] assets in its existing systems by recognizing the amortized cost of the asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The difference between amortized cost and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the asset is accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.
>
> Assume that Entity E pays $750,000 for a debt instrument with a par amount of $1,000,000. The instrument is classified at amortized cost. At the time of purchase, the expected credit loss embedded in the purchase price is $175,000. At that date of acquisition, the statement of financial position would reflect a financial asset carrying value of $925,000 (that is, par less the non-credit-related discount) and an associated allowance for expected credit losses of $175,000. The acquisition-date journal entry is as follows.

	Debit	Credit
Loan — par amount	$ 1,000,000	
Loan — noncredit discount		$ 75,000
Allowance for credit losses		175,000
Cash		750,000

> Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the debt instrument . . . . The $175,000 allowance for expected credit losses would be updated in subsequent periods . . . , with changes in the allowance for expected credit losses reflected immediately in the statement of financial performance as a provision for credit losses.

Appendix D — Application of the CECL Model to Trade Receivables

The CECL model would apply to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASC 825-15-55-37 and 55-38 of the proposed ASU, illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.

> Entity D manufactures and sells toys to a broad range of customers, primarily retail toy stores. Customers typically are provided payment terms of 90 days with a 2 percent discount if paid within 60 days. The entity has tracked historical loss experience for its trade receivables over the past five years and calculated the following historical loss experience:
>
> a. 0.3 percent for receivables that are current
>
> b. 8 percent for receivables that are 1–30 days past due
>
> c. 26 percent for receivables that are 31–60 days past due
>
> d. 58 percent for receivables that are 61–90 days past due
>
> e. 82 percent for receivables that are more than 90 days past due.
>
> Entity D believes that this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of the receivables at the reporting date is consistent with that used in developing the historical statistics (that is, the shared risk characteristics of its customers has not changed significantly over time) and the economic conditions in which the historical statistics were calculated generally are consistent with the economic conditions expected over the remaining lives of the receivables.
>
> At the reporting date, Entity D develops the following provision matrix to estimate current expected credit losses.

Past-Due Status	Carrying Value	Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.3%	$ 17,954
1–30 days past due	8,272	8%	662
31–60 days past due	2,882	26%	749
61–90 days past due	842	58%	488
More than 90 days past due	1,100	82%	902
	$ 5,997,794		$ 20,755

Editor's Note: The proposed ASU's example highlights that application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from an entity's current methods for determining the allowance for doubtful accounts. However, the example illustrates that moving to an expected loss model would require entities to consider the following when using a provision matrix to estimate credit losses on trade receivables:

- Under the CECL model, an entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered "current" (i.e., not past due). In the example above, a loss rate of 0.3 percent is applied to the trade receivables that are classified as current.
- When using historical loss rates in a provision matrix, an entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).

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