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Technical Line

FASB — final guidance

A closer look at the new credit impairment standard

All entities will need to change the way they recognize and measure impairment of financial assets.

What you need to know

- The FASB issued credit impairment guidance that modifies or replaces existing models for trade and other receivables, debt securities, loans, beneficial interests held as assets, purchased-credit impaired financial assets and other instruments.
- For receivables, loans and held-to-maturity debt securities, entities will be required to estimate expected credit losses, which generally will result in the earlier recognition of credit losses.
- For available-for-sale debt securities, entities will be required to recognize an allowance for credit losses rather than a reduction to the carrying value of the asset.
- Entities will have to make significantly more disclosures, including disclosures by year of origination for certain financing receivables.
- The earliest effective date is 2020 for calendar-year public business entities that meet the definition of an SEC filer. Despite the long lead time, entities should be taking steps now to prepare for the potentially significant changes they will need to make. Early adoption is permitted beginning in 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standards Update (ASU)[1] that significantly changes how entities will account for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The new standard will supersede today's guidance and apply to all entities.

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The FASB began working on the new guidance during the global financial crisis in 2008, when concerns were raised that today's guidance delays the recognition of credit losses and is too complex. The FASB initially worked with the International Accounting Standards Board (IASB) to develop converged guidance, but the two Boards ultimately reached different conclusions on certain significant issues. In July 2014, the IASB added new guidance on credit impairment to IFRS 9,[2] its comprehensive standard on accounting for financial instruments that covers recognition and measurement, credit impairment, hedging and other topics. The FASB issued targeted amendments to its guidance on the recognition and measurement of financial instruments, including amendments to the guidance on the impairment of equity investments not measured at fair value, in January 2016.[3] Similar to the new standard on revenue recognition, the FASB has formed a Transition Resource Group for Credit Losses (TRG) to address implementation issues.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process.

Summary of the new guidance

The ASU addresses the recognition, measurement, presentation and disclosure of credit losses on trade and reinsurance receivables, loans, debt securities, net investments in leases, off-balance-sheet credit exposures and certain other instruments. It replaces or modifies the guidance in today's US GAAP impairment models.

After implementing the standard, entities will account for credit impairment (also referred to as credit losses) of financial assets and certain other instruments as follows:

- ***Financial assets measured at amortized cost and certain other instruments***. For receivables, loans, held-to-maturity (HTM) debt securities, net investments in leases and off-balance-sheet commitments, entities will be required to use a current expected credit loss (CECL) model to estimate credit impairment. This estimate will be forward-looking, meaning management will be required to use forecasts about future economic conditions to determine the expected credit loss over the remaining life of an instrument. This will be a significant change from today's incurred credit loss model and generally will result in allowances being recognized more quickly than they are today. Allowances that reflect credit losses expected over the life of an asset are also likely to be larger than allowances entities record under today's incurred loss model.

- ***Available-for-sale debt securities.*** For available-for-sale (AFS) debt securities, entities will be required to recognize an allowance for credit losses rather than a direct reduction in the amortized cost of the asset, which is how these credit losses are recognized today. The new approach will allow an entity to reverse a previously established allowance for credit losses when there is an improvement in credit and immediately recognize the amount in the income statement. An entity will no longer be permitted to use the length of time a security has been in an unrealized loss position by itself or in combination with other factors to determine that a credit loss does not exist. Other aspects of today's impairment guidance won't change, including the requirement to use management's best estimate to measure credit losses.

- ***Certain beneficial interests.*** For certain beneficial interests in securitized financial assets that are not of high credit quality, entities generally will follow one of the two impairment models described above, depending on whether the beneficial interest is classified as HTM or AFS.

For items that are excluded from the scope of the new guidance, today's model for loss contingencies in Accounting Standards Codification (ASC) 450-20[4] will generally continue to apply. Specifically, the ASU excludes from its scope loans made to participants in certain employee benefit plans, an insurance entity's policy loan receivables, a not-for-profit entity's pledge receivables and related party loans and receivables between entities under common control. The standard amends the scope of ASC 450-20 to exclude items that are in the scope of the new credit impairment guidance but doesn't change the loss contingencies model.

The standard also eliminates today's accounting for purchased credit impaired (PCI) loans and debt securities in ASC 310-30.[5] Instead, an entity will determine whether all purchased financial assets (not just loans or debt securities) qualify as a purchased financial asset with credit deterioration (PCD asset) and, if that's the case, record the sum of (1) the purchase price and (2) the estimate of credit losses as of the date of acquisition, as the initial amortized cost. Thereafter, the entity will account for PCD assets using the approaches discussed above.

The standard also requires new disclosures, the most significant of which are:

- For financial assets measured at amortized cost, entities will be required to disclose information about changes in the factors that influenced management's estimate of expected credit losses, including the reasons for those changes.

- For most financing receivables[6] and net investments in leases[7] measured at amortized cost, entities will be required to significantly expand their disclosures about credit risk by presenting information that disaggregates the amortized cost basis of financial assets by each credit quality indicator and year of the asset's origination (i.e., vintage) for as many as five annual periods. For example, an entity that uses internal risk grades to monitor the credit quality of its commercial loans will need to disclose, by internal risk grade, the amortized cost basis of its commercial loans at the balance sheet date that were originated in each of the last five years.

- For AFS debt securities, the existing disclosure requirements will be modified to require a rollforward of the new allowance for credit losses on AFS debt securities.

Effective date and transition

The standard sets the following effective dates:

- For public business entities (PBEs) that meet the definition of a US Securities and Exchange Commission (SEC) filer, the standard is effective for annual periods beginning after 15 December 2019, and interim periods therein. That means calendar-year SEC filers will begin applying it in the first quarter of 2020.

- For other PBEs, the standard will be effective for annual periods beginning after 15 December 2020, and interim periods therein. That means calendar-year PBEs that are not SEC filers will begin applying it in the first quarter of 2021.

- For all other entities, the standard will be effective for annual periods beginning after 15 December 2020, and interim periods within annual periods beginning after 15 December 2021. That means these entities that have calendar years will begin applying it in their annual financial statements for 2021 and in interim statements in 2022.

Early adoption is permitted for all entities for annual periods beginning after 15 December 2018, and interim periods therein.

When deciding on the effective dates, the FASB cited the difficulty of implementing several major new standards over the next several years, including those involving revenue recognition and leases. Entities should consider the FASB's definition of an SEC filer when determining which effective date applies to them.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Overall

Glossary

Securities and Exchange Commission (SEC) Filer

An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

Entities should be taking steps now to prepare for the potentially significant changes they will need to make.

The standard requires 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. For example, a calendar-year company that will adopt the standard in 2020 will record the cumulative effect adjustment on 1 January 2020 and provide the related transition disclosures in its first quarter 2020 Form 10-Q.

How we see it

With more than three years until the first effective date, entities may think they have ample time to implement the standard. But entities should be taking steps now to prepare for the potentially significant changes they will need to make.

Although financial institutions will likely experience the most change, virtually all entities will be affected. For example, entities will need to decide how to identify information (internal or external) that can be used to develop what the FASB calls a "reasonable and supportable" forecast to estimate expected credit losses on receivables, loans, HTM debt securities and other instruments. Further, even though it's unclear to what degree the standard may change the amount recognized as an allowance for entities with trade receivables, they will need to evaluate and modify their existing processes.

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[1] ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments.*

[2] IFRS 9, *Financial Instruments.*

[3] ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities.*

[4] ASC 450-20, *Loss Contingencies*.

[5] ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*.

[6] ASU 2016-13 defines financing receivables generally as a financing arrangement that is both a contractual right to receive money (on demand or on fixed or determinable dates) and is recognized as an asset on the balance sheet.

[7] ASU 2016-02, *Leases (Topic 842),* defines the net investment in the lease for a sales-type lease as the sum of the lease receivable and the unguaranteed residual asset and the net investment in a direct financing lease as the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

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1 Scope and scope exceptions

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Overall

Overview and Background

326-10-05-1

This Topic provides guidance on how an entity should measure credit losses on financial instruments.

326-10-05-2

Topic 326 includes the following Subtopics:

a. Overall

b. Financial Instruments — Credit Losses — Measured at Amortized Cost

c. Financial Instruments — Credit Losses — Available-for-Sale Debt Securities

Scope and Scope Exceptions

326-10-15-1

The guidance in this Subtopic applies to all entities.

The current expected credit loss model applies to most financial assets measured at amortized cost.

The standard applies to all entities and creates or modifies the following approaches to measuring credit impairment generally based on the classification of the financial instrument:

- The current expected credit loss or CECL impairment model (ASC 326-20)
- The AFS debt security impairment model (ASC 326-30)
- The model for certain beneficial interests (ASC 325-40)
- The approach for initially recognizing purchased financial assets with evidence of credit deterioration (included in ASC 326-20 and ASC 326-30)

The instruments to which each of these approaches applies are described in the following sections.

1.1 The current expected credit loss impairment model (ASC 326-20)

The current expected credit loss impairment model in ASC 326-20 replaces the impairment guidance in ASC 310-10 and applies to all of the following instruments that are not measured at fair value:

- Financial assets measured at amortized cost
- Net investments in leases
- Off-balance-sheet credit exposures not accounted for as insurance

1.1.1 Financial assets measured at amortized cost

The current expected credit loss impairment model applies to all financial assets measured at amortized cost, including:

- Financing receivables — A financing receivable is a recognized financial asset that represents a contractual right to receive money on demand or on fixed or determinable dates. Loans and notes receivable are examples.

- HTM debt securities — An HTM debt security means a reporting entity has the positive intent and ability to hold the debt security to maturity. The category includes beneficial interests that are classified as HTM and are not included in the scope of ASC 325-40 because they are of high credit quality.
- Receivables that result from revenue transactions — Receivables that result from revenue transactions within the scope of ASC 606[1] include contract assets as well as trade receivables.
- Reinsurance receivables — These receivables result from insurance transactions within the scope of ASC 944[2] on insurance.
- Receivables that relate to repurchase agreements and securities lending agreements — These receivables primarily relate to reverse repurchase agreements and securities borrowing transactions recognized pursuant to ASC 860.[3]

How we see it

We believe the FASB intended for the current expected credit loss model to apply broadly to financial assets measured at amortized cost. The list of examples provided in the ASU is not all inclusive and entities, including those outside the financial services industry, will need to review their financial statements for financial assets measured at amortized cost that will be subject to this model.

1.1.2 Net investments in leases

The CECL model also applies to a lessor's net investment in sales-type and direct financing leases. Generally, this consists of the lease receivable (the total lease payments discounted using the rate implicit in the lease and any guaranteed residual asset) and any unguaranteed residual asset (the lessor's right to the expected unguaranteed value of the leased asset at the end of the lease). For a direct financing lease, the lease receivable is also net of any deferred selling profit.

The lease receivable is generally considered a financial asset. While the unguaranteed residual asset does not meet the definition of a financial asset, the Board decided that it would be overly complex and provide little benefit to require entities to separately assess the lease receivable (under the ASC 326-20 expected credit loss impairment model) and the unguaranteed residual asset (under ASC 360[4]). Therefore, the entire lease receivable should be measured for credit losses pursuant to the new standard.

1.1.3 Off-balance-sheet credit exposures not accounted for as insurance

The ASU requires entities to measure credit losses using the CECL model for off-balance-sheet credit exposures including credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments. However, it excludes instruments in the scope of ASC 815.[5]

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[1] ASC 606, *Revenue from Contracts with Customers*.

[2] ASC 944, *Financial Services — Insurance*.

[3] ASC 860, *Transfers and Servicing*.

[4] ASC 360, *Property, Plant and Equipment*.

[5] ASC 815, Derivatives and Hedging.

1.1.4 *Items explicitly excluded from the scope of the model*

The Board decided to exclude the following items from the scope of the CECL model:

- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Pledges receivable of a not-for-profit entity
- Related party loans and receivables between entities under common control

Impairment of these items will continue to be measured under ASC 450-20.

Refer to Section 2, *The current expected credit loss model (ASC 326-20)*, for more information on how to apply this model to the instruments in its scope.

1.2 The AFS debt security impairment model (ASC 326-30)

The impairment model for AFS debt securities, previously contained in ASC 320 and now in ASC 326-30, applies to debt securities classified as AFS. The model also applies to:

- Beneficial interests (e.g., certain mortgage-backed securities) classified as AFS that are not included in the scope of ASC 325-40 because they are of high credit quality.
- Financial assets (except those that are in the scope of ASC 815-10) that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investments (as these instruments are measured like investments in debt securities classified as AFS, even if they do not meet the definition of a security) pursuant to ASC 860-20-35-2 and 35-3.

Refer to Section 3, *The AFS debt security impairment model (ASC 326-30)*, for more information on how to apply this model to the instruments in its scope.

1.3 The model for certain beneficial interests (ASC 325-40)

Beneficial interests are rights to receive all or portions of specified cash inflows from a trust or other entity. Beneficial interests may be created in connection with securitization transactions such as those involving collateralized debt obligations or collateralized loan obligations.

Beneficial interests subject to the guidance in ASC 325-40 can be either (1) beneficial interests retained in securitization transactions and accounted for as sales under ASC 860 or (2) purchased beneficial interests in securitized financial assets. The ASU modifies the accounting model for beneficial interests in ASC 325-40.

ASC 325-40 applies only to beneficial interests that have all of the following characteristics:

- They are either debt securities under ASC 320[6] or are required by ASC 860 to be accounted for like debt securities.
- They involve securitized financial assets that have contractual cash flows (e.g., loans, receivables, debt securities).
- They do not result in the holder of the beneficial interests consolidating the issuer of those interests.

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[6] ASC 320, *Investments — Debt and Equity Securities.*

- They are not beneficial interests in securitized financial assets that (1) are of high credit quality and (2) cannot be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment.

ASC 325-40 provides that beneficial interests guaranteed by the US government, its agencies or other creditworthy guarantors and loans or securities that are sufficiently collateralized to make the possibility of credit loss remote are considered to be of high credit quality.

Additionally, ASC 325-40 currently does not apply to a beneficial interest that is in the scope of ASC 310-30 (a so-called purchased credit impaired asset). However, because ASC 310-30 has been eliminated by the ASU, beneficial interests that are otherwise in the scope of ASC 325-40 that meet the ASU's definition of a PCD asset will now be accounted for pursuant to ASC 325-40.

Refer to Section 4, *The model for certain beneficial interests (ASC 325-40),* for more information on how to apply this model to the instruments in its scope.

1.4 The approach for initially recognizing purchased financial assets with credit deterioration

For purchased financial assets that have experienced a more-than-insignificant deterioration in credit since origination (PCD assets), the standard requires an entity to record as the amortized cost basis the sum of the purchase price and the entity's estimate of credit losses as of the date of acquisition. Thereafter, PCD assets will be in the scope of the CECL impairment model, the AFS debt security impairment model or the model for certain beneficial interests.

Refer to Section 5, *Purchased financial assets,* for more information on how to apply this model to the instruments in its scope.

The following sections describe the accounting for credit losses under each of these models, including key changes from today's guidance and challenges entities will likely face in implementing the new requirements.

2 The current expected credit loss model (ASC 326-20)

ASU 2016-13 replaces today's "incurred loss" model with an "expected loss" model that requires consideration of a broader range of information to estimate expected credit losses over the lifetime of the asset. The primary conceptual differences between these models are as follows:

- Under an incurred model, the loss (or allowance) is recognized only when an event has occurred that causes the entity to believe that a loss is probable (i.e., that it has been "incurred"). Under an expected loss model, the loss (or allowance) is recognized upon initial recognition of the asset, in anticipation of a future event that will lead to a loss being realized, regardless of whether the future event is probable of occurring.
- Under an incurred model, the loss is generally estimated considering past events and current conditions. Under an expected loss model, management must include in its estimate its expectations of the future.

2.1 The expected credit loss objective

The standard does not define the term "expected credit loss," commonly referred to as the current expected credit loss or CECL model. Rather, the standard says the allowance for expected credit losses is intended to achieve a net asset measurement on the balance sheet that reflects the "net amount expected to be collected." The standard also does not define what is meant by the phrase "net amount expected to be collected." Instead the Board has articulated a credit loss objective.

The allowance for expected credit losses represents the portion of the amortized cost of a financial asset that an entity does not expect to collect.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-1

The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

In other words, the allowance for credit losses should represent the portion of the amortized cost basis of a financial asset that an entity does not expect to collect. The standard is best understood when considering the following core concepts that illustrate the Board's objective.

Objective

Recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset

Core concepts

Based on an asset's amortized cost	**Reflect losses over an asset's contractual life**	**Consider available relevant information**	**Reflect the risk of loss**

The current expected credit loss estimate should:

- Be based on an asset's amortized cost
- Reflect losses expected over the remaining contractual life of an asset, recognizing that voluntary prepayments reduce credit losses
- Consider available relevant information about the collectibility of cash flows, including information about past events, current conditions, and reasonable and supportable forecasts
- Reflect the risk of loss, even when that risk is remote, meaning that an estimate of zero credit loss would be appropriate only in limited circumstances

The standard permits companies to use estimation techniques that are practical and relevant to their circumstances, as long as they are applied consistently over time and aim to faithfully estimate expected credit losses using the concepts listed above. The standard requires management to apply judgment when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

Implementation Guidance and Illustrations

326-20-55-7

Because of the subjective nature of the estimate, this Subtopic does not require specific approaches when developing the estimate of expected credit losses. Rather, an entity should use judgment to develop estimation techniques that are applied consistently over time and should faithfully estimate the collectibility of the financial assets by applying the principles in this Subtopic. An entity should utilize estimation techniques that are practical and relevant to the circumstance. The method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity.

The standard does not prescribe approaches for estimating the allowance for expected credit losses. Rather, the Board decided that, given the subjective nature of the estimate, an entity should use judgment to develop an approach that faithfully reflects expected credit losses for financial assets and can be applied consistently over time. The standard lists, but does not define, several common credit loss methods that should continue to be acceptable under the new guidance, including:

- Discounted cash flow (DCF) methods
- Loss-rate methods
- Roll-rate methods
- Probability-of-default (PD) and loss-given-default (LGD) methods

- Methods that use an aging schedule (which are commonly used today for allowances for bad debts on trade accounts receivable)

All of these methods are used today with many different variations. Although the ASU says these methods would be acceptable under the new guidance, these methods will need to be adjusted to account for the differences between an incurred loss model and the CECL model. The adjustments will be required to provide an estimate of expected credit losses over the remaining contractual life of an asset and should be able to incorporate reasonable and supportable forecasts about future economic conditions and the effect of those conditions on historical loss information.

Bank regulatory perspectives

The US banking regulators issued a Joint Statement on the New Accounting Standard on Financial Instruments — Credit Losses[7] (Joint Statement) on 17 June 2016 to provide initial information about the new standard to banks, savings associations, credit unions and financial institution holding companies of all sizes.

The Joint Statement said: "The new accounting standard does not specify a single method for measuring expected credit losses; rather, institutions should use judgment to develop estimation methods that are well documented, applied consistently over time, and faithfully estimate the collectability of financial assets by applying the principles in the new accounting standard."

"The new accounting standard allows expected credit loss estimation approaches that build on existing credit risk management systems and processes, as well as existing methods for estimating credit losses (e.g., historical loss rate, roll-rate, discounted cash flow, and probability of default/loss given default methods). However, certain inputs into these methods will need to change to achieve an estimate of lifetime credit losses. For example, the input to a loss rate method would need to represent remaining lifetime losses, rather than the annual loss rates commonly used under today's incurred loss methodology. In addition, institutions would need to consider how to adjust historical loss experience not only for current conditions as is required under the existing incurred loss methodology, but also for reasonable and supportable forecasts that affect the expected collectability of financial assets."

How we see it

During the FASB's deliberations, certain constituents cautioned against taking a rules-based approach that would explicitly define expected credit losses and require entities to consider the time value of money. These constituents asked the FASB to strike a balance between providing enough guidance to make the objective clear and articulating the accounting model in a way that gives entities the flexibility to develop reasonable methods, considering cost/benefit limitations on data availability, forecasting and loss modeling.

Given the flexibility provided by the new guidance, we expect an implementation challenge to be determining whether certain modeling approaches are too simple to satisfy the Board's objective.

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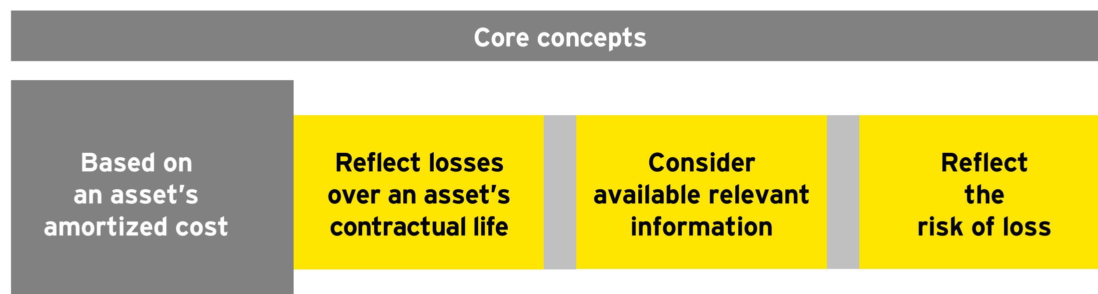
[7] Joint Statement on the New Accounting Standard on Financial Instruments — Credit Losses, Issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency on 17 June 2016.

2.2 Based on the asset's amortized cost



The standard requires the allowance for credit losses estimated by entities to be based on the underlying financial instrument's amortized cost basis.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

General

326-20-30-4

If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

326-20-30-5

If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including both of the following:

a. Amortized cost basis, excluding premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance)

b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments.

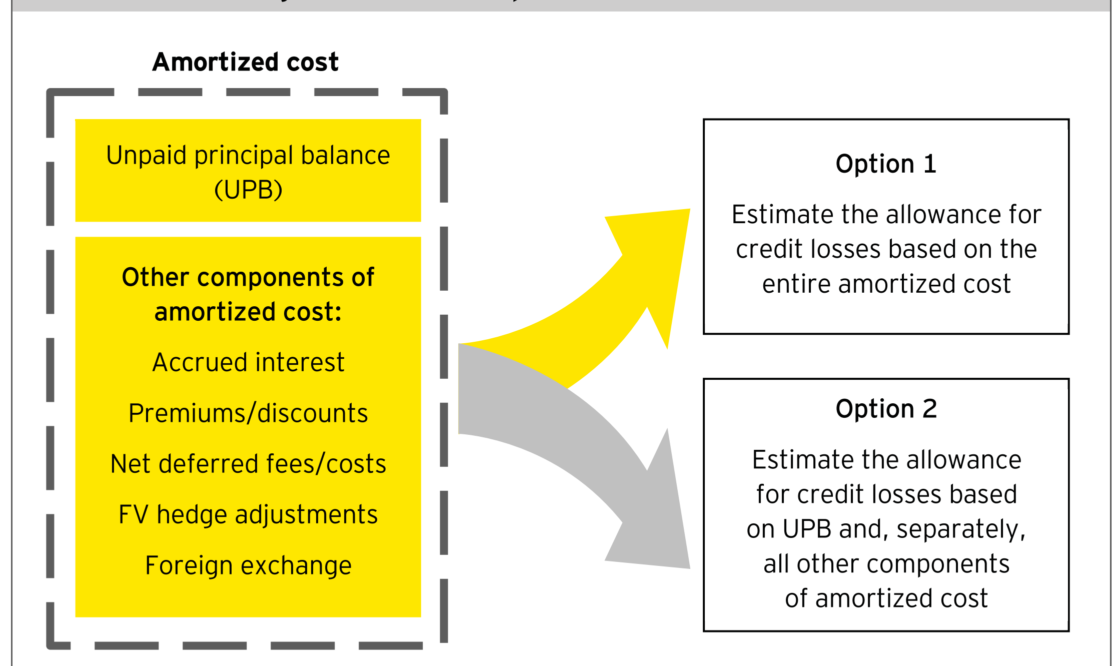
Glossary

Amortized Cost Basis

The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.

Regardless of how an entity determines the allowance, the standard requires credit losses to reflect expected losses of the amortized cost basis of an asset. An entity can develop that estimate based on the entire amortized cost of the asset. The standard also permits an entity to develop an estimate of expected credit losses by measuring components of the amortized cost separately or on a combined basis, as highlighted in ASC 326-20-30-5 and illustrated below. We understand that the FASB included this guidance to allow entities to use their current systems to make the estimate. That is, because some entities currently have systems that estimate their allowance on the unpaid principal balance, the FASB allowed entities to separately consider the components of amortized cost. Whichever approach is used, the objective is to recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset.

Illustration 1 — Basing the estimate of expected credit losses on an asset's amortized cost



Although the ASU requires the estimate to be based on a financial asset's amortized cost, it also says that when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. For example, currently some entities do not recognize any allowance at initial recognition when the amount of discount is greater than the calculated allowance (even though the discount is accreted over time). These entities recognize an allowance when the discount is accreted to an amount that is less than the required allowance. Under the new guidance, in such situations the estimate of credit loss would not be based on the total amortized cost of the financial asset, since you would ignore the discount component of the amortized cost in estimating the allowance.

How we see it

An entity's loss history could include only write-offs of the unpaid principal balance, or it could include all components of amortized cost (e.g., premiums, discounts, net deferred fees and costs). If only the unpaid principal balance write-offs are considered in an entity's loss history, adjustments would need to be made to make sure all elements of amortized cost are considered in the allowance estimate. We understand that some entities today apply historical loss rates to unpaid principal balances and then assess the need for additional allowances on the remaining components of amortized cost. The standard allows these practices to continue.

2.2.1 Effective interest rate when using DCF models

Although the standard does not mandate the use of certain loss estimation models, it does say that when an entity uses a DCF model, under which expected cash flows are forecasted and then discounted to a present value, the cash flows should be discounted using the financial asset's original effective interest rate. The following illustrates one way an entity might use a DCF approach to estimate the allowance for credit losses on an individual financial asset.

Illustration 2 — Estimating credit losses using a DCF approach

Assume that at 31 December 20X0, Company A originates a note receivable with the following characteristics:

- Par value (or unpaid principal balance) of $1,000,000
- Contractual interest rate of 10%
- Amortized cost of $980,000
- Effective interest rate of 10.64%

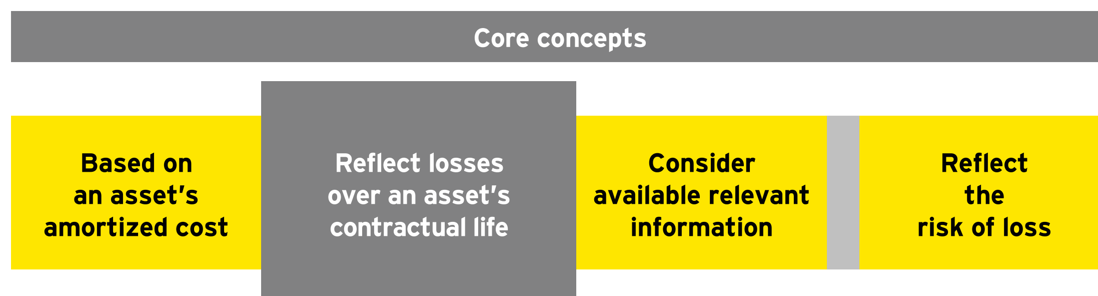
The note matures on 31 December 20X4 with the contractual cash flows presented below in the first column. Company A uses the concepts in ASU 2016-13 to estimate the cash flows it expects to receive, which are shown in the table below. Company A estimates the allowance on the note using the guidance in ASC 326-20-30-4 as follows:

	Contractual cash flows	Estimated expected cash flows
31 December 20X1	$ 100,000	$ 95,000
31 December 20X2	100,000	95,000
31 December 20X3	100,000	95,000
31 December 20X4	1,100,000	1,060,000
Total gross cash flows	$ 1,400,000	$ 1,345,000

Present value of cash flows discounted at 10.64%	$ 941,010
Amortized cost basis	980,000
Difference between the amortized cost basis and the present value of the expected cash flows	$ 38,990

Based on the expected cash flows forecasted by management, Company A would recognize an allowance for credit losses of $38,990 as of 31 December 20X0.

2.3 Reflect losses over an asset's remaining contractual life



Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

The standard states that expected credit losses should reflect losses expected over the contractual life of an asset, with two important clarifications:

- Prepayments reduce potential loss by shortening the time period over which the lender (investor) is expected to be exposed to credit losses to a period of time less than the full contractual term. As a result, the estimate of expected credit losses should reflect expected prepayments.
- The life of an asset generally should not include extensions, renewals and modifications that would extend the expected remaining life beyond the contractual term, unless the entity has a reasonable expectation that it will execute a troubled debt restructuring (TDR) with the borrower, as discussed later. As a result, future losses that could result from an extension should only be considered in the estimate of expected credit losses when there is a reasonable expectation of a TDR.

These clarifications are intended to result in an estimate of expected credit losses that reflects losses expected over the remaining period of time that the lender is expected to be exposed to losses on outstanding borrowings.

2.3.1 Prepayments

Prepayments reduce an entity's outstanding credit exposure (e.g., amortized cost outstanding in any given year). If these prepayments had not occurred, total losses on the portfolio might have been higher. An entity needs to understand how prepayments affect its historical loss statistics, and the guidance in paragraph ASC 326-20-30-6 explains the treatment of prepayments under both a DCF approach (i.e., ASC 326-20-30-4) and a non-DCF approach (i.e., ASC 326-20-30-5).

How to consider prepayments when estimating expected credit losses

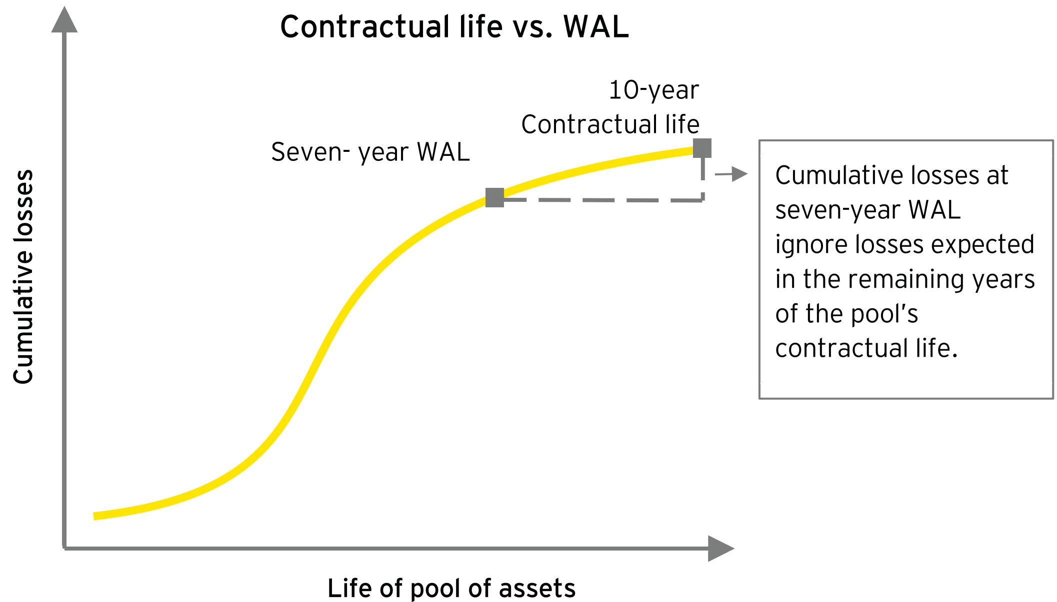
When using an approach that discounts expected cash flows	When using an approach that does not rely on discounted expected cash flows
▸ Prepayments can be reflected in the timing and amount of future cash flows used as inputs into the DCF calculation	▸ Prepayments can be embedded in the historical credit loss statistics used to estimate expected credit losses ▸ Prepayments can be a separate input in the approach or method used to estimate expected credit losses

We believe there is a difference between estimating losses over the contractual life of a pool of assets, recognizing that prepayments reduce loss, and using the weighted average life (WAL) of the pool of assets (i.e., the typical duration for the product). Illustration 3 below shows this difference.

Estimating losses on a pool of assets over the pool's weighted average life will ignore losses that occur later in the contractual life on assets that aren't prepaid.

Illustration 3 — Contractual life versus WAL considering prepayments

This illustration depicts the cumulative losses of a pool of assets with a 10-year contractual life and a seven-year WAL (i.e., the weighted average duration of this pool of assets based on the entity's past prepayment experience with similar loans). If expected credit loss is calculated only on the WAL, there is an element of credit risk in the later years of the pool's life that is not considered.



How we see it

Estimating losses over the contractual life of an asset rather than the WAL is more consistent with the Board's objective because it reflects the risk of losses occurring late in the life of an asset. However, it is not clear whether estimating losses over the WAL of an asset combined with other adjustments would meet the objective of the standard.

This isn't an issue under today's guidance, which doesn't require a lifetime loss estimate for non-impaired financial assets.

2.3.2 Extensions, renewals and modifications

As noted above, the ASU provides that the contractual term over which credit losses are established shouldn't include expected extensions, renewals and modifications. However, an exception is provided when an entity reasonably expects to execute a TDR with the borrower in the future. In those circumstances, the entity's estimate of credit losses should cover the expected life of the loan, including extensions, modifications and renewals. For example, if commercial real estate values have declined significantly, borrowers in commercial real estate loans may experience financial difficulty and may be unable to meet the terms of their contracts. If it is reasonably expected that the lender will modify the loan by executing a TDR, the expected extension period would be considered part of the life of a loan for purposes of estimating expected credit losses. To determine whether a TDR is reasonably expected, the lender would need to evaluate its past history and whether it expects a borrower to be able to refinance the loan on similar terms with another lender. This exception for "reasonably expected" TDRs is consistent with the Board's view that a loan that is modified in a TDR is a continuation of the original loan, not a new loan.

How we see it

By using the words "reasonable expectation" and "with the borrower," we believe the FASB is indicating that entities need to have expectations that they will execute TDRs that are more precise than general forecasts. For example, an entity may not have this type of expectation when it offers a program modification with more favorable terms to a large group of borrowers. That's because the entity wouldn't be able to identify the loans it reasonably expects to restructure in a TDR, even though it may have a general sense of the percentage of loans it will restructure in TDRs. However, as time passes, the entity should be able to develop an expectation at a more granular level.

2.3.3 Modeling considerations

In modeling credit losses under today's guidance, most entities pool financial assets without regard to remaining term to maturity. This is because today's guidance doesn't require an estimate of credit losses over the remaining life of a loan unless that loan's credit quality has deteriorated to the point where the loan is considered impaired under ASC 310-10. One question that has arisen is whether pooling assets with varying remaining terms to maturity and estimating losses over a WAL is an acceptable alternative to segregating financial assets by remaining term to maturity. The following illustration shows the potential differences between these two approaches.

Illustration 4 — Remaining contractual life versus WAL for a pool of assets

This illustration shows the difference between estimating expected credit losses using the contractual remaining life of individual assets in a pool and using the WAL of the assets in the pool.

Description	Amortized cost	Remaining life (years)	Rating	Cumulative PD	LGD	Expected credit loss
Contractual life calculation						
Loan #1	$ 1,000,000	1	A	0.095	20%	$ 190
Loan #2	$ 1,000,000	3	A	0.584	20%	1,168
Loan #3	$ 1,000,000	5	A	1.244	20%	2,488
						$ 3,846
WAL calculation						
Loan pool average	$ 3,000,000	3	A	0.584	20%	$ 3,504
				Difference		$ 342

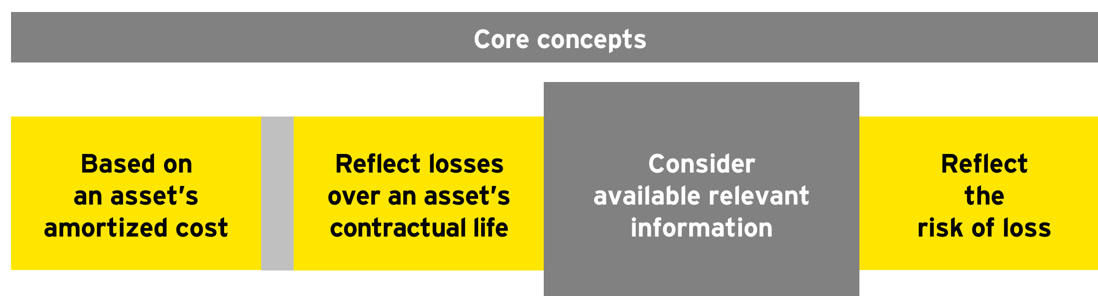
Expected credit loss is calculated considering the number of years until each individual loan matures and applying the PD that corresponds to the remaining life of the loan. (Note that PDs vary, based on the length of time to maturity.) For example, Loan #1 has one year until maturity and an associated PD of 0.095 (based on historical experience adjusted for current conditions and reasonable and supportable forecasts), which results in an expected loss of $190 for that individual loan. By adding each loan's expected credit loss based on the contractual years to maturity, the entity would calculate its total expected loss for the pool as $3,846.

However, the amount of the expected credit loss will be different if it is calculated based on the WAL of the pool. The pool has a three-year weighted average remaining life and an associated three-year PD of 0.584. This results in a total expected credit loss for the pool of $3,504. That is, in this example, there is a difference of $342 or approximately 9% between the expected credit loss using the WAL and the expected credit loss using the individual contractual lives of each loan in the pool.

How we see it

As Illustration 4 shows, there could be a significant difference between these two approaches. As indicated above, we believe one of the more challenging aspects of implementing the ASU will be determining which modeling simplifications are appropriate and faithfully represent the concepts described by the FASB.

2.4 Consider available relevant information



The standard requires an entity's estimate of expected credit losses to reflect available information that is relevant to assessing the collectibility of cash flows. Entities should consider information about past events, current conditions and forecasts about the future that are reasonable and supportable. This may include information that is (1) internal or external, (2) qualitative or quantitative and (3) related to the specific borrower or the broader environment in which the entity operates (e.g., the macroeconomic environment).

Bank regulatory perspectives

The Joint Statement states that "to implement the new accounting standard, institutions should collect data to support estimates of expected credit losses in a way that aligns with the method or methods that will be used to estimate their allowances for credit losses. Depending on the method selected, institutions may need to capture additional data. Institutions also may need to retain data longer than they have in the past on loans that have been paid off or charged off."

In a significant change from today's guidance, the ASU requires an entity to incorporate reasonable and supportable forecasts in its estimate of expected credit losses. Because it's more difficult to accurately forecast the future over longer time horizons, the new standard requires entities to use forecasts only if they are reasonable and supportable. While some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, we do not believe it will be acceptable for an entity to say it cannot develop such a forecast and just use historical losses.

The standard states that an entity is only required to use information that is "reasonably available without undue cost and effort." The standard also says that internal information may be more relevant than external information.

How we see it

A question that we believe will need to be addressed is whether it is acceptable for management to take a contrarian view of the future when establishing its allowance. For example, if the ASU had been in effect in 2007 and a bank's management had forecasted that a global economic crisis would begin in 2008, most "experts" at the time likely would have disagreed with that forecast.

We believe that the FASB intended for management to use its expectation of the future when estimating credit losses, regardless of whether that is a contrarian view, as long as the forecast is reasonable and supportable. What is reasonable and supportable will be a matter of judgment. We generally believe the terms "reasonable" and "supportable" provide parameters around the types of forecasted information that is acceptable in an estimate of expected credit loss. Clearly, a forecast that is either unreasonable or unsupportable would not be acceptable. Entities will have different forecasts of the future and as long as they are reasonable and supportable, they will be acceptable.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-7

When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both

relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

The standard provides guidance in the following areas to assist an entity in considering relevant information:

- Obtaining relevant historical loss information
- Assessing current conditions
- Developing reasonable and supportable forecasts about the future
- Adjusting for current conditions and reasonable and supportable forecasts

2.4.1 *Obtaining relevant historical loss information*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-8

Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

Implementation Guidance

326-20-55-2

In determining its estimate of expected credit losses, an entity should evaluate information related to the borrower's creditworthiness, changes in its lending strategies and underwriting practices, and the current and forecasted direction of the economic and business environment. This Subtopic does not specify a particular methodology to be applied by an entity for determining historical credit loss experience. That methodology may vary depending on the size of the entity, the range of the entity's activities, the nature of the entity's financial assets, and other factors.

326-20-55-3

Historical loss information generally provides a basis for an entity's assessment of expected credit losses. An entity may use historical periods that represent management's expectations for future credit losses. An entity also may elect to use other historical loss periods, adjusted for current conditions, and other reasonable and supportable forecasts. When determining historical loss information in estimating expected credit losses, the information about historical credit loss data, after adjustments for current conditions and reasonable and supportable forecasts, should be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed.

The guidance states that historical information about losses generally provides a basis for the estimate of expected credit losses. That is, historical credit loss experience for similar assets is likely a relevant data point for estimating the credit losses that will emerge for assets currently held by the entity.

The standard doesn't specify a particular approach for determining an entity's historical credit loss information. However, the implementation guidance indicates that it is important that the historical loss information (after adjustments for current conditions and reasonable and supportable forecasts) be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed. For example, if an entity is estimating expected credit losses on its portfolio of five-year auto loans to borrowers with prime Fair Isaac Company (FICO) scores, one would generally expect that the historical information used in that estimate to reflect information for five-year auto loans to borrowers with prime FICO scores.

Management will need to consider the historical time period and any required adjustments to reflect current expectations of lifetime credit loss (i.e., current conditions and reasonable and supportable forecasts). For example, if management expects an economic downturn, it might either:

- Use historical credit loss information reflecting a downturn in a previous economic cycle
- Use long-term historical credit loss statistics that include an economic cycle, and adjust those statistics for its assessment of current conditions (including the current point in the economic cycle) and the forecasted direction of the economic cycle

We believe management's choice between these or other alternatives would likely be influenced by data availability and how management judges its ability to estimate the current point in the economic cycle and correlate it to previous economic cycles.

How we see it

Entities will need to evaluate the contractual lives of their products and determine whether they possess sufficient historical data to meet the new standard's objective of estimating lifetime expected losses. Today, many loss rate and PD methods for loss estimation under ASC 450 use an annual loss rate or a 12-month PD, which would be inconsistent with the objective of estimating expected credit losses over the contractual life of an asset if that period is longer than 12 months. Under the expected credit loss model, a lifetime loss will be booked upon origination or purchase of the asset.

2.4.2 *Assessing and adjusting for current conditions and reasonable and supportable forecasts*

Assessing and adjusting historical loss information for current conditions and reasonable and supportable forecasts generally will require an entity to perform the following steps:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-9

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

326-20-55-4

Because historical experience may not fully reflect an entity's expectations about the future, management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information. In making this determination, management should consider characteristics of the financial assets that are relevant in the circumstances. To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility…

The assessment of how to adjust historical loss information to reflect current conditions and reasonable and supportable forecasts may include consideration of factors that are borrower-specific (e.g., the borrower's credit rating) and those that are more macro-economic (e.g., unemployment, growth in gross domestic product or GDP). To adjust historical information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant in determining the expected collectibility of cash flows. The implementation guidance in the ASU describes factors that may be relevant to determining the expected collectibility of cash flows. These factors are generally consistent with those in SEC Staff Accounting Bulletin (SAB) Topic 6.L, Accounting for Loan Losses (SAB 102).[8]

[8] SEC Staff Accounting Bulletin (SAB) Topic 6.L, Financial Reporting Release 28 — Accounting for Loan Losses by Registrants Engaged in Lending Activities.

The ASU provides examples of factors an entity may consider, depending on the nature of the asset. Keep in mind that not all of the following factors may be relevant to every situation, and factors not on the list may be relevant:

Potential factors for an entity to consider in assessing collectibility	
Credit profile of the customer or borrower	**An entity's other considerations**
‣ Customer's or borrower's financial condition, credit rating, asset quality or business prospects ‣ Customer's or borrower's failure to make scheduled interest or principal payments ‣ Remaining payment terms of the financial asset ‣ Remaining time to maturity and the timing and extent of prepayments on the financial asset ‣ Value of underlying collateral when the collateral dependent practical expedient has not been used ‣ Environmental factors of a customer or borrower	‣ Nature and volume of the entity's financial assets ‣ Volume and severity of past due financial assets and the volume and severity of adversely classified or graded financial assets ‣ Lending policies and procedures, including changes in underwriting standards and collection, write-offs and recovery practices ‣ Quality of the entity's credit review system ‣ Experience and ability of the entity's management and other relevant staff ‣ Areas in which the entity's credit is concentrated

Entities will revert to historical loss information during periods over which they can't develop or obtain reasonable and supportable forecasts.

The ASU provides relatively little implementation guidance on how an entity should develop its forecast, or which factors to consider. We expect most entities to focus on the economic variables that management believes most significantly affect the collectibility of cash flows. The following table highlights some economic variables that may be relevant in this analysis.

Potential economic variables used in developing forecasts	
‣ Gross domestic product	‣ Housing price indices
‣ Inflation	‣ Factory orders
‣ Unemployment rates	‣ Bankruptcies
‣ Interest rate environment	‣ Stock market indices
‣ Credit spreads	‣ Savings rates
‣ Business confidence metrics	

The standard acknowledges that an entity may not be able to develop forecasts over the full remaining life of a financial asset. The Board decided that an entity should revert to using historical loss information when it is no longer able to develop or obtain a reasonable and supportable forecast. This decision reflects the Board's view that it is not useful to assign a credit loss estimate of zero to certain periods merely because an entity is unable to precisely estimate future economic conditions for those periods. Rather, the Board indicated in the Background Information and Basis for Conclusions (BC45) that historical information about loss is a relevant metric upon which to base an entity's current estimate of credit losses for periods beyond which the entity believes it is able to develop or obtain reasonable and supportable forecasts.

Importantly, the ASU requires entities to revert to historical loss information, but doesn't prescribe how an entity should do this. In practice, we expect an entity will likely determine how to revert to historical loss information based on the depth of its historical loss information and its ability to use systems or processes to efficiently and effectively redefine the calculation parameters for key historical loss statistics. For example, an entity might develop a projection of lifetime losses based on historical loss information and adjust the estimate for only the periods over which the entity is able to develop a reasonable and supportable forecast about the future. After that period, the entity would revert back to historical loss experience. Under this approach, the entity is effectively using an "immediate reversion" to historical loss amounts because it is starting with an estimate based on historical information and only adjusting for the periods that it is able to forecast. Alternatively, an entity might have the data and modeling capabilities to forecast a more gradual change in factors, and that entity may choose to revert to historical information over time using a rational and systematic approach.

How we see it

Economic cycles are often influenced by forces that are difficult to predict and model. Entities are likely to hold a variety of views about where the economy is in the cycle at each reporting date.

An entity will need to apply forecasts consistently across the organization. Management will need to maintain robust processes and controls to mitigate the risks associated with the use of highly subjective forecasts in estimating credit losses.

An entity will need to consider how historical loss patterns differ from current expectations (including both current conditions and reasonable and supportable forecasts). This process may be very challenging and may require significant judgment. When performing this analysis, entities will likely compare the economic indicators they used in developing their forecasts to historical economics factors. The standard requires an entity to then adjust its historical credit loss experience, as necessary, for its current expectations.

The guidance states that adjustments to historical loss experience may be qualitative in nature. For example, business confidence surveys may suggest that there is a perception that the economy is weakening, or surveys of credit underwriting standards may suggest that there is a loosening of credit. This may indicate that the estimate of expected credit losses should be raised. The practical challenge is for management to translate qualitative factors like this, and other forecasted information, into an appropriate amount to adjust the estimate of expected credit loss.

The ASU provides the following example to illustrate one way in which forecasts might be incorporated into the estimate of expected credit losses:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 1: Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation)

326-20-55-18

This Example illustrates one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

326-20-55-19

Community Bank A provides 10-year amortizing loans to customers. Community Bank A manages those loans on a collective basis based on similar risk characteristics. The loans within the portfolio were originated over the last 10 years, and the portfolio has an amortized cost basis of $3 million.

326-20-55-20

After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A's historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts, but determined none were necessary.

326-20-55-21

In accordance with paragraph 326-20-55-4, Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates a 10-basis-point increase in credit losses incremental to the 1.5 percent historical lifetime loss rate due to the expected decrease in real estate values and a 5-basis-point increase in credit losses incremental to the historical lifetime loss rate due to expected deterioration in unemployment rates. Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment rates beyond the reasonable and supportable forecast period. Under this loss-rate method, the incremental credit losses for the current conditions and reasonable and supportable forecast (the 15 basis points) is added to the 1.5 percent rate that serves as the basis for the expected credit loss rate. No further reversion adjustments are needed because Community Bank A has applied a 1.65 percent loss rate where it has immediately reverted into historical losses reflective of the contractual term in accordance with paragraphs 326-20-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

326-20-55-22

The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be $49,500.

In the example above, Bank A determined that a 15-basis-point increase from its historical lifetime credit loss rate was reasonable for Year 1 and Year 2, due to its forecast of certain macroeconomic factors. However, the example does not explain how Bank A determined how much each factor would increase losses in years 1 and 2. That is, it isn't clear why the forecasted decrease in real estate values would lead to a 10-basis-point increase in losses rather than a 20-basis-point increase. The standard does not provide an example that demonstrates how to quantify adjustments to historical information.

The example also illustrates an immediate reversion to historical losses. As noted above, Bank A added 15 basis points to the historical lifetime credit loss rate representing the additional lifetime credit losses it expects, based on current conditions and its reasonable and supportable forecasts of the primary factors that could affect the expected collectibility of the amortized cost basis of the loan portfolio (in this example the reasonable and supportable forecast period is two years). Bank A makes no further adjustment to this loss rate for potential changes in these factors beyond the two years because it is unable to make a reasonable and supportable forecast of those factors beyond that point. Because no changes in the factors are assumed for years beyond the reasonable and supportable forecast period, Bank A is immediately reverting to their historical lifetime credit loss rate. It should be noted that in this illustration, Bank A has chosen to revert based on the entire estimate (and not at the input level).

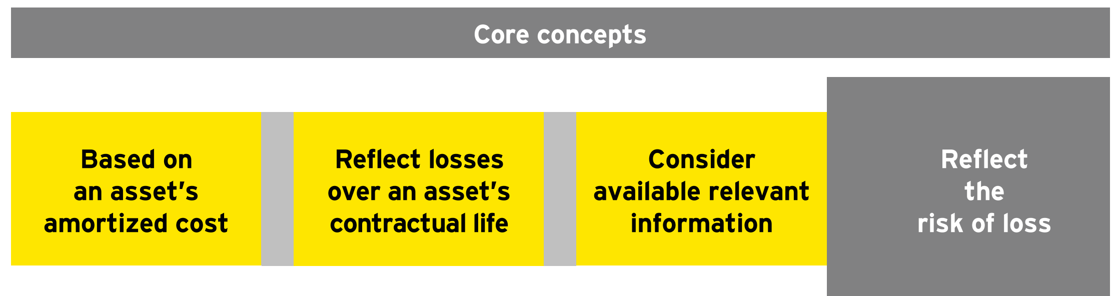
An entity's allowance for credit losses should reflect the risk of loss, even when that risk is remote.

How we see it

We believe quantifying the adjustment to historical credit loss rates will be one of the more challenging aspects of applying the new standard, and we expect there to be diversity in practice in how entities convert the effect of reasonable and supportable forecasts into a quantitative adjustment to the allowance.

Further, diversity in practice will also result from the fact that, after the reasonable and supportable forecast period, entities can revert to historical loss information immediately, on a straight-line basis or using another rational and systematic basis and because they can revert at either the input level or based on the entire estimate.

2.5 Reflect the risk of loss, even when that risk is remote



The standard requires an entity's allowance for credit losses to reflect the risk of loss, even when that risk is remote. This is required whether the entity is estimating the allowance for an individual asset or a group of assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-10

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

For example, if there is a 97% chance that the loss will be zero and a 3% chance of a total loss, the expected loss estimate under the new standard would reflect the 3% likelihood of a total loss. The ASU requires a collective approach when assets share similar risk characteristics because a pool-based approach produces an outcome that is consistent with the "risk of loss" principle. However, this principle also applies to the estimate of an expected credit loss for an individual asset.

How we see it

The requirement to reflect the risk of loss in the estimate of expected credit loss will change practice for HTM debt securities and will create a difference between how impairment will be measured for HTM securities and AFS debt securities.

Today, impairment for an HTM debt security is measured considering the best estimate of the present value of the cash flows expected to be collected. This "best estimate" frequently does not reflect the risk of loss when that risk is low (e.g., a 3% likelihood of loss).

Under the ASU, there will be an allowance for HTM securities measured using the "risk of loss" concept. Impairment for an AFS debt security will continue to be measured on a best-estimate basis (as discussed later).

2.5.1 When an entity may reasonably expect 'zero loss'

The new standard provides that there would not be an expected credit loss when historical credit loss experience adjusted for current conditions and reasonable and supportable forecasts provides an expectation that nonpayment of the amortized cost basis is zero.

However, the standard is clear that in the case of a financial asset that is secured by collateral (e.g., a commercial real estate loan), an entity is not permitted to estimate a loss of zero simply because the current value of the collateral exceeds the amortized cost basis of the asset. Rather, an entity should consider potential future changes in collateral value (e.g., potential changes in the value of a specific commercial property or the broader commercial real estate index) and historical loss experience for financial assets that were secured by similar collateral.

The following example from the standard illustrates the zero loss expectation for US Treasury securities.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

326-20-55-48

This Example illustrates one way, but not the only way, an entity may estimate expected credit losses when the expectation of nonpayment is zero. This example is not intended to be only applicable to U.S. Treasury securities.

326-20-55-49

Entity J invests in U.S. Treasury securities with the intent to hold them to collect contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.

326-20-55-50

Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J's management still believes that there is a possibility of default, even if that risk is remote. However, Entity J considers the guidance in paragraph 326-20-30-10 and concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity's currency is routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its U.S. Treasury securities at the end of the reporting period. The qualitative factors considered by Entity J in this Example are not an all-inclusive list of conditions that must be met in order to apply the guidance in paragraph 326-20-30-10.

How we see it

We believe that entities will be able to establish a "zero loss" expectation only in very limited cases. While the amounts entities will calculate for expected credit losses for many individual "very low risk" financial assets may not be individually significant, entities should consider whether expected losses for these assets could be significant in the aggregate.

While the ASU provides an example of a zero loss expectation for US Treasury securities and says they aren't the only instruments for which an entity could have a zero loss expectation, it's not clear when else such an expectation would be appropriate. For example:

- ***Corporate bonds***. While an entity may have no history (or expectation) of loss for a particular corporate borrower, corporate bond default studies generally demonstrate that there is a risk of loss, even for highly rated bonds. As a result, it might be challenging for an entity to establish a "zero loss" expectation for a highly rated (e.g., AAA) corporate bond it classifies as HTM.
- ***Indirect obligations of the US Government***. It is not clear whether it would be reasonable for an entity to develop a "zero loss" expectation for indirect obligations of the US Government, such as an obligation of a government-sponsored enterprise (e.g., Fannie Mae, Freddie Mac) that it classifies as HTM.

2.6 Measurement considerations for financial assets secured by collateral

2.6.1 Measuring expected credit losses when foreclosure is probable

Similar to today's guidance, the standard requires an entity to measure expected credit losses using the fair value of the collateral when the entity determines that foreclosure is probable.

2.6.2 Practical expedients for financial assets secured by collateral

The standard provides two practical expedients that an entity can use for measuring expected credit losses on financial assets secured by collateral even when foreclosure is not probable.

2.6.2.1 Collateral-dependent financial assets

An entity is permitted to estimate credit losses on certain collateral-dependent financial assets as the difference between the collateral's fair value and the amortized cost basis of the financial asset. Both of the following criteria must be met for an entity to use this practical expedient for an individual asset:

- The entity expects repayment of the financial asset to be provided substantially through the operation or sale of the collateral.
- The entity has assessed that the borrower is experiencing financial difficulty as of the report date.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-5

An entity may use, as a practical expedient, the fair value of the collateral at the reporting date when recording the net carrying amount of the asset and determining the allowance for credit losses for a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date (collateral-dependent financial asset). If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell (on a discounted basis). However, the entity shall not incorporate in the net carrying amount of the financial asset the estimated costs to sell the collateral if repayment or satisfaction of the financial asset depends only on the operation, rather than on the sale, of the collateral. For a collateral-dependent financial asset, an entity may expect credit losses of zero when the fair value (less costs to sell, if applicable) of the collateral at the reporting date is equal to or exceeds the amortized cost basis of the financial asset. If the fair value of the collateral is less than the amortized cost basis of the financial asset for which the practical expedient has been elected, an entity shall recognize an allowance for credit losses on the collateral-dependent financial asset, which is measured as the difference between the fair value of the collateral, less costs to sell (if applicable), at the reporting date and the amortized cost basis of the financial asset. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses.

Current US GAAP provides a similar practical expedient but defines "collateral dependent" as a loan for which the repayment is expected to be provided "solely by the underlying collateral." In the new standard, the FASB modified this definition to say "substantially through the operation or sale of the collateral" and to emphasize the financial difficulty criterion. We generally believe application of this practical expedient will be similar to current practice.

The entity should consider costs to sell in addition to the collateral value when it expects the collateral to be sold to repay the financial asset. Costs to sell should not be considered if the entity expects that repayment will come through the operation of the collateral.

2.6.2.2 *Financial assets with collateral maintenance provisions*

If the financial asset being measured for credit losses includes a collateral maintenance agreement, an entity may be able to elect a practical expedient to compare the amortized cost basis of the financial asset with the fair value of collateral at the reporting date to measure the allowance for expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

ASC 326-20-35-6

For certain financial assets, the borrower may be required to continually adjust the amount of the collateral securing the financial asset(s) as a result of fair value changes in the collateral. In those situations, an entity may use, as a practical expedient, a method that compares the amortized cost basis with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary. If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, an entity shall limit the allowance for credit losses on the financial asset to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

This practical expedient can be used if the financial asset includes a collateral maintenance provision that requires the borrower to continually adjust the amount of collateral securing the financial asset.

An entity will need to assess whether the amount of collateral is "continually" adjusted. While the term "continually" is not defined, we expect that financial contracts requiring collateral to be adjusted daily would meet this requirement.

If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, the standard provides that the entity limit the expected credit loss on the financial asset to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

How we see it

The FASB provided this practical expedient for "standard" repurchase (repo) agreements, as we learned in discussions with the FASB staff. It's unclear what is meant by "continually" adjusting the amount of collateral that secures the financial asset. We believe that certain lending arrangements with provisions to adjust collateral daily would qualify for this practical expedient. The less frequently the collateral is adjusted, the more challenging it will be for an entity to assert that collateral is continually adjusted. In any case, an entity will need to consider factors such as the liquidity of the collateral and the extent of overcollateralization to determine whether it can apply this practical expedient.

The paragraph that provides the practical expedient also illustrates when an entity may be able to establish a "zero loss expectation," that is, when an entity may conclude a loss of zero. An entity might reach this conclusion when:

- The collateral securing the financial asset is replenished continually, and the amount always equals or exceeds the amortized cost basis of the financial asset.
- The entity expects the borrower to continue to replenish the collateral under the collateral maintenance agreement.

This may occur in repurchase arrangements where the "repo party" borrows funds in exchange for highly liquid security collateral that is valued daily. The amount of the collateral is adjusted up or down frequently for changes in the fair value of the underlying securities transferred. This collateral maintenance provision is designed so that at any point during the arrangement, the fair value of the collateral held by the lender (also referred to as the "reverse repo party") equals or is greater than the amortized cost basis of the "loan" (i.e., the financial asset, which in this case is the reverse repurchase arrangement).

The following example illustrates one way an entity may apply the practical expedient.

Illustration 5 — Applying the collateral maintenance practical expedient to a secured receivable under a reverse repurchase agreement

Dealer B (the repo party or borrower) holds a security with a fair value of $1,000 and a coupon rate of 7% that will mature in three years. The security is highly liquid. Bank A (the reverse repo party or lender) enters into a reverse repurchase agreement with Dealer B to provide short-term financing in exchange for Dealer B's security, which is used as collateral.

Under the agreement, Dealer B transfers the security to Bank A and Bank A transfers $980 in cash to Dealer B. Dealer B agrees to repurchase the identical security from Bank A in one year for $1,020. The agreement also requires Dealer B to maintain a collateralization level of 102% of the repurchase price (i.e., the purchase price of $980 plus interest accrued at such time) throughout the life of the transaction. To maintain sufficient levels of collateralization, the collateral is adjusted daily based on the current market value of the securities transferred. If Dealer B defaults on the repurchase, Bank A can liquidate the collateral to recover some or all of its cash.

Assume that the transfer of the security collateral is accounted for as a secured borrowing because the requirements of ASC 860-10-40-24 are met. As a result, Bank A will not recognize the security it received from Dealer B but will initially record a receivable from Dealer B for the cash it has transferred ($980). Subsequently, Bank A will accrete the receivable of $980 to $1,020 over one year using an interest method. In addition, the amount of the collateral is adjusted up or down daily for daily changes in the fair value of the underlying securities so that the fair value of the collateral will always equal 102% of the amortized cost of the receivable.

In this case, the collateral is adjusted "continually" for changes in the market price of the underlying securities. Bank A elects to apply the practical expedient in ASC 326-20-35-6 to measure the expected credit losses for the receivable by comparing the fair value of the collateral at the reporting date with the amortized cost basis of the receivable.

The collateral maintenance provision in the arrangement makes sure that the fair value of the collateral equals or is greater than the amortized cost basis of the receivable. Furthermore, Bank A has the right to sell or pledge the security collateral, which is highly liquid. Bank A also expects Dealer B to continue to be able to adjust the collateral in the future based on an assessment of the counterparty's credit profile. In this situation, Bank A believes a "zero loss expectation" for its receivable is appropriate.

How we see it

For financial assets secured by collateral maintenance provisions, we believe entities will need to understand both the contractual terms of the agreements and how these terms are put into effect to determine whether they qualify for this practical expedient. An entity that does not intend to enforce its contractual right related to collateral maintenance should not apply this practical expedient.

2.7 Other considerations for developing an expected credit loss estimate

The ASU also provides guidance on the following matters that should be considered when developing the CECL allowance:

- Level of aggregation
- Credit enhancements
- Write-offs and recoveries
- Modifications of financial assets
- Judgments

2.7.1 *Level of aggregation*

Entities will measure expected credit losses on pools of financial assets when they have similar risk characteristics.

The ASU requires an entity to measure expected credit losses of financial assets on a collective basis or pool of assets unless the assets do not have similar risk characteristics.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-2

An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

Implementation Guidance

326-20-55-5

In evaluating financial assets on a collective (pool) basis, an entity should aggregate financial assets on the basis of similar risk characteristics, which may include any one or a combination of the following (the following list is not intended to be all inclusive):

a. Internal or external (third-party) credit score or credit ratings

b. Risk ratings or classification

c. Financial asset type

d. Collateral type

e. Size

f. Effective interest rate

g. Term

h. Geographical location

i. Industry of the borrower

j. Vintage

k. Historical or expected credit loss patterns

l. Reasonable and supportable forecast periods

In requiring a pool-based estimate, the FASB reasoned that while an entity may expect an individual asset to fully recover, an entity that, for example, has a pool of 1,000 similar assets may reasonably expect that some portion of those assets will default, even if it isn't sure which individual asset will default. In the Basis for Conclusions (BC 49) in the ASU, the FASB said that "because there is no 'trigger' for recognition, the method should reflect changes in the status of the assets, as well as changes in the entity's experience and expectations in a timely manner, and the allowance should be commensurate with the expected losses inherent in the assets held at the reporting date." The FASB believes that the "risk of loss" concept is easier to understand and reflect in the estimate when assets are pooled; however, the estimate must still consider the risk of loss when expected losses are measured for an individual asset.

Today, many entities segment their portfolios as a means to better manage credit risk within their entities. This segmentation is often used for estimating the allowance for credit losses. The ASU allows an entity to continue to estimate the allowance for credit losses based on the way it manages credit risk today by allowing the entity to pool assets with similar risk characteristics. Regardless, entities should consider whether changes are needed to their existing pools based on how they monitor credit risk.

The standard provides flexibility for entities to segment a portfolio of financial assets. That is, ASC 326-20-55-5 says that an entity should aggregate based on "any one or a combination" of the characteristics listed in that paragraph. What's more, the list includes characteristics that are not typically associated with credit quality (e.g., size, term, industry of the borrower), suggesting that some assets with different credit profiles could be grouped together based on their other characteristics. We expect entities to generally elect to use the same approach or a similar approach for grouping assets as they do today. Furthermore, although we expect segmentation will be similar for many entities, in the case where vintage is not used as a similar risk characteristic, entities may further disaggregate these pools for determining their allowance estimates to reflect differing time to maturities of the assets within the pool.

Entities should not include financial assets in both their collective assessments and their individual assessments.

Bank regulatory perspectives

The Joint Statement provides the following observations about portfolio segmentation:

"The new accounting standard requires institutions to measure expected credit losses on a collective or pool basis when similar risk characteristics exist. Although the new accounting standard provides examples of such characteristics, smaller and less complex institutions may continue to follow the practices they have used for appropriately segmenting the portfolio under an incurred loss methodology or they may refine those practices."

"Further, if a financial asset does not share risk characteristics with other financial assets, the new accounting standard requires expected credit losses to be measured on an individual asset basis. As with practices applied under the incurred loss methodology, financial assets on which expected credit losses are measured on an individual basis should not also be included in a collective assessment of expected credit losses."

How we see it

We believe the standard provides flexibility in how entities can choose to pool assets. That is, we believe that entities will be able to use their internal risk management policies and practices to determine which assets to aggregate.

2.7.2 Credit enhancements

An entity should consider the mitigating effects of certain credit enhancements, such as guarantees and subordinated interests, when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments- Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-12

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

The guidance prohibits an entity from considering how freestanding credit enhancements, such as purchased credit-default swaps, would mitigate expected credit losses on financial assets. The standard defines a freestanding contract as one that is entered into either (1) separate and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. A guarantee that is not freestanding would be considered in the assessment of expected credit loss. For example, in the case of a residential mortgage loan, a lender may require a borrower with a low credit profile to obtain a guarantee from a second individual with a higher credit profile (or income level) (also known as a guarantor) to co-sign the mortgage agreement. In such a case, this guarantee from the guarantor is embedded in the contract and would be considered in the assessment of credit loss.

How we see it

We believe a credit enhancement is generally not freestanding if it "travels" with the related financial asset. For example, if a holder of a financial asset that is the subject of the credit enhancement transfers that financial asset to a new investor and that new investor is now the beneficiary of the credit enhancement, the credit enhancement is not freestanding and should be considered in the estimate of expected credit losses.

2.7.3 *Write-offs and recoveries*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-8

Write-offs of financial assets, which may be full or partial write-offs, shall be deducted from the allowance. The write-offs shall be recorded in the period in which the financial asset(s) are deemed uncollectible. Recoveries of financial assets and trade receivables previously written off shall be recorded when received.

The standard retains existing guidance for both write-offs and recoveries on receivables and extends that guidance to all assets within the scope of the expected credit loss model. It also clarifies that an entity may write off either a portion of a financial asset or the full amount. As a result, when an entity deems all or a portion of the financial asset to be uncollectible, it should reduce the allowance for expected credit losses by the same amount as the portion that is being written off. The standard does not define what "deemed uncollectible" means; however, an asset is generally considered uncollectible when all efforts at collection have been exhausted. Some entities may apply accounting policies that deem a financial asset to be uncollectible at some point in time before all efforts at collection have been exhausted. For example, some regulated financial institutions may use regulatory guidance as a basis to write off or charge down certain consumer loans after they are a certain number of days (e.g., 120 or 180) past due.

If, at a later date, the entity receives consideration (e.g., cash) in satisfaction of some or all of the amounts previously written off, the guidance in ASC 326-20-35-8 states that the recovery may be recognized by either (1) increasing the allowance for expected credit losses or (2) increasing earnings directly. In providing two alternatives, the Board acknowledged today's differences in practice. For example, entities in some industries currently credit such recoveries directly to earnings, while financial institutions typically credit recoveries to the allowance for credit losses. Ultimately, if an entity recognizes a recovery by immediately increasing the allowance for expected credit losses and then determines at the end of the reporting period that the increase in the allowance was not necessary, the same credit to earnings will occur (i.e., the recovery will be recognized through earnings).

How we see it

This guidance will result in a change in practice for entities with HTM debt securities. Under today's other-than-temporary impairment (OTTI) model, entities write off the amortized cost basis of a debt security when they recognize an OTTI. Under the new standard, they will initially recognize an allowance, and then later write off the amortized cost basis when the security is deemed uncollectible. As such, entities will need to develop accounting policies to consistently reflect write-offs for HTM debt securities. This is also the case for AFS debt securities.

2.7.4 *Modifications of financial assets*

Excerpt from Accounting Standards Codification

Financial Instruments Measured at Amortized Cost — Credit Losses

310-40-35-10

A loan restructured in a troubled debt restructuring shall not be accounted for as a new loan because a troubled debt restructuring is part of a creditor's ongoing effort to recover its investment in the original loan. Topic 326 provides guidance on measuring credit losses on financial assets and requires credit losses to be recorded through an allowance for credit loss account, including concessions given to the borrower upon a troubled debt restructuring.

US GAAP will continue to require that an entity evaluate whether a modification made to a financial asset qualifies as a TDR under ASC 310-40. The effective interest rate on the asset modified in a TDR will continue to be the asset's original effective interest rate.

Similarly, like expected losses on all other financial assets under the ASC 326-20 expected credit loss model, expected losses on assets that have undergone TDRs will be recognized using a valuation allowance. While current guidance requires that the allowance for an asset that has undergone a TDR be measured using a DCF technique, the new standard eliminates that requirement and permits an entity to measure the allowance using the broader principles of the ASC 326-20 expected loss model. For example an entity may estimate the allowance using a loss rate method or PD method. Nevertheless, we expect many entities to continue to use a DCF approach because that process is well established.

How we see it

Some TDR's are simply an interest rate concession. Under today's guidance, entities reflect these interest rate concessions provided to borrowers in their allowance estimates through their use of a DCF approach. This will not change for entities that use a DCF approach under the new standard. However, entities that elect to use a non-DCF approach under the new standard will need to consider how to reflect an interest rate concession provided to the borrower in the allowance for credit losses.

For modifications that are not TDRs, entities will continue to look to the guidance in ASC 310-20-35-9 through 35-11 to determine when a modification results in a new loan or the continuation of an existing loan. Specifically, if the terms of the refinanced or restructured loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan should be accounted for as a new loan. This condition is met if the effective yield of the new loan is at least equal to the effective yield for such loans, and if modifications to the original loan are more than minor. To make a determination regarding whether a modification is more than minor, an entity first determines whether there is at least a 10% difference between the present value of the cash flows under the terms of the new loan and the present value of the remaining cash flows under the terms of the original loan. If there is a least a 10% difference, the modification is more that minor. If the difference is less than 10%, the entity then evaluates whether the modification is more than minor based on the facts and circumstances (and other relevant considerations) of the refinancing or restructuring.

2.7.5 *Judgments*

The implementation guidance describes a number of the judgments an entity may need to make when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance

326-20-55-6

Estimating expected credit losses is highly judgmental and generally will require an entity to make specific judgments. Those judgments may include any of the following:

a. The definition of default for default-based statistics

b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest

c. The approach to determine the appropriate historical period for estimating expected credit loss statistics

d. The approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period

e. The methods of utilizing historical experience

f. The method of adjusting loss statistics for recoveries

g. How expected prepayments affect the estimate of expected credit losses

h. How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses

i. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.

Estimating expected credit losses will require significant judgment and entities will need to develop effective controls over the process.

This list illustrates the highly subjective nature of the estimate. It is also important to remember that the list of judgments the standard provides is not all inclusive, and management may need to consider other key judgments based on the entity's facts and circumstances.

Wesley R. Bricker, Interim Chief Accountant at the SEC, recently told attendees at the AICPA National Bank Conference on Banks and Savings Institutions that "the new credit loss standard will require significantly more judgments. This highlights the importance of another element of a company's control environment — setting the right "tone at the top" and expectations for appropriate conduct throughout the organization. Appropriate tone at the top is the foundation for the consistent application of the sound judgments required by the new standard. Management should consider whether the existing control environment is adequate to support the formation and enforcement of sound judgments that will be necessary in executing control activities or whether changes are necessary."[9]

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[9] Speech by SEC Interim Chief Accountant Wesley R. Bricker at the AICPA National Conference on Banks and Savings Institutions, 21 September 2016, https://www.sec.gov/news/speech/bricker-remarks-aicpa-national-conf-banks-savings-institutions.html.

Bank regulatory perspectives

The Joint Statement states that "similar to the agencies' expectations under an incurred loss methodology, institutions should develop and document their allowance methodology and apply it in a thorough, disciplined, and consistent manner. Estimating allowance levels, including assessments of qualitative adjustments to historical lifetime loss experience, involves a high degree of management judgment, is inevitably imprecise, and results in a range of estimated expected credit losses. For these reasons, institutions are encouraged to build strong processes and controls over their allowance methodology."

2.8 Interest income

Excerpt from Accounting Standards Codification

Financial Instruments– Credit Losses — Measured at Amortized Cost

Initial Recognition

ASC 326-20-35-10

This Subtopic does not address how a creditor shall recognize interest income. See paragraphs 310-10-35-53A through 35-53C for guidance on recognition of interest income on purchased financial assets with credit deterioration. See paragraph 326-20-45-3 for presentation guidance.

The standard does not address interest income recognition, except for PCD assets as discussed later in this publication. An entity will continue to apply the interest method outlined in ASC 835-30 (including the requirement to impute interest when there is no stated interest rate) and the guidance in ASC 310-20 for nonrefundable fees and other costs, premiums and discounts.

The standard does not provide nonaccrual guidance for assets other than PCD assets and eliminates the nonaccrual guidance in ASC 310-10 that relates to impaired loans. In addition, the new revenue recognition guidance specifically excludes from its scope financial instruments and other contractual rights that are within the scope of ASCs 310, 320 and 325 (e.g., receivables, debt securities, certain beneficial interests). As a result, entities will have no specific US GAAP guidance for determining whether to apply a nonaccrual policy.

How we see it

The Board decided not to include nonaccrual guidance for financial assets in the standard because it didn't want to change current practice in this area. Entities are already required to make disclosures about financial assets on nonaccrual status. The standard continues to require these disclosures. Accordingly, we believe entities will have latitude in determining whether, and if so, how, to apply a nonaccrual approach. As such, we expect many entities to continue using their existing approach. We also believe that US banking regulators will continue to require regulated financial institutions to apply certain nonaccrual approaches in specific situations.

2.9 Presentation of credit losses

The standard provides the following guidance on the presentation of credit losses:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Other Presentation Matters

326-20-45-1

For financial assets measured at amortized cost within the scope of this Subtopic, an entity shall separately present on the statement of financial position, the allowance for credit losses that is deducted from the asset's amortized cost basis.

326-20-45-2

For off-balance-sheet credit exposures within the scope of this Subtopic, an entity shall present the estimate of expected credit losses on the statement of financial position as a liability. The liability for credit losses for off-balance-sheet financial instruments shall be reduced in the period in which the off-balance-sheet financial instruments expire, result in the recognition of a financial asset, or are otherwise settled. An estimate of expected credit losses on a financial instrument with off-balance-sheet risk shall be recorded separate from the allowance for credit losses related to a recognized financial instrument.

326-20-45-3

When a discounted cash flow approach is used to estimate expected credit losses, the change in present value from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. An entity that measures credit losses based on a discounted cash flow approach is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense). Alternatively, an entity may report the change in present value attributable to the passage of time as interest income. See paragraph 326-20-50-12 for a disclosure requirement applicable to entities that choose the latter alternative and report changes in present value attributable to the passage of time as interest income.

326-20-45-4

The fair value of the collateral of a collateral-dependent financial asset may change from one reporting period to the next. Changes in the fair value of the collateral shall be reported as credit loss expense or a reversal of credit loss expense when the guidance in paragraphs 326-20-35-4 through 35-6 is applied.

Disclosure

326-20-50-12

Paragraph 326-20-45-3 explains that a creditor that measures expected credit losses based on a discounted cash flow method is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense) but also may report the change in present value attributable to the passage of time as interest income. Creditors that choose the latter alternative shall disclose the amount recorded to interest income that represents the change in present value attributable to the passage of time.

Under the standard, the balance sheet presentation of the estimate of expected credit losses for recognized assets differs from the presentation of the estimate of expected credit losses for off-balance-sheet exposures. The estimate of expected credit losses for recognized financial assets is presented as an allowance that reduces the amortized cost basis of the asset, while estimates of expected credit losses for off-balance-sheet credit exposures (e.g., loan commitments, standby letters of credit, financial guarantees) are presented as a liability.

An entity that uses the guidance for collateral-dependent financial assets and financial assets secured by collateral maintenance provisions should present subsequent changes in the fair value of the collateral as credit loss expense or a reversal of credit loss expense.

2.9.1 Presenting changes attributable to the passage of time when using a DCF approach

Consistent with current US GAAP, the standard allows an entity to present as interest income the change in present value attributable to the passage of time, when using a DCF method to estimate the allowance for credit losses. Alternatively, this change can be presented as credit loss expense.

2.10 Disclosures

The ASU says the required disclosures are intended to help financial statement users to understand:

- The credit risk inherent in a portfolio and how management monitors the related credit quality
- Management's estimate of expected credit losses
- Information about the changes in the estimate of expected credit losses that have taken place during the period

The standard requires information to be provided by either portfolio segment or class of financing receivable as defined in the standard. The same disclosure requirements apply to net investments in leases (including the unguaranteed residual asset). For HTM debt securities, the ASU requires information to be provided by major security type. The following chart describes these categorizations.

Portfolio segment	Class of financing receivables	Major security type
The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. All of the following are examples of portfolio segments: ‣ Type of financing receivable ‣ Industry sector of the borrower or customer ‣ Risk rating	A class of financing receivables is a level of disaggregation beyond a portfolio segment that is determined on the basis of both of the following: ‣ Risk characteristics of the financing receivable ‣ An entity's method for monitoring and assessing credit risk An entity should base its principal determination of class of financing receivable by disaggregating to the level that the entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables. In its assessment, the entity should consider the risk characteristics of the financing receivables.	Major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity should consider the following: ‣ Shared activity or business sector ‣ Vintage ‣ Geographic concentration ‣ Credit quality ‣ Economic characteristic

Entities will need to determine the appropriate level of disclosure for portfolio segments and classes of financial assets. The objective is to provide information at a level that provides sufficient detail for a user to understand the portfolio or class without being overwhelmed by insignificant data.

The standard's disclosure requirements related to CECL are described in the sections that follow.

2.10.1 *Credit quality information*

An entity is required to provide information that allows a financial statement user to both understand how it monitors credit quality of its financial assets and assesses the quantitative and qualitative risks that arise because of the associated credit quality. An entity must therefore provide, by class of financing receivable and major security type, information about the credit quality, including a description of each credit quality indicator and when the information was last updated for that credit quality indicator (i.e., according to date or range of dates). In addition, an entity will need to disclose the amortized cost basis by each credit quality indicator. PBEs will be required to further disaggregate the amortized cost basis by credit quality indicator and the year of the financial asset's origination for up to the past five annual periods.

Although the standard doesn't specify how an entity should develop its credit quality indicators, including the granularity of its indicators, the example disclosure in the standard suggests that an entity should provide more disaggregated credit quality information than it does today.

Public business entities will be required to disclose the amortized cost basis by credit quality indicator and the year of the financial asset's origination for up to the past five annual periods.

The following illustration highlights one way a PBE might meet the standard's requirement to provide tabular credit quality information by year of origination requirement and is based on Example 15, *Disclosing Credit Quality Indicators of Financing Receivables by Amortized Cost Basis,* in the ASU.

Illustration 6 — Example tabular disclosure of amortized cost basis by year of origination and credit quality indicator

Amortized cost basis by year of origination and credit quality indicator

	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Total
Residential mortgage:								
FICO:								
780 and greater	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
720–779	-	-	-	-	-	-	-	-
660–719	-	-	-	-	-	-	-	-
600–659	-	-	-	-	-	-	-	-
Less than 600	-	-	-	-	-	-	-	-
Total residential mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$-
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer:								
Loan delinquency:								
Current	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
30–59 days past due	-	-	-	-	-	-		-
60–89 days past due	-	-	-	-	-	-		-
90–119 days past due	-	-	-	-	-	-		-
120+ days past due	-	-	-	-	-	-		-
Total consumer	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Illustration 6 — Example tabular disclosure of amortized cost basis by year of origination and credit quality indicator (continued)

	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Total
Commercial business:								
Risk rating:								
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-		-
5 internal grade	-	-	-	-	-	-		-
6 internal grade	-	-	-	-	-	-		-
7 internal grade	-	-	-	-	-	-		-
Total commercial business	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial mortgage:								
Risk rating:								
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-		-
5 internal grade	-	-	-	-	-	-		-
6 internal grade	-	-	-	-	-	-		-
7 internal grade	-	-	-	-	-	-		-
Total commercial mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

As illustrated, the amortized cost basis of financing receivables with revolving features, like credit cards, is shown in total and is not disaggregated by year of origination. Receivables measured at the lower of amortized cost or fair value and trade receivables due within one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606) are not included in this tabular disclosure.

To determine the year of origination, an entity should use the guidance in ASC 310-20-35-9 through 35-12 for evaluating whether a loan refinancing or restructuring results in a new loan. Under that guidance, a refinancing or restructuring (other than a TDR) will result in a new loan if the new terms are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks. See section 2.7.4, *Modifications of financial assets*, for discussion of this guidance.

How we see it

Entities will have to provide more disclosures about the credit quality of their financial assets than they do today. PBEs will need to implement new processes and controls to gather and summarize the information required to produce vintage disclosures.

Furthermore, an entity will need to consider its determination of whether a modification results in a new loan or the continuation of an old loan (i.e., applying the guidance in ASC 310-20-35-9 through 35-11) when making the new vintage disclosures (i.e., disclosures by year of origination) for financing receivables.

2.10.2 Allowance for credit losses and management's estimation process

The standard requires an entity to provide information that allows users to understand its methods for developing its allowance for credit losses, the information used in developing its current estimate of expected credit losses and the changes in those estimates within the period. Specifically, the new guidance requires, by portfolio segment and major security type, a discussion of:

- How expected loss estimates are developed
- The entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts about the future
- Risk characteristics relevant to each portfolio segment
- Changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (e.g., changes in portfolio composition or underwriting practices, significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- Changes to the entity's accounting policies and changes to the methodology from the prior period, the entity's rationale for making those changes and the quantitative effect of the changes
- Reasons for significant changes in the amount of write-offs, if applicable
- The reversion method applied for periods beyond the reasonable and supportable forecast period
- The amount of any significant purchases of financial assets during each reporting period
- The amount of any significant sales of financial assets or reclassifications of loans to held for sale during each reporting period

Due to the inherent subjectivity of forecasting, management will need to provide information related to the judgments incorporated into this process. For example, an entity will likely need to provide information about its assessment of the point in the economic cycle and how that affected management's estimate of expected credit losses. These disclosures will be important for understanding the differences in estimates among different entities.

2.10.3 Rollforward of the allowance for credit losses

The standard requires an entity to provide information that allows users to understand the changes in the allowance for expected credit losses for each period by requiring an entity to disclose, by portfolio segment and major security type, the following amounts:

- Beginning balance of the allowance
- Current-period provision for expected credit losses
- Initial allowance for credit losses recognized on purchased financial assets with credit deterioration, if applicable

- Write-offs charged against the allowance, if applicable
- Recoveries of amounts previously written off, if applicable
- Ending balance of the allowance

How we see it

To produce the allowance rollforward for HTM securities and net investments in leases, entities will need to develop new processes and controls to collect the required information. This disclosure requirement also applies to accounts receivable arising from the sale of goods or services.

2.10.4 Past due and nonaccrual assets

Like today's guidance, the standard requires an entity to provide an aging analysis of the amortized cost for financial assets that are past due as of the reporting date, disaggregated by class of financing receivable and major security type. Under the new guidance, an entity will also be required to disclose its policy for determining when a financial asset is past due. The requirement to disclose past-due status will not apply to receivables measured at the lower of amortized cost or fair value, or trade receivables due in one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606).

For financial assets that are on nonaccrual status, the standard requires an entity to disclose all of the following, disaggregated by class of financing receivable and major security type:

- The amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period
- The amount of interest income recognized during the period on nonaccrual financial assets
- The amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date
- The amortized cost basis of financial assets on nonaccrual status for which there is no allowance for credit losses as of the reporting date

An entity also will be required to disclose its policies for placing financial assets on nonaccrual status, for recording payments received on these assets (i.e., cost recovery method, cash basis method, a combination of both methods), for resuming the accrual of interest, for determining past due or delinquency status, and for recognizing write-offs within the allowance for credit losses. The requirement to disclose nonaccrual status will not apply to receivables measured at the lower of amortized cost or fair value, or trade receivables due in one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606).

2.10.5 Purchased financial assets with credit deterioration

For PCD assets that were purchased during the period, the standard requires an entity to disclose a reconciliation of the difference between the purchase price and the par value. This reconciliation must include the purchase price, the allowance for expected credit losses at the acquisition date as determined by the entity, the discount (or premium) attributable to other factors and the par value. This is the only separate disclosure about PCD assets required because, after they are purchased, these assets are treated like other assets.

2.10.6 *Collateral-dependent financial assets*

For collateral-dependent financial assets (a financial asset for which repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty), an entity is required to describe, by class of financial receivable and major security type, the type of collateral and the extent to which collateral secures its financial assets, including an explanation of significant changes in the extent to which collateral secures the financial assets, regardless of whether the change is the result of a general deterioration or some other reason. An example of a general deterioration might be a decline in real estate values in a particular geography.

2.10.7 *Off-balance-sheet credit exposures*

The standard requires an entity to disclose the accounting policies and methodology it uses to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures, including a description of the factors that influenced management's judgment and the risk elements relevant to particular categories of financial instruments. These disclosure requirements apply to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments, except for instruments within the scope of ASC 815.

2.11 Considerations for certain instruments

2.11.1 *Lessor's net investments in sales-type and direct financing leases*

Lessors will measure impairment of their net investments in a sales-type and direct financing lease using the CECL model.

Excerpt from Accounting Standards Codification

Amendments to Subtopic 842-30, Leases — Lessor

Subsequent Measurement

Sales-type and Direct Financing Leases

Credit losses on the Net Investment in the Lease

842-30-35-3

A lessor shall determine credit losses related to the net investment in the lease and shall record any credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

Master Glossary

Net Investment in the Lease

For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset.

For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

The new leases guidance in ASC 842 requires lessors to evaluate their net investment in a sales-type lease and a direct financing lease for impairment using the guidance for financial receivables. The FASB indicated in the Basis for Conclusions (BC310) of ASU 2016-02, that even though the unguaranteed residual asset component of the net investment in the lease

does not meet the definition of a financial asset in US GAAP, it would be overly complex and provide little benefit to financial statement users to require entities to separately assess the unguaranteed residual asset for impairment in accordance with ASC 360 while the receivable (i.e., the financial asset) is evaluated for impairment in accordance with financial receivable literature. Therefore lessors will be required to evaluate the entire net investment in the lease, including the unguaranteed residual asset, for impairment as a financial asset measured at amortized cost.

When determining the loss allowance for a net investment in the lease, a lessor takes into consideration the collateral relating to the net investment in the lease, which represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term. The collateral relating to the net investment in the lease excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (e.g., cash flows from leasing the asset after the end of the lease term).

How we see it

It is unclear why a lessor would exclude the cash flows that it expects to derive from this underlying asset following the end of the lease term in determining the loss allowance for the entire net investment in the lease, which includes the unguaranteed residual asset.

2.11.2 Reinsurance receivables

Reinsurance receivables represent the portion of an insurance company's losses from claims that can be recovered from reinsurance companies. Reinsurance receivables include the amounts owed to the insurer by the reinsurer for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported and other policy benefits. A variety of risks (e.g., contractual coverage disputes) affect the collectibility of reinsurance receivables by the ceding entity, but only expected losses relating to the credit risk of the reinsurer (e.g., the assuming entity) are subject to the CECL model.

The first step in determining the allowance for credit losses associated with reinsurance receivables will be determining whether to do so on a collective or individual basis. This will depend on whether individual reinsurance agreements have similar risk characteristics. One factor to consider is the attachment point (e.g., the point at which reinsurance coverage applies). For example, reinsurers that cover high severity but low frequency losses may have a higher credit risk than reinsurers that cover high frequency but low severity risks, given that a few large events could strain the reinsurer's finances. Other factors that should be considered in determining whether similar risk characteristics exist include the size and financial condition of the reinsurers, jurisdictions in which the reinsurers write business (e.g., global, domestic) and the existence of state-sponsored reinsurance programs.

The ASU provides an example of considerations for reinsurance receivables such as whether the reinsurance agreement allows the insurer to retain assets as collateral, as is the case in funds withheld arrangements, or incorporates credit enhancements, such as the reinsurer providing letters of credit from another financial institution. An insurer is not permitted to estimate a loss of zero simply because the current value of the collateral exceeds the amortized cost basis of the reinsurance receivable. Rather, the insurer should consider the terms of the collateral and any collateral maintenance provisions and potential fluctuation in the collateral assets. The insurer also should consider the terms of the credit enhancements as well as the credit risk of the third-party provider of the credit enhancement. Refer to earlier sections about financial assets secured by collateral (section 2.6.2) and credit enhancements (section 2.7.2) for additional discussion.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 17: Identifying Similar Risk Characteristics in Reinsurance Receivables

326-20-55-81

Reinsurance receivables may comprise a variety of risks that affect collectibility including:

a. Credit risk of the reinsurer/assuming company

b. Contractual coverage disputes between the reinsurer/assuming company and the insurer/ceding company including contract administration issues

c. Other noncontractual, noncoverage issues including reinsurance billing and allocation issues.

326-20-55-82

This Subtopic only requires measurement of expected losses related to the credit risk of the reinsurer/assuming company.

326-20-55-83

In situations in which similar risk characteristics are not present in the reinsurance receivables, the ceding insurer should measure expected credit losses on an individual basis. Similar risk characteristics may not exist because any one or a combination of the following factors exists, including, but not limited to:

a. Customized reinsurance agreements associated with individual risk geographies

b. Different size and financial conditions of reinsurers that may be either domestic or international

c. Different attachment points among reinsurance agreements

d. Different collateral terms of the reinsurance agreements (such as collateral trusts or letters of credit)

e. The existence of state-sponsored reinsurance programs.

326-20-55-84

However, similar risk characteristics may exist for certain reinsurance receivables because any one or combination of the following exists:

a. Reinsurance agreements that have standardized terms

b. Reinsurance agreements that involve similar insured risks and underwriting practices

c. Reinsurance counterparties that have similar financial characteristics and face similar economic conditions.

326-20-55-85

Judgment should be applied by ceding insurers in determining if and when similar risks exist within their reinsurance receivables.

To apply the new impairment model, an insurer will need to assess all available information relevant to the collectibility of cash flows including historical information, current conditions and expectations of future conditions. The standard says entities can use a loss rate approach or an aging schedule to measure the allowance for credit losses. Insurers may also consider

using an approach that applies default rates or impairment rates for similarly rated companies based on the duration of the receivables. Sources for such information may include insurance rating agencies' industry reports (e.g., A.M. Best's Impairment Rate Study).

How we see it

Applying the expected credit loss impairment model to reinsurance receivables could significantly change practice for insurers and require changes in processes and controls. Reinsurance receivables may need to be assessed on a collective basis rather than individually. Another change will be incorporating reasonable and supportable forecasts about the future into the assessment.

2.11.4 Off-balance-sheet commitments

When estimating expected credit losses on off-balance-sheet commitments (e.g., loan commitments), an entity will apply the CECL model. An entity likely will be able to estimate expected credit losses on loan commitments by using the same method it uses for estimating expected credit losses for loans except that it will need to also consider the probability that the unfunded commitment will become funded. The estimate of expected credit losses for off-balance-sheet credit commitments will be recognized as a liability (i.e., a reserve for credit losses instead of an allowance for credit losses).

An entity should consider the following when estimating credit losses for off-balance-sheet commitments:

- The contractual period in which the entity is exposed to credit risk because of a present contractual obligation to extend credit, unless that obligation is unconditionally cancelable by the entity
- The likelihood that funding will occur, which may be affected by a material adverse change clause, among other things
- An estimate of expected credit losses on commitments expected to be funded over its estimated life

In certain cases, a legal analysis of the commitment may be necessary to appropriately conclude whether the contract is unconditionally cancelable.

The following illustration from the standard shows how an entity will apply the new standard when the commitment provides the entity with the ability to unconditionally cancel it.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 10: Application of Expected Credit Losses to Unconditionally Cancellable Loan Commitments

326-20-55-54

This Example illustrates the application of the guidance in paragraph 326-20-30-11 for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer.

326-20-55-55

Bank M has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. Bank M's card holder agreements stipulate that the available credit may be unconditionally cancelled at any time.

326-20-55-56

When determining the allowance for credit losses, Bank M estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank M does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present contractual obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability.

How we see it

An entity will need to evaluate the terms of individual commitments to assess whether they include provisions that allow the issuing entity to unconditionally cancel the commitment. This likely will require new processes and controls.

2.11.5 Accounts receivable

Entities with trade accounts receivable will need to evaluate and update their current impairment processes to align with the objectives of the ASU.

The standard will change the recognition and measurement of expected credit losses for accounts receivable (e.g., trade receivables). Entities will be allowed to measure expected credit losses using certain current practices, such as a provision matrix (i.e., grouping receivables by age and applying historical loss rates). To estimate expected losses, an entity will need to consider adjustments to its existing processes for estimating credit losses on trade receivables, since those existing processes likely only capture incurred losses and do not reflect reasonable and supportable forecasts. In that regard, the entity will have to determine:

- Whether the historical loss rates calculated and applied to each aging bucket reflect current conditions and reasonable and supportable economic forecasts
- How to make sure the allowance for bad debts reflects the risk of loss, which will result in an entity including a loss factor for:
  - Current balances, even if historically no allowance has been estimated for such receivables
  - Individually significant balances for which an entity has historically concluded there is no risk of loss (e.g., major customers that have always paid on time, such as federal and municipal customers)

The following example from the standard shows how an entity might apply the new standard to its trade accounts receivable balance.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 5: Estimating Expected Credit Losses for Trade Receivables using an Aging Schedule

326-20-55-37

This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

326-20-55-38

Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

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.

326-20-55-39

Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

326-20-55-40

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.27%	$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	$ 5,997,794		$ 18,681

How we see it

It's unclear whether the new guidance will change the allowance for bad debts significantly from what an entity recognizes today as an incurred loss because many of these receivables have contractual maturities of less than one year. Entities will need to make sure their accounting policies, processes and controls are updated to reflect the added requirements of the new standard.

3 The AFS debt security impairment model (ASC 326-30)

The FASB decided that the CECL model should not apply to AFS debt securities. Instead, the Board made targeted amendments to the existing AFS debt security impairment model and reorganized the guidance in a new subtopic (i.e., ASC 326-30). As a result, different impairment models will exist for debt securities that are classified as AFS from those that are classified as HTM.

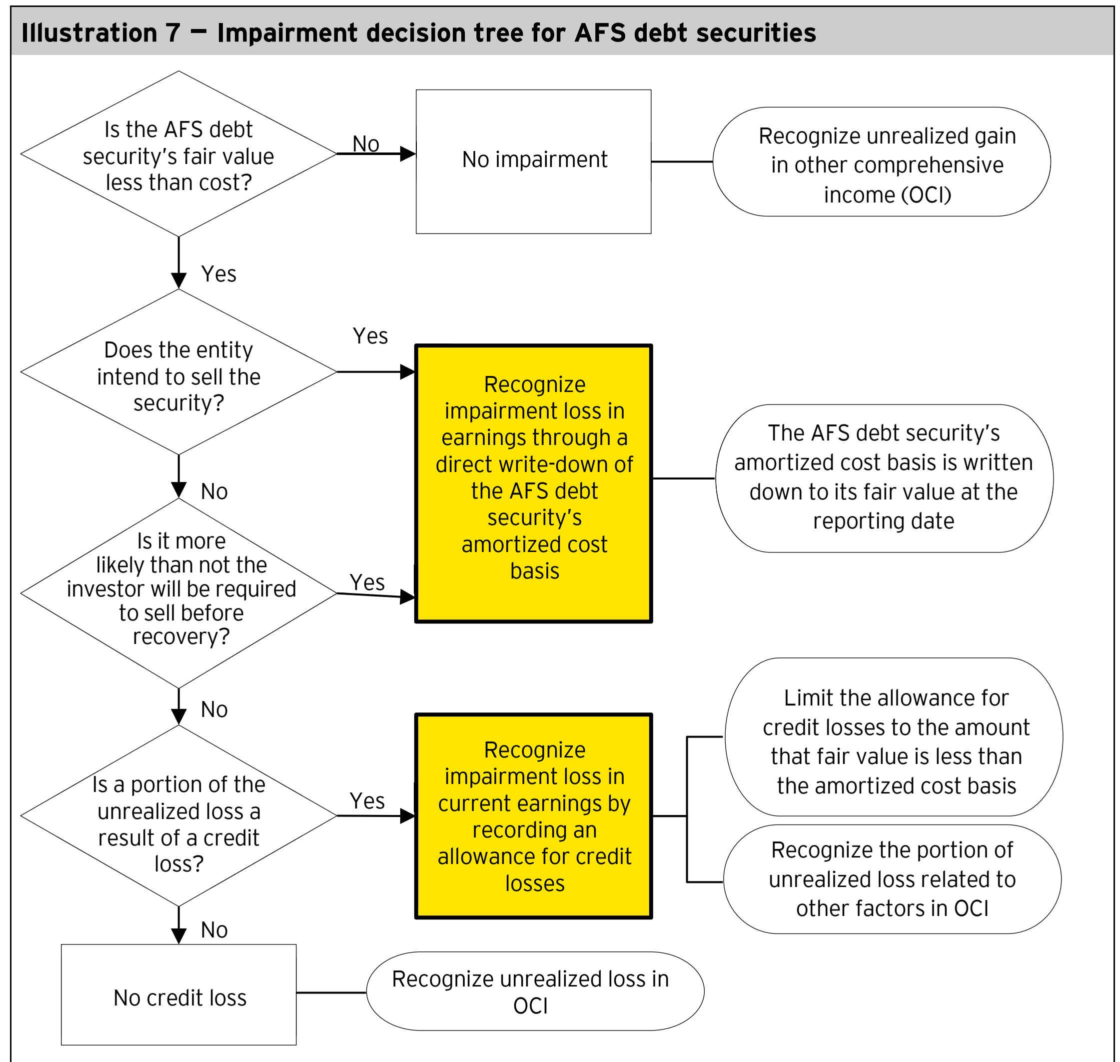
Under the new guidance, an entity will recognize an allowance for credit losses on AFS debt securities rather than recognize impairment as a reduction of the cost basis of the investment as is done today. Further, an entity will recognize subsequent improvements in estimated credit losses on AFS debt securities immediately in earnings as a reduction in the allowance and credit loss expense. Today, a recovery of an impairment loss on an AFS debt security is prospectively recognized as interest income over time.

The new guidance also eliminates the concept of "other-than-temporary" impairment and instead focuses on determining whether the unrealized loss is a result of a credit loss or other factors. As a result, the standard says that management may not use the length of time a security has been in an unrealized loss position as a factor, either by itself or in combination with other factors, to conclude that a credit loss does not exist, as they are permitted to do today.

The following graphic illustrates the new model.

Entities with AFS debt securities will recognize changes in credit loss estimates through an allowance for credit losses.

Illustration 7 — Impairment decision tree for AFS debt securities



How we see it

One of the primary changes is that the new model requires the use of an allowance to recognize credit losses, and entities will need to adjust the allowance in each reporting period when the estimate of credit losses changes. The potential for reversals of previously recognized credit losses in subsequent periods may increase earnings volatility because adjustments will result in immediate increases or decreases to net income.

3.1 Determining whether an AFS debt security is impaired

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-1

An investment is impaired if the fair value of the investment is less than its amortized cost basis.

326-30-35-4

Impairment shall be assessed at the individual security level (referred to as an investment). Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities. (For example, debt securities bearing the same Committee on Uniform Security Identification Procedures [CUSIP] number that were purchased in separate trade lots may be aggregated by a reporting entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses for the debt securities.) Providing a general allowance for an unidentified impairment in a portfolio of debt securities is not appropriate.

326-30-35-5

An entity shall not combine separate contracts (a debt security and a guarantee or other credit enhancement) for purposes of determining whether a debt security is impaired or can contractually be prepaid or otherwise settled in such a way that the entity would not recover substantially all of its cost.

An entity will be required to assess whether its AFS debt securities are impaired at every reporting period (i.e., quarterly for public companies). An individual AFS debt security will be considered impaired if the fair value of the investment is less than its amortized cost, which is the amount at which the investment was acquired, adjusted for items such as amortization of any discount or premium and cash collections. This evaluation is unchanged from today's guidance.

Consistent with current guidance, investments in the same instrument may be aggregated for evaluating impairment if the entity aggregates the securities for purposes of measuring realized and unrealized gains and losses. That's the case, even if the securities are purchased on different dates. For example, debt securities with the same CUSIP number that were purchased on separate dates may be aggregated by an entity on an average cost basis if that is the basis the entity uses to measure realized and unrealized gains and losses on the securities.

3.2 Impairment when an entity intends, or is required, to sell an AFS debt security

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-10

If an entity intends to sell the debt security (that is, it has decided to sell the security), or more likely than not will be required to sell the security before recovery of its amortized cost basis, any allowance for credit losses shall be written off and the amortized cost basis shall be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings. If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs). In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, the entity shall consider the factors in paragraphs 326-30-55-1 through 55-2.

The guidance for recognizing impairment when an entity intends, or is required, to sell an AFS debt security, will remain consistent with current guidance. That is, an entity must recognize the entire impairment in earnings if the entity has decided to sell the AFS debt security, or it is more likely than not that the entity will be required to sell the AFS debt security.

The phrase "intends to sell the debt security" means a decision has been made to sell the debt security. If no decision has been made to sell the debt security, an entity will need to estimate the period over which the security is expected to recover and whether its cash or working capital requirements and contractual or regulatory obligations may indicate that the security may need to be sold before the forecasted recovery occurs. If it is more likely than not that the entity will be required to sell the security before recovering its cost basis, an impairment loss exists.

Determining whether it is more likely than not that an entity will be required to sell a debt security before recovering its amortized cost basis is a matter of judgment. Entities will need to consider all facts and circumstances including their legal and contractual obligations and operational, regulatory and liquidity needs.

If an entity intends, or is required, to sell the AFS debt security before recovery of its amortized cost basis, an impairment loss must be recognized in earnings in an amount that is equal to the difference between the debt security's amortized cost and fair value. In these circumstances, the entity will not recognize an allowance. Rather, the impairment will be recognized as a reduction in the amortized cost of the debt security.

3.2.1 Accounting after a write-down resulting from a decision or requirement to sell

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-14

Once an individual debt security has been written down in accordance with paragraph 326-30-35-10, the previous amortized cost basis less writeoffs, including non-credit-related impairment reported in earnings, shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value.

326-30-35-15

For debt securities for which impairments were reported in earnings as a writeoff because of an intent to sell or a more-likely-than-not requirement to sell, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted in accordance with existing applicable guidance as interest income. An entity shall continue to estimate the present value of cash flows expected to be collected over the life of the debt security. For debt securities accounted for in accordance with Subtopic 325-40, an entity should look to that Subtopic to account for changes in cash flows expected to be collected. For all other debt securities, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, those changes shall be accounted for as a prospective adjustment to the yield. Subsequent increases in the fair value of available-for-sale securities after the write-down shall be included in other comprehensive income. (This Section does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security.)

After writing down an AFS debt security because of a decision to sell or meeting the more likely than not requirement, the holder's new amortized cost basis of the debt security is the previous amortized cost basis less the amount written off. The difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income. As such, an entity should continue to estimate the present value of cash flows expected to be collected over the life of the debt security.

If there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes must be accounted for as a prospective adjustment to the security's yield, except for securities in the scope of ASC 325-40, which should continue to follow that guidance. An impairment recognized in earnings from a write-down resulting from a decision or requirement to sell should not be reversed.

The accounting for subsequent increases and decreases in fair value (if not determined at that date to be an impairment) remains the same (i.e., they should be included in OCI).

3.3 Assessing whether a credit loss exists

The standard provides guidance on how an entity will assess, either quantitatively or qualitatively, whether a credit loss exists when the fair value of a security is below the security's amortized cost basis at the balance sheet date.

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-6

In assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses shall be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis. Credit losses on an impaired security shall continue to be measured using the present value of expected future cash flows.

An entity won't be able to consider the length of time a security has been in an unrealized loss position as a factor in assessing whether a credit loss exists.

326-30-35-7

In determining whether a credit loss exists, an entity shall consider the factors in paragraphs 326-30-55-1 through 55-4 and use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in paragraphs 326-30-35-8 through 35-10. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

326-30-55-1

There are numerous factors to be considered in determining whether a credit loss exists. The length of time a security has been in an unrealized loss position should not be a factor, by itself or in combination with others, that an entity would use to conclude that a credit loss does not exist. The following list is not meant to be all inclusive. All of the following factors should be considered:

a. The extent to which the fair value is less than the amortized cost basis.

b. Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors. Examples of those changes include any of the following:

   1. Changes in technology

   2. The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security

   3. Changes in the quality of the credit enhancement.

c. The payment structure of the debt security (for example, nontraditional loan terms as described in paragraphs 825-10-55-1 through 55-2) and the likelihood of the issuer being able to make payments that increase in the future.

d. Failure of the issuer of the security to make scheduled interest or principal payments.

e. Any changes to the rating of the security by a rating agency.

The factors in ASC 326-30-55-1 are consistent with the factors in the current guidance (ASC 320-10-35-33F), except that the following factors were removed from the list of factors that are considered today:

- The length of time fair value has been less than the amortized cost basis of the debt security
- The historical and implied volatility of the fair value of the security
- Recoveries or additional declines in fair value after the balance sheet date

How we see it

Although the standard does not specifically preclude an entity from considering volatility of the fair value of the security, as well as recoveries or additional declines in fair value after the balance sheet date, we believe the FASB removed them from the list of factors in ASC 326-30-55-1 because the FASB believes they are not relevant in assessing whether a credit loss exists and should not be considered, given the elimination of the OTTI concept.

The ASU prohibits an entity from considering the length of time a security has been in an unrealized loss position either as a factor by itself, or in combination with others. In making this change, the FASB has shifted the focus from "time" (e.g., how long a debt security's fair value has been below its amortized cost) to a focus on whether the impairment is due to a credit loss. An entity will recognize the impairment relating to credit-related factors through an allowance for credit losses and recognize the impairment relating to non-credit-related factors through other comprehensive income (OCI), net of applicable taxes.

How we see it

Today, many entities use the length of time a debt security's fair value has been below amortized cost as a filter to reduce the number of debt securities requiring a more thorough credit analysis. That is, an entity may have a policy that any debt security that has been in an unrealized loss position for, say 30 days or 60 days, absent other impairment indicators, would not be considered to have a credit loss. Because the ASU will preclude an entity from making this type of conclusion, these entities will need to adjust their process for evaluating whether there is an impairment due to a credit loss when the security has been impaired for a short period of time.

In addition to considering the qualitative factors enumerated in paragraph 55-1, an entity should use its best estimate of the present value of cash flows expected to be collected from the debt security when evaluating whether a credit loss exists. Entities should consider reasonably available data points in that assessment, including industry analyses, credit ratings and other relevant market data. An entity should also consider how other credit enhancements that are not separate contracts affect the expected performance of the debt security, including consideration of the current financial condition of the guarantor of a security and/or whether any subordinated interests are capable of absorbing estimated losses on the financial assets underlying the security

How we see it

Questions have arisen about whether the guidance in paragraphs ASC 326-30-35-6 and 35-7 stating that "an entity shall… use its best estimate of the present value of cash flows expected to be collected from the debt security" in assessing whether a credit loss exists requires an entity to prepare a quantitative DCF analysis for all impaired securities that management does not intend to sell or is not required to sell.

We believe that a calculation of the present value of cash flows generally will not be necessary when assessing whether a credit loss exists, but will be required to measure a credit loss. For example, if after considering the factors in ASC 326-30-55-1, management's best estimate is that all contractual cash flows will be collected timely, our view is that a thorough qualitative analysis supporting the conclusion that there is no credit loss will be sufficient.

3.4 Measuring the credit impairment allowance

For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities.

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-2

For individual debt securities classified as available-for-sale securities, an entity shall determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. An entity shall record impairment relating to credit losses through an allowance for credit losses. However, the allowance shall be limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses shall be recorded through other comprehensive income, net of applicable taxes. An entity shall consider the guidance in paragraphs 326-30-35-6 and 326-30-55-1 through 55-4 when determining whether a credit loss exists.

326-30-35-3

At each reporting date, an entity shall record an allowance for credit losses that reflects the amount of the impairment related to credit losses, limited by the amount that fair value is less than the amortized cost basis. Changes in the allowance shall be recorded in the period of the change as credit loss expense (or reversal of credit loss expense).

When an entity does not intend to sell an impaired debt security and it is not more likely than not that it will not be required to sell the security prior to recovery, the impairment amount representing the credit loss will be recognized as an allowance for credit losses. This allowance is a contra-account to the amortized cost basis of the AFS debt security. The amount related to all other factors is recognized in OCI. The allowance for credit losses should be re-measured each reporting period and adjusted when necessary.

The requirement to recognize an allowance for credit loss is a significant change from today's approach, which requires an entity to take a direct write-down and reduce the AFS debt security's amortized cost basis. An entity will recognize improvements in estimated credit losses (i.e., expected cash flows) on AFS debt securities immediately in earnings through a reversal to the allowance. Today, a recovery of an AFS debt security impairment loss is recognized as interest income over time.

3.4.1 *Measuring the credit loss for an AFS debt security*

Using the methodology described in ASC 326-30-35-6 through 35-9 and a single best estimate of expected cash flows, an entity would measure credit losses as the difference between the current amortized cost and the present value of revised cash flows discounted at the original effective interest rate (at the AFS debt security's purchase).

Illustration 8 — Estimating the allowance for credit losses for an AFS debt security

Assume Entity E purchases a five-year, $10,000 par bond with a 5% coupon (a market rate at the time of purchase) on 1 January 20X0. The bond is accounted for under ASC 320 and is classified as an AFS debt security. As of 31 December 20X0, the amortized cost basis of the AFS debt security is $10,000 and Entity E expects to collect less than the contractual cash flows for the years 20X3 and 20X4. Entity E estimates that only $250 of interest will be collected in 20X4 and only $9,000 of the principal balance and no interest will be collected in 20X5.

As of 31 December 20X0, the fair value of the debt security is $6,000, which implies an effective yield or discount rate of approximately 16% based on the new estimate of cash flows expected to be collected. Also, assume that Entity E does not intend to sell the debt security and it is not more likely than not Entity E will be required to sell the debt security before recovery of its amortized cost basis. The table below shows the original and revised cash flows expected to be collected and illustrates how Entity E will estimate the allowance for expected credit losses and the amount attributable to other factors:

		Original cash flows expected to be collected	**Revised cash flows expected to be collected**	**Decrease in cash flows expected to be collected**
	20X0	$ 500	(collected)	n/a
	20X1	500	$ 500	$ –
	20X2	500	500	–
	20X3	500	250	250
	20X4	10,500	9,000	1,500
Total gross cash flows		$12,500	$ 10,250	$ 1,750
Present value discounted at 5% (original effective rate)		$10,000	$ 8,550	$ 1,450
Fair value as of 31 December 20X0			$ 6,000	
Impairment due to other factors (noncredit)			$ 2,550	
Initial carrying amount			$ 10,000	
Plus: Interest recognized in 20X0			500	
Less: Interest collected in 20X0			(500)	
Impairment amounts as of 31 December 20X0 recognized:				
As an allowance for credit losses		(1,450)		
In OCI for amounts related to other factors		(2,550)		
Total impairment			(4,000)	
Fair value at end of 20X0			$ 6,000	

As illustrated above, applying the guidance in ASC 326-30-35-7 through 35-9, the entity separates the total impairment of $4,000 (the cost basis of $10,000 less the fair value of $6,000 as of 31 December 20X0) into the following two parts:

- The amount representing the decrease in cash flows expected to be collected (i.e., the credit loss) of $1,450, which is discounted at the original effective rate of 5% (rate at the debt security's purchase)
- The amount related to all other factors of $2,550

The entity will recognize an allowance for credit losses with a corresponding credit loss expense in net income of $1,450 for the credit loss and recognize the remaining impairment loss of $2,550 separately in OCI.

Although the method for estimating credit losses for AFS debt securities (e.g., DCF calculation) doesn't change from current practice, the write-down will now be recognized as an allowance instead of a reduction to the amortized costs basis of the debt security. The following illustrates the journal entries required for Illustration 8.

Illustration 9 — Recognizing the allowance estimated in Illustration 8

Entity E would make the following journal entries, which we have simplified to exlcude income taxes and interest:

Dr. Credit loss expense	$ 1,450	
Cr. Allowance for credit losses		$ 1,450
To recognize the credit loss in earnings through an allowance		

Dr. Other comprehensive income	$ 2,550	
Cr. Investment in AFS debt security		$ 2,550
To recognize the impairment due to other factors		

As a result, the carrying value of the investment is calculated as follows:

Amortized cost	$ 10,000
Less allowance	(1,450)
Less impairment due to other factors	(2,550)
Net carrying value (i.e., fair value)	$ 6,000

At 31 December 2020, Company A's balance sheet would reflect the net $6,000 carrying value (i.e., the fair value) of the investment. The allowance of $1,450 would be presented parenthetically on the face of the balance sheet.

The $1,450 credit loss would be recognized in income and the noncredit impairment of $2,550 would be separately recognized in OCI, net of income taxes. In a change from today's OTTI model, assuming all interest is accrued and collected and assuming Entity E concludes that a write-off is not necessary, the amortized cost basis remains at $10,000 (i.e., under today's OTTI model, the amortized cost basis would have been reduced by the recognized credit loss).

How we see it

Because different impairment models will exist for debt securities that are classified as HTM and AFS, entities will need to consider the guidance in each model when evaluating credit losses for these securities. For example, a security held in an entity's HTM portfolio will have a credit loss recorded even if the fair value is greater than the security's amortized cost basis. However, credit losses will be recognized for AFS debt securities only when the security's fair value is less than its amortized cost basis.

3.4.2 *Accounting for an AFS debt security after a credit impairment*

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-12

An entity shall reassess the credit losses each reporting period when there is an allowance for credit losses. An entity shall record subsequent changes in the allowance for credit losses on available-for-sale debt securities with a corresponding adjustment recorded in the credit loss expense on available-for-sale debt securities. An entity shall not reverse a previously recorded allowance for credit losses to an amount below zero.

326-30-35-13

An entity shall recognize writeoffs and recoveries of available-for-sale debt securities in accordance with paragraphs 326-20-35-8 through 35-9.

After the recognition of a credit loss through the allowance, an entity should continue to reassess credit losses and adjust the allowance at each subsequent report date as necessary. This will result in subsequent gains and losses to net income as the measured credit loss changes. However, the allowance should never be reversed to a negative amount.

3.5 Interest income

Entities will continue to apply the interest method outlined in ASC 835-30[10] (including the requirement to impute interest when there is no stated interest rate) and the guidance in ASC 310-20[11] for nonrefundable fees and other costs, premiums and discounts.

As discussed in section 3.2.1, for securities written down resulting from an intent to sell or a requirement to sell, if there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes must be accounted for as a prospective adjustment to the accretable yield. This is consistent with practice today.

The AFS debt security impairment model does not provide nonaccrual guidance, but does not preclude the application of such policies.

How we see it

Although the standard does not change the interest recognition methods under current US GAAP, the amount of interest income recognized may change. This is because interest income accruals are calculated using the amortized cost basis of the security as the base. Because an entity will now record an allowance for credit losses instead of directly reducing the amortized cost basis of an AFS debt security (when there is no intent to sell and it is not more likely than not the entity will be required to sell the AFS debt security before recovery), there will be a larger amortized cost basis, which will result in higher interest income accruals than under current guidance. However, because the allowance is a discounted amount, the higher interest income will generally be offset in the income statement by the accretion of the discount on the allowance.

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[10] ASC 835-30, *Imputation of Interest*.

[11] ASC 310-20, *Nonrefundable Fees and Other Costs*.

Entities will have a choice about where to present the accretion of this discount (i.e., the change in present value attributable to the passage of time) as either a credit loss expense or as a reduction of interest income. Further, entities will see a difference in interest recognition when cash flows are expected to improve, since the change in expected cash flows for these securities will no longer be accreted into income over time, but will be recognized as a reversal of the allowance.

3.6 Disclosures

The new standard retains today's disclosure requirements related to AFS debt securities described in ASC 320-10-50 (e.g., details of the difference between fair value and amortized cost, information about the contractual maturities of the securities) but updates them to reflect the use of an allowance for credit losses and the removal of the other-than-temporary concept.

The purpose of the disclosures about impaired AFS debt securities is to help financial statement users understand the credit risk inherent in an entity's AFS debt securities, management's estimate of credit losses and changes in the estimate of credit losses that have taken place during the period.

The ASU requires information to be provided by major security type. Major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity should consider the following:

- Shared activity or business sector
- Vintage
- Geographic concentration
- Credit quality
- Economic characteristic

Entities will need to determine the appropriate level of disclosure for major security types. The objective is to provide information at a level that provides sufficient detail for a user to understand the portfolio or class without being overwhelmed by insignificant data.

The sections that follow highlight changes and additions to current disclosure requirements.

3.6.1 Rollforward of the allowance for credit losses

Entities will have to disclose a tabular rollfoward of the allowance for credit losses at each balance sheet date. This requirement will change practice for entities with AFS debt securities. The rollforward should be disclosed by major security type and include a minimum of the following:

- The beginning balance of the allowance for credit losses
- Additions to the allowance for credit losses on securities for which credit losses were not previously recorded
- Additions to the allowance for credit losses arising from purchases of AFS debt securities accounted for as PCD assets (including beneficial interests that meet the criteria in paragraph 325-40-30-1A)
- Reductions for securities sold during the period

- Reductions in the allowance for credit losses because the entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis
- If the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, additional increases or decreases to the allowance for credit losses on securities that had an allowance recorded in a previous period
- Write-offs charged against the allowance
- Recoveries of amounts previously written off
- The ending balance of the allowance for credit losses

3.6.2 Accounting policy for recognizing write-offs

Entities will be required to disclose their accounting policy for recognizing write-offs. This will be a change in practice for investors in AFS debt securities as they did not need policies for determining when to write off a security. Under the current OTTI model, all credit losses result in a direct write-off of the cost basis of the security, thus a write-off policy was not necessary.

3.7 Comparison of impairment models for AFS and HTM debt securities

An entity may record different amounts for credit losses on the same security depending on whether it is classified as HTM or AFS.

The following summarizes key differences between the impairment models for AFS and HTM debt securities.

Topic	AFS debt security impairment model*	HTM current expected credit loss model
Unit of measurement	Individual AFS debt security	Collective (pool) when similar risk characteristics exist; otherwise, individual
Allowance recognition threshold	When a decline in fair value below the amortized cost basis has resulted from a credit loss	None
Measurement of credit losses	Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost	Expected credit loss that reflects the risk of loss even if that risk is remote
Acceptable methods for measuring credit losses	DCF	Various methods are appropriate, including DCF, loss rate, PD and others that faithfully estimate collectibility by applying the principles in ASC 326-20
*When the entity has decided to sell the debt security or it's more likely than not the entity will be required to sell the security before recovery of the security's amortized cost basis, the security's amortized cost basis should be written down to fair value through earnings at the reporting date.		

How we see it

Because the models for AFS and HTM debt securities are different, an entity may record different amounts for credit losses on the same debt security in its AFS and HTM portfolios.

4 The model for certain beneficial interests (ASC 325-40)

Today's ASC 325-40 model for beneficial interests applies to certain interests in securitized financial assets as described in Section 1.3, *Scope: The model for certain beneficial interests (ASC 325-40).* A mortgage-backed security (MBS) made up of subprime loans is an example of a beneficial interest that may fall within the scope of ASC 325-40.

The ASC 325-40 model for beneficial interests provides an integrated approach to recognizing interest income and impairment expense for such investments. Under the model, an entity evaluates both (1) changes in expected cash flows from the beneficial interest and (2) whether the fair value of the beneficial interest exceeds the carrying amount. Based on those two factors, an entity may need to recognize an allowance for credit losses and/or prospectively adjust the yield to be recognized on the beneficial interest.

ASC 325-40 requires an entity to use a DCF approach to estimate expected cash flows from period to period. Changes in expected cash flows can arise from prepayments, credit concerns, changes in interest rates or other factors.

4.1 Initial recognition

As discussed in Section 1.3, ASC 325-40 currently does not apply to a beneficial interest that is in the scope of ASC 310-30 (a so-called purchased credit impaired asset). A beneficial interest in the scope of ASC 310-30 is initially and subsequently measured in accordance with that guidance.

The ASU eliminates the guidance in ASC 310-30 and replaces it with a special day-one accounting for purchased financial assets with credit deterioration (PCD assets), as described more fully in Section 5, *Purchased financial assets*. Under the ASU, an entity that purchases a beneficial interest in the scope of ASC 325-40 will have to determine whether it should apply the PCD asset guidance. An entity will need to apply that guidance to a purchased beneficial interest classified as HTM or AFS that meets either of the criteria described in the following excerpt from the Codification:

Excerpt from Accounting Standards Codification

Investments — Other — Beneficial Interests in Securitized Financial Assets

Initial Measurement

Initial Investment

325-40-30-1A

An entity shall apply the initial measurement guidance for purchased financial assets with credit deterioration in Subtopic 326-20 to a beneficial interest classified as held-to-maturity and in Subtopic 326-30 to a beneficial interest classified as available for sale, if it meets either of the following conditions:

a. There is a significant difference between contractual cash flows and expected cash flows at the date of recognition.

b. The beneficial interests meet the definition of purchased financial assets with credit deterioration.

How we see it

It's unclear what "contractual cash flows" means in the context of a beneficial interest in the scope of ASC 325-40. For example, some believe the contractual cash flows used in this scoping exercise should be based on the contractual terms of the beneficial interest, while others believe they should use the contractual cash flows of the underlying assets within the structure. In certain cases, we believe using either approach could yield a similar result.

The ASU also isn't clear about what prepayment speeds to use when determining the contractual cash flows under either scenario. For example, if prepayments are not assumed when determining the contractual cash flows, an entity will often conclude that there is a significant difference between contractual and expected cash flows because an investor will most likely have some expectation of prepayments when they purchase the beneficial interest. If this is the case, the beneficial interest would meet the threshold to be accounted for as a PCD asset, and the entity would recognize an allowance upon initial recognition by grossing up the beneficial interest's amortized cost. This approach would change the pattern of interest income recognition from what it is today because in subsequent periods, an entity will adjust the allowance for changes in cash flow expectations before prospectively adjusting yield.

On the other hand, if prepayments are assumed for the purposes of determining contractual cash flows, an entity might not conclude that there is a significant difference between contractual cash flows and expected cash flows on the date of recognition.

4.1.1 Accretable yield

Accretable yield is an important concept in the ASC 325-40 model that represents the amount of cash flows that should be accreted as interest income over the remaining life of the beneficial interest using the effective interest method. Entities should consider the following guidance when determining a beneficial interest's accretable yield at purchase:

Excerpt from Accounting Standards Codification

Investments — Other — Beneficial Interests in Securitized Financial Assets

Initial Measurement

Accretable yield

325-40-30-2

For beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all cash flows expected to be collected attributable to the beneficial interest estimated at the acquisition-transaction date (the transaction date) over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition-transaction date (the transaction date) over the amortized cost basis (the purchase price plus the initial allowance for credit losses).

An entity's initial estimate of credit loss will not be accreted to income. This is because for non-PCD assets an entity will only consider expected cash flows in determining the yield on the beneficial interests. For PCD assets, the yield is determined by equating contractual cash flows to the beneficial interests amortized cost, which has been grossed up for the entities initial estimate of credit loss.

4.2 Subsequent measurement

The following chart summarizes the subsequent measurement of beneficial interests under the ASU based on whether the beneficial interest is classified as AFS or HTM and highlights the differences and similarities of the two classifications.

<table>
<tr><th rowspan="2">Topic</th><th colspan="2">Beneficial interests in the scope of ASC 325-40 classified as</th></tr>
<tr><th>AFS</th><th>HTM</th></tr>
<tr><td rowspan="2">If there is a favorable or adverse change in cash flows expected to be collected from the cash flows previously projected*</td><td>Apply the guidance in ASC 326-30 on measuring credit losses on AFS debt securities to account for that favorable or adverse change</td><td>Apply the guidance in ASC 326-20 on financial instruments measured at amortized cost to account for that favorable or adverse change</td></tr>
<tr><td colspan="2">After application of the guidance in either ASC 326-30 or ASC 326-20 (as discussed above), if the amount of the favorable or adverse change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses pursuant to ASC 326-30 or ASC 326-20, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.**</td></tr>
<tr><td>Unit of measurement</td><td>Individual debt security</td><td>Collective (pool) when similar risk characteristics exist; otherwise, individual</td></tr>
<tr><td>Allowance recognition threshold</td><td>When a decline in fair value below the amortized cost basis has resulted from a credit loss</td><td>None</td></tr>
<tr><td>Measurement of credit losses</td><td>Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost.</td><td>Expected credit loss that reflects the risk of loss even if that risk is remote</td></tr>
<tr><td>Acceptable methods for measuring credit losses</td><td colspan="2">DCF</td></tr>
<tr><td colspan="3">* A favorable or an adverse change in cash flows expected to be collected is considered in the context of both timing and amount of the cash flows expected to be collected. If the present value of the estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable. If the present value of the estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is greater than the present value of the current estimate of cash flows expected to be collected, the change is considered adverse.
** The reference amount is equal to the initial investment (or initial amortized cost basis for beneficial interests that apply the accounting for PCD assets) minus cash received to date minus any write-off of amortized cost basis plus the yield accreted to date.</td></tr>
</table>

5 Purchased financial assets

5.1 Purchased financial assets with credit deterioration

The standard eliminates today's separate model in ASC 310-30 (pre-Codification Statement of Position 03-3[12]) for purchased credit impaired (PCI) assets, which include both loans and securities. In its place, the standard provides a special Day 1 accounting for purchased financial asset with credit deterioration (PCD assets). After initial recognition (i.e., Day 1 accounting), the accounting for the instrument will follow one of the credit loss models within the standard, depending on which one applies to the instrument:

- ASC 326-20 CECL model
- ASC 326-30 AFS debt security impairment model
- ASC 325-40 impairment model for certain beneficial interests

An asset is considered a PCD asset if it has experienced more than insignificant credit deterioration since origination. For a PCD asset, the entity will gross up the amortized cost basis for the initial estimate of credit losses under the applicable impairment model. The allowance is established without an income statement effect.

The following illustrates the Day 1 gross-up approach for PCD assets.

For a PCD asset, an entity will gross up the amortized cost basis for the initial estimate of credit losses.

Illustration 10 — PCD asset gross-up

Assume Company A purchases a note receivable with the following characteristics:

- Par amount of $100,000
- Purchase price of $80,000, due to the more than an insignificant deterioration in credit quality the note has experienced since origination
- Expected credit loss embedded in the $20,000 discount to par is determined by Company A to be $15,000

Company A recognizes the $15,000 credit loss through a "gross-up" of the asset's carrying value. The remaining $5,000 (i.e., total discount from par of $20,000 less credit loss of $15,000) relates to other factors and is recorded as a non-credit-related discount in the carrying value of the investment and accreted through income over the life of the instrument.

The following sample journal entries would be recorded at acquisition:

	Debit	Credit
Debt instrument	$ 100,000	
Debt instrument (non credit discount)		$ 5,000
Allowance for credit losses		$ 15,000
Cash		$ 80,000

To account for a PCD asset on acquisition

[12] Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*.

Illustration 10 — PCD asset gross-up (continued)

Amortized cost and Day 1 carrying value are determined as follows:

Purchase price	$ 80,000
Add: Day 1 allowance	15,000
Amortized cost	95,000
Less: allowance	(15,000)
Day 1 carrying value	(80,000)

As discussed above, the difference between the amortized cost of the debt instrument ($95,000) and its par amount will be accreted through income over the life of the insturment.

As illustrated above, the allowance recorded at acquisition for a PCD asset would not be a charge to income on Day 1. Instead the allowance is created by "grossing up" the purchase price of the instrument at initial recognition.

The FASB's view is that for a PCD asset, if interest were accreted to the amount of contractual cash flows, interest could be accreted to an amount greater than the amount expected to be collected at acquisition, thus inflating the yield. Under this view, it is not appropriate to accrete interest income to the contractual cash flow amount when a purchased financial asset has experienced more than insignificant credit deterioration since origination (i.e., a PCD asset).

Therefore, upon initial recognition of a PCD asset, the discount embedded in the purchase price that is attributable to the purchaser's initial estimate of credit losses at acquisition (i.e., the allowance) is removed from the amount to be accreted as interest income. Thereafter, changes in expected credit losses (i.e., the allowance) are recognized as increases or decreases in credit loss expense, and the non-credit-related discount or premium is accreted /amortized as interest income over the life of the asset.

The accounting treatment for purchased assets that do not meet the scope criteria described in Section 5.1, *Scope*, is discussed in Section 5.2, *Purchased financial assets with no credit deterioration*.

5.1.1 Scope

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses

Glossary

Purchased Financial Assets with Credit Deterioration

Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

For a purchased asset to qualify for the PCD asset gross-up treatment upon initial recognition, the standard states that it must have experienced more-than-insignificant credit deterioration since its origination. Under today's guidance, an asset is considered PCI when there is evidence of deterioration in credit qualify such that it is "probable, at acquisition, that the investor will be unable to collect all contractually required payments." The new standard does not mention a threshold of probable losses or impairment.

As highlighted in the Basis for Conclusions (BC90), the Board did not intend for the gross-up approach to be limited to financial assets that are considered to be impaired. The Board was concerned that stakeholders would misinterpret its intent and incorrectly apply the new PCD asset gross-up approach to the same population of assets as the existing PCI model. As a result, the Board intentionally changed the term from PCI to PCD and revised the definition. The Board believes this new definition applies to a larger population of purchased financial assets than the population of purchased financial assets eligible for the PCI model.

Bank regulatory perspectives

US banking regulators said "the definition of purchased credit-deteriorated assets is broader than the definition of purchased credit-impaired assets in current accounting standards."

How we see it

We believe that the FASB intended to create a very low threshold for applying the new PCD asset guidance. This will result in the Day 1 gross-up being applied to a much larger population of purchased loans than under today's PCI guidance.

The scope of today's PCI guidance excludes certain loan types that are not scoped out of the new PCD asset guidance. For example, the new guidance applies to purchased loans drawn under revolving credit agreements such as credit card and home equity loans that, at the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination. Entities will need to change their processes, systems, reporting and documentation to reflect this change in scope.

5.1.1.1 Pooling assets to determine whether they are PCD assets

Another significant change relates to the treatment of groups of assets (i.e., pools). Under today's guidance, for an acquisition of a pool of loans, an entity individually assesses each loan to determine whether it meets the PCI scope criteria. Under the new guidance, an entity is permitted to assess acquired groups of financial assets with similar risk characteristics and determine whether they meet the scope criteria.

The Board concluded that it would be impossible to individually evaluate each purchased financial asset in an asset acquisition or business combination within the reporting deadlines to determine whether each individual asset qualifies as a PCD asset. As a result, the Board decided that an entity should be able to assess whether individual financial assets or groups of financial assets with similar risk characteristics qualify as having experienced a more-than-insignificant deterioration in credit quality since origination.

Similar risk characteristics may include any one or a combination of the following:

- Internal or external (third-party) credit score or credit ratings
- Risk ratings or classification
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term

- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods

How we see it

The FASB deliberately removed the guidance in ASC 310-30 that requires pools of loans to be maintained as a single unit of account because of the many practice issues related to pooled units of account. As such, we generally believe an entity could:

- Group loans together for purposes of determining whether the pool of loans has experienced a more-than-insignificant deterioration in credit quality
- Estimate the allowance to be recognized through the Day 1 gross-up
- Allocate any resulting noncredit discount or premium to each individual asset

After the Day 1 recognition, the pool of loans is not considered to be a unit of account. That is, the entity can change the composition of the pool for purposes of measuring the allowance to most faithfully estimate expected credit losses. Unlike today's guidance, the new guidance doesn't restrict an entities ability to remove assets from a pool.

We believe entities will need to establish a consistent accounting policy for deciding how to group financial assets for purposes of determining whether they should be treated as PCD assets.

5.1.1.2 PCD asset scope considerations for assets under the CECL model

For assets that are included in the scope of the CECL model, the standard does not provide specific guidance on when an instrument should be considered PCD asset, other than the basic definition of a PCD asset. However, the guidance includes the example below that illustrates one way an entity might assess, at the individual asset level, which purchased assets qualify as PCD assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 11: Identifying Purchased Financial Assets with Credit Deterioration

326-20-55-57

This Example illustrates factors that may be considered when assessing whether the purchased financial assets have more than an insignificant deterioration in credit quality since origination.

326-20-55-58

Entity N purchases a portfolio of financial assets subsequently measured at amortized cost basis with varying levels of credit quality. When determining which assets should be considered to be in the scope of the guidance for purchased financial assets with credit deterioration, Entity N considers the factors in paragraph 326-20-55-4 that are relevant for determining collectibility.

326-20-55-59

Entity N assesses what is more-than-insignificant credit deterioration since origination and considers the purchased assets with the following characteristics to be consistent with the factors that affect collectibility in paragraph 326-20-55-4. Entity N records the allowance for credit losses in accordance with paragraph 326-20-30-13 for the following assets:

a. Financial assets that are delinquent as of the acquisition date

b. Financial assets that have been downgraded since origination

c. Financial assets that have been placed on nonaccrual status

d. Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in its policy.

326-20-55-60

Judgment is required when determining whether purchased financial assets should be recorded as purchased financial assets with credit deterioration. Entity N's considerations represent only a few of the possible considerations. There may be other acceptable considerations and policies applied by an entity to identify purchased financial assets with credit deterioration.

The illustration lists the widening of credit spreads as a qualifying characteristic for a PCD asset. This evidences the lower threshold the FASB intended to be used when applying the new guidance.

Further, the example refers to ASC 326-20-55-4 for the factors relevant to collectibility that should be considered when assessing whether a financial asset has experienced a more than insignificant deterioration in credit quality since origination. The factors, which are discussed earlier in this publication, include:

- The customer's or borrower's financial condition, credit rating, credit score, asset quality or business prospects
- The customer's or borrower's ability to make scheduled interest or principal payments
- The volume and severity of past due financial assets and the volume and severity of adversely classified or rated financial assets
- The value of underlying collateral on financial assets for which the collateral-dependent practical expedient has not been used
- The environmental factors of a customer or borrower and the areas in which the entity's credit is concentrated, such as:
  - Regulatory, legal or technological environment to which the entity has exposure
  - Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
  - Changes and expected changes in the international, national, regional and local economic and business environment, including the condition and expected condition of various market segments

5.1.1.3 *PCD asset scope considerations for AFS securities*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Available-for-Sale Debt Instruments

326-30-30-2

A purchased debt security classified as available-for-sale shall be considered to be a purchased financial asset with credit deterioration when the indicators of a credit loss in paragraph 326-30-55-1 have been met. The allowance for credit losses for purchased financial assets with credit deterioration shall be measured at the individual security level in accordance with paragraphs 326-30-35-3 through 35-10. The amortized cost basis for purchased financial assets with credit deterioration shall be considered to be the purchase price plus any allowance for credit losses. See paragraphs 326-30-55-1 through 55-7 for implementation guidance.

The standard specifies that an AFS debt security should be considered a PCD asset when the relevant indicators of a credit loss in paragraph 326-30-55-1 have been met. Those factors include:

- Any changes to the rating of the security by a rating agency
- The likelihood of the issuer being able to make payments that increase in the future
- Failure of the issuer of the security to make scheduled interest or principal payments
- Adverse conditions specifically related to the security, an industry or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors

The threshold for applying PCD asset accounting to a purchased AFS debt security is different from the threshold for an asset subject to the CECL model.

How we see it

We believe an entity would apply different thresholds to determine when to use PCD accounting for an asset subject to the CECL model and one subject to the AFS debt security model.

- For CECL instruments, an entity will apply the Master Glossary definition of PCD assets.
- For AFS debt securities, an entity will apply the guidance in 326-30-30-2 that says the purchased debt security meets the PCD asset definition when the impairment indicators in 326-30-55-1 are met.

As a result, we generally believe the threshold for applying PCD asset accounting to a purchased AFS debt security is higher than that for an asset subject to the CECL model. A higher threshold for AFS securities is consistent with the requirement that a credit loss must exist before recognizing an allowance under the AFS impairment model. The CECL model has no such trigger or threshold that must be reached before an entity recognizes expected credit losses.

Entities will need to consider these differences when establishing their accounting policies for assessing whether to apply Day 1 gross-up accounting.

5.1.2 *Applying the PCD asset Day 1 accounting treatment*

5.1.2.1 *Grossing-up assets subject to the CECL model*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-13

An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration in accordance with paragraphs 326-20-30-2 through 30-10 and 326-20-30-12. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

326-20-30-14

If an entity estimates expected credit losses using a discounted cash flow method, the entity shall discount expected credit losses at the rate that equates the present value of the purchaser's estimate of the asset's future cash flows with the purchase price of the asset. If an entity estimates expected credit losses using a method other than a discounted cash flow method, the entity shall estimate expected credit losses on the basis of the unpaid principal balance (face value) of the financial asset(s). See paragraphs 326-20-55-66 through 55-78 for implementation guidance and examples.

The standard specifies that the effective interest rate for a PCD asset should exclude the discount that was embedded in the purchase price that is attributable to credit losses expected at the purchase date.

Consistent with other aspects of the guidance, the standard does not require a specific method to be used when determining the initial allowance gross-up for a PCD asset. Instead, the standard states that when an entity estimates credit losses using a method that does not project future interest and principal cash flows (i.e., a loss rate approach is used), the PCD asset gross-up should be based on the unpaid principal balance (or par) amount of the asset. However, when an entity estimates credit losses using a DCF approach, the gross-up for expected credit losses should be determined using a discount rate that equates the present value of estimated future cash flows with the purchase price of the financial asset.

The standard provides the following example to show how this would be done under a loss-rate approach for assets in the scope of the CECL model.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 13: Using a Loss-Rate Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

326-20-55-66

This Example illustrates the application of the guidance to determine the expected credit loss using a loss rate for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial

assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses for financial assets by applying this Subtopic. This does not mean that the application of a loss-rate approach is an irrevocable election.

326-20-55-67

Bank P purchases a $5 million amortizing nonprepayable loan with a 6 percent coupon rate and original contract term of 5 years. All contractual principal and interest payments due of $1,186,982 for each of the first 3 years of the loan's life have been received, and the loan has an unpaid balance of $2,176,204 at the purchase date at the beginning of Year 4 of the loan's life. The original contractual amortization schedule of the loan is as follows.

Period	Beginning Balance	Total Payment	Interest	Principal	Ending Balance
1	$ 5,000,000	$ 1,186,982	$ 300,000	$ 886,982	$ 4,113,018
2	4,113,018	1,186,982	246,781	940,201	3,172,817
3	3,172,817	1,186,982	190,369	996,613	2,176,204
4	2,176,204	1,186,982	130,572	1,056,410	1,119,794
5	1,119,794	1,186,982	67,188	1,119,794	-
Totals		$ 5,934,910	$ 934,910	$ 5,000,000	

326-20-55-68

At the purchase date, the loan is purchased for $1,918,559 because significant credit events have been discovered. The purchaser expects a 10 percent loss rate, based on historical loss information over the contractual term of the loan, adjusted for current conditions and reasonable and supportable forecasts, for groups of similar loans. In accordance with paragraph 326-20-30-14, as a result of the expected credit losses, the allowance is estimated as $217,620 by multiplying the 10 percent loss rate by the unpaid principal balance, or par amount, of the loan (see beginning balance in Year 4 in the table above). The following journal entry is recorded at the acquisition of the loan:

Loan	$ 2,176,204	
Loan—noncredit discount		$ 40,025
Allowance for credit losses		217,620
Cash		1,918,559

326-20-55-69

The contractual interest rate is adjusted for the noncredit discount of $40,025 to determine the discount rate (consistent with paragraph 326-20-30-14) of 7.33 percent, which excludes the purchaser's assessment of expected credit losses at the acquisition date. The 7.33 percent (rounded from 7.3344 percent) is computed as the rate that equates the amortized cost of $2,136,179 (computed by adding the purchase price of $1,918,559 to the gross-up adjustment of $217,620) with the net present value of the remaining contractual cash flows on the purchased asset ($1,186,982 in each of Years 4 and 5).

326-20-55-70

A default occurs in the last year of the loan's life. The amortization of the purchased loan would be recorded as follows for the periods after the purchase date in Years 4 and 5 of the loan's life.

Period	Beginning Balance (a)	Total Payment (b)	Writeoff (c)	Accrued Interest (d)	Reduction (e)	Ending Balance (f)
4	$ 2,136,179	$ 1,186,982		$ 156,67[illegible]	$ 1,030,306	$ 1,105,873
5	1,105,873	969,362	$ 217,62[illegible]	81,10[illegible]	1,105,873	-
Totals		$ 2,156,344	$ 217,62[illegible]	$ 237,78[illegible]	$ 2,136,179	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $217,620.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 7.33 percent (as determined in accordance with paragraph 326-20-55-69).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

326-20-55-71

The rollforward of the allowance would be as follows.

Beginning allowance for credit losses	$	217,620
Plus, credit loss expense		-
Less, writeoffs		(217,620)
Ending allowance for credit losses	$	–

The standard also provides the following example to show how the PCD asset approach would work under a DCF method for assets in the scope of the CECL model.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 14: Using a Discounted Cash Flow Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

326-20-55-72

This Example illustrates the application of the guidance to determine the expected credit loss using a discounted cash flow approach for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses for financial assets by applying this Subtopic. This does not mean that the application of a discounted cash flow approach is an irrevocable election.

326-20-55-73

This Example uses the same assumptions as in Example 13, as described in paragraphs 326-20-55-66 through 55-71.

326-20-55-74

To determine the discount rate in accordance with paragraph 326-20-30-14, the expected cash flows would be estimated and discounted at a rate that equates the purchase price with the present value of expected cash flows. The expected cash flows, including the considerations for current conditions and reasonable and supportable forecasts, are expected to be $1,186,982 in Year 4 and $969,362 in Year 5. The discount rate that equates the purchase price with the cash flows expected to be collected is 8.46 percent (rounded from 8.455 percent). This also is the same rate that equates the amortized cost basis (purchase price plus the acquisition date allowance for credit losses) with the net present value of the future contractual cash flows.

326-20-55-75

To determine the allowance for credit losses at the purchase date, the expected credit loss (that is, the contractual cash that an entity does not expect to collect) is discounted using the discount rate of 8.46 percent. The expected credit loss is $217,620 in Year 5, as

determined by finding the difference between the contractual cash flows of $1,186,982 and the expected cash flows of $969,362. The present value of the expected loss at the purchase date is $185,012. The journal entry to record the purchase of this loan is as follows:

Loan	$ 2,176,204	
Loan—noncredit discount		$ 72,633
Allowance for credit losses		185,012
Cash		1,918,559

326-20-55-76

The amortization of the loan in the years following the purchase date is as follows.

Period	Beginning Balance (a)	Total Payment (b)	Writeoff (c)	Accrued Interest (d)	Reduction (e)	Ending Balance (f)
4	$ 2,103,571	$ 1,186,982		$ 177,857	$ 1,009,125	$ 1,094,446
5	1,094,446	969,362	$ 217,620	92,536	1,094,446	-
Totals		$ 2,156,344	$ 217,620	$ 270,393	$ 2,103,571	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $185,012.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 8.46 percent (as determined in accordance with paragraph 326-20-55-74).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

326-20-55-77

The Day 1 allowance established at the purchase date was $185,012. The allowance for credit losses was estimated on a discounted cash flow approach and, therefore, the allowance for credit losses needs to be adjusted for the time value of money. The rollforward of the allowance for credit losses is shown below.

Beginning allowance for credit losses	$ 185,012
Plus, credit loss expense	15,643[a]
Less, writeoffs	-
Ending allowance for credit losses (Year 4)	$ 200,665
Plus, credit loss expense	16,965[a]
Less, writeoffs	(217,620)[b]
Ending allowance for credit losses (Year 5)	$ -

(a) The provision for credit losses in Years 4 and 5 is determined by multiplying the beginning allowance for credit losses by the discount rate of 8.46 percent to adjust for the time value of money

(b) The writeoff represents the default in year 5. The default is the difference between the Year 5 contractual cash flows of $1,186,982 and the actual cash flows received of $969,362

326-20-55-78

The net income effect of a loss-rate approach illustrated in Example 13 and of a discounted cash flow approach illustrated in this Example is the same ($237,785 net income). The difference between the two approaches is that the Day 1 allowance for credit losses under a discounted cash flow approach explicitly reflects the time value of money. Therefore, it needs to be accreted to the future value of the loss that ultimately will occur. The change in the allowance for credit losses associated with the time value of money can be presented either as credit loss expense or as an adjustment to interest income in accordance with paragraph 326-20-45-3. Therefore, the discounted cash flow approach, over the life of the asset, presents interest income as $270,393 but will require $32,608 ($15,643 in Year 4

plus $16,965 in Year 5) of credit loss expense to be recorded for the time value of money, resulting in net interest income after credit loss expense of $237,785. Under a loss-rate approach as illustrated in Example 13, interest income over the life of the asset is $237,785 but does not require credit loss expense to be recognized.

Further, the estimate of CECL for PCD assets should be measured on an aggregate (pool) basis when similar risk characteristics exist. However, even though the "default" is for this estimate to be measured on a pool basis, any noncredit discount or premium must be allocated to each individual asset.

How we see it

The effective interest rate (EIR) that results from the DCF approach may not be the same as the EIR that results from a non-DCF approach, given the different amortized cost amounts that could result from the Day 1 gross-up.

Further, the amount of interest income and credit loss expense recognized in future periods may be affected by which approach is used to estimate credit losses (DCF versus non-DCF). To see the difference, compare illustrations 13 and 14 above. While the gross amount of expected credit losses is the same under both methods, that amount is discounted under the DCF approach to determine the amount of the allowance but it is not discounted under a non-DCF approach.

As a result, the credit-related discount (allowance) is smaller, and the non-credit-related discount is larger, under the DCF approach. Over time, the allowance will increase (i.e., accrete as an increase in credit loss expense or reduction in interest income) under a DCF approach due to the time value of money, and the non-credit-related discount will be accreted (in an equal amount) through an increase in interest income.

Because the guidance does not require a specific method for allocating the allowance and noncredit discount or premium to individual assets, entities will need to exercise judgment to determine an appropriate approach.

5.1.2.2 *Measurement of PCD assets under the CECL model after initial recognition*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-1

At each reporting date, an entity shall record an allowance for credit losses on financial assets (including purchased financial assets with credit deterioration) within the scope of this Subtopic. An entity shall compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded. An entity shall report in net income (as a credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s). The method applied to initially measure expected credit losses for the assets included in paragraph 326-20-30-14 generally would be applied consistently over time and shall faithfully estimate expected credit losses for financial asset(s).

The guidance indicates that the method (i.e., DCF or non-DCF method) applied to initially measure expected credit losses for PCD assets would generally be applied consistently over time.

ASC 326-20-30-14 says that the initial measurement of expected credit losses under a non-DCF approach should be based on the unpaid principal balance. As mentioned above, ASC 326-20-35-1 says that an entity generally should use a consistent method for measurement over time, but does not address the basis (i.e., unpaid principal balance or amortized cost) on which the loss should be measured. As a result, it's unclear whether the assessment of credit losses after Day 1 for PCD assets under a non-DCF approach should be based on the unpaid principal balance (consistent with the Day 1 accounting) or on the amortized cost basis (consistent with the measurement for non-PCD assets).

How we see it

The ASU says that the PCD asset estimation method should generally be applied consistently over time. Entities that initially use a non-DCF approach to estimate expected credit losses for PCD assets may, in the future, determine that they can apply a DCF approach (e.g., additional information about cash flow expectations). We believe that by saying that the PCD asset estimation method should "generally be applied consistently over time," the standard provides the ability to make such a change.

5.1.2.3 *Grossing up AFS debt securities*

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Instruments — Credit Losses

Initial Measurement

326-30-30-3

Estimated credit losses shall be discounted at the rate that equates the present value of the purchaser's estimate of the security's future cash flows with the purchase price of the asset.

326-30-30-4

An entity shall record the holding gain or loss through other comprehensive income, net of applicable taxes.

The standard specifies that the effective interest rate for a PCD asset that is a security classified as AFS should exclude the discount that was embedded in the purchase price that is attributable to expected credit losses at the purchase date. For AFS debt securities, the standard requires that the gross-up amount upon acquisition (and corresponding allowance for credit losses) be measured at the individual security level in accordance with the provisions of the AFS debt security impairment model in ASC 326-30. That is, the gross-up should be measured on a present value basis (i.e., a DCF approach) using the best estimate of the present value of cash flows expected to be collected.

5.1.2.4 *Measurement of PCD assets under the AFS debt security impairment model after initial recognition*

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Instruments — Credit Losses

Subsequent Measurement

326-30-35-16

An entity shall measure changes in the allowance for credit losses on a purchased financial asset with credit deterioration in accordance with paragraph 326-30-35-6. The entity shall report changes in the allowance for credit losses in net income as credit loss expense (or reversal of credit loss expense) in each reporting period.

Subsequent to acquisition, the estimate of expected credit losses for PCD assets that are AFS debt securities uses the same "best estimate" model that is used for other AFS debt securities. Post-acquisition changes in the allowance for credit losses for PCD assets that are AFS debt securities will be recorded as credit loss expense (or a reversal in credit loss expense) rather than as an increase in the amortized cost basis of the asset.

5.1.3 Interest income recognition on PCD assets

Under the new standard, interest income for a PCD asset should be recognized by accreting the amortized cost basis of the instrument to its contractual cash flows. The discount related to estimated credit losses on acquisition (that is, the allowance recognized at the date of purchase through the gross-up accounting) will not be accreted into interest income, and only the non-credit-related discount will be accreted. Recognition of income requires a reasonable expectation about both the timing and amount of cash flows expected to be collected, and nonaccrual approaches can be applied. It is not yet clear how nonaccrual practices will be applied to PCD assets.

5.1.4 Disclosures for PCD assets

The disclosure requirements for PCD assets acquired during the current reporting period apply to all PCD assets, regardless of whether they are measured at amortized cost (as outlined in ASC 326-20-50-19) or are AFS debt securities (as outlined in ASC 326-30-50-10). A reconciliation of the difference between the purchase price and the par amount must be provided. Separate disclosure of the purchase price, the allowance for credit losses at acquisition, the discount (or premium) attributable to other factors and par value must be included in that reconciliation.

Impairment of an originated asset and a purchased financial asset that does not meet the definition of PCD is accounted for in the same way.

5.2 Purchased financial assets that don't qualify as PCD assets

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-15

An entity shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets in accordance with paragraphs 326-20-30-1 through 30-10 and 326-20-30-12. An entity shall not apply the guidance in paragraphs 326-20-30-13 through 30-14 for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination.

Purchased financial assets that do not meet the definition of PCD assets are accounted for in a manner consistent with the same type of originated financial asset (as described in Section 2, 3 or 4 above). There is no "gross-up" of the amortized cost by the amount of the initial allowance for purchased non-PCD assets (i.e., those that have not experienced more than insignificant credit deterioration since origination), and instead, entities will recognize the allowance through earnings on Day 1.

In addition, for non-PCD assets, the discount that is embedded in the purchase price that is attributable to the purchaser's initial estimate of credit losses at acquisition (i.e., the allowance) is not removed from the amount to be accreted as interest income, and the entire discount or premium is recognized as interest income over the life of the asset. This differs from the treatment of the credit-related discount for PCD assets, which is not accreted through interest income. As discussed above, the PCD asset approach is based on the Board's view that it is not appropriate to accrete interest income to the contractual cash flow amount when purchased financial assets have experienced more than insignificant credit deterioration since origination.

The FASB included the following sections in the ASU, which clarify its view that there is no fundamental difference between an originated asset and a non-PCD asset and, as such, the two should be accounted for in the same way. That is, an entity should recognize an allowance through earnings when it originates new assets or purchases assets not deemed to be PCD assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-5

...In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses...

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-4A

For acquired financial assets that are not purchased financial assets with credit deterioration, the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date.

As a result, the accounting model for PCD assets is very different from that for non-PCD assets.

How we see it

When purchased financial assets in the scope of the CECL model are not considered PCD assets, the purchaser recognizes a Day 1 loss. That is, there is no allowance established on the date of acquisition by grossing up the amortized cost of the asset. Rather, at the first reporting date after the date of acquisition, the purchaser recognizes an allowance (and corresponding expense) for expected credit losses on those assets.

While some constituents, including both preparers and users, expressed concerns that the treatment of assets that aren't PCD assets, and therefore don't receive gross-up treatment, amounted to "uneconomic accounting," the Board ultimately decided not to extend the gross-up approach to all purchased assets. The FASB cites the following reasons for that decision:

- Credit risk may be difficult to reliably isolate from other discounts reflected in the purchase price when the credit risk is insignificant.
- Benefits would not justify the incremental costs associated with a requirement to separate the credit and non-credit-related discounts when the amounts are insignificant.
- Accretion of the discount into income due to credit would be insignificant.

Given the requirements to record Day 1 losses for non-PCD assets, we expect entities that engage in significant business combinations or asset acquisitions to seek to maximize the portion of purchased financial assets considered PCD assets. We note that the Board's reference to the factors in paragraph ASC 326-20-55-4 may make it easier for pools of purchased assets to qualify as PCD assets. For example, this may be the case if a pool of assets has experienced a more than insignificant increase in the volume and severity of past due or adversely classified financial assets even though some items in the pool may not individually meet the definition of PCD assets.

6 Transition

The ASU requires 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. For example, a calendar-year PBE that meets the definition of an SEC filer will apply the cumulative effect adjustment on 1 January 2020 and provide the related transition disclosures in its first quarter 2020 Form 10-Q.

Bank regulatory perspectives

The Joint Statement states that "until institutions implement the new accounting standard, they must continue to calculate their allowances for loan and lease losses using the existing incurred loss methodology. Institutions should not begin increasing their allowance levels beyond those appropriate under existing U.S. GAAP in advance of the new standard's effective date. However, institutions are encouraged to take steps to assess the potential impact on capital."

Additionally, the standard includes the following transition provisions to ease the burden of calculating the cumulative-effect adjustment for certain items.

The ASU includes transition provisions to ease the burden of calculating the cumulative-effect adjustment for certain items.

6.1 Application to purchased financial assets with credit deterioration

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(d)

An entity shall apply prospectively the pending content that links to this paragraph for purchased financial assets with credit deterioration to financial assets for which Subtopic 310-30 was previously applied. 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 the date of adoption. An entity shall not reassess whether recognized financial assets meet the criteria of a purchased financial asset with credit deterioration as of the date of adoption. An entity may elect to maintain pools of loans accounted for under Subtopic 310-30 at adoption. An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are troubled debt restructurings as of the date of adoption. The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the effective interest rate determined after the adjustment for credit losses at the adoption date. The same transition requirements should be applied to beneficial interests for which Subtopic 310-30 was applied previously or for which there is a significant difference between the contractual cash flows and expected cash flows at the date of recognition.

As previously discussed, the definition of a PCD asset under the new standard differs from that of a PCI asset under ASC 310-30. The Board decided that when calculating the cumulative effect adjustment, an entity should simply apply the new PCD asset gross-up approach to all assets that are accounted for as PCI prior to adoption of the new guidance. In addition, an entity should not reassess whether prior modifications of individual PCI loans accounted for in pools are TDRs at the adoption date.

Upon transition, the effective interest rate of a PCD asset will be determined after the amortized cost basis gross-up adjustment for expected credit losses at adoption. An entity will use the new PCD asset definition for evaluating purchases after the date of adoption.

How we see it

We believe the Board's decision to simplify the transition for PCD assets will significantly reduce the cost and complexity of adopting the standard for entities with these assets. Because of the transition relief, an entity will not need to reassess whether any recognized PCI financial assets as of the date of adoption meet the definition of a PCD asset.

6.2 Application to debt securities with an other-than-temporary impairment

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(e)

An entity shall apply prospectively the pending content that links to this paragraph to debt securities for which an other-than-temporary impairment had been recognized before the date of adoption, such that the amortized cost basis (including previous write-downs) of the debt security is unchanged. In addition, the effective interest rate on a security will remain unchanged as a result of the adoption of the pending content that links to this paragraph. Amounts previously recognized in accumulated other comprehensive income as of the adoption date that relate to improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. Recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption shall be recorded to income in the period received.

Today's AFS debt security impairment model requires a write-down of the amortized cost basis of a security for the credit-loss portion of an OTTI. The new standard, however, requires the use of an allowance for estimated credit losses on an AFS debt security. For purposes of calculating the cumulative effect adjustment, the Board decided that when transitioning to the new standard, an entity should simply use the pre-transition amortized cost basis (and related yield) and apply the allowance approach on a prospective basis (i.e., to changes in credit impairment subsequent to adoption), except for recoveries of amounts previously written off that occur after the date of adoption, which are recorded in income in the period received instead of the period in which the entity's best estimate has changed.

How we see it

The Board's guidance on recoveries of amounts written off prior to the date of adoption relating to improvements in cash flows that occur after the date of adoption was intended to make sure that entities would not recognize a "negative allowance."

For example, assume a bond was originally purchased at $100 and was later written down to $80 for credit-related reasons. If the amortized cost of the bond upon transition is $80, but after adoption the investor expects to collect all contractual cash flows, the new guidance would require the investor to wait to record the $20 in improved cash flows until it is actually received.

This approach may cause operational challenges for some entities because it will require them to maintain separate records for securities for which an OTTI was recognized before transition compared to securities for which a credit loss is recognized post-transition. Entities will need to track cash flows received on pre-transition OTTI securities to determine whether those cash flows represent the receipt of amounts previously written off through an OTTI.

6.3 Transition disclosures

An entity is required to provide the following transition disclosures in the period of adoption.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(f)

An entity shall disclose the following in the period that the entity adopts the pending content that links to this paragraph:

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 pending content that links to this paragraph 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 pending content that links to this paragraph is effective.

An entity that issues interim financial statements is required to provide the above disclosures in each of the interim and the annual financial statements in the year of the change.

6.4 SEC SAB Topic 11.M[13] disclosures

For registration statements and periodic reports filed with the SEC between now and the date of adoption, entities will need to provide disclosures about the effects of the standard. SEC SAB Topic 11.M requires disclosure of the potential effects of recently issued accounting standards, if those effects are known. Companies should consider making the following disclosures within management's discussion and analysis and the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier
- A discussion of the methods of adoption allowed by the standard
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn't known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

[13] SEC SAB Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period.*

At the September 2016 Emerging Issues Task Force meeting, the SEC Observer reminded registrants that they need to disclose the effect of adopting new accounting standards in future periods in accordance with SAB Topic 11.M in light of new guidance issued by the FASB, including the guidance on measuring credit losses on financial instruments in the ASU.

Consistent with SAB Topic 11.M, the SEC Observer said that if a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the significance of the effect on the registrant's financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies. In addition registrants should describe the status of their processes to implement the new standards and the significance of any implementation matters yet to be addressed in those processes.

The SEC Observer said that registrants should consider disclosing this information no later than in their next year-end filing.

How we see it

Initially, we anticipate companies may not know, or be able to make a reasonable estimate of, the effect the new standard will have on its financial statements, and will make a statement to that effect.

Consistent with the SEC staff's expectations, an entity's disclosures should evolve over time as more information about the effects of the new standard becomes available.

Entities should monitor developments as regulators, the TRG and others discuss this new guidance over the coming months.

6.5 Interpretations and further guidance

We expect further discussion about this new guidance over the coming months. The FASB has formed a Transition Resource Group for Credit Losses (TRG). The group held its first public meeting on 1 April 2016, to address implementation issues raised by stakeholders, much like a similar group that the FASB and the IASB created jointly to address implementation issues related to their new revenue standards. In the case of the credit loss standard, however, the FASB convened the TRG before issuing the final standard in an effort to avoid having to amend it and add more implementation guidance.

The purpose of the TRG is to:

- Solicit, analyze and discuss stakeholder issues arising from implementation of the new guidance
- Inform the FASB about those implementation issues, which will help the Board determine what, if any, action will be needed to address those issues
- Provide a forum for stakeholders to learn about the new guidance from others involved with implementation

The TRG will meet periodically to discuss potential issues arising from the implementation of the new guidance. Preparers, auditors and users may submit issues for the TRG to discuss. The FASB staff will evaluate each submission and prioritize the issues for discussion at a TRG meeting. During the meetings, the TRG members will share their views on the issues. The TRG will not issue guidance. Subsequent to each meeting, the FASB will determine what action, if any, it should take on each issue. To date, no other TRG meetings have been scheduled.

In addition, the AICPA has formed two task forces related to the standard: one will address concerns related to the ASU and credit models and the other will address audit matters.

Finally, we expect the bank regulators to continue to provide their views and interpretations prior to the standard's effective date. Guidance from regulators will clearly affect how regulated financial institutions implement the standard and may influence how other entities approach implementation issues.

Bank regulatory perspectives

The Joint Statement indicates that the federal agencies are in the process of "determining the nature and extent of supervisory guidance institutions will need during the implementation period, with a particular focus on the needs of smaller and less complex institutions. If institutions have issues or concerns about implementing the new accounting standard, they should discuss their questions with their primary federal supervisor."

The regulators go on to say that their "goal is to ensure consistent and timely communication, delivery of examiner training, and issuance of supervisory guidance pertaining to the new accounting standard. The agencies will be especially mindful of the needs of smaller and less complex institutions when developing supervisory guidance describing the expectations for an appropriate and comprehensive implementation of this standard. The guidance will not prescribe a single approved method for estimating expected credit losses. Furthermore, because appropriate allowance levels are institution-specific amounts, the guidance will not establish benchmark targets or ranges for the change in institutions' allowance levels upon adoption of CECL or for allowance levels going forward."

The Joint Statement concludes that "the move to an expected credit loss methodology represents a change to current allowance practices for the agencies and institutions. The agencies support an implementation of the FASB's new accounting standard that is both reasonable and practical, taking into consideration the size, complexity, and risk profile of each institution."

As highlighted in this publication, there are various topics that remain unclear and we expect additional discussion about them by various stakeholders over the coming months. Some of these topics are:

- Should a pool of financial assets have certain shared risk characteristics, such as credit quality or remaining contractual life, to be included in a pool for estimation of credit losses?
- Which modeling approaches faithfully estimate expected credit losses for financial assets and which do not?
- Over what period of time should an entity measure expected credit losses for financial assets that do not have a contractual maturity (e.g., credit cards)?
- What does it mean for a forecast to be reasonable and supportable?
- What does it mean to have a reasonable expectation that an entity will execute a TDR?
- What constitutes a more than insignificant deterioration in credit quality?
- How should an entity that uses a non-DCF approach account for interest rate concessions?

6.6 Processes and controls

To implement the ASU, entities may need to change their credit loss estimation practices. Thjs will likely require significant adjustments to processes, systems and controls. How much an entity will be affected will depend on the types of financial assets it holds. While financial institutions will likely see the most significant change, virtually all entities will be affected. For example, entities with accounts receivable will need to change their process to make sure their estimate of bad debts reflects forecasted economic conditions. Additionally, entities that hold AFS or HTM debt securities will need to measure and record credit loss each reporting period through an allowance rather than reduce the carrying value of the asset, as they do today.

One of the potential challenges — and opportunities — related to implementing the ASU is the latitude given to financial statement preparers by the FASB. The ASU is largely principles based and does not provide specific rules on how an entity should measure expected credit losses. For example, even though some might argue that a DCF approach is the "gold standard," the ASU is clear that an entity is not required to reconcile a chosen approach to a DCF approach. In addition, through the Basis for Conclusions and other avenues, including speeches, Board members have made it clear that preparers have latitude in the methods they choose to estimate expected credit losses, acknowledging that different methods could yield very different outcomes. As such, we believe entities will need to focus on (1) developing a systematic methodology that is both disciplined and consistently applied, (2) documenting the methodology, including supporting documentation for policies and procedures as well as key decisions, assumptions and processes, and (3) designing an appropriate mix of internal controls that operate at an acceptable level of precision. Entities should not underestimate the effort that all this may require.

6.7 Next steps

Entities should begin developing detailed implementation plans to address the ASU. The SEC's Mr. Bricker recently said that "it is a good time for companies, their audit committees, and their auditors to assess the quality and status of implementation plans so that the implementation of the standard achieves the financial reporting objectives intended by the standard setters. Without an appropriate allocation of time and resources, companies risk financial reporting failures that can lead to significant, adverse consequences for shareholders."

"Implementation will involve in many cases a fresh look at estimation processes and related policies, procedures, systems and internal controls. Investors expect companies to have internal controls in place to reasonably assure the reliability of the financial information reported by management. Therefore, transition plans for the new standard should include initiatives for identifying and implementing the necessary changes to controls."

The federal bank regulators have also provided guidance on how to plan for a successful transition over the coming months and years before the standard becomes effective. While this guidance was aimed at regulated financial institutions, it is helpful for all entities.

Bank regulatory perspectives

"Although the agencies recognize the impact of CECL will vary from institution to institution, the agencies encourage institutions to start planning and preparing for their transition to the new accounting standard by:

- Becoming familiar with the new accounting standard.
- Discussing with the board of directors, industry peers, external auditors, and supervisory agencies how best to implement the new accounting standard in a manner appropriate to the institutions' size and the nature, scope, and risk of their lending and debt securities investment activities.
- Reviewing existing allowance and credit risk management practices to identify processes that can be leveraged when applying the new accounting standard.
- Identifying data needs and necessary system changes to implement the new accounting standard consistent with its requirements, the allowance estimation method or methods to be used, and supervisory expectations.
- Determining how and when to begin collecting the additional data that may be needed for implementation.
- Planning for the potential impact of the new accounting standard on capital.

Senior management, under the oversight of the board of directors, should work closely with staff in their accounting, lending, credit risk management, internal audit, and information technology functions during the transition period leading up to the effective date of the new accounting standard as well as after its adoption."

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Appendix: US GAAP vs. IFRS

This table compares key aspects of the US GAAP CECL model in ASC 326-20 with IFRS 9.

Topic	US GAAP's CECL model (ASC 326-20)	IFRS 9
Scope	Applies to financial assets measured at amortized cost, including debt instruments (e.g., loans), held-to-maturity (HTM) debt securities and trade receivables); net investments in leases recognized by a lessor under ASC 842; contract assets under ASC 606; and off-balance-sheet credit exposures that are not accounted for as insurance (e.g., loan commitments, standby letters of credit and financial guarantees), except for instruments in the scope of ASC 815, *Derivatives and Hedging*. Entities will account for credit losses on AFS debt securities pursuant to ASC 326-30 and not the CECL model.	Applies to debt instruments recorded at amortized cost or at fair value through OCI (FV-OCI) such as loans, debt securities and trade receivables; lease receivables under IFRS 16; contract assets under IFRS 15; and loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss.
Unit of measurement	The standard requires a collective (i.e., pool-based) estimate of expected credit losses (ECLs) when similar risk characteristics exist.	The standard allows expected credit losses (ECLs) to be estimated on a collective basis when there are shared risk characteristics. The assessment of significant deterioration in credit risk and the estimate of ECLs are made collectively if they cannot be done at the individual asset level.
Measurement objective	<u>One measurement objective:</u> The allowance for credit losses is the amount that, when deducted from the amortized cost basis of the financial asset, reflects the net amount expected to be collected.	<u>Two measurement objectives:</u> The amount of the allowance depends on the extent of credit deterioration since the initial recognition of the asset. For assets that have experienced a significant increase in credit risk since initial recognition, the allowance reflects lifetime ECLs. For all other assets, the allowance reflects 12 months of ECLs (i.e., the portion of lifetime ECLs that result from default events that are possible within the next 12 months). There is a simplified approach for certain trade & lease receivables as well as contract assets. See below for discussion of originated or purchased credit-impaired assets.

Topic	US GAAP's CECL model (ASC 326-20)	IFRS 9
Elements of an estimate of expected credit losses	Be based on the asset's amortized cost. The ASU does not require a specific approach to determine the allowance and there is no explicit requirement to consider the time value of money. If a discounted cash flow (i.e., future principal and interest cash flows) approach is used, then the discount rate is the financial asset's original effective interest rate (EIR).	A discounted cash flow approach is required. ECLs must be discounted using a rate that approximates the EIR of the asset.
	Reflect losses expected over the remaining contractual life of an asset, recognizing that prepayments reduce loss.	Reflect the present value of all cash shortfalls over the remaining expected life of the financial asset, including consideration of prepayments and expected renewals and extensions.
	Reflect the risk of loss, even when that risk is remote (an estimate based solely on the most likely outcome is not permitted).	ECLs are an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes that is representative of the loss distribution. The number of scenarios is not specified but should consider the possibility of non-linear outcomes with respect to ECLs.
	Consider available information about the collectibility of cash flows, including information about past events, current conditions, and reasonable and supportable forecasts.	Generally consistent with the ASU, but multiple scenarios should be considered.
Recognizing credit losses	An allowance (contra asset) is established through net income for expected credit losses. Changes in the allowance are recognized immediately in net income.	Generally consistent with the ASU; movements between the two measurement objectives are also recognized immediately in net income.
Write-off principle	Financial assets are written off when they are deemed uncollectible.	Financial assets are written off when the entity has no reasonable expectation of recovery.
Interest income recognition and measurement	Interest income is recognized based on the asset's EIR and amortized cost amount. For PCD assets, the purchase price discount attributable to the ECLs at acquisition date is not recognized as interest income. The non-credit-related discount or premium is accreted as interest income.	Interest revenue is based on the asset's EIR and gross carrying amount (without deducting the loss allowance). If a financial asset subsequently becomes credit-impaired, an entity is required to calculate interest revenue by applying the EIR to the amortized cost of the financial asset (i.e., the gross carrying amount net of loss allowance) rather than to the gross carrying amount.
Purchased financial assets with evidence of credit deterioration	Defined as purchased financial assets that have experienced a more-than-insignificant deterioration in credit quality since origination.	Defined as purchased or originated assets for which one or more events that have a detrimental impact on the estimated future cash flows of the asset have occurred.
	Allowance for expected credit losses is recognized at acquisition, but not through net income (the initial amortized cost is the purchase price plus the allowance for credit losses at the acquisition date). Subsequent changes in the allowance for expected credit losses are recognized immediately in the income statement.	No allowance is recorded at initial recognition; lifetime expected credit losses at origination or acquisition are incorporated in determining the effective interest rate. Subsequent changes in lifetime expected credit losses are recognized immediately in the income statement.