



# ACCOUNTING

## CONTINUING EDUCATION

### Current Expected Credit Losses

(CECL4)



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(CECL4)

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CURRENT EXPECTED CREDIT LOSSES (CECL4)  
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## NOTES

# UNIT 1

## Introduction

### LEARNING OUTCOME

After completing this course, participants will have a thorough understanding of the concepts in ASU Topic 326, *Financial Instruments—Credit Losses* in order to apply the new current expected credit loss (CECL) model to its financial instruments within the scope of Topic 326. Participants will also be able to properly present and disclose information related to credit loss estimates as outlined in Topic 326.

### LEARNING OBJECTIVES

*After completing this unit, participants will be able to accomplish the following.*

- › Identify and describe the differences between legacy-incurred credit loss guidance and the new expected credit loss standard.
- › Understand financial asset investments approach.

### INTRODUCTION

This program design is to explain the accounting, financial reporting, and disclosure of the new credit impairment guidance in the Financial Accounting Standards Board (FASB or the Board) Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses*. In particular, this program focuses on ASC Section 326-20, the Current Expected Credit Loss (CECL) model for debt assets measured at amortized cost.

CECL applies to industries beyond banks and financial institutions. Within the CECL scope are:

- Many companies in all industries have financial assets recorded at amortized cost
- Most all companies have customer trade accounts receivable. Even if accounts receivable have short repayment terms, they are within the CECL scope

- Other receivables, such as vendor rebates
- Customer deferred, financed, or installment payments

In June 2016, (FASB) issued this new guidance as Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses* (ASC Topic 326). Due to its significant change to then-existing credit loss accounting recognition, measurement, reporting, and disclosure, FASB codified the guidance into a new topic, ASU Topic 326.

This new Standard will clearly impact financial institutions in the financial services industry, such as banks, that lend money. The guidance also impacts all industries and covers a broad scope of financial debt instruments.

In addition to significant changes in accounting, implementing the new Topic will require major revisions to an entity's operating processes, information technology (IT) data management, and internal controls over financial reporting (ICFR). This begins with identifying existing financial debt instruments covered by the new guidance and accumulating appropriate internal and external data to analyze credit losses and forecast future economic expectations.

Prior to the new Standard, generally accepted accounting principles (GAAP) in the United States of America required an "incurred loss" methodology for recognizing credit losses. Waiting until it was probable that a credit loss occurred delayed recognition. In fact, the legacy guidance restricted recognizing expected credit losses that did not meet the probable threshold.

Both financial institutions and financial statement users supported the new guidance, and the global financial crisis beginning in 2008 intensified their credit loss recognition concerns. Financial statement users analyzed credit losses by utilizing forward-looking information to assess an entity's allowance for credit losses based on their own expectations. This resulted in financial statement users devaluing financial institutions before entities recognized credit losses and called attention to financial statement users' different information needs versus what GAAP required. Financial institutions were concerned that they were prohibited from recognizing expected credit losses that had not yet met the probable recognition threshold.

The new Standard's objective is to provide financial statement users with more decision-useful information about a reporting entity's

1. expected credit losses on financial assets—thus, the guidance replaces the legacy incurred loss impairment methodology with an expected credit loss methodology and requires considering a broader range of reasonable and supportable information to estimate credit losses—, and
2. other commitments to extend credit.

This is accomplished by changing the measurement and presentation of estimated credit losses on assets involving contractual cash flows.

Due to continued deliberations on the approach to be used to measure credit losses, this portion of FASB's project on financial instruments was split off and issued separately. The other parts of this project were addressed in ASU 2016-01.



With the issuance of ASU 2016-13 (codified into ASC Topic 326), the Board's work on financial instruments is now complete. Its conclusions differ somewhat from the corresponding guidance issued by the International Accounting Standards Board (IASB), despite this having started out as a joint project.

Before the Update, legacy guidance set credit loss recognition thresholds at a high "probable" level for incurred losses. The impact was to delay credit loss recognition, even though the reporting entity may be expecting a future credit loss. Legacy guidance did not allow financial statement preparers to recognize expected credit losses because the probable threshold was not reached.

The biggest change from current GAAP is the manner in which credit losses (in essence, uncollectible amounts) are estimated. In the past, losses were recorded when it became *probable* that all contractual amounts would not be collected, based on information known at the balance sheet date. This is referred to as an incurred loss model. Now, an entity records estimated losses based on expected losses over the contractual life of the instrument. This approach is referred to as the current expected credit loss (CECL) model.

The most notable difference is that no "probable" threshold need be met before credit losses are recognized. Rather, if historical experience and future expectations suggest that some amounts will not be collected, an allowance for credit losses—reducing the asset's carrying value—is recorded, with a corresponding impact on earnings.

The expectation is that uncollectible amounts will be reflected in the financial statements earlier under the CECL model.

Although the CECL model will have the largest impact will be on financial institutions holding large portfolios of interest-bearing investments and receivables, the new standard applies to all assets representing a contractual right to receive cash. This includes investments in debt securities and even trade receivables. The degree of impact will depend on the credit quality of assets held; their terms; and how prior GAAP for credit losses was being applied, i.e., how the incurred loss model was used.

Overall, the Update results in more timely reporting of credit losses, forward-looking measurements, greater transparency, and enhanced comparability. Financial statement users benefit (and reduce costs) because forward-looking information is how they generally analyze financial instrument risk and valuation based on the user's own expectations.

This Update produces the following:

- Earlier credit loss recognition and measurement, including changes during the reporting period
- Increased transparency of credit loss expectations
- Increased transparency of financial asset realizability
- Enhanced comparability of financial asset credit quality

The Update also provides new guidance for recognizing, measuring, presenting, and disclosing credit losses (also referred to as credit impairment) on trade and reinsurance receivables, loans, debt securities, net investments in leases, off-balance-sheet credit exposures, and certain other financial instruments that have the contractual right to receive cash.

The following chart from the Federal Deposit Insurance Corporation (FDIC) provides a basic comparison between the financial asset loss rate estimation process today versus the CECL approach.

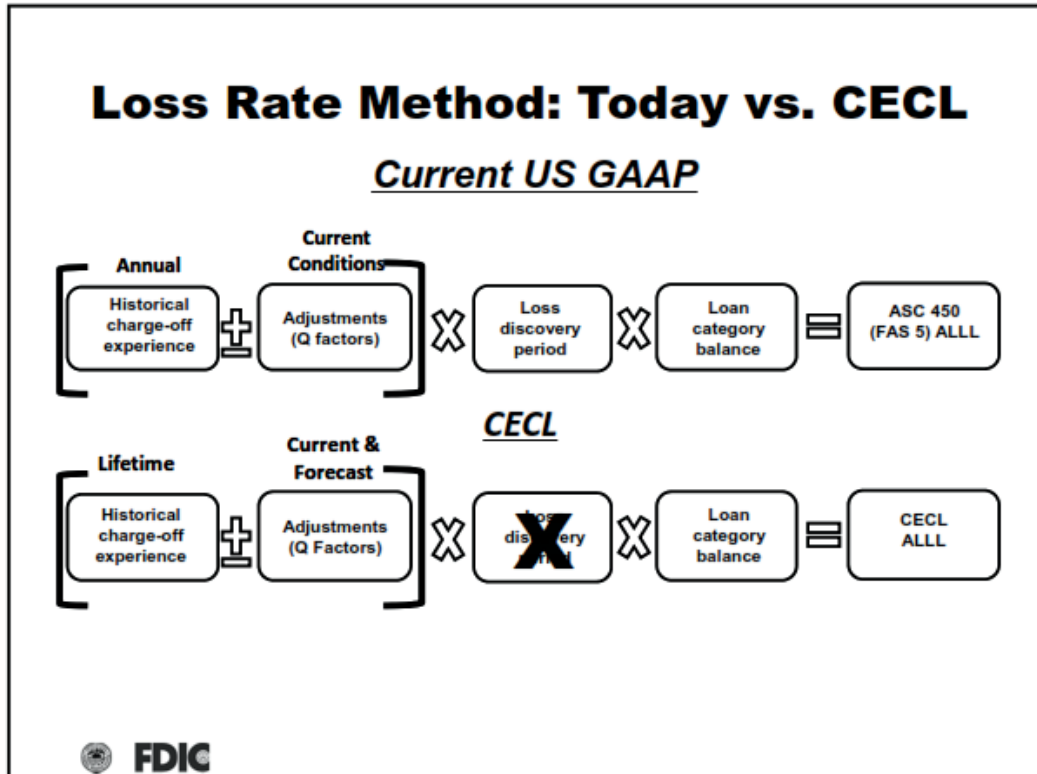


Image source: <https://www.fdic.gov/news/conferences/accounting/2018-presentations/cecl-smaller-jung-rieger-simpson-bw.pdf>

## EFFECTIVE DATE AND TRANSITION

For public business entities (PBEs) that are U.S. Securities and Exchange Commission (SEC) registrants, ASC Topic 326 was effective for years beginning after December 15, 2019, including interim periods.

For public companies (excluding SRCs), ASC Topic 326 (ASU 2016-13), ASU 2019-04, and ASU 2019-05 are currently effective. ASU 2022-02 is effective for fiscal years beginning after December 15, 2022.

**ASU 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842); Effective Dates** once again extended the effective date by an additional year to fiscal years beginning after December 15, 2022 (including interim periods), for all entities except SEC filers that are not smaller reporting companies (SRCs). All entities include private companies, not-for-profits, and employee benefit plans.

For nonpublic entities (including SRCs) that have not yet adopted ASC Topic 326 (ASU 2016-13), the effective date for ASU 2019-04, ASU 2019-05, and ASU 2022-02 are the same as the effective date Topic 326.

For nonpublic entities (including SRCs) that have adopted ASC Topic 326, ASU 2019-04 and ASU 2019-05 are currently effective, and ASU 2022-02 is effective for fiscal years beginning after December 15, 2022.

All entities may early adopt as of fiscal years beginning after December 15, 2018.

Transition rules are as follows:

- The ASU is adopted with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption (modified-retrospective approach).
- A prospective approach should be used for Purchased Credit Deteriorated (PCD) assets held at the time of adoption. Consequently, an allowance for credit losses will be booked immediately, with the offset debiting the amortized cost. This is intended to provide transition relief, so that reporting entities will not have to determine expected credit losses that would have been booked when the assets were first acquired.



#### PRACTICE POINT

The effective date may change due to the CARE Act.

## BACKGROUND AND RECENT GAAP GUIDANCE

The FASB and the IASB had been working together since 2005 to improve and simplify financial instruments accounting and reporting and to converge their two standards.

The FASB decided the subject was too broad for one topic and divided its approach into three phases. This is often referred to as the “three-prong approach.” The IASB decided to take a different approach and issued its single standard, IFRS 9, *Financial Instruments*, in 2014. The three FASB financial instruments standards are as follows:

1. ASU 2016-01, *Financial Instruments – Overall* (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*, issued in January 2016  
Subsequently, in March 2018, the FASB issued ASU 2018-03, *Recognition and Measurement of Financial Assets and Financial Liabilities* (Topic 825): *Technical Corrections and Improvements to Financial Instruments*.
2. ASU 2016-13, *Financial Instruments – Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*, issued in June 2016
3. ASU 2017-12, *Derivatives and Hedging* (Topic 815): *Targeted Improvements to Accounting for Hedging Activities*, issued in August 2017

GAAP defines financial instruments as cash, evidence of an ownership interest in an entity, or a contract that does both of the following:

- Imposes on one entity a contractual obligation to either
  - deliver cash or another financial instrument to a second party, or
  - exchange other financial instruments or potentially unfavorable terms with the second entity
- Conveys to that second entity a contractual right to either
  - receive cash or another financial instrument from the first entity, or
  - exchange other financial instruments or potentially unfavorable terms with the first entity

The following material summarizes the principal provisions of the above three standards and concludes with financial instrument implementation recommendations.

### **ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities**

This ASU changes financial instrument recognition, measurement, presentation, and disclosures for all reporting entities (including not-for-profit, cooperative and mutual entities, trusts, and employee benefit plans). Reporting entities will now have to measure all **equity financial instruments at fair value** and recognize fair value changes in net income. The guidance established a term for this called “FV-NI,” which eliminated prior-GAAP terminology for equity financial instruments of available-for-sale and trading. Prior to adoption, reporting entities recognized fair value changes in equity investments classified as “available-for-sale” through other comprehensive income (OCI).

This ASU also provides a new measurement alternative if the equity financial instruments do not have readily determinable fair value (and do not qualify for the net asset value (NAV) practical expedient in ASC Topic 820, *Fair Value Measurement*). Reporting entities may now elect to measure these investments at cost, less any impairment, plus/(minus) changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

ASU 2016-01 also provides a new recognition method for financial instrument liabilities using the Fair Value Option (FVO) in ASC Topic 825, *Financial Instruments*. Reporting entities now need to present any fair value change caused by changes in instrument-specific credit risk (the issuing entity’s own credit risk) separately in OCI. Entities may early-adopt this provision.

For nonpublic business entities, the ASU removes the previously existing requirement to disclose either the fair value or significant assumptions and valuation methodology used for financial instruments measured at amortized cost. Entities may early-adopt this provision as well.

Unchanged (except for financial liabilities measured using the FVO) is classification and measurement guidance for all financial instruments, specifically investments in financial liabilities, debt securities, and loans.

The effective date for PBEs is 2018 (periods beginning after December 15, 2017). All other entities have an additional year for annual financial statements and another additional year for interim financial statements. Early adoption is permitted only for specific sections. In the year of adoption, a reporting entity reports a cumulative-effect adjustment to retained earnings as of the beginning of the year. However, the section related to financial investment equity securities without readily determinable fair values have prospective application.

Application considerations of the ASU for equity investments and financial liabilities measured using the fair value option follow:

**For Equity Investments**—the new guidance is codified in a new Topic, ASC 321, *Investments—Equity Securities*:

The ASU excludes entities in certain industries with specialized accounting practices, such as broker/dealers (ASC Topic 940), defined benefit pension and postretirement plans (ASC Topics 960, 962, and 965), and investment companies (ASC Topic 946).

The ASU defines an equity security as any security representing the following:

- An ownership interest in an entity (common, preferred, or other capital stock)
- The right to acquire (warrants, rights, forward purchase contracts, call options)
- The right to dispose (forward sale contracts and put options)

The following are not equity securities:

- Written equity options which represent obligations of the option-writer—these are not financial investments
- Cash-settled options and index options—these do not represent ownership interests
- Convertible debt or preferred stock that must be redeemed by (or at the option of) the issuer

Also excluded from the ASU are financial investments that are:

- derivatives, even if the derivative was separated from an equity investment host contract;
- accounted for under the equity method, including limited partnerships;
- consolidated;
- an exchange membership;
- Federal Home Loan Bank and Federal Reserve Bank Stock; and
- qualified affordable housing projects.

**For Financial Liabilities**—measured using the fair value option in ASC Topic 825:

The ASU requires a fair value change caused by the reporting entity's own credit rating change to be presented separately in OCI. This is a significant change from the prior guidance requiring the liability financial instrument's total fair value change to be recognized through earnings. The prior guidance was misleading because a reporting entity with debt reported higher earnings when its own credit risk increased and vice versa.

In response to questions raised by the practitioners, the FASB has already proposed clarifying the new guidance in ASU 2016-01. Any amendments would generally have the same effective date and transition requirements as ASU 2016-01. The proposed clarifications include the following:

- Transition—amending ASU 2016-01 so that reporting entities would use a prospective transition approach only for equity securities they elect to measure using the new measurement alternative.
- Equity securities without readily determinable fair values—clarify that a reporting entity using the measurement alternative may change its measurement approach to fair value by applying ASC Topic 820, *Fair Value Measurement*. Such a change would also be guided by ASC Topic 250, *Accounting Changes and Error Corrections*.
- Clarify the adjustment date made under the measurement alternative should be the date that an observable market transaction occurred instead of the reporting date in the ASU.
- Financial liabilities measured under the fair value option—clarifying how to apply the measurement alternative for changes in the reporting entity's own credit risk in a hybrid financial liability. Also, clarifying the presentation requirements for financial liabilities measured in a foreign currency and using the fair value option when the entity's own credit risk is presented separately in OCI from the liability's other fair value changes. Changes should first be measured in the liability's currency.

**NONPUBLIC COMPANY EXAMPLE**

Following is a private company example. The company has the following financial instruments on its balance sheet at the date ASU 2016-01 was effective:

- a. Investment in a mutual fund that invests in bonds, previously classified as available-for-sale
- b. A 30% ownership in an unincorporated joint venture
- c. 2,000 shares (10% ownership) of common stock of a privately held corporation, carried at cost
- d. A \$250,000 note payable to a bank
- e. Several municipal bonds

For each item, the effects of implementing ASU 2016-01 will be as follows:

- a. Shares in the mutual fund represent an equity investment. There is no “look-through” to the investments held in classifying the shares as an equity investment. Consequently, the classification as available-for-sale no longer applies. A cumulative effect adjustment at adoption will “move” the related amount in “Accumulated Other Comprehensive Income” to “Retained Earnings,” and all unrealized gains or losses will now flow through earnings.
- b. This investment is accounted for under the equity method and is outside the scope of ASU 2016-01. Therefore, nothing will change. (Note that there is a proposal to simplify the equity method that has not yet been finalized.)
- c. This is an equity investment without a readily determinable fair value. At each balance sheet date, it must be evaluated for possible impairment. Although this was always the case, ASU 2016-01 introduces a qualitative approach to assessing impairment.
  - Further, the company may now elect to adjust the carrying value of this investment up or down if there is information available on observable price changes for identical or similar securities from the same issuer. (If elected, this change is applied prospectively.)
- d. Unless the company elects the “fair value option” for this liability—which is highly unlikely for a nonpublic company—there will be no change. It will be carried at \$250,000.
- e. Municipal bonds are marketable debt securities. ASU 2016-01 does not really change previous GAAP

**ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities**

In August 2017, the FASB completed its three-prong approach to its new financial instrument guidance with this ASU. The ASU requires a reporting entity to increase risk management economic activity disclosures, and it improves hedging transparency and understandability.

This ASU makes targeted improvements to hedge accounting to accomplish the following objectives:

- Better align financial reporting with the economic results of an entity’s risk management activities
- Simplify—and in some cases expand—the application of hedge accounting

When entities use derivative instruments to reduce or eliminate risk from exposure to market fluctuations, foreign currency exchange rates, interest rates, commodity prices, and the like, the intent is to be able to utilize hedge accounting. **Hedge accounting is designed to combine (and offset) the financial effects of the hedged items and the related derivative instruments.** (If an arrangement does not qualify for hedge accounting, the item being hedged is reported as though it wasn't and the derivative is accounted for as a standalone speculative investment.)

Two exposure drafts were issued in 2008 and 2010, but FASB decided to postpone finalizing any revisions to ASC Topic 815 until its project on financial instruments was completed. In addition, the Board decided to limit new standards to targeted improvements rather than a comprehensive overhaul of hedge accounting.

Specific changes in ASU 2017-12 follow:

- Hedging instrument effects—recognition and measurement. The ASU eliminates the requirement to separately measure and report hedge ineffectiveness in certain situations. Instead, for qualifying **cash flow and net investment hedges**, the total hedge instrument fair value change for instruments included in hedge effectiveness will now be recorded in other comprehensive income (OCI) and amounts deferred in OCI will now be reclassified to earnings in the same income statement line item.

For qualifying **fair value hedges**, the hedged item fair value change for its hedged risk and the hedge instrument fair value change included in hedge effectiveness will both be recognized in earnings and presented in the same income statement line item.

The ASU allows for excluding from hedge effectiveness the hedge instrument fair value change portion attributable to a cross-currency basis (basis spread added to USD LIBOR<sup>1</sup> when the USD is funded by foreign exchange). Legacy guidance allowed for excluding only the hedge instrument fair value change due to time value.

The initial value of any excluded components will now be amortized into earnings using a systematic and rational approach. Differences between the excluded component fair value change and the amount amortized into earnings will be recognized in OCI. This also applies to fair value hedges that generally impact current earnings. As an alternative, an entity may make an accounting policy election to continue pre-ASU guidance and recognize in earnings all excluded components fair value changes.

For fair value and cash flow hedges, entities must now include in the same income statement line item 1) amounts excluded from the hedge effective assessment and 2) the earnings effect of the hedged item. This is regardless of whether these amounts are amortized or recognized immediately in earnings.

#### EXAMPLE

Excluding option time value from assessing cash flow hedge effectiveness and from recording in earnings under an amortization approach:

On December 31, 20X0, Mark Co. intends to purchase 1,000 barrels of crude oil in December 20X4. On that intent date, Mark hedges changes in crude oil prices by paying \$9,250 for an at-the-money call option at \$75 on the 1,000 barrels and designates the purchase as a cash flow hedge of the forecasted oil purchase.

<sup>1</sup> As has been widely publicized, LIBOR is being phased out due to the recent scandals involving improper manipulation of the rate by banks. US LIBOR cessation date is June 30, 2023.

Following guidance in ASU 2017-12, Mark elects to exclude the option time value from its hedge effectiveness calculation and applies a systematic and rational amortization approach to recognize the exclusion. The annual amortization calculation is  $\$9,250 / 4 \text{ years} = \$2,312.50$ .

Mark recognizes \$2,312.50 annual amortization in earnings with an offsetting entry to OCI independently from the option's fair value changes. Mark records option fair value changes in its recorded amount in the balance sheet with an offset in OCI.

Over the life of the designated hedged relationship, Mark records all amounts related to the excluded component in earnings in the same line item that it records the earnings effect of the hedged item. This line item is cost of goods sold, because in 20x4 Mark will record the crude oil purchase in inventory. When the option expires, Mark will not reclassify any amounts still remaining in AOCI into cost of goods sold until Mark ultimately sells the product containing the purchased crude oil.

- Hedging risk components. The ASU expands the permissible hedging strategies for cash flow hedges to include hedging the variability in cash flows from the following:
  - A contractually specified component in the forecasted purchase or sale of a non-financial asset
  - A contractually specified variable interest rate in a variable-rate financial instrument

For hedges of fixed-rate financial instruments, the ASU continues to limit component hedging to benchmark interest rates. The ASU, however, expanded permitted benchmarks.

This new guidance should increase the non-financial hedging strategies that qualify for hedge accounting because the derivative's underlying will now be more closely aligned with the hedged risk, which means increased hedge effectiveness. An example of a non-financial item is commodities.

- For hedged risks on non-financial items, legacy GAAP permits hedge accounting only for the variability in total cash flows or overall changes in fair value. ASU 2017-12 permits hedge accounting when derivatives are used to reduce or eliminate the risk associated with any legally enforceable “contractually specified component.”
- For example, this provision will liberalize hedge accounting used when an entity desires to hedge risk in commodity prices that affect forecasted purchases and sales of inventory, such as using rubber futures to hedge future transactions involving tires or precious metal futures to hedge activity involving jewelry. These hedges are not 100% effective but would now qualify for hedge accounting.
- For cash flow hedges of variable interest rates, the requirement that the contracts reflect qualifying “benchmark interest rates” is removed, permitting hedge accounting of cash flows attributable to any contractually specified interest rate. Most notably, use of “prime rate” will now be permitted if it is the contractual rate.
- This provision is relevant to the interest rate swaps common to private company loan arrangements. The prevalent use of LIBOR<sup>2</sup> for both the loans and the swaps (rather than prime) occurred because LIBOR was a qualifying “benchmark” rate, while prime was not.
- For fair value hedges of interest rate risk (rare for nonpublic entities), the Securities Industry and Financial Markets Associations (SIFMA) Municipal Swap Rate is added

<sup>2</sup> As has been widely publicized, LIBOR is being phased out due to the recent scandals involving improper manipulation of the rate by banks. US LIBOR cessation date is June 30, 2023.



to those already permitted by GAAP as an eligible benchmark rate. (The previous list included U.S. Treasury rate, LIBOR<sup>3</sup>, and the Fed Funds Effective Swap Rate.) This allows an entity that issues or invests in fixed-rate tax-exempt bonds to designate this rate as the hedged item rather than the fair value of the instrument itself.

The FASB issued ASU 2018-16, *Derivatives and Hedging (ASC Topic 815), Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*. The Update resulted from sustainability concerns with the London Interbank Offered Rate (LIBOR).

The Update adds the overnight index swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) to the list of eligible United States benchmark interest rates for hedging. Although the SOFR OIS is not widely quoted, reporting entities may now designate the following United States benchmark interest rates as the hedged risk in a fixed-rate financial instrument hedge:

- Direct Treasury obligations of the U.S. government
- The LIBOR swap rate
- The OIS rate based on the Fed Funds Effective Rate
- The Securities Industry and Financial Markets Association municipal swap rate

The Update defines the SOFR OIS rate as

the fixed rate on a U.S. dollar, constant notional interest rate swap that has its variable-rate leg referenced to the SOFR with no additional spread over SOFR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

ASU 2018-16 is effective when a reporting entity adopts ASU 2017-12, *Derivatives and Hedging (ASC Topic 815) Targeted Improvements to Accounting for Hedging Activities*. The ASU 2017-12 effective date is 2019 for PBEs including interim periods. All other entities have until 2020 plus one additional year for interim periods. Reporting entities that already adopted ASU 2017-12 may begin to apply ASU 2018-16 in any interim period.

- Accounting for the Hedged Item in Fair Value Hedges of Interest Rate Risk:
  - The ASU makes targeted changes to designating hedges and measuring changes in the fair value of hedged items arising from fair value hedges of interest rate risk to better align reported results with the entity's risk management strategy and be more consistent with the accounting for cash flow hedges.

**Note:** Interest rate hedges utilized by nonpublic entities are almost exclusively cash flow hedges rather than fair value hedges, as addressed in these provisions.

  - This ASU simplifies the long-haul method (quantification) of fair value hedges of benchmark interest rates because it allows an entity to:
    - Determine hedged item fair value changes by using only the portion of the contractual cash flows of the benchmark interest rate, instead of the entire coupon.

<sup>3</sup> As has been widely publicized, LIBOR is being phased out due to the recent scandals involving improper manipulation of the rate by banks. US LIBOR cessation date is June 30, 2023.

**EXAMPLE**

Mark Co. issues \$100,000 of five-year, non-callable, fixed-rate debt. At the same time, Mark enters into a \$100,000 two-year receive-fixed pay-variable interest rate swap and designates it as a fair-value hedge of the debt's interest rate over the first two years.

When Mark records the effects of this hedging arrangement by calculating the debt's fair value change attributable to the benchmark interest rate changes, Mark follows ASU 2017-12 and properly assumes that:

- The hedged debt term is two years.
- Repayment of the hedged debt occurs at the end of the second year.

Prior to the ASU, successfully hedging partial-term exposure was not possible due to the difficulty of finding a highly effective hedge and as a result of the timing difference between the debt's (hedged item) principal repayment in five years and the hedge maturity date in two years.

- Consider only how benchmark interest rate changes affect the decision to prepay a hedged pre-payable instrument, instead of all factors that could impact the prepayment decision, such as credit risk
- Calculate a hedged item fair value change in a partial-term hedge of a fixed-rate - financial instrument by assuming the same maturity date for the hedge and hedged item.
- The ASU introduces a new “last-of-layer” method for hedging **pre-payable** assets in a closed portfolio or for hedging beneficial interests secured by pre-payable financial instruments. When used with a partial-term hedge of benchmark cash flows, an entity can designate the hedged item as a stated amount of assets not expected to be affected by prepayments (the last layer). Any prepayment (or default) will be first applied to the portion of the closed portfolio or beneficial interest that is not part of the hedged item.

**Note:** At the FASB Board Meeting on February 14, 2018, the FASB has received technical inquiries about which financial instruments meet the definition of *pre-payable* in the FASB Accounting Standards Codification Master Glossary. Financial instruments that currently meet the pre-payable definition are or contain the following:

- Currently exercisable and pre-payable at any time
- Contingent payment features, such as time passage, specified event occurring, or change in a specified interest rate
- Conversion features

Financial instruments, however, that do not meet the current definition of *pre-payable* have a contractual maturity that can be accelerated. The FASB directed its staff to research a potential technical correction related to the use of the term “pre-payable.”

- *Recognition and Presentation of the Effects of Hedging Instruments:* These changes are intended to clarify the presentation of the economic effects of hedging in the financial statements:
  - The earnings effect of a hedging instrument is included in the same income statement line item as the effects of the hedged item (for example, the change in value of a derivative would not be shown as a “below the line” gain or loss). The effect of hedging inventory purchases for example is included in cost of goods sold, and the effect of hedging interest rates is included in interest expense.

- Included in this approach is the elimination of the distinction between effective and ineffective portions of cash flow and net investment hedges. Previously, any ineffective portion was recognized immediately in earnings, while the effective portion went through OCI. Under ASU 2017-12, the entire change in the fair value of the hedging instrument will be included in OCI.
- Hedge documentation and effectiveness assessment: The ASU reduces complexity by now allowing an entity to do the following:
  - Allow more time to perform the initial quantitative hedge effectiveness assessment by performing the initial quantitative hedge assessment up until the end of the quarter when designating the hedge. Nonpublic entities have until their financial statements are available to be issued. Legacy GAAP required this assessment at the date entering the hedge.
  - Subsequently assess effectiveness **qualitatively** as long as the hedge relationship has not changed to the extent that it can no longer assert hedge effectiveness quantitatively.
  - Use the “critical terms match method” without performing a de minimis test to assess hedge effectiveness of a group of forecasted transactions occurring within the same monthly period of the hedge derivative maturity.
  - Switch to the simplified long-haul method from an inappropriate shortcut method if, at hedge inception, 1) the entity documented the long-haul methodology to be used if needed and 2) the hedge is highly effective when applying this method.
  - Permitting the combining of anticipated forecasted transactions that occur within a 31-day period, so long as their critical terms match. (This might apply when a company hedges currency risk on future purchases denominated in a foreign currency but cannot predict the exact date that payment will be made.)
- Disclosures:
  - This ASU modifies disclosures required in legacy GAAP. Those modifications include a tabular disclosure related to the effect on the income statement of fair value and cash flow hedges and eliminate the requirement to disclose the ineffective portion of the change in fair value of hedging instruments. This ASU also requires new tabular disclosures related to cumulative basis adjustments for fair value hedges.
  - Additional risk management disclosures relating to the reporting entity’s objectives and strategies for using derivative instruments (and non-derivative instruments that are designated and qualify as hedging instruments).
  - There are also additional disclosures for the “last-of-layer” method for designated hedge relationships. This eliminates the legacy requirement for hedge ineffectiveness disclosure because this method no longer separately measures hedge ineffectiveness.

The standard became effective for public entities with fiscal years beginning after December 15, 2018, including interim periods within those years. For all other entities, the effective date is for fiscal years ending after December 15, 2019, and interim periods thereafter. Early application is permitted.

Transition rules are applied to all hedging relationships in force at the date of adoption. Adoption of cash flow and net investment hedge relationships that exist on the adoption date using a modified retrospective approach records a cumulative-effect adjustment to the opening balance of retained earnings for the first reporting period of adoption. Presentation and disclosure requirements are prospective adoption.

Transition is accomplished with a cumulative-effect adjustment as of the beginning of the year of adoption with an entry that transfers prior period amounts reflected in earnings (ineffective portion of cash flow or net investment hedges) from retained earnings to accumulated other comprehensive income.

The transition provisions also provide for certain one-time transition elections to simplify adoption.

### **ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities (ASC Topic 825, Technical Corrections and Improvements to Financial Instruments)**

The objective was to provide technical corrections and improvements to ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. Although the content is comparable to that in a “traditional” technical corrections standard, FASB decided to issue this material on a standalone basis to increase awareness and expedite implementation.

ASU 2016-01 was intended to provide an enhanced reporting model for financial instruments. The standard, which applies to all entities that hold financial instruments, includes targeted improvements to recognition, measurement, presentation and disclosure, and involves major changes – especially to investments.

It does *not* apply to investments accounted for under the equity method, investments that result in consolidation, or to financial instruments that fall under ASC Topic 815, *Derivatives*.

ASU 2016-01 is well over 200 pages long, largely because the detailed changes to the Codification extend to so many topics, including derivatives and specialized industries. As discussed previously, it is built on a number of broad concepts that are then carried through in all of these changes:

1. It separates GAAP for debt securities and equity securities into separate topics. ASC Topic 320 has been amended to cover only debt securities. An entirely new topic, ASC Topic 321, has been added for equity securities.
2. The classifications among trading, available-for-sale, and held-to-maturity are retained only for debt securities. They are no longer used for equity securities.
3. Equity securities with readily determinable fair values continue to be measured at fair value, but all changes in fair value go to earnings – never other comprehensive income (“OCI”).
4. The approach for evaluating equity securities without readily determinable fair values for impairment has been simplified, using a qualitative assessment model.
5. There are a few new additions and exemptions in required disclosures.
6. There are also a few changes in presentation and some very specific accounting rules.

The amendments in this ASU include items brought to the Board’s attention by stakeholders. The amendments clarify certain aspects of the guidance in ASU 2016-01 as described as follows:

#### **■ Issue 1: Equity Securities without a Readily Determinable Fair Value—Discontinuation**

Once an entity elects the measurement alternative in paragraph 321-10-35-2, the entity must continue to apply the alternative until the investment has a readily determinable fair

value or becomes eligible for the net asset value practical expedient. Stakeholders raised questions about additional situations that may allow for an entity to discontinue the measurement alternative in paragraph 321-10-35-2.

The amendment clarifies that an entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with ASC Topic 820, *Fair Value Measurement*, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with ASC Topic 820.

■ **Issue 2: Equity Securities without a Readily Determinable Fair Value—Adjustments**

When an observable transaction occurs for a similar security, paragraph 321-10-55-9 states that adjustments made should reflect the current fair value of the security. Stakeholders raised questions about whether adjustments should be made to reflect the fair value as of the observable transaction date or the current reporting date.

The amendment clarifies that the adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place.

■ **Issue 3: Forward Contracts and Purchased Options**

Forward contracts and purchased options on equity securities for which the measurement alternative is expected to be applied are accounted for on a look-through basis in accordance with paragraph 815-10-35-6. Stakeholders raised questions about whether a change in observable price or impairment of the underlying equity investment would result in remeasuring the entire value of the forward contract or purchased option.

The amendment clarifies that remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities.

■ **Issue 4: Presentation Requirements for Certain Fair Value Option Liabilities**

Stakeholders raised questions about whether certain hybrid financial liabilities for which the fair value option has been elected would be within the scope of the presentation requirement in paragraph 825-10-45-5.

The amendment clarifies that when the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, *Derivatives and Hedging—Embedded Derivatives*, or 825-10, *Financial Instruments—Overall*.

■ **Issue 5: Fair Value Option Liabilities Denominated in a Foreign Currency**

Paragraph 825-10-45-5 requires an entity to present separately the portion of the total change in the fair value of a liability attributable to a change in the instrument specific credit risk within other comprehensive income. Stakeholders raised questions about how an entity should apply ASC Topic 830, *Foreign Currency Matters*, when determining the amount of fair value changes that are attributable to instrument-specific credit risk for a foreign-currency-denominated liability for which the fair value option is elected.

The amendments clarify that for financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates.

■ **Issue 6: Transition Guidance for Equity Securities without a Readily Determinable Fair Value**

Stakeholders raised a question about whether a prospective transition approach is required for all equity securities without a readily determinable fair value, including those for which the measurement alternative is not applied upon transition.

The amendment clarifies that the prospective transition approach for equity securities without a readily determinable fair value in the amendments in Update 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in ASC Topic 944, *Financial Services—Insurance*, should apply a prospective transition method.

An insurance entity should apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected.

ASU 2016-01 was effective for public entities for fiscal years beginning after December 15, 2017, including interim periods within those years.

All other entities, including not-for-profits and employee benefit plans, must adopt one year later for annual periods, and interim periods beginning after December 15, 2019.

Early adoption is limited.

- Nonpublic entities may elect to adopt as of the effective dates for public business entities.
- Any entity may early adopt the following two provisions as of any period for which financial statements have not been issued:
  - The exemption for nonpublic entities from disclosing fair value information on financial instruments measured at amortized cost
  - Presentation of the separate component of OCI for gains or losses attributable to credit risk on liabilities carried at fair value under the fair value option

Transition is accomplished with a cumulative effect adjustment to the balance sheet as of the beginning of the year of adoption. The changes relating to equity securities without readily determinable fair values (including disclosure changes) should be applied prospectively; this will only be relevant if an entity elects the measurement alternative discussed above upon adoption.

ASU 2018-03 is generally effective at the same time as ASU 2016-01, but permitted public entities with fiscal years beginning after December 15, 2017, and before June 15, 2018, to adopt the changes in interim periods beginning after June 15, 2018.

### **Recent FASB Updates on Financial Instruments**

The FASB recently issued updates its new guidance on the three financial instruments standards—credit losses (ASC Topic 326), hedging (ASC Topic 815), and recognizing and

measuring financial instruments (ASC Topic 825). Most of these changes resulted from questions addressed by the Transition Resource Group (TRG) for Credit Losses.

ASU 2019-04, Codification Improvements to Topic 326 *Financial Instruments—Credit Losses*, Topic 815 *Derivatives and Hedging*, and Topic 825 *Financial Instruments* clarified these three Topics. The Update addressed the following issues about ASC Topic 326:

■ **Accrued interest**

Allow an entity to separately measure an allowance for credit losses on accrued interest receivables from other components of the amortized cost basis.

Also, allow an entity to make an accounting policy election for where to present and disclose accrued interest receivables and the related allowance for credit losses. An entity that writes-off uncollectible accrued interest receivables in a timely manner could make an accounting policy election not to measure an allowance on the accrued interest receivable.

■ **Recoveries**

An entity should include all expected recoveries in its estimate of the allowance for credit losses, which cannot exceed the aggregate of amounts previously written off and expected to be written off. Due to the significant management judgment in this situation, the accounting policy would need to contain specific methodology to avoid this from becoming a “cookie jar reserve.”

■ **Future interest rate environment projections**

Allowing future interest rate environment projections when employing a discounted cash flow method to measure expected credit losses on variable-rate instruments. The same projections would be consistently used for determining the effective interest rate for discounting those expected cash flows.

■ **Prepayment considerations**

Allowing an entity to make an accounting policy election to adjust the effective interest rate used to discount expected future cash flows for expected prepayments on financial assets and available-for-sale debt securities to appropriately isolate credit risk when determining the allowance for credit losses.

Also, an entity should not adjust the effective interest rate used to discount expected cash flows for changes in the expected timing of cash flows resulting from a troubled debt restructuring.

■ **Other**

Clarify the following areas of credit loss guidance:

- the scope for reinsurance recoverables
- estimated costs to sell when foreclosure is probable
- the vintage disclosure requirements for lines of credit converted to term loans
- extension or renewal options that are not unconditionally cancelable by the entity
- transfers between classifications or categories for loans and debt securities

ASU 2019-04, Codification Improvements to Topic 326 *Financial Instruments—Credit Losses*, Topic 815 *Derivatives and Hedging*, and Topic 825 *Financial Instruments* clarified these three Topics. The Update addressed the following issues about ASC Topic 815:

■ Partial-term fair value hedges

An entity may designate and measure the change in fair value of a hedged item attributable to both interest rate risk and foreign exchange risk in a partial-term fair value hedge.

Also, multiple partial-term fair value hedging relationships of a single financial instrument can be outstanding at the same time.

■ Fair value hedge basis adjustments

If an entity elects to amortize the basis-adjustment on an outstanding partial-term fair value hedging relationship, then it should be fully amortized on or before the hedged item's assumed maturity date.

Also, exclude the fair-value hedge-basis adjustments on hedges of foreign exchange risk from some of the new disclosure requirements.

■ Not-for-profit and private companies

A not-for-profit entity that does not separately report earnings may not elect the amortization approach for amounts excluded from the assessment of effectiveness for fair value hedging relationships.

Also, clarify the application of cash flow hedging for not-for-profit health care entities.

In addition, require a private company that is not a financial institution to document its analysis supporting a last-of-layer hedge designation at hedge inception and clarify that certain not-for-profit entities would receive the same subsequent quarterly hedge effectiveness timing relief as certain private companies.

■ First-payments-received cash flow hedging

An entity is still permitted to apply the first-payments-received cash flow hedging technique to overall cash flows on a group of variable interest payments.

■ ASU 2017-12 hedge transition requirements

- If an entity elects to change its measurement methodology for the hedged item in an existing fair value hedge of interest rate risk, the transition adjustment should be made as of the Update initial application date and not the adoption date.
- For an entity that modifies the measurement methodology used for the hedged item from total contractual coupon cash flows to the benchmark rate component of the contractual coupon cash flows in a fair value hedging relationship of interest rate risk, allow other rebalancing approaches beyond de-designating a portion of the hedged item.
- An entity may transition from a quantitative method of hedge effectiveness assessment to the critical terms match method without de-designating the hedging relationship.
- A debt security reclassified from held-to-maturity to available-for-sale under ASC Topic 815, *Derivatives and Hedging*, does not affect other held-to-maturity securities classification, is not required to be designated in a last-of-layer hedging relationship, and may be sold by the entity after reclassification.



ASU 2019-04, Codification Improvements to Topic 326 *Financial Instruments—Credit Losses*, Topic 815 *Derivatives and Hedging*, and Topic 825 *Financial Instruments* clarified these three Topics. The Update addressed the following issues about ASC Topic 825:

Amend the guidance on recognizing and measuring financial instruments by:

- Requiring an entity to remeasure an equity security without a readily determinable fair value accounted for under the measurement alternative at fair value, in accordance with ASC Topic 820, *Fair Value Measurement*, for a transaction for an identical or similar investment of the same issuer.

Also, add disclosures for a nonrecurring fair value measurement.

- Only foreign-denominated equity securities without readily determinable fair values accounted for under the measurement alternative must be remeasured at historical exchange rates. Historical exchange rate is as of the acquisition date or most recent date on which the equity security was adjusted to fair value.
- Including health and welfare plans accounted for under ASC Topic 965 (*Plan Accounting—Health and Welfare Benefit Plans*) in the list of entities excluded from the scope of ASC Topic 320 (*Investments—Debt Securities*) and ASC Topic 321 (*Investments—Equity Securities*).
- Only public business entities must provide the fair value disclosures for financial instruments not measured at fair value on the balance sheet.

#### Transition and Effective Date

For entities that have not yet adopted the new standards on credit losses, hedging, and recognizing and measuring financial instruments, the Update has the same effective dates and transition requirements as each of their respective topics.

For entities already adopted the credit losses standard, the Update is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. Early adoption is permitted, and it should be applied on a modified retrospective basis.

For entities that have already adopted the hedge accounting standard, the Update is effective as of the beginning of the reporting entity's next annual period. Early adoption is permitted. Entities either retrospectively apply the amendments as of the date they adopted ASU 2017-12 or prospectively apply them as of the date they adopt the amendments, with certain exceptions.

The Update on recognizing and measuring financial instruments is effective for fiscal years beginning after December 15, 2019, including interim periods in those years. Early adoption is permitted for reporting entities that already adopted the Standard. Application is on a modified retrospective basis, with one exception. The items related to equity securities without readily determinable fair values that are measured using the measurement alternative, have prospective application.

### **ASU 2019-05, *Financial Instruments—Credit Losses (Topic 326) Targeted Transition Relief***

The FASB issued ASU 2019-05, *Financial Instruments—Credit Losses* (ASC Topic 326) *Targeted Transition Relief* allowing reporting entities to elect irrevocably the fair value option for certain financial instruments, upon adopting ASC Section 326-20.

This Update reduces complexity of certain reporting entities having to maintain dual measurement methodologies for identical or similar financial instruments that are being managed in the same manner. The portion of a reporting entity's financial instruments measured at fair value may not be comparable to other identical, or similar, financial instruments measured at amortized cost basis that are owned by the same reporting entity.

The financial instruments must both be

- within the scope of ASC Section 326-20, the CECL model, and
- eligible for the fair value option in ASC Section 825-10, *Financial Instruments—Overall*

This fair value option election should be applied on an instrument-by-instrument basis for eligible financial assets. It is not applicable to debt securities classified as available-for-sale or held-to-maturity.

A reporting entity electing the fair value option would recognize the difference between the carrying amount and the fair value of the financial instrument as part of the cumulative effect adjustment associated with the adoption of ASC Topic 326. Subsequent financial instrument fair value measurement changes become reported in current earnings.

Under the current guidance, the fair value option can only be elected for eligible instruments on specified election dates. The most common example is the date a reporting entity first recognizes the financial asset. The Update allows reporting entities to elect the fair value option for existing eligible instruments upon adopting ASC Topic 326.

ASC Section 326-20 does not apply to financial assets measured at fair value through net income, so the CECL model would not be applied to financial assets to which an entity elects to apply the fair value option.

ASU 2019-05 is effective concurrent with adopting ASC Topic 326, the new credit losses standard. The effective dates are 2020 for PBEs and 2022 (including interim) for all other entities. For entities that already adopted ASC Topic 326, the Update is effective for calendar year-end entities on January 1, 2020. Early adoption is permitted.

***ASU 2020-02, Financial Instruments – Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section of Effective Date Related to Accounting Standards Update 2016-02, Leases (Topic 842)***

ASU 2020-02 amended the accounting guidance in response to SEC Staff Accounting Bulletin (SAB) No. 119 and provides useful information for applying CECL in ASC Topic 326.

For CECL, the Update:

- Describes the measurement process for current expected credit losses
- Provides interpretive responses to questions surrounding the development, governance, and documentation of using a systemic methodology to apply CECL
- Guides appropriate documentation of the results and validation of the systematic methodology applied
- Indicates good internal controls over CECL processes, includes written policies and procedures

The Update applies to all entities with transactions within the scope of Topic 326 or Topic 842. The Update did not modify the effective dates for these two accounting standards.

### **ASU 2022-02, Financial Instruments – Credit Losses (Topic 326) Troubled Debt Restructurings and Vintage Disclosures**

The FASB issued this update in response to feedback received during the Post-Implementation Review (PIR) process for ASC Topic 326 (ASU 2016-13), *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

The Update eliminates previously existing recognition and measurement guidance on troubled debt restructurings (TDR) in Subtopic 310-40, receivables, for creditors, enhances disclosures about loan modifications for borrowers experiencing financial difficulty, and requires public business entities to present current-period gross write-offs by year of origination in their vintage disclosures.

Since the FASB issued ASU 2016-13, which became codified as ASC Topic 326, it provided resources to monitor and assist stakeholders implementing ASC Topic 326. This included forming a Transition Resource Group (TRG) for Credit Losses, conducting outreach with stakeholders of all types, developing educational materials and staff question-and-answer guidance, conducting educational workshops, and performing archival review of financial reports.

After adopting ASC Topic 326, stakeholder feedback was that the existing TDR accounting guidance was no longer relevant because ASC Topic 326 required companies account for the entire expected credit losses over the life of the credit instrument investment. Additional feedback was that disclosing gross write-offs and gross recoveries in vintage (year or origination) was no longer relevant.

### **ASU 2022-02 Contains Two Issues**

#### Issue 1: Troubled Debt Restructurings by Creditors

Feedback was that, after applying ASC Topic 326, the required accounting and disclosures for a TDR loan modification no longer provide decision-useful information because ASC Topic 326 requires recognizing the lifetime expected credit losses upon originating or acquiring a financial instrument. The result is the allowance for credit losses already includes the effect of credit losses from TDR loan modifications. Investors and financial statement preparers observed that the additional designation of a loan modification as a TDR (and the related accounting and disclosure) is unnecessarily complex and no longer provides decision-useful information.

Legacy guidance requires that a lender entity determine whether a loan modification represents a TDR. A TDR exists if the borrower is in financial difficulty and the lender's modification represents a concession that the lender would not grant absent the borrower's financial difficulty. The lender records any incremental expected loss on the impaired loan in the allowance for credit losses and then must make additional disclosures for the remaining loan term.

The Update eliminates the TDR recognition and measurement guidance and requires that a company evaluate whether the modification represents a new loan or a continuation of an existing loan. The Update enhances existing legacy disclosures and introduces new requirements related to certain modifications. The enhanced disclosures would include

the types and magnitude of lender modifications and the lender's loan performance experience from mitigating potential loan losses. For loan modifications resulting solely from insignificant payment delays, lenders may elect an accounting policy about disclosing these loan modifications.

#### Issue 2: Vintage Disclosures – Gross Write-Offs

Feedback was that there is an inconsistency in the requirement for a public business entity to disclose gross write-offs and gross recoveries by class of financing receivable and major security type in the vintage (year of origination) disclosures. Investors and financial statement users reported that gross write-offs by year of origination disclosure provide important information for financial statement users to understand changes in the credit quality of a company's loan portfolio and underwriting performance.

The Update requires public business entities to disclose gross write-offs by year of origination for financing receivables and net investments in leases in the current-period vintage disclosures. Companies would not be required to disclose gross recoveries in the vintage disclosures.

#### **Transition and Effective Date**

For companies that have not yet adopted Topic 326, ASU 2022-02 would have the same effective dates and transition requirements as Topic 326. Topic 326 was effective for public companies (excluding SRCs) beginning after December 15, 2019, including interim periods. For all other companies (including SRCs), the effective date was periods beginning after December 15, 2022, including interim periods.

For companies that have adopted Topic 326, the Update is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. The Update permits early adoption.

Prospective application applies. When adopting Issue 1 for TDRs, companies would have the option to apply a modified retrospective transition and record an adjustment to the opening balance of retained earnings in the adoption period. This adjustment represents any incremental allowance for credit losses for loans modified in TDRs under ASC Section 310-40.

## **ASU 2016-13 (CODIFIED INTO ASC TOPIC 326) SCOPE AND SCOPE EXCEPTIONS**

The provisions of ASU 2016-13 apply to all entities holding financial assets that are not currently measured at fair value with holding gains and losses reflected in earnings. The CECL model includes the following financial assets:

- Financial assets measured at amortized cost

Financial assets are cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- Receive cash or another financial instrument from a second entity
- Exchange other financial instruments on potentially favorable terms with the second entity

Amortized cost is the amount at which a financing receivable or investment is originated or acquired; and then adjusted for the following: applicable accrued interest; accretion or amortization of premium, discount, and net deferred fees or costs; cash collection; write-offs; foreign exchange; and fair value hedge accounting adjustments.

Examples of financial assets measured at amortized cost include the following:

1. Financing receivables

Financing receivables generally—but not always—have a stated interest rate and may be either collateralized or uncollateralized. A financing arrangement has both of the following characteristics:

- It represents a contractual right to receive money in either of the following ways:
  - On demand
  - On fixed or determinable dates
- It is recognized as an asset in the entity's statement of financial position.

2. Held-to-maturity debt securities

Reporting entities classify debt securities as held-to-maturity if the entity has both the intent and ability to hold the debt security to maturity.

A debt security is any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

- Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
- A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
- U.S. Treasury securities
- U.S. government agency securities
- Municipal securities
- Corporate bonds
- Convertible debt
- Commercial paper
- All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
- Interest-only and principal-only strips

A debt security excludes all of the following:

- Option contracts
- Financial futures contracts
- Forward contracts
- Lease contracts

- Receivables that do not meet the definition of security which means they are not debt securities (unless they have been securitized, in which case they would meet the definition of a security), for example:
  - Trade accounts receivable arising from sales on credit by industrial or commercial entities
  - Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions
- 3. Receivables that result from revenue transactions within the scope of ASC Topic 605 on revenue recognition, ASC Topic 606 on revenue from contracts with customers, or ASC Topic 610 on other income

Examples include receivables from customers, including short-term trade receivables resulting from selling goods and services. In instances where a third party will make payment on the customer's behalf, the value includes all amounts due.

- 4. Receivables that relate to repurchase agreements and securities lending agreements within the scope of ASC Topic 860

### **A Lessor's Net Investment in Leases in Accordance With ASC Topic 842, Leases**

A lease receivable is a financial asset. Therefore, the entire net investment in the lease is measured for credit losses under the new standard. Examples include a lessor's net investment in sales-type and direct financing leases, which typically consist of a lease receivable and any unguaranteed residual asset.

A lease receivable is the present value, at the rate implicit in the lease, of all lease payments, plus the present value of a guaranteed residual asset, which is 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 the recognized net of any deferred selling profit.

Even though a lease's unguaranteed residual asset does not meet the definition of a financial asset, the FASB decided that separately assessing the lease receivable (following ASC Section 326-20) and the unguaranteed residual asset (under ASC Topic 360 for property, plant, & equipment impairment) is highly complex and fails the cost/benefit analysis for financial statement users.

In late 2018, the FASB issued a proposed amendment to ASC Topic 326 clarifying that operating lease receivables are not in the scope of the CECL model.

### **Off-Balance-Sheet Credit Exposures Not Accounted for as Insurance**

Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments. ASC Section 326-20 does not apply to any instruments within the scope of ASC Topic 815 on derivatives and hedging.

Also, a reporting entity is precluded from estimating expected credit losses when its credit exposure is unconditionally cancelable. This would be when the lender can cancel the commitment at any time without reason or cause.

According to Ernst & Young, the CECL model is intended to measure expected credit losses on credit exposures (i.e., the nonpayment of financial obligations), not exposures to other risks. Some guarantees in the scope of ASC Topic 460—Guarantees are also in the scope of the CECL model.

Guarantees are recorded as liabilities on the balance sheet initially at fair value. Certain guarantees in the scope of ASC Topic 460 must be assessed for expected credit losses in accordance with ASC Section 326-20. ASC Section 326-20 includes in its scope off-balance-sheet credit exposures on financial guarantees not accounted for as insurance, including standby letters of credit. For a financial guarantee to be in the scope of ASC Section 326-20, the financial guarantee must relate to the nonpayment of a financial obligation.

Examples of financial guarantees with credit exposures include the following:

- A financial standby letter of credit, which is an irrevocable undertaking to guarantee payment of a specified financial obligation
- A guarantee of the collection of scheduled contractual cash flows from a loan

### **Reinsurance Recoverables That Result From Insurance Transactions Within the Scope of ASC Topic 966 on Insurance**

ASC Topic 326 defines these as all amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits.

The guidance in ASC Section 326-20 does not apply to the following:

- Financial assets measured at fair value through net income
- Available-for-sale debt securities (ASC Section 326-30 guidance does apply)
- Loans made to participants by defined contribution employee benefit plans. ASC Topic 962, *Plan Accounting—Defined Pension Contribution Plans*, provides this guidance.
- Policy loan receivables of an insurance entity. ASC Topic 944, *Financial Services—Insurance*, provides this guidance.
- Promises to give (pledges receivable) of a not-for-profit entity. ASC Topic 958, *Not-For-Profit Entities*, provides this guidance.
- Related-party loans and receivables between entities under common control

The FASB excluded related party loans and receivables between entities under common control due to Private Company Council (PCC) concerns that some related party loans may be viewed as a capital contribution instead of a loan to be repaid. This scope exception applies whether loans and receivables are held by the parent or a subsidiary.<sup>4</sup>

SEC staff indicated, as noted in EITF 02-5, “that common control exists between (or among) separate entities only in the following circumstances:

- a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.

<sup>4</sup> The FASB staff provided its response to the technical inquiry, “Loans and Receivables between Entities under Common Control,” in the Cover Memo for the meeting materials of the FASB TRG meeting held on June 11, 2018. The FASB TRG members supported the FASB staff’s interpretation.

- b. Immediate family members hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).

(1) Immediate family members include a married couple and their children, but not the married couple's grandchildren.

(2) Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.

- c. A group of shareholders holds more than 50 percent of the voting ownership interest of each entity and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists."

- Perpetual Preferred Securities (PPS)

A firm interpretive response with regard to perpetual preferred securities (PPS) is that they are not to be included in the scope of ASC Section 326-20.

Ernst & Young also said that perpetual preferred securities (PPS) are not in the scope of ASC Section 326-20. Perpetual preferred securities may have either variable or fixed dividend rates, but they have no contractual maturity or redemption date. PPSs are often perceived in the marketplace as similar to debt securities because they frequently provide periodic cash flows in the form of dividends, contain call features, are rated similarly to debt securities, and are priced like other long-term callable bonds.<sup>5</sup> KPMG, in the KPMG Credit Impairment Handbook, mentions that because PPS "are equity securities, the guidance in Topic 321 – created by ASU 2016-01 (Recognition and Measurement of Financial Assets and Financial Liabilities) – applies."

- Operating lease receivables accounted for in accordance with Topic 842, Leases<sup>6</sup>
  - Loans held for sale, as they would be accounted for in accordance with Topic 948, Financial Services-Mortgage Banking

## COMPARISON OF HELD-TO-MATURITY (HTM) AND AVAILABLE-FOR-SALE (AFS) SECURITIES

The HTM and AFS credit impairment models are different. This means, a reporting entity may record different credit impairment amounts for the same investment debt security.

### EXAMPLE

In this E&Y example, a reporting entity holds the same investment debt security. Due to its intent and ability, it classified some of the debt security as held-to-maturity and some of the same debt security as available-for-sale.

The security held in the HTM portfolio may have a credit loss recorded even if the fair value is greater than the security's amortized cost basis.

The security classified as AFS, however, credit losses will be recognized only when the security's fair value is less than its amortized cost basis.

<sup>5</sup> Ernst & Young LLP, A comprehensive Guide: Certain Investments in Debt and Equity Securities, [https://www.ey.com/publication/vluassetsdld/financialreportingdevelopments\\_bb0961\\_debtandequitysecurities\\_24june2019-v2/\\$file/financialreportingdevelopments\\_bb0961\\_debtandequitysecurities\\_24june2019-v2.pdf](https://www.ey.com/publication/vluassetsdld/financialreportingdevelopments_bb0961_debtandequitysecurities_24june2019-v2/$file/financialreportingdevelopments_bb0961_debtandequitysecurities_24june2019-v2.pdf)

<sup>6</sup> KPMG LLP, Credit Impairment, <https://frv.kpmg.us/reference-library/2017/credit-impairment.html>



The following from E&Y summarizes key differences between the credit impairment models for HTM and AFS debt securities.

Topic	HTM CECL Model ASC Section 326-20	AFS Debt Security Impairment Model ASC Section 326-30
Unit of Measurement	Pool when similar risk characteristics exist; otherwise, individual	Individual AFS debt security
Allowance Recognition Threshold	When lifetime credit losses are expected (virtually all cases)	When fair value decline below the amortized cost basis resulted from a credit loss
Measurement of Credit Losses	The amount that reflects the risk of loss, even if that risk is remote	Excess of the amortized cost basis over the best estimate (either single best or probability-weighted) of the present value of expected future cash flows to be collected  Limited to the difference between the security's fair value and amortized cost
Acceptable Methods for Measuring Credit Losses	Various methods, including DCF, loss rate, Probability of Default and others that faithfully estimate collectability	DCF

## NOTES

# UNIT 2

## The CECL Model

### LEARNING OBJECTIVES

*After completing this unit, participants will be able to accomplish the following.*

- › Use the CECL Model to recognize an allowance for credit losses.
- › Account for off-balance sheet credit exposures.

### ASU 2016-13 (CODIFIED INTO ASC TOPIC 326)—THE CECL MODEL

ASC Topic 326's underlying principle is that a reporting entity holding financial assets is exposed to credit risk throughout the holding period. Thus, a credit loss may exist at financial asset purchase or origination, as well as until the financial asset is settled or disposed of.



#### PRACTICE POINT

This may create more earnings volatility depending on the volume of new financial assets acquired/originated and on changes in general economic conditions.

As a result of the new Standard, a reporting entity will recognize an allowance for credit losses, which is a valuation account, recognizing the financial asset amount that the reporting entity does not expect to collect. The net amount of the financial assets after subtracting the allowance **reflects the amount of cash expected to be collected from the financial asset**. Changes in the allowance for credit losses impacts ordinary income.

The current expected credit loss estimate:

- Is based on an asset's amortized cost
- Reflects the risk of loss

There is no recognition threshold. Thus, even when credit risk is remote, credit loss would exist. As a result, estimating that zero credit loss exists would be rare. (This is addressed later in this section.)

- Reflects losses expected over the remaining contractual life of a financial asset
  - Term modifications or borrower prepayments would impact expected credit losses.
  - Requires considering available relevant information about cash flow collectability
    - This includes information about past events, current conditions, and reasonable and supportable forecasts of future economic conditions. In the absence of reliable future economic conditions forecasts, past events become more reliable support.

## Amortized Cost Basis

ASC Topic 326 requires basing the CECL allowance on a financial asset's amortized cost; thus, the allowance represents the portion of amortized cost that the reporting entity does not expect to recover due to credit losses.

On the balance sheet, the allowance is classified as an offset to the amortized cost balance. If the allowance is related to off-balance-sheet credit risk, then it is a separate liability.

ASC Topic 326 defines amortized cost as 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 cost, write-offs, foreign exchange, and fair value hedge accounting adjustments.<sup>7</sup>

These terms are defined as follows:

- **Accrued interest** is the interest on a financial asset that has accumulated since the principal investment or since the previous coupon payment. It may be combined with the financial asset balance or presented separately from the related loan balance.
- **Premium or discount** is the amount above or below, respectively, of the acquisition or origination price of a financing asset over its face (par) amount due at maturity. Premiums and discounts are amortized using the effective interest method.
- **Deferred origination fees or costs** are lenders' expenses for originating loans. Origination fees are amounts charged to the borrower as prepaid interest, to reduce the loan's nominal interest rate, or as the lender's incremental direct costs to originate the loan. The lender expenses include evaluating the borrower's financial condition and assessing risk, evaluating and recording guarantees, and preparing and processing loan documents.
- **Write offs** are financial asset amounts deemed uncollectible and, as a result, reduce a financial asset's amortized cost basis.
- A **foreign exchange adjustment** results from consolidating financial assets denominated in a currency other than the reporting entity's functional currency. This results from foreign currency exchange rate fluctuations.
- A **fair value hedge accounting adjustment** is applied to the amortized cost of a hedged item and reflects the effect of applying fair value hedge accounting. The adjustment is driven by changes in the hedged risk, such as interest rate risk.

The new guidance allows great flexibility in the methodology for measuring estimating expected credit losses, as long as the methods are practical, relevant, and applied consistently over time and faithfully reflects the net amounts management expects to collect. The methods

<sup>7</sup> Financial Accounting Standards Board. Financial Instruments – Credit Losses (Topic 326).

used may vary by the financial asset type, the reporting entity's ability to predict cash flows, and the information available. As a result, there is significant management judgment in applying this new standard.

Due to this subjectivity, ASC Topic 326 does not require specific approaches when estimating expected credit losses. Rather, management should use judgment to develop estimation techniques that are applied consistently over time to faithfully estimate financial asset collectability. Furthermore, these estimation techniques should be practical and relevant to the circumstance. The methods 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.

Examples (non-all-inclusive) of management judgment may include the following:

- The definition of default for default-based statistics
- 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 to reflect the entity's policies for recognizing accrued interest
- The approach to determine the appropriate historical period for estimating expected credit loss statistics
- 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
- The methods of utilizing historical experience
- The method of adjusting loss statistics for recoveries
- How expected prepayments affect the estimate of expected credit losses
- How the entity plans to revert to historical credit loss information for periods beyond which the entity can make or obtain reasonable and supportable forecasts of expected credit losses
- The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets

### **Unit of Measurement—Collective (Pool) Basis**

Reporting entities need to assess whether financial assets share similar risk characteristics. If so, then the reporting entity designates them as a pool and measures risk and expected credit losses on a collective—or pool—basis. The same financial asset CECL guidance also applies to off-balance-sheet credit exposures.

If management determines that a financial asset does not share risk characteristics with other financial assets, then it evaluates the financial asset for risk and expected credit losses on an individual basis. If a financial asset's risk is evaluated on an individual basis, an entity also should not include it in a collective evaluation.

An individual classification is more common for assets that have deteriorated in credit quality because they will no longer share similar risk characteristics with other assets in the pool. Instead, collection risk is now more specific to the individual asset. As a result, management should remove this financial asset from the pool and redetermine the pool's CECL allowance with the asset excluded, include the financial asset in a different pool and redetermine that

pool’s CECL allowance with the asset included, or calculate an allowance for the asset based on its individual risk characteristics.

This collective, or pool, determination can change over time. Thus, if a financial asset’s risk characteristics change, management should re-evaluate it to determine whether it is appropriate to continue to remain in its existing pool, move it to a different pool that may be more consistent with its now-current risk characteristics, or evaluate it separately.



**PRACTICE POINT**

Many entities have good processes for initial risk assessment and pool formation. Unfortunately, subsequent evaluation is often lacking. Entities need processes to evaluate whether financial asset risk has changed, and it should remain in its existing pool, be moved to another pool, or evaluated separately.

If a financial asset no longer displays risk characteristics like those of the pool, the reporting entity may decide to revise its pools or perform an individual assessment of expected credit losses. For example, if a national company has receivables grouped by geographical region, and there is a natural disaster such as wildfires in California, the assets specific to that area of the state may need to be assessed separately, as their rate of default will likely be higher.

**EXAMPLE**

Pooling Trade Receivables

Widget Co. produces widget parts and sells both to wholesalers and retailers. Widget Co. requires payment within 30 days and provides no other financing.

Widget Co. notes that its historical credit loss experience correlates with delinquency status.

Widget Co. also notes that expected credit losses in its wholesaler segment differ from its retailer segment. Based on this historical experience, it pools the trade receivables first by customer type, then by delinquency status.

Widget Co. pools its \$5 million in outstanding trade receivables as of December 31 into the following eight pools:

Customer type	<30 days	30–89 days	90+ days	
Current	Delinquent	Delinquent	Delinquent	
Wholesalers	\$3,400,000	\$225,000	\$100,000	\$60,000
Retailers	\$1,000,000	\$140,000	\$60,000	\$15,000

Financial asset pools function so reporting entities can track and manage credit losses. Thus, management should pool financial assets based on credit risk key drivers that would increase their CECL estimate’s precision, which should result in relatively homogenous assets within the pool. Defining a pool using more granular risk characteristics will produce a more precise CECL estimate.

In evaluating financial assets as a collective (pool) basis, a reporting entity should aggregate financial assets based on similar risk characteristics. The Standard does not, however, require which characteristics to employ.

Examples may include any one or a combination of the following (not-all-inclusive) list:

- 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

The following example illustrates how an entity might determine pools for three different loan types.

#### **EXAMPLE**

A lender makes mortgage loans, auto loans, and personal loans. The lender not only will separate the pools by loan type, but also based on the varying characteristics of the different loan types, such as the following:

- Mortgage loans: grouped initially by lien position (first or second) then by delinquency, original loan-to-value (LTV) ratio, and original consumer credit score. In adverse economic environments, the lender might determine that some of the pools need to be disaggregated further by geography, updated LTVs, and/or updated credit scores.
- Auto loans: grouped by delinquency, consumer credit score band, and vintage. Used auto collateral does not currently constitute a significant portion of the entity's portfolio, but it is projected to grow relative to the total auto loan portfolio over the next few years. At some point, the lender may need to disaggregate the pools into new auto collateral and used auto collateral.
- Personal loans: grouped by collateral—secured versus unsecured, delinquency, and consumer credit score band.

During a period, a reporting entity deemed uncollectable all or a portion of a financial asset, it should reduce the CECL allowance by the same amount as the portion that it writes-off.

ASC Topic 326 does not define “deemed uncollectible” means; thus, management judgment determines when a financial asset is not uncollectible. An asset is generally deemed uncollectible no later than after all collection efforts have been exhausted. When evaluating whether a financial asset is deemed uncollectible, a reporting entity may consider whether

- amounts owed have been past due for a certain time period, and the borrower does not respond to inquiries;
- sufficient information exists to support that the borrower is insolvent;
- the reporting entity received notice that the borrower has filed for bankruptcy, and, as a result, collectability is not expected;

- the reporting entity received borrower correspondence indicating that the borrower does not intend to pay;
- a significant deterioration in collateral value if the collateral is being used to repay the obligation; or
- the borrower has violated several debt covenants.

Some entities may implement an accounting policy that deems a financial asset uncollectable before all collection efforts have been exhausted. For example, some regulated financial institutions may use regulatory guidance as a basis to write-off certain consumer loans to the estimated collateral value, if any, once they are delinquent by a certain number of days, such as 120 or 180 days. For this, the accounting policy needs to be supported by prior collection experience.

Reporting entities may have different write-off policies for different financial assets, such as securities, commercial loans, and consumer loans. They may also segregate further by the type of receivable or the collateral nature. Reporting entities should consistently apply their policies and clearly document these differences and the rationale for the differences in their policies.

#### EXAMPLE

CECL write-off and recovery should look familiar.

Bank K currently evaluates its loan to Entity L on an individual basis because Entity L is 90 days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio.

At the end of December 31, 20X3, the amortized cost basis for Entity L's loan is \$500,000 with an allowance for credit losses of \$375,000. During the first quarter of 20X4, Entity L issues a press release stating that it is filing for bankruptcy.

Bank K determines that the \$500,000 loan made to Entity L is uncollectible. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance in accordance with paragraph, as follows:

Credit loss expense	\$125,000
Allowance for credit losses	\$125,000
Allowance for credit losses	\$500,000
Loan receivable	\$500,000

During March 20X6, Bank K receives a partial payment of \$50,000 from Entity L for the loan previously written off. Upon receipt of the payment, Bank K recognizes the recovery as follows:

Cash	\$50,000	
	Allowance for credit losses (recovery)	\$50,000

For its March 31, 20X6, financial statements, Bank K estimates expected credit losses on its financial assets and determines that the current estimate is consistent with the estimate at the end of the previous reporting period. During the period, Bank K does not record any change to its allowance for credit losses account other than the recovery of the loan to Entity L.



To adjust its allowance for credit losses to reflect the current estimate, Bank K reports the following on March 31, 20X6:

Allowance for credit losses	\$50,000
Credit loss expense	\$50,000

Alternatively, Bank K could record the recovery of \$50,000 directly as a reduction to credit loss expense, rather than initially recording the cash received against the allowance.

Reporting entities should include expected recoveries in its CECL estimate. This means the CECL estimate is a net write-off that includes expected recoveries. The loss estimate in the event of default should capture the entity's expectation of recoveries based on the entity's historical experience.

ASC Topic 326 was unclear about expected recoveries in the CECL estimate, but this was clarified by **ASU 2019-04, Codification Improvements to Topic 326 *Financial Instruments—Credit Losses***, Topic 815 *Derivatives and Hedging*, and Topic 825 *Financial Instruments*. The Update clarified that a reporting entity should include all expected recoveries in its estimate of the allowance for credit losses, which cannot exceed the aggregate of amounts previously written off and expected to be written off. Due to the significant management judgment in this situation, the accounting policy would need to contain specific methodology to avoid this becoming a “cookie jar.”

Reporting entities should not “write up” an asset's amortized cost for expected recoveries. As with trade receivables, financial asset recoveries of amounts previously written-off are recorded when received. Further, the receipt of consideration (e.g., cash) should be recorded as either an increase to the allowance, which is common practice among financial institutions, or an offset to credit loss expense. Entities should not increase the amortized cost basis of the financial instrument that was previously written-off.

The vast array of CECL loss estimation methodologies can seem a daunting challenge to winnow down the list of possible methods. Reporting entities must evaluate competing concerns, such as (1) data availability and accuracy; (2) method auditability, reasonability, and cost; (3) and the value of model reusability.

Reporting entities must convince not only insiders (management and the board of directors) but also external stakeholders (auditors, lenders, shareholders) that their methodology choices are appropriate and reasonable. The CECL process includes grouping loans into pools. Each pool may have a different loss estimation method.

ASC Topic 326 explicitly mentions five CECL estimation methodologies, and these are the methodologies most commonly considered by practitioners. The Standard also allows other loss estimation methods, and it may also be appropriate to combine elements of more than one method.

The guidance does not require a discounted cash flow (DCF) method; nor does it required a reconciliation of the estimation technique used with the DCF method. If a reporting entity

uses a non-DCF method, the allowance for credit losses shall reflect the expected credit losses of the financial asset's amortized cost basis as of each reporting date.

■ Discounted cash flow (DCF)

The DCF method estimates expected credit losses by projecting future principal and interest cash flows and discounting these cash flows at the financial asset's effective interest rate.

If the contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, then the discount rate may change over the financial asset's life. Index or rate examples are the prime rate, LIBOR<sup>8</sup>, or the U.S. Treasury bill weekly average. Reporting entities shall not project changes in the independent factor to determine the effective interest rate or to estimate expected future cash flows.

The allowance for credit losses is the difference between the amortized cost basis and the present value of the expected cash flows.

■ Loss-rate

The loss-rate method, also called the cumulative loss rate methodology, is the simplest CECL method. It requires the least amount of data and can be easily calculated in an Excel spreadsheet. Nevertheless, it is still a significant change from the incurred loss model used by financial institutions before CECL.

The only data required to compute a loss-rate method CECL is

- pool loan balance as of the pool date;
- the date and amount of loan losses (charge-offs net of recoveries) between the pool date and the reporting date; and
- the origination date of loans that had loan losses during the period.

The loss rate method measures the amount of loan losses (charge-offs net of recoveries) recognized over the life of a loan pool and compares those loan losses to the outstanding pool loan balance as of a specific point in time ("pool date").

Loans in the loan pool have been originated at different times. Some loans may have only a few days remaining before maturing, and other loans may have been originated recently and will remain for the entire loan term.

Since the loss rate method captures all of the material loan losses over the life of the loans in the loan pool, the pool date selected must precede the date of the CECL analysis ("reporting date") by at least the same amount of time as the maximum loan term of the pool.

**EXAMPLE**

*Loss-Rate Method for Pooled Loans with Balloon rates*

This example will illustrate how to calculate the estimate a CECL allowance for loan losses as of December 31, 20X8 ("20X8"). The loan pool being evaluated consists of balloon notes with terms ranging from two to four years. Accordingly, the pool date

<sup>8</sup> As has been widely publicized, LIBOR is being phased out due to the recent scandals involving improper manipulation of the rate by banks. US LIBOR cessation date is June 30, 2023.

would be December 31, 20X4 (“20X4”) so that the full four years of the loan losses on loans outstanding as of the pool date can be captured in the analysis.

1. Identify loan losses recognized between the pool date and the reporting date for the pool and determines which loan losses were related to loans outstanding at the pool date.
  - The reporting entity recognized \$2.4 million of loan losses on the loan pool between 20X4 and 20X8. After looking at the origination date of each loan with a loan loss, management determines only \$2.0 million of loan losses were on loans actually outstanding as of 20X4.
2. A calculation of the loss rate is then completed. As of the pool date, divide the loan losses recognized on loans outstanding by the outstanding loan balance.
  - The outstanding loan balance was \$120 million as of 20X4. Thus, the initial CECL loss rate would be \$2.0 million ÷ \$120 million, or 1.67%. Therefore, there is a 167% loss rate on the 20X4 loan pool.
3. The calculated loss rate becomes the starting point for estimating a CECL loss rate for the 20X8 pool balance.
  - The calculated rate should be adjusted for qualitative differences in the current pool balance, such as current unemployment rates and inflation and their effect on this loan pool. Qualitative factors to consider will include many of the same factors currently used in the incurred loss methodology plus some additional factors that will be used to help forecast changes to the pool in the future.

The loss-rate method has two downsides.

1. Analyzing **qualitative** factors requires much more effort versus other CECL methodologies. This is because the data are stale, being five years old. The loss-rate method does not capture changes in the loan pool’s credit quality from the pool date to the reporting date.

An example of changes in credit quality, using data from 2012 at the tail end of the recession is supporting the expected future loss estimate in the 2017 loan pool, which presumably comprises higher-quality loans. The 2.33% loss rate calculated in the example above is probably too high for the 2017 portfolio and needs to be adjusted downward through qualitative factors.

Any adjustment increases judgment, and additional analysis is needed to come up with a reasonable and supportable answer. This analysis should be documented by management.

2. It will likely result in a higher CECL loss rate than other methodologies because appropriate qualitative adjustments are less precise. Since it can be difficult to come up with supportable ranges for qualitative adjustments, management will likely have to err on the side of more conservative qualitative estimates, which logically produces a more conservative overall CECL estimate for the allowance for loan losses.

Smaller reporting entities may use the loss rate because of its relative simplicity. Larger institutions may use it for insignificant loan pools. However, management teams must also weigh the cost of more complex analysis of qualitative factors that comes along with this methodology.

An example diagram of the loss-rate method, created by RiskSpan is as follows:

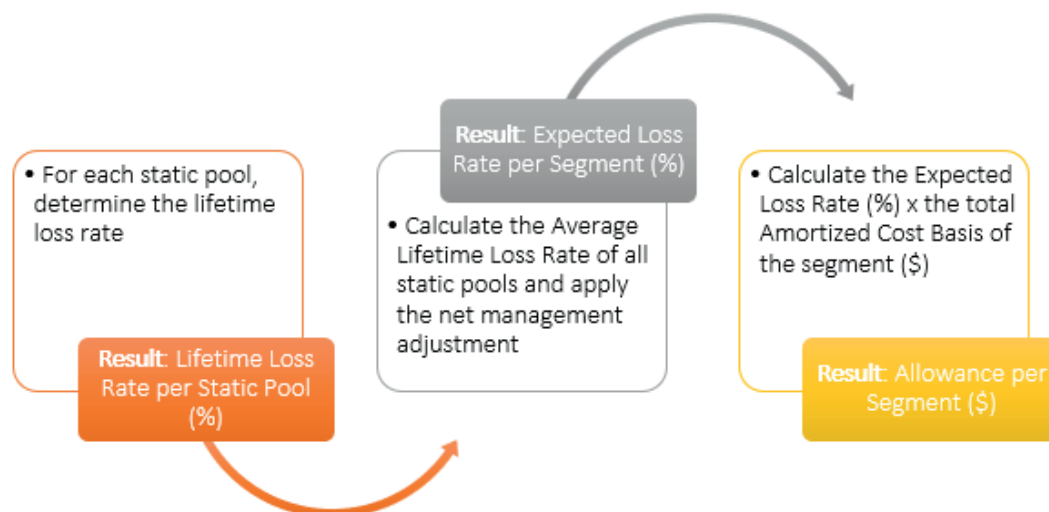


Image credit: <https://riskspan.com/news-insight-blog/choosing-a-cecl-methodology/>

### EXAMPLE

#### *Estimating CECL Using a Loss-Rate Approach*

#### *Collective Evaluation on a loan portfolio with similar risk characteristics*

Bank A provides loans to customers and manages those loans on a collective basis based on similar risk characteristics.

- 10-year amortizing loans originated over the last ten years
- Amortized cost basis is \$3 million

After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Bank A believes that its most recent 10-year period is a reasonable period for basing its expected credit-loss-rate calculation. The bank also considered the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio.

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%. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged.

Bank A considered whether any adjustments to historical loss information were needed before considering adjustments for current conditions and reasonable and supportable forecasts and determined none were necessary.

Bank A considered significant factors that could affect the expected collectability of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. 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, 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, Bank A estimates a 10-basis-point (bps) increase in credit losses incremental to the 1.5% historical lifetime loss rate due to the expected

decrease in real estate values and a five bps increase in credit losses incremental to the historical lifetime loss rate due to expected deterioration in unemployment rates.

Management estimates the incremental 15bps 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 bps) is added to the 1.5% 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% loss rate where it has immediately reverted into historical losses reflective of the contractual term. This approach reflects an immediate reversion technique for the loss-rate method.

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

### EXAMPLE

#### *Estimating CECL Using a Loss-Rate Approach Individual Evaluation when no similar risk characteristics exist*

Bank B primarily provides residential real estate loans to borrowers in the community. In the current year, Bank B expanded a program to originate commercial loans. Bank B has a few commercial loans outstanding at period end.

In evaluating the commercial loans, Bank B determines that one of the loans does not share similar risk characteristics with other loans outstanding; therefore, it believes that it is inappropriate to pool this commercial loan for purposes of determining its allowance for credit losses. This commercial loan has an amortized cost of \$1 million. Historical loss information for commercial loans in the community with similar risk characteristics shows a 0.50 percent loss rate over the contractual term.

Bank B considers relevant current conditions and reasonable and supportable forecasts that relate to its lending practices, its environment, and the specific borrower. Bank B determines that the significant factors affecting the performance of this loan are borrower-specific operating results and local unemployment rates. Bank B considers other qualitative factors, including national macroeconomic conditions, but determines that they are not significant inputs to the loss estimates for this loan.

Bank B can reasonably forecast local unemployment rates and borrower-specific financial results for one year only. Bank B's reasonable and supportable forecasts of those factors indicate that local unemployment rates are expected to remain stable (based on the main employer in the community continuing to operate normally) and that there will be a deterioration in the borrower's financial results (based on an evaluation of rent rolls).

Management determines that no adjustment is necessary for local unemployment rates because they are expected to be consistent with the conditions in the 0.50% loss-rate estimate. However, the current and forecasted conditions related to borrower-specific financial results are different from the conditions in the 0.50% loss-rate estimate, based on borrower-specific information.

Bank B determines that an upward adjustment of 10 basis points that is incremental to the historical lifetime loss information is appropriate based on those factors.

Management estimates the 10-basis-point adjustment based on its knowledge of commercial loan loss history in the community when borrowers exhibit similar declines in financial performance.

Management is unable to support its estimate of expectations for local unemployment and borrower-specific financial results beyond the reasonable and supportable forecast period. Under this loss-rate method, Bank B applies the same immediate reversion technique as in the above example, where Bank B has immediately reverted into historical losses reflective of the contractual term.

The historical loss rate to apply to the amortized cost basis of the individual loan would be adjusted an incremental 10 basis points to the 0.50% loss-rate estimate to get to 0.60%. The allowance for expected credit losses for the reporting period date would be \$6,000 (\$1 million  $\times$  0.60%).

#### ■ Roll-rate

The Roll Rate method projects ultimate losses based on historical roll rates and the historical loss given default estimate. Roll rates are either

- the frequency with which loans transition from one delinquency status to another, or
- the frequency with which loans “migrate” or “transition” from one risk grade to another.

The first is preferred due to its transparency and objectivity. The second is appropriate for reporting entities with established risk grades.

Management applies adjustments for macroeconomic and other factors at the individual roll rate level, as well as on-top adjustments as needed. Roll rate matrices can include prepayment as a possible transition, thereby incorporating prepayment probabilities. Roll rates can be used in a cash flow engine that incorporates contractual loan features and generates probabilistic (expected) cash flows, or outside of a cash flow engine to generate expected charge-offs of amortized cost. Finally, it is possible to use statistical regression techniques to express roll rates as a function of macroeconomic variables, and thus, to condition future roll rates on macroeconomic expectations.

An example diagram of the roll-rate method created by RiskSpan is as follows:

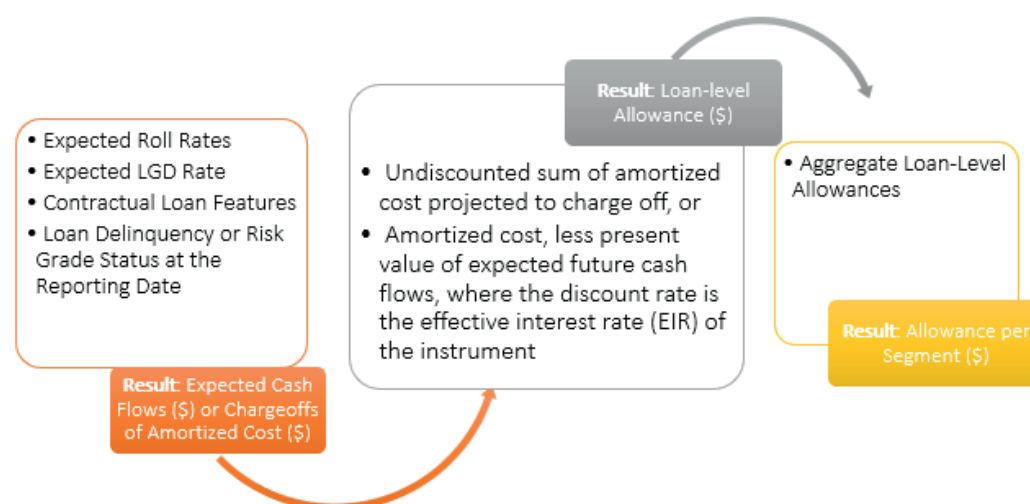


Image credit: <https://riskspan.com/news-insight-blog/choosing-a-cecl-methodology/>

■ Probability of Default × Loss Given Default (PD × LGD)

This method, ranging from simple to sophisticated, goes by the name “PD × LGD.”

- PD (lifetime Probability of Default) means the probability the financial asset will default within a given timeframe
- LGD (Loss Given Default) means the percentage of the financial asset not expected to be collected due to default

Sophisticated models calculate loan-by-loan, month-by-month, macro-conditioned probabilities of default and corresponding loss given default estimates. Such estimates can be used both inside and outside a discounted cash flow context. These monthly estimates combine to produce a cumulative default probability and corresponding exposure-at-default and loss-given-default estimates, which yield a single lifetime loss rate estimate.

Simple models calculate the lifetime default rates and corresponding loss given default rates of static pools (not marginal monthly or annual default rates like the sophisticated models). This simpler calculation is the method that most reporting entities have in mind when referring to “PD × LGD methods.”

The PD × LGD method calculates the loss rate based on the same static pool concept as the loss-rate method. As with the loss-rate method, use the default rates and loss given default rates of different static pools to quantify the relationship between those rates and the credit mix of the segment. Then use this relationship going forward based on the credit mix of today’s portfolio.

Because the PD × LGD and loss-rate methods derive the expected loss rate for the segment using different but related approaches, an important quality control is to verify that the final calculated rates are equal under both methodologies, and investigate any discrepancies.

The final allowance calculation multiplies the PD times the LGD.

**EXAMPLE**

*Estimating CECL by measuring components separately in a probability of default methodology*

In this example, at December 31, 20X0, Acme Company originates a pool of loans with the following characteristics:

- Par value (or unpaid principal balance): \$10,000,000
- Contractual interest rate: 10%
- Net deferred fees: \$100,000
- Maturity: Five years

Acme Company elects to develop its estimate of expected credit losses by considering the components of amortized cost separately and uses a probability of default x loss given default (PD × LGD) approach.

Based on past experience with similar loans and considering current conditions and reasonable and supportable forecasts of future economic conditions, Acme Company determines the following:

- The cumulative five-year PD is 5%.
- The LGD is 30% of the original principal amount.

- Write-offs due to credit events of similar loans generally occur between years two and three when 55% of the original net fees have been accreted (i.e., when 45% of the net deferred fees remain on the balance sheet).

Acme Company does not expect the timing of expected credit losses to differ from the timing of historical losses, so it does not adjust its historical accretion rates.

(The unpaid principal balance at time of default, probability of default (PD) and the loss given default rate (LGD) should all be adjusted for current and forecasted changes individually.)

As on 31 December, 20X0, the estimate of expected credit losses is measured as follows:

#### CECL

Estimated CECL loss on principal amount ( $\$10,000,000 \times 5\% \times 30\%$ )	\$150,000
Less: Unaccreted deferred fees included in the expected credit losses of amortized cost basis ( $\$100,000 \times 45\% \times 5\%$ )	<u>(2,250)</u>
Credit loss expense	\$147,750

Balance sheet presentation	31-Dec-20X0	
Amortized cost balance ( $\$10,000,000 - \$100,000$ )		\$9,900,000
<u>Allowance for expected credit losses</u>		<u>(147,750)</u>
Carrying value		\$9,752,250

- The RiskSpan PD  $\times$  LGD method depiction is shown as follows.

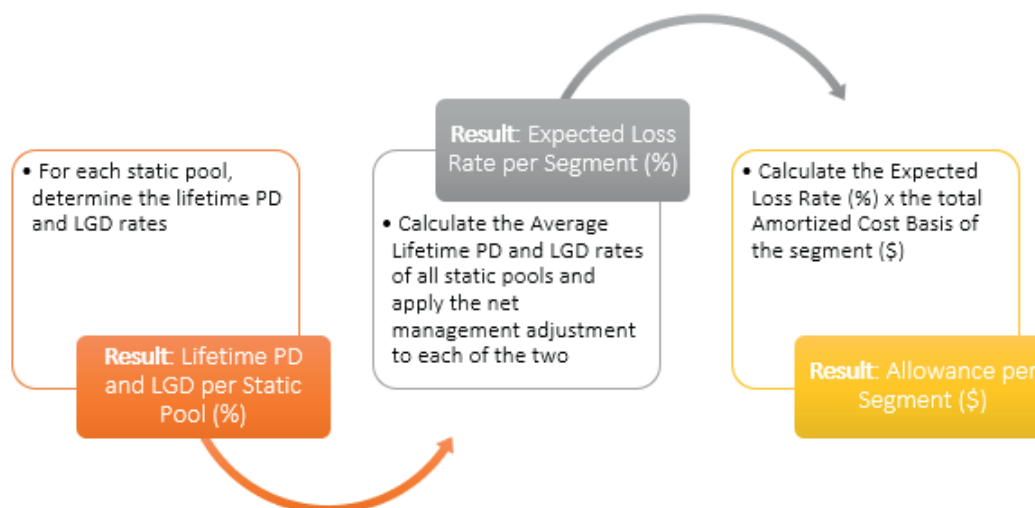


Image credit: <https://riskspace.com/news-insight-blog/choosing-a-cecl-methodology/>

- Vintage

The vintage method is also called an aging method. It is used by most reporting entities to estimate the allowance for bad debts on trade accounts receivable. Using the vintage method, historical losses are tabulated by vintage and by loan age, as a percentage of origination balances by vintage year.



**EXAMPLE**

Bank C provides financing to consumers purchasing new or used farm equipment throughout the local area. Bank C originates approximately the same amount of loans each year. The four-year amortizing loans it originates are secured by collateral that provides a relatively consistent range of loan-to-collateral-value ratios at origination. If a borrower becomes 90 days past due, Bank C repossesses the underlying farm equipment collateral for sale at auction.

Bank C tracks those loans based on the calendar year of origination and developed the following pattern of credit loss information (**actual historical** data appear in the non-shaded cells in the table below) based on the amount of amortized cost basis in each vintage that was written off as a result of credit losses.

Year of Origination	Loss Experience in Years Following Origination					
	Year 1	Year 2	Year 3	Year 4	Total	Expected
20X1	\$ 50	\$ 120	\$ 140	\$ 30	\$ 340	-
20X2	\$ 40	\$ 120	\$ 140	\$ 40	\$ 340	-
20X3	\$ 40	\$ 110	\$ 150	\$ 30	\$ 330	-
20X4	\$ 60	\$ 110	\$ 150	\$ 40	\$ 360	-
20X5	\$ 50	\$ 130	\$ 170	\$ 50	\$ 400	-
20X6	\$ 70	\$ 150	\$ 180	\$ 60	\$ 460	\$ 60
20X7	\$ 80	\$ 140	\$ 190	\$ 70	\$ 480	\$ 260
20X8	\$ 70	\$ 150	\$ 200	\$ 80	\$ 500	\$ 430
20X9	\$ 70	\$ 160	\$ 200	\$ 80	\$ 510	\$ 510

In estimating expected credit losses on the remaining outstanding loans on December 31, 20X9, Bank C considers its historical loss information. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans. The entire shaded region is the “forecast triangle” and the cells within the forecast triangle are “forecast cells.”

Management notes that historical loss experience has worsened since 20X3 and that loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5 even though the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5.

In considering current conditions and reasonable and supportable forecasts, Bank C notes that there is an oversupply of used farm equipment in the resale market, a trend that is expected to continue, thereby putting downward pressure on the resulting collateral value of equipment. It also notes that severe weather in recent years has increased the cost of crop insurance and that this trend is expected to continue.

Based on those factors, Bank C determines adjustments to historical loss information for current conditions and reasonable and supportable forecasts. The remaining **expected** losses (represented by the shaded cells in the table in each respective year) reflect those adjustments, and Bank C arrives at expected losses of \$60, \$260, \$430, and \$510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively. Therefore, the allowance for credit losses for the reporting period date would be \$1,260.<sup>9</sup>

- The vintage method limitation is that it does not differentiate loss forecasts based on the reporting entity’s macroeconomic outlook, which is a core requirement of CECL. Thus, a reporting entity this method will need to incorporate its macroeconomic outlook via management adjustments and qualitative factors (Q-factors). Management should ensure it does not double-count the influence of macroeconomics (Q-factors) on allowance estimates (in the model).

<sup>9</sup> Financial Accounting Standards Board. Financial Instruments—Credit Losses (Topic 326).

- The RiskSpan vintage method depiction is shown below.

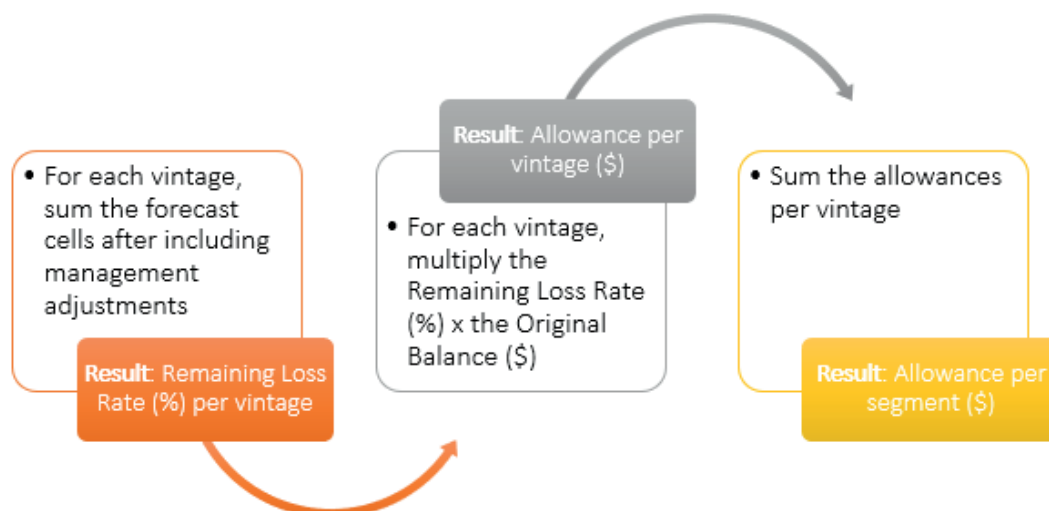


Image credit: <https://riskspan.com/news-insight-blog/choosing-a-cecl-methodology/>

### EXAMPLE

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

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:

0.3%	for receivables that are current
8%	for receivables that are 1–30 days past due
26%	for receivables that are 31–60 days past due
58%	for receivables that are 61–90 days past due
82%	for receivables that are more than 90 days past due

Entity E believes that this historical loss information is a reasonable base 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, 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% 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. 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
	<u>\$ 5,997,794</u>		<u>\$ 18,681</u>

For further information, please see “Accounts Receivable and Other Short-Term Financial Assets” later in this section.

Although ASC Topic 326 requires the CECL estimate to be based on a financial asset’s amortized cost, when a reporting entity amortizes (accretes) a discount into interest income, the discount should not offset the credit loss expectation. This means the discount embedded in a financial asset’s purchase price cannot be used to avoid recognizing an allowance.

### EXAMPLE

#### *Estimating CECL when acquiring a discount loan*

In this example, Company A purchases from Company B a discounted loan with the following terms:

- Acquisition date (Day 1): January 30, 20X7
- Face value of loan: \$1,000,000
- Purchase price: \$890,000
- Discount: \$110,000

Company A assesses the portfolio and determines that it has not experienced more-than-insignificant credit deterioration since origination. On Day 1, the purchase accounting entry that would have been made:

Purchased loan	\$1,000,000
Discount	\$110,000
Cash	\$890,000

To recognize purchased loans acquired at a discount.

In addition, Day 1 accounting will require Bank A to assess and recognize a loss for the estimated credit risk of non-PCD assets. Therefore, in this example, Bank A assesses the acquired portfolio under the CECL model using a non-DCF approach applied to the total amortized cost basis of \$890,000 (\$1,000,000 purchase price less \$110,000 discount) and determines that the loss rate on the amortized cost of \$890,000 is 2%, considering its historical loss experience, current conditions, and a reasonable and supportable forecast. As such, expected credit losses over the lifetime of the portfolio are \$17,800. Based on ASC 326-20-30-5, Bank A cannot use the \$110,000 purchase price discount to offset the required allowance of \$17,800 because Bank A expects to

accrete the discount into interest income. Therefore, Bank A would make the following additional journal entry on acquisition:

Credit loss expense (P&L)	\$17,800	
Allowance for expected credit losses (balance sheet)		\$17,800
To recognize Day 1 CECL allowance on purchased loans		

As a result of the entries above, Bank A would present the following on its January 30, 20X7 balance sheet:

Par value of the loan	\$1,000,000
Less: Discount	(110,000)
Amortized cost	890,000
Less: Allowance for expected credit losses	(17,800)
Carrying value of the loan	\$872,200

In this example, the estimate of expected credit losses is assessed on the amortized cost (\$890,000) of the financial asset. An entity should recognize an allowance at initial recognition, even when the amount of the purchase discount is greater than the calculated Day 1 allowance. In subsequent periods, the discount is accreted into interest income, and the allowance is reassessed.

### **Subsequent Measurement**

At each reporting date, a reporting entity shall record an allowance for credit losses on financial assets, including purchased financial assets with credit deterioration and off-balance-sheet credit exposures. The process is to compare the current estimate of expected credit losses with the existing amount previously recorded with any change reported in net income as a credit loss expense or a reversal of credit loss expense. The method applied to initially measure expected credit losses for the financial assets generally would be applied consistently over time.

With pooled financial assets, reporting entities must evaluate whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in that pool. For example, there may be changes in credit risk, borrower circumstances, write-off recognition, or cash collections that have been fully applied to principal based on nonaccrual practices that may require a reevaluation to determine if the financial asset has migrated to have similar risk characteristics with assets in another pool or if the credit loss measurement of the asset should be performed individually because the asset no longer has similar risk characteristics.

### **Assessing Zero CECL**

Except for the circumstances described below, a reporting entity shall not expect CECL risk (amortized cost nonpayment) to be zero solely based on the current value of collateral securing the financial asset. Instead, the reporting entity 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.

In rare cases, such as a three-month U.S. Treasury Bill, reporting entities may conclude that credit loss risk approximates zero. ASC Topic 326 requires reporting entities to consider some

possibility of a default, even if that risk is remote. As a result, the assessment of a financial instrument's loss upon a default needs to be zero to arrive at a CECL allowance of zero.

**EXAMPLE**

Mark Co. holds a corporate bond of a company that has no history of credit default. Furthermore, Mark has an expectation of future credit loss on this financial asset.

Corporate bonds, however, have some loss or default risk, even for highly-rated AAA borrowers. If a highly-rated borrower defaults, some will result. Thus, it would be difficult to demonstrate a zero-loss expectation for a highly-rated AAA corporate bond.

The market interest rate for U.S. Treasury securities is widely-recognized as a risk-free rate. U.S. Treasury securities have a long history with no credit losses and consistently receive a high rating by credit rating agencies. Thus, they should be minimally affected by current economic conditions because they are:

- Explicitly guaranteed by a sovereign entity, which can print its own currency
- Denominated in a currency routinely held by central banks and other major financial institutions
- Denominated in a currency used in international commerce
- Commonly viewed as a reserve currency

**EXAMPLE**

*Credit Default is Greater than Zero but Expected Nonpayment is Zero*

Entity J invests in U.S. Treasury securities with the intent and ability 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.

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.

Entity J 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.

Management judgment is required to determine the nature, depth, and extent of the analysis necessary to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors.

The qualitative factors Entity J notes are 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 these 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.

Investors that purchase U.S. Government Agency securities and classify them as held-to-maturity must assess the expected credit losses on these securities by considering the terms and guarantees provided by the issuer. These securities are not the same as U.S. Treasury securities.

In this context, according to E&Y, agencies refer to two types of issuers or guarantors of mortgage-backed securities (MBSs):

1. U.S. federal government agencies, and
2. Government-sponsored enterprises (GSEs) that were created by Congress to foster the public purpose of supporting home ownership by increasing access to home loans

Like U.S. Treasuries, MBSs issued or guaranteed by U.S. federal agencies such as the Government National Mortgage Association (Ginnie Mae) are backed by the “full faith and credit of the U.S. government.” The agency provides an unconditional commitment to pay interest payments and to return the principal investment in full to investors when a debt security reaches maturity.

MBSs issued by GSEs such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Agricultural Mortgage Corporation (Farmer Mac) are not backed by the same explicit guarantee as issuances of federal government agencies. MBSs issued by GSEs carry credit risk.

The following illustrates how an entity might estimate credit losses on age:

#### **EXAMPLE**

##### *CECL Estimation on Agency Mortgage-Backed Securities*

Company A purchases Ginnie Mae and Fannie Mae MBSs and classifies them as held-to-maturity. Company A considers the specific terms of these securities and the guarantees provided by their issuers to assess the risk of loss in the event of default.

Company A considers the following in assessing the expected credit losses for its investment in Ginnie Mae securities:

- These securities have over 40 years of history with no credit losses.
- Principal and interest are explicitly guaranteed by an agency of the U.S. government.
- The underlying mortgages carry either Federal Housing Authority (FHA) insurance or a US Department of Veteran Affairs (VA) guarantee, providing an additional layer of risk protection. The FHA and VA are agencies of the U.S. government.
- Ginnie Mae provides significant liquidity and stability to the home financing market in the U.S.
- Given the implications of allowing the relevant agencies (i.e., Ginnie Mae, FHA, VA) to default and causing investors to realize expected credit losses, it is unlikely that the ultimate guarantor, the U.S. government, would not perform on its guaranteed obligation in the event of a default.
- The rate of return on these instruments is generally above the risk-free rate, but this is due to noncredit-related risk, such as prepayment risk and liquidity risk. Market participants do not price this instrument with the expectation of credit losses.
- The ultimate guarantor, the U.S. government, can print its own currency.

Based on these considerations, Company A determines that the loss-given default is zero. Accordingly, it does not record expected CECL for these securities. Company A must reassess these considerations at every reporting period to continue to support its estimate of no expected credit losses.

For a collateral-dependent financial asset, an entity may expect zero CECL when the collateral's fair value less selling cost is equal to or exceeds the financial asset's amortized cost basis. If the collateral's fair value is less than the amortized cost basis of the financial asset the CECL measurement is the difference between the fair value of the collateral less selling costs and the financial asset's amortized cost basis.

A reporting entity may not automatically assume a zero CECL on a secured (collateralized) financial asset simply because the current collateral value exceeds the financial asset's amortized cost basis. Reporting entities need to consider the potential for future collateral value adverse changes over the financial asset's remaining expected life. Evidence could be historical loss experience for financial assets secured by similar collateral. A collateralized financial asset example is a mortgage, which is a loan secured by real estate. Examples of change evidence may come from specific real estate values or broader real-estate indexes.

For example, a loan of \$250 million may be collateralized by a property worth \$400 million, resulting in an LTV ratio of 62.5%. Company A cannot simply compare the fair value of the collateral to the loan amount and determine that it does not need to record an estimate of expected credit losses because the loan amount is less than the fair value of the collateral. In its consideration, it should consider the economic environment and potential future adverse changes in local real estate values, as well as historical experience with similar collateral. Based on those considerations, Company A may conclude that there will be future adverse changes in the value of the property, and therefore, it needs to recognize a CECL allowance. At each subsequent reporting date, Company A will reassess available relevant information to determine the appropriate CECL allowance amount.

## **CECL REFLECTS EXPECTATIONS OVER A FINANCIAL ASSETS CONTRACTUAL LIFE**

A reporting entity shall estimate expected credit losses over the contractual term of the financial asset. The financial asset's contractual life is the time horizon of credit risk exposure for the reporting entity.

Reporting entities must base their CECL estimate based on its historical data for the timing and pattern of contractual life credit losses. Financial assets may experience a credit loss at any point during their life; however, the loss rate is not linear. The loss rate is determined by the financial asset life and economic cycles.

- Residential mortgages generally have higher defaults in earlier years but lower losses in later years. This is because the borrower pays down the principal balance and the collateral property value increases.
- Commercial mortgages generally follow opposite timing and have higher defaults near the end of their term. This is because the borrower maybe cannot access new funding to refinance the commercial loan.

As a result, it would be incorrect to estimate CECL to use an average annual historical credit loss rate multiplied by financial asset's remaining contractual life. This approach would capture neither the financial assets life stage nor current economic conditions nor forecasts of future conditions.

This is especially true over long contractual lives because longer time horizons create greater uncertainty in expected cash flows, which will impact the CECL estimate. Thus, using a historical annual loss-rate might become more accurate for shorter-duration financial instruments, such as trade receivables.

## Contractual Life Compared with Weighted-Average Life

According to the FASB Staff Q&A, Topic 326, No. 1: Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses, FASB staff indicated that “the standard does not require a specific credit loss method; however, it allows entities to use judgment in determining the relevant information and estimation methods that are appropriate in their circumstances.” A reporting entity may consider simplifying its calculation by averaging the remaining lives of all pooled financial assets to arrive at a weighted average remaining maturity (WARM) method that could be used in determining its CECL estimate.

However, a weighted average is less precise because losses often occur at different rates over a financial asset’s contractual term. As a result, the reporting entity would need to consider adjusting the weighted average life for estimated prepayments when determining CECL for the financial asset pool. FASB staff indicated that the WARM method is best used for smaller, less complex portfolios.



### PRACTICE POINT

Entities may decide to pool assets based on the term to maturity if that characteristic drives losses for the portfolio. Given the requirement to estimate losses over the remaining contractual life of an asset, pooling assets by remaining term to maturity will allow reporting entities to track and predict losses more accurately for certain assets or portfolios.

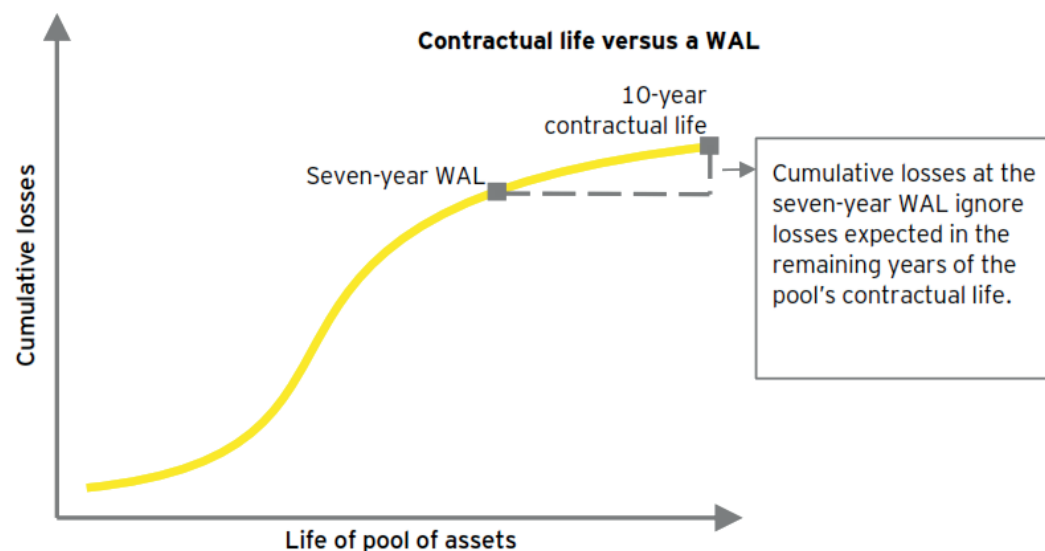


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**EXAMPLE***CECL Estimate—Contractual Life Versus Weighted Average Life<sup>10</sup>*

This example compares the CECL estimate calculation using two different methods:

Description	Amortized cost	Remaining life (years to maturity)	Rating	Cumulative probability of default	Loss given default	Expected credit losses
<b>Pooling based on remaining life (i.e., considering the full contractual life) – Method A</b>						
Loan pool one	\$ 1,000,000	1	A	0.095%	20%	\$ 190
Loan pool two	\$ 1,000,000	3	A	0.584%	20%	1,168
Loan pool three	\$ 1,000,000	5	A	1.244%	20%	2,488
						<u>\$ 3,846</u>
<b>Pooling with varying terms to maturity using a WAL – Method B</b>						
Loan pool average	\$ 3,000,000	3	A	0.584%	20%	\$ 3,504
				Difference		\$ 342

Contractual Life Method—calculates CECL using the predicted default rate based on the remaining loan life. The predicted default rate varies, based on the length of time to maturity.

Loans in pool one have one year until maturity and a predicted default rate of 0.095% based on historical experience adjusted for current conditions and reasonable and supportable forecasts of future economic conditions.

This results in an expected loss of \$190 ( $\$1,000,000 \times 0.00095 \times 0.20$ ) for the pool. By adding each pool's expected credit losses based on the contractual years to maturity, the entity would calculate its total expected loss as \$3,846.

Weighted Average Life Method—calculates CECL using a predicted default rate corresponding to the weighted average life of all assets.

The pool has a three-year weighted average remaining life and a three-year predicted default rate of 0.584%. This results in total expected credit losses for the pool of \$3,504 ( $\$3,000,000 \times 0.00584 \times 0.20$ ).

There is a difference of \$342 or approximately 9% between the expected CECL using the weighted average loss without considering term to maturity versus using the remaining contractual lives of each loan in the pool.

**Prepayments**

ASC Topic 326 requires considering estimated prepayments when estimating CECL. They may be a separate input, embedded in the credit loss information, or incorporated in the future principal and interest cash flow projections.

Significant judgment is needed to determine the prepayment impact on the estimated CECL allowance. A reporting entity must evaluate whether it can accurately estimate and support a prepayment estimate. For example, generally there exists less observable prepayment experience on commercial loans than on residential mortgages.

10 Ernst & Young LLP, A comprehensive Guide: Certain Investments in Debt and Equity Securities, [https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments\\_bb0961\\_debtandequitysecurities\\_24june2019-v2/\\$file/financialreportingdevelopments\\_bb0961\\_debtandequitysecurities\\_24june2019-v2.pdf](https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_bb0961_debtandequitysecurities_24june2019-v2/$file/financialreportingdevelopments_bb0961_debtandequitysecurities_24june2019-v2.pdf)

Prepayments are early borrowing settlements, typically not due to a borrower's deteriorating credit condition. They often result from changing economic conditions, such as lower interest rates, that create more favorable financing alternatives for the borrower. They may also result from borrower-specific factors, such as a home sale for a residential mortgage or completing an equity financing for a commercial loan.

Prepayments generally reduce the potential loss on an individual asset by shortening the time period over which the lender or investor is expected to be exposed to credit losses. If prepayments are not estimated, total estimated losses on the portfolio could significantly exceed the actual losses experienced.

CECL estimate methods use prepayments differently. For the discounted cash flow method, prepayments impact the amount and timing of future cash flows. For other methods, prepayments can be embedded in the historical credit loss statistics or can be evaluated separately.

Forecasting prepayments and financial asset life is difficult when there are no contractual prepayment terms. It is also difficult if there are variable terms that may affect prepayment timing, such as options for prepayment, extension, renewal, and puts or calls. Prepayment guidance in ASC Topic 326 on repayment timing is as follows:

- Prepayments reduce expected losses by shortening the time period that the lender is exposed to credit loss risk.
- The financial asset life generally should not include extensions, renewals, and modifications the entity expects to negotiate that would extend the remaining life beyond the contractual term, unless the entity has a reasonable expectation that it will execute a troubled debt restructuring with the borrower.

Thus, in estimating CECL, future losses that could result from an extension expected to be negotiated after origination should only be considered when there is a reasonable expectation of a Troubled Debt Restructuring (TDR).

The TRG and FASB decided that reporting entities are not required to use the loan modification guidance in ASC Topic 310, *Receivables*, to determine whether a refinancing is a prepayment but are not precluded from doing so. The FASB noted that using market prepayment information would become significantly more complex if using the loan modification guidance was required. Entities need to use their judgment to define what constitutes a prepayment and apply this definition consistently.

#### **EXAMPLE**

##### *Mortgage Loans*

If a reporting entity has loans for which the contracts allow for prepayment of the unpaid principal balance, the entity should consider, based on historical experience, prepayments to be made on those loans. For example, refinancing may occur due to changes in market interest rates, or prepayments of the loans may occur when taking out a new mortgage in conjunction with the purchase of a new home.

When a borrower that is not experiencing financial difficulty refinances a mortgage solely due to changes in market interest rates, it is a prepayment of the old mortgage and an origination of a new mortgage at the current market interest rate.

A reporting entity will need to estimate expected prepayments based on historical experience to limit the time horizon over which it is exposed to credit risk for the mortgage loans expected to be prepaid. The entity will want to consider current

economic conditions reasonable and supportive forecasts of future economic conditions to apply, as well. The adjustments related to prepayment estimates will affect the life of the financial asset and, consequently, the amount of losses to be included in the CECL estimate.

#### **EXAMPLE**

##### *Bond Call Options*

Bonds with call options can be classified as held-to-maturity, and, as a result, accounted for, in accordance with the CECL model.

For bonds that contain a call option, a reporting entity can consider the call option. If the reporting entity expects interest rates to decline, the issuer will be more likely to redeem the bond at par prior to maturity. This accelerated redemption limits the time for which the entity is exposed to credit risk, reducing the estimated life for measuring expected CECL.

\*ASC Topic 320, *Investments in Debt and Equity Securities*, states that a security shall not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. However, a debt security with a call feature that allows the issuer to repurchase the security at a specified price can generally be classified as held-to-maturity because the issuer's exercise of a call feature effectively accelerates the debt security's maturity.

## **Loan Changes—Extensions, Renewals, Modifications, and Troubled Debt Restructuring**

Lending agreements frequently include extensions, renewals, or other modifications. ASC Topic 326 guides that a reporting entity should not extend the contractual term for expected extensions, renewals, or modifications negotiated after origination unless it reasonably expects that it will incur a TDR.

However, ASC Topic 326 is not clear whether certain contractual extension options should be considered. The dilemma is whether an entity should consider explicit contract terms that allow the borrower to extend payment terms because those terms can expose the lender to credit risk beyond the loan's maturity date.

Many loan agreements give the borrower the unilateral right to extend the loan or the borrower must meet specified conditions, that are in the borrower's control, to extend the loan. Both expose the lender to credit risk over the extension period.

Other loan agreements require the borrower to meet certain conditions that are not in the borrower's control. An example would be an option that becomes exercisable upon changes in regulations or tax law. In this situation, some believe the lender would measure the allowance, considering both the probability the conditions will be met and the likelihood that the borrower will request the extension.

Subsequent to the loan agreement, a lender and borrower may agree to modify the loan terms. Examples are extensions or renewals of existing loans to align with current business strategies and maintain positive customer relationships. Or, if market interest rates decline, a lender may choose to reduce a loan's contractual interest rate to retain the loan and the overall borrower relationship. Because these loan modifications occur in the normal course of business and are offered to borrowers who are not experiencing financial difficulty, it is not a TDR.

ASC Topic 310, *Receivables*, provide guidance to determine whether a refinanced or restructured loan results in a new debt instrument or the continuation of an existing loan, which determines accounting for the change fees and costs. The FASB said reporting entities are not required to follow ASC Topic 310 to determine what constitutes a prepayment for determining loan contract life, but are not precluded from doing so.

ASC Topic 310 guides accounting for a TDR, which exists if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. When a borrower experiences financial difficulty, a creditor entity may renew, extend, or modify the debt through a TDR. The creditor's objective is to mitigate its credit loss risk and protect its debt investment.

Some indicators of debtor financial difficulty are as follows:

- The debtor is currently in payment default on any of its debt. The default does not have to be on the creditor's debt agreement.
- It is probable that the debtor may become in payment default on any of its debt in the foreseeable future without a debt modification.
- The debtor has declared or is in the process of declaring bankruptcy.
- Substantial doubt exists about whether the debtor will continue to be a going concern.
- The debtor has publicly traded securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- The creditor forecasts that the debtor's cash flows may become insufficient to make future required interest and principal payments on any of its debt.

Examples of TDR concessions are principal reduction, interest rate reduction, postponed principal or interest payments, or contractual life extension. A reporting entity must consider the CECL impact of all TDR concessions reasonably expected to be given to the borrower.

With a TDR, whether anticipated or actual, borrower-specific financial and economic conditions would lead a creditor reporting entity to assess greater credit risk and increase the CECL allowance. In addition, although modifying a loan is a way to mitigate expected CECL, TDRs that provide more time to pay off a loan result in extending the loan contractual life and, therefore, could further increase the CECL allowance.

ASC Topic 326 does not prescribe a method for measuring CECL for a TDR. A reporting entity may estimate the allowance using any of the methods previously presented in this course. However, a FASB TRG on ASC Topic 326, the FASB clarified in the September 6, 2017, meeting<sup>11</sup> that it expects entities to measure the effect of a TDR using a DCF method if the TDR involves a concession that can be captured only using a DCF method. Their rationale is that it may be difficult to determine an interest rate concession impact without using a DCF.

## Off-Balance-Sheet Commitments

In estimating CECL for off-balance-sheet credit exposures, a reporting entity must cover the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer.

<sup>11</sup> Financial Accounting Standards Board, September 6, 2017, board meeting, [https://www.fasb.org/cs/ContentServer?c=Document\\_C&c\\_id=1176169320227&d=&pagename=FASB%2FDocument\\_C%2FDocumentPage](https://www.fasb.org/cs/ContentServer?c=Document_C&c_id=1176169320227&d=&pagename=FASB%2FDocument_C%2FDocumentPage)

An example is loan commitments that are not derivatives (which would be accounted for under ASC Topic 815, *Derivatives and Hedging*).

A credit card is an example of a conditionally cancelable financial instrument because the bank can cancel the credit at any time. In this situation, the bank would apply the CECL model only to the credit card balance.

The estimate of expected credit losses for off-balance-sheet credit commitments is recognized as a liability and is not included in the allowance for expected credit losses or another contra-asset account. A reporting entity reports a credit loss expense for the amount to adjust the credit loss liability for management's current CECL estimate on off-balance-sheet credit exposures. When the loan is funded, an allowance for expected credit losses is estimated for that loan using the CECL model, and the liability for off-balance-sheet commitments is reduced.

Consider several factors:

- The likelihood that funding will occur. This may be affected by a material Adverse change clause.
- Contractual period of credit risk exposure
- Loss risk
- Current economic conditions as well as expectations for future conditions

#### **EXAMPLE**

March 31, 20X1

A reporting entity has a \$300,000 loan commitment that is not unconditionally cancelable. The likelihood of funding is estimated to be 80%. The loss rate factoring in current and future economic conditions is 3%.

September 31, 20X1

The borrower draws against the loan commitment in the amount of \$100,000. The estimated loss rate has not changed for the funded amount from the estimate used for the previous quarter.

Accounting for the Unfunded Portion

- Expected credit losses are to be estimated over the contractual term of the loan that will be originated.
- It will compute the expected credit losses for the unfunded portion and report it as a liability for off-balance sheet credit losses.
- March: estimated credit losses for the unfunded commitment is \$7,200 ( $\$300,000 \times 80\% \times 3\%$ ).
- September: estimated credit losses for the unfunded commitment is \$4,800 ( $\$200,000 \times 80\% \times 3\%$ ). Therefore, the liability decreases by \$2,400 from last quarter.

Accounting for the Funded Portion

- Expected credit losses are to be estimated under the scope of Subtopic 326-20, the same as for other financial assets within this guidance.
- It will compute the expected credit losses for the funded portion and report in as an allowance for credit losses.
- March: There is no funded portion at this time.

- September: Allowance for expected credit losses is established for \$3,000 ( $\$100,000 \times 3\%$ ). The net increase in credit loss expense of \$600 is recognized to reflect the funded portion of the commitment

## CONSIDERING AVAILABLE RELEVANT INFORMATION

When developing an estimate of expected credit losses on financial assets, reporting entities need to consider available information relevant to assessing the collectability of cash flows. Reporting entities are not required to search all possible information that is not reasonably available without undue cost and effort.

This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. Using its internal information may be sufficient for determining collectability. Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for assessing expected credit losses. Thus, ASC Topic 326 requires reporting entities revert to historical loss information if it cannot develop a reasonable and supportable forecast.

The guidance requires significant management judgment to select the historical data and determine potential adjustments to the historical loss information. Estimating CECL requires a reporting entity to understand the interaction between the historical loss data, current conditions, and the reasonable and supportable forecast of future economic conditions. ASC Topic 326 provides no practical expedients with respect to historical information or the adjustments to such historical information. Entities will need to support each of the adjustments in connection with the estimate as a whole.

Adjustment examples include the following:

Asset-specific risk characteristics	Could include portfolio mix, different type of financial asset, asset terms, different borrower types, underwriting standards, et cetera. For example, adjust historical data if it represented loss experience on loans collateralized by new automobiles to prime-rated borrowers if newly-originated loans were made to a mix of prime and near-prime borrowers.
Current conditions	Adjustments may need to be made to historical data to reflect current economic conditions if those differ from when the historical data was collected in order to reflect the historical data adjustments for the current economy.
Reasonable and supportable forecasts of future economic conditions expected to exist throughout the financial asset's contractual life	<p>Determine the expected credit losses over the financial asset's contractual life by considering the effect of economic conditions that will exist during this period by creating a reasonable and supportable forecast of future economic conditions.</p> <p>If an entity cannot obtain reasonable and supportable future economic conditions for the life of the asset, it is required to revert to historical loss information from the end of the reasonable and supportable forecast period to the end of the contractual life.</p> <p>Reverting to historical information does not imply that the estimate of losses beyond the reasonable and supportable forecast period is also not both reasonable and supportable.</p> <p><b>Both the</b> forecast and reversion periods are a component of the overall estimate of credit losses and must be supported by management in its entirety.</p>

In determining its estimate of expected credit losses, a reporting 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. ASC Topic 326 does not specify a methodology for determining historical credit loss experience. The 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.

Historical loss information generally provides the starting point for the CECL assessment. This is because historical credit loss experience for similar assets is relevant for estimating CECL that may result for assets currently held by the entity. Following are examples of relevant credit loss historical information categories:

- Loan characteristics, such as term, amortization period, collateral, position
- Loss experience, including migration statistics, charge-offs and recoveries, and the components of amortized cost affected by the default event
- The effect of modifications, prepayments, and extensions on loss experience. This includes TDRs.
- Macroeconomic conditions that tie to historical loss experience

A reporting entity may select historical periods representing management's expectations for future credit losses. Or, it also may select other historical loss periods adjusted for current conditions and other reasonable and supportable forecasts. When determining historical loss information in estimating CECL, the 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.

Reporting entities should consider historical information from various sources to produce an accurate CECL estimate. Source examples are internal, entity-specific, and external data. Regardless of whether using internal or external information, management should assess the information reliability and relevance as well as its ability to support its conclusions. Internal information is more relevant than external information if it more closely aligns with the financial assets being assessed for CECL.

#### **EXAMPLE**

A privately-owned manufacturer with receivables from a consistent customer base in a specific geography.

The manufacturer may find that its own historical internal data is more relevant than current external loss or credit data, especially if the customer base is consistent with those in the past. The specific credit risk characteristics of its customers or contract terms would be reflected in its historical data.

On the other hand, the manufacturer may need to use external information to supplement its internal data. This would occur if the internal information is insufficient to determine the collectability of the financial assets being evaluated, the data are not complete, or the data have not been adequately controlled in such a way to provide a reliable estimate.

Reliable and objective internal historical data may still require management judgment. The reason is external macroeconomic conditions may be different than existed for the historical data, current conditions, and reasonable and supportable forecasts of future economic conditions. Thus, reporting entities need to identify the macroeconomic variables that are

most relevant to evaluating and predicting expected credit losses. These macroeconomic variables can vary by product, geography, and borrower type. Additionally, entities may use one or many economic variables to adjust for current conditions and reasonable and supportable forecasts of future economic conditions.

Reporting entities also need to consider relevant **qualitative and quantitative** factors that relate to the environment in which the entity operates and are specific to the borrowers. Qualitative factors include 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 loan 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.

Management is not required to develop forecasts over the contractual term of the financial assets. For periods beyond which it can make or obtain reasonable and supportable forecasts of expected credit losses, it may revert to historical loss information.

Qualitative factors with historical loss information may require adjustment if management determines current conditions and forecasts differ from the conditions that existed for the historical period. In making this determination, management should consider characteristics of the financial assets that impact collectability.

Examples include any of the following, depending on the nature of the financial asset. Not all of these may be relevant to every situation, and other factors not on the list may be relevant.

- The borrower's financial condition, credit rating, credit score, asset quality, or business prospects
- The borrower's ability to make scheduled interest or principal payments
- The remaining payment terms of the financial assets
- The remaining time to maturity and the timing and extent of prepayments on the financial assets
- The nature and volume of the entity's financial assets
- 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 in which the collateral-dependent practical expedient has not been utilized
- The entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, write-off, and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- The quality of the entity's credit review system
- The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- The environmental factors of a 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, and



- changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments.

Although ASC Topic 326 provides the factors (above) a reporting entity may consider, there is little implementation guidance on how to adjust historical credit loss information for asset-specific characteristics, current conditions, or reasonable and supportable forecasts of future economic conditions. Adjustments may be needed to make the historical information relevant to the financial asset pool when estimating CECL.

When using historical information to estimate CECL, management needs to consider whether the information is complete and reliable, whether it is relevant to the assets in the portfolio under consideration, and whether it reflects current conditions. Management should consider whether the historical data is accurate, accessible, relevant, and complete.

- Accurate
  - Are the internal controls in place to ensure historical data is correct?
  - Is the historical data at the appropriate granularity?
- Accessible
  - Is all the historical data readily available for use in calculations?
- Relevant
  - Is the historical data representative of the current portfolio?
  - Is the time period covered by the historical data similar to that being assessed?
- Complete
  - Are there any data gaps in the historical data?

When evaluating economic adjustments, management should focus on economic variables that most significantly affect the collectability of cash flows. An entity may

- use historical credit loss information that reflects the current economic conditions, or
- start with historical loss information that represents a full credit cycle and adjust for current economic conditions, or
- different historical data, such as a variable period that aligns with the expected remaining life of the portfolio, includes all of the entity's historical losses, or captures one or more credit cycles.

A reporting entity must analyze how historical credit loss economic patterns differ both from current conditions and from reasonable and supportable forecasts of future economic conditions. This analysis is often difficult and requires significant management judgment, such as estimating the current point in the economic cycle and match it to internal historical data reflecting historical economic cycles. The reporting entity then must use this economic analysis to adjust its historical credit loss experience for current expectations and reasonable and supportable forecasts of future economic conditions.

Making reasonable and supportable forecasts of future economic conditions into the estimate of expected credit losses requires significant management judgment. U.S. GAAP provides no guidance on how to develop future economic forecasts or how to determine the length of the forecast period.

Most reporting entities use their forecasting experience from developing business plans, capital budgeting, and estimating fair values. From this experience, it is well known that reliability diminishes for a forecast and its supporting evidence the further out in the forecast period one looks.

An entity may use different methods to quantify adjustments. A common statistical forecasting technique is regression analysis to determine the correlation or relationship between a qualitative factor and the financial asset's historical credit loss experience. The method an entity uses is affected by the availability and quality of its relevant historical loss information and systems currently in place. A reporting entity needs to assess its ability to measure and quantify adjustments driven by qualitative factors in order to incorporate them into its expected credit losses estimate.

It should be noted that adjustments for current conditions and reasonable and supportable forecasts may be incremental to, and are different from, differences between historical data and asset-specific risk characteristics. So, for instance, a reporting entity will adjust historical loss rates down to reflect that it is now lending to customers with credit scores only in the favorable ranges versus the lending practices during the historical period used. Then the reporting entity may also adjust rates again to reflect a change in the employment rates between the current period and the historical period being used. In this case, by observing and documenting how historical loss experience has reacted to economic variables that affect expected collectability, it would be appropriate in determining the reasonable and supportable forecast.

#### EXAMPLE

Lender Co. started originating commercial loans in Town A in 20X2. Lender management has made no changes to its lending practices.

Lender management noticed that when the rate of inflation decreased by more than 2% its commercial loan portfolio experienced credit losses. In estimating its CECL allowance, management determined that the rate of inflation directly affected unemployment in Town A, and therefore, unemployment was the primary driver affecting financial asset collectability and gathered the following data.

Year	Town A unemployment rate	Cumulative loss experience	Change in cumulative loss experience from prior year
20X2	4.0%	1.0%	
20X3	4.5%	1.5%	+0.5%
20X4	5.0%	3.0%	+1.5%
20X5	5.5%	3.5%	+0.5%
20X6	6.0%	4.0%	+0.5%
20X7	6.5%	5.0%	+1.0%

Lender management concludes that it needs to adjust for the effect that future unemployment rates will have on the portfolio of commercial loans in determining its allowance for expected losses at year end 20X8. Lender management expects the unemployment rate in 20X8 to decrease to 6.0%. Therefore, it will adjust the cumulative loss rate by approximately 1.0% using the previous table, which illustrates the correlation between the unemployment rate of 6.0% and cumulative loss experience of 4.0%.

## Reversion Method

ASC Topic 326 says that a reporting entity may not estimate zero credit losses for periods that it is not able to reasonably and supportably forecast economic conditions. Although some reporting entities can develop reasonable and supportable forecasts of future economic conditions over the entire contractual term for all financial assets, other entities may not be able to accomplish this.

At the point that the reasonable and supportable forecast is no longer a better CECL estimate than using historical loss information, reporting entities should revert to historical loss information for the financial asset's remaining contractual term.

In the reasonable and supportable forecast period, reporting entities should consider both financial-asset-specific characteristics and economic factors that affect cash flow collectability. When an entity reverts to historical loss information, this information is adjusted only for financial-asset-specific characteristics such as differences in underwriting standards, portfolio mix, or asset term. In the reversion period, reporting entities are not permitted to adjust for economic conditions. However, an entity can revert to historical data taken from a period that most accurately reflects its expectation of economic conditions expected to exist during the reversion period.

The Standard allows entities to exercise judgment when selecting the historical information to be used in the reversion period. Entities should consider the relevance of the historical period to the estimate of expected credit losses. Relevance examples are whether it includes a complete economic cycle, sufficient history over the contractual life of the assets, or significant or unusual events (such as the beginning of the global financial crisis in 2008).

## ***Purchased Financial Assets with Credit Deterioration (PCDs)***

Entities may acquire financial assets involving contractual cash flows as a portfolio of instruments. Examples are sales between financial institutions of bundled loans, mortgage-backed securities, credit card receivables, or commitments, or in connection with a business acquisition. When acquired, the assets bring with them the potential for credit losses.

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. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset.

ASC Topic 326 eliminates existing guidance in ASC Section 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, for purchased credit impaired (PCI) loans and debt securities. Legacy guidance considered only loans or debt securities, and now an entity must determine whether all purchased financial assets qualify as PCI financial assets.

A reporting entity adds 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.

Guidance for PCI financial assets requires recording both

1. the purchase price, and
2. a reduction for the estimate of credit losses at the acquisition date.

Combined, these two become the initial amortized cost.

Upon acquisition, PCDs are recorded at cost. There is no credit loss expense affecting net income upon acquisition. Then, an “initial” allowance for credit losses is recorded in accordance with this ASU. The credit to the allowance is offset with a debit that increases the cost basis of the asset—referred to as the “gross up” approach.

The CECL method is then applied going forward with changes in estimated cash flows going immediately to earnings. Interest income is recognized based on the rate that equates the adjusted cost basis (purchase price plus initial allowance) to the contractual cash flows.

Similar to accounting for financial assets held, these changes to accounting for PCDs result in a reduced carrying value in virtually all cases, rather than only if it is probable, credit losses will occur. Additionally, previous GAAP could involve additional write-downs going forward, but “write-ups” for recoveries in value were recognized as an adjustment of yield. ASC Topic 326 eliminates this lack of symmetry by recording all changes in the allowance for credit losses through income, whether “plus” or “minus.”

### EXAMPLE

**Facts:** National Bank acquires PCD assets with a par value of \$1,200,000 for \$900,000. At the time of acquisition, estimated credit losses on the portfolio are \$225,000.

**Result:** The balance sheet will show an amortized cost of \$1,125,000 (\$900,000 price + \$225,000 allowance). The difference between \$1,200,000 par and \$1,125,000 adjusted cost basis represents the discount on the loans.

The resulting journal entry is:

Loans receivable—par \$1,200,000	
Discount on loans	\$75,000
Allowance for credit losses	\$225,000
Cash	\$900,000

Going forward, the \$75,000 is treated as an adjustment of yield through interest income. The allowance is adjusted at each balance sheet date with an offset to earnings (credit losses).

## CREDIT ENHANCEMENTS—GUARANTEES OR INSURANCE

Reporting entities commonly require credit guarantees or insurance to mitigate credit risk. CECL needs to reflect mitigating effects of credit enhancements (except freestanding or legally-detachable 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.

Reporting entities must account for freestanding (or legally detachable) credit guarantees or credit insurance as a separate asset. Thus, when estimating CECL, an entity shall not combine (or offset) a financial asset with a separate freestanding contract that serves to mitigate credit loss. An example is a purchased credit-default swap that may mitigate expected credit losses on the financial asset.

For the CECL estimate to consider the mitigating effects of a credit enhancement contract, the contract must be embedded in the financial asset and cannot be a separate freestanding contract. Determining whether a contract is freestanding or embedded in a financial

instrument requires management judgment and an understanding of both the form and substance of the transaction. Thus, a credit enhancement contract is not always freestanding when it is in a separate contract. Conversely, a credit enhancement embedded in a single financial asset may be treated as separate freestanding financial instruments.

When entering into a credit enhancement contract concurrently when acquiring or originating a financial asset, both of the following, must exist for each to be freestanding and accounted for separately:

1. Legally detachable—the two contract items can be legally separated and transferred so they may be held by different parties

A credit enhancement is generally not freestanding if it “travels” with the related financial asset. If a holder of a financial asset with a credit enhancement transfers that financial asset to a new investor and that new investor becomes the beneficiary of the credit enhancement, the credit enhancement is not freestanding, and the investor should consider it in its estimate of expected credit losses.

For example, in the case of a residential mortgage loan, a lender may require a borrower with a low credit score to obtain a guarantee from a second individual with a higher credit score or income level (i.e., a guarantor) to co-sign the mortgage agreement. This kind of guarantee always “travels” with the loan because it is not legally detachable or separately exercisable. As a result, this type of guarantee would be considered in the assessment of expected credit losses. Certain guarantees and third-party insurance that municipalities attach to the bonds that they sell are also considered enhancements that are not freestanding and would therefore be considered in the assessment of expected credit losses.

2. Separately exercisable

If a contract is entered into separately from any other transaction, it suggests that the contract may be freestanding. One contract is capable of being exercised without terminating the other. An example is entering into a credit enhancement contract subsequent to acquiring (or originating) the underlying financial asset with enough time between the two transactions. In this example, the credit enhancement would generally be separate from the financial asset and therefore a freestanding contract.

#### **EXAMPLE**

Private mortgage insurance (PMI) versus mortgage insurance obtained on an existing pool of mortgage loans

PMI is entered into at the same time as a mortgage for which the borrower does not have a 20% or more of the home’s purchase price as a down payment. This insurance covers the lender for the difference in the down payment and 20% of the home’s value. If the loan were to be resold, the PMI would be included with the loan as owned by the new purchaser. Whether PMI should be included in the CECL estimate, two factors should be present in order for the PMI to be freestanding: whether the PMI is (1) legally detachable and (2) separately exercisable.

Because the PMI travels with the loan, and the new purchaser of the loan would also own the PMI, it is not legally detachable. Therefore, the PMI is not freestanding and should be considered in the calculation of expected credit losses.

Mortgage insurance is purchased to insure a pool of existing mortgage loans, and the purchase can occur separate and apart from the origination of the loans.

Because premiums receivables are trade accounts receivables, they are within the scope of ASC Topic 326. However, Subtopic 326-20 states that policy loan receivables of an insurance entity are excluded from the scope of this Subtopic. As discussed previously, a credit enhancement should be considered for the purposes of estimating credit losses only if it is not freestanding. Therefore, a freestanding credit insurance contract should not be considered when estimating CECL.

Insurance claim accounting depends on several factors, including the claim nature, the proceeds amount, and the loss and corresponding recovery timing. In addition, insurance proceeds accounting is affected by claim coverage evaluation and the insurance company's ability to satisfy a claim.

The accounting for proceeds from insurance depends on whether the proceeds partially or fully cover or exceed the amount of loss recognized. Proceeds from freestanding insurance covering, but not exceeding, the amount of a loss are considered insurance recoveries.

Reinsurance recoverables that result from insurance transactions that are within the scope of Topic 944 are accounted for under the guidance in Topic 326 for determining credit losses. However, reinsurance recoverables for pooling arrangements with entities under common control would not be within the scope of Subtopic 326-20 because loans and receivables between entities under common control are not in the scope of Subtopic 326-20.

Anticipated proceeds in excess of the amount of loss recognized would be considered a gain, subject to gain contingency guidance in ASC Topic 450. Anticipated proceeds in excess of a loss recognized in the financial statements may not be recognized until all contingencies related to the insurance claim are resolved.

## **Collateralized Financial Assets**

For collateralized financial assets, regardless of the initial measurement method, a reporting entity shall measure expected CECL impairment based on the collateral when reporting entity determines that foreclosure is probable. At this time, the reporting entity remeasures the financial asset at the collateral's fair value so that the reporting of a credit loss is not delayed until actual foreclosure. An entity also shall consider any financial asset credit enhancements when recording the CECL allowance.

If foreclosure is not probable, the reporting entity evaluates collateral value changes at the same time as its CECL assessment. In the period the reporting determines that foreclosure is probable, it must determine the collateral fair value and recognize an allowance. The allowance is measured by deducting the collateral fair value from the financial asset's amortized cost.

If the collateral fair value is less than the financial asset's amortized cost, the difference should be recognized as an allowance for expected credit losses at the measurement date. The allowance for expected credit losses may be zero if the fair value of the collateral the measurement date exceeds the amortized cost basis of the financial asset.

For collateral-dependent financial assets, reporting entities may use a practical expedient to measure CECL based on the collateral's fair value at the reporting date. This would be for determining the CECL allowance when repayment is expected to be provided substantially through the collateral's operation or sale when a borrower is experiencing financial difficulty.

Using this practical expedient on a collateral-dependent financial asset depends on how an entity measures the collateral fair value when estimating CECL depends on whether financial asset repayment is expected to be from the collateral's operation or sale.

- Operation—the fair value is the present value of expected cash flows from operating the collateral (an income approach)

Note that selling costs are not used if the reporting entity expects that repayment will come through the collateral operation.

- Sell—the fair value is the collateral fair value less the present value of the costs to sell. The present value of estimated costs to sell is determined by the estimated selling costs and the timing of the collateral sale

ASC Topic 326 does not address what comprises costs in a collateral sale. In reviewing what most major accounting firms feel the costs in a collateral sale should represent, it is widely believed that “costs to sell” are incremental direct costs incurred to sell the collateral. This view reflects guidance in other areas of GAAP.

ASC Topic 360, *Property, Plant, and Equipment*, impairment that defines “costs to sell” as “incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made.”

ASC Topic 310, *Receivables*, defines “incremental direct costs” in a similar manner, as costs that “result directly from and are essential to the lending transaction and would not have been incurred by the lender had that lending transaction not occurred.”

Therefore, costs to sell should include brokerage fees, legal and transfer fees, and closing costs that would not have been incurred if the reporting entity had not sold the collateral. Property taxes and insurance expected to be paid by the lender on behalf of the borrower would be considered carrying costs and not costs to sell.

ASC Section 326-20-35-4 states that estimated costs to sell collateral must be considered when foreclosure is probable when the reporting entity intends to sell the collateral. This treatment is consistent with the practical expedient (discussed below) when the financial asset's repayment or satisfaction depends on selling the collateral.

A collateral-dependent asset exists when meeting both of the following:

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

At each reporting date, reporting entities need to re-evaluate the above criteria about whether a collateralized financial asset still meets the collateral-dependent definition. Borrower situations may change such that it may no longer be experiencing financial difficulty, or the reporting entity may no longer be expecting loan repayment through selling or operating the business (collateral).

For collateralized financial assets that do not meet the collateral-dependent definition, ASC Topic 326 states that

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 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 a collateral-dependent financial asset, an entity may expect zero CECL when the collateral's fair value less selling cost is equal to or exceeds the financial asset's amortized cost basis. If the collateral's fair value is less than the amortized cost basis of the financial asset the CECL measurement is the difference between the fair value of the collateral less selling costs and the financial asset's amortized cost basis.

### EXAMPLE

#### *CECL Practical Expedient for Collateral-Dependent Financial Assets*

This example is for estimating CECL on a collateral-dependent financial asset for a borrower experiencing financial difficulty based on the reporting entity's assessment.

Bank F provides commercial real estate loans to developers of luxury apartment buildings. Each loan is secured by a respective luxury apartment building. Over the past two years, comparable standalone luxury housing prices have dropped significantly, while luxury apartment communities have experienced an increase in vacancy rates.

At the end of 20X7, Bank F reviews its commercial real estate loan to Developer G and observes that Developer G is experiencing financial difficulty as a result of, among other things, decreasing rental rates and increasing vacancy rates in its apartment building.

#### Scenario 1: Repayment depends on selling the collateral

After analyzing Developer G's financial condition and the operating statements for the apartment building, Bank F believes that it is unlikely Developer G will be able to repay the loan at maturity in 20X9. Therefore, Bank F believes that loan repayment is expected to be substantially through the foreclosure and sale (rather than the operation) of the collateral.

As a result, in its financial statements for the period ended December 31, 20X7, Bank F selects the ASC Topic 326 practical expedient and uses the apartment building's fair value less costs to sell when developing its CECL estimate.

Amortized cost of the loan	\$16,500,000
Fair value of the collateral	\$15,100,000
Estimated cost to sell	(90,000)
FV less cost to sell	15,010,000
Total expected credit losses	\$1,490,000

#### Scenario 2: Repayment depends on the operation of the collateral

After analyzing Developer G's financial condition and the operating statements for the apartment building, Bank F believes it is unlikely Developer G will be able to repay the loan at maturity in 20X9. However, it also believes that it could substantially recover its investment through operating the collateral (business) by engaging a property management company to manage the leasing of the apartments for the next eight years.

As a result, in its financial statements for the period ended December 31, 20X1, Bank F selects the ASC Topic 326 practical expedient and uses the PV of the cash flows from operation of the collateral to determine its CECL estimate. The amortized cost is compared to the PV of the cash flows to determine what the CECL estimate should be.



Amortized cost of the loan	\$16,500,000
Present value of expected cash flows	\$15,100,000
Total expected credit losses	\$1,400,000

For certain financial assets secured by **collateral maintenance provisions**, the borrower may be required to continually adjust the collateral amount when the fair value changes. A practical expedient is to measure CECL by comparing the amortized cost basis with the collateral's fair value at the reporting date.

To apply this practical expedient, a reporting entity needs to consider whether the borrower can continue to replenish the collateral. This requirement of assessing the expectation of nonpayment introduces the concept of assessing the counterparty's ability to continue to adjust the collateral in the future.

In certain situations, a reporting entity may determine that the amortized cost basis nonpayment expectation is zero. This could occur when the following occur:

- The borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral continues to be equal to or exceed the financial asset's amortized cost basis.
- The reporting entity expects the borrower to continue to replenish the collateral as necessary.

ASC Topic 326 does not define the term “continually” regarding the timing for adjusting the collateral amount securing the financial asset. The less frequently the collateral is adjusted, the more challenging it will be for a reporting entity to assert that collateral is continually adjusted. Reporting entities need to consider factors such as the collateral's liquidity and the collateral posting frequency to determine whether it can apply this practical expedient.

This situation may occur in repurchase arrangements in which the “repo party” borrows funds in exchange for highly liquid securities that are 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).

If the fair value of the collateral at the measurement date is less than the amortized cost basis of the financial asset, the standard requires the entity to evaluate the difference between the fair value of the collateral at the measurement date and the amortized cost basis of the financial asset for expected credit losses.

#### EXAMPLE

##### ■ *CECL Practical Expedient for Financial Assets with Collateral Maintenance Provisions*

Bank H enters into a reverse repurchase agreement with Entity I that needs short-term financing. Under the terms of the agreement, Entity I sells securities to Bank H with the expectation that it will repurchase those securities for a certain price on an agreed-upon date.

In addition, the agreement contains a provision that requires Entity I to provide security collateral that is valued daily and the amount of the collateral is adjusted up or down to

reflect changes in the fair value of the underlying securities transferred. This collateral maintenance provision design ensures that at any point during the arrangement, the fair value of the collateral continually equals or is greater than the amortized cost basis of the reverse repurchase agreement.

At the end of the first reporting period, Bank H evaluates the reverse repurchase agreement's collateral maintenance provision to determine whether it can use the ASC Topic 326 practical expedient for estimating expected credit losses. Bank H determines that there is a risk that Entity I may default.

Bank H's expectation of nonpayment of the amortized cost basis on the reverse repurchase agreement is zero. This is because Entity I continually adjusts the collateral amount such that the fair value of the collateral is always equal to or greater than the amortized cost basis of the reverse repurchase agreement. Bank H continually monitors that Entity I adheres to the collateral maintenance provision.

Bank H uses the ASC Topic 326 practical expedient and does not record expected CECL reserve because the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Bank H performs a reassessment of the fair value of collateral in relation to the amortized cost basis each reporting period.

Based on these facts, Bank A elects to apply the practical expedient in ASC Topic 326 and measures CECL by comparing the fair value of the collateral with the receivable's amortized cost basis (\$980 plus accrued interest).

At the measurement date, the amortized cost of the receivable is \$1,000. Bank A determines that the fair value of the collateral is currently 97% of the receivable's amortized cost, which is below the required collateralization level of 102%. Accordingly, Bank A notifies Dealer B that it needs to post additional collateral. Based on the agreement, Dealer B is permitted to post the additional collateral on the next business day, and, therefore, at the measurement date, the fair value of the collateral of \$970 is less than the amortized cost of the receivable of \$1,000.

Bank A expects the borrower to continue to replenish the collateral based on an assessment of the counterparty's creditworthiness and is able to establish a "zero loss expectation" for the portion of the receivable (\$970) that is fully collateralized at the measurement date. Bank A will assess the difference of \$30 (\$1,000 amortized cost less \$970 collateral fair value) for expected credit loss under the CECL model.

## Interest Income and Non-Accrual Policies

Under the guidance in ASC Section 835-30 and Section 310-20, recognize accrual interest income on a debt instrument as follows:

$$\text{Amortized Cost} \times \text{Effective Interest Rate} = \text{Interest Income}$$

Many entities apply nonaccrual policies and methods to mitigate the risk of overstating interest income when collection is doubtful. Classifying a financial debt asset on non-accrual status means stopping accruing interest income recognition.

US GAAP does not provide guidance on when to apply a nonaccrual policy for many financial assets, other than for beneficial interests in securitized financial assets and purchased credit deteriorated assets. Because of no guidance, several approaches exist in practice. The two most common methods are:

- Cash basis—recognize contractual interest payments as interest income if and when received, rather on an accrual basis

- Cost recovery—apply all cash collected, whether contractual principal or contractual interest, to the asset’s amortized cost basis

Reporting entities may use either method and the method applied may vary by financial instrument based on the extent of credit deterioration and the collection likelihood. For example, cost recovery is often applied to non-accrual assets that have the lowest credit quality.

Nonaccrual policies can affect whether reporting entities have to estimate expected credit losses on accrued interest. **ASU 2019-04, Codification Improvements to Topic 326 (and other Topics)**, allows a reporting entity to make an accounting policy election to separately measure an allowance for credit losses on accrued interest receivables from other components of the amortized cost basis. Reporting entities may also make an accounting policy election about where to present and disclose accrued interest receivables and the related allowance for credit losses. Reporting entities that write-off uncollectible accrued interest receivables in a timely manner can make a policy election not to measure an allowance on the accrued interest receivable. Entities must disclose the accounting policy elections.

The choice of non-accrual policy can impact the amount and timing of interest income, write-offs, and credit loss allowances on accrued interest. The method used to account for any contractual interest payments collected while an asset is on nonaccrual status has a direct effect not only on interest income but also on the amount of any future write-off. Thus, disclosure is important for financial statement users to compare interest income and credit loss information among different reporting entities.

The following table shows the potential impact of a reporting entity’s non-accrual accounting policy:

	Non-Accrual Policy Cash Basis	Non-Accrual Policy Cost Recovery	No Policy
<b>Contractual Interest Collected</b>	1. Lower interest income and write-offs than no policy 2. Greater interest income and write-offs than cost recovery method	1. Interest applied to asset's amortized cost 2. Lower interest income and write-offs than cash basis	1. Contractual interest continues to accrue and increase asset's amortized cost
<b>No Contractual Interest Collected</b>	Write-offs and interest income lower than no policy	Write-offs and interest income lower than no policy	2. Write-offs higher than if non-accrual policy in place

## Foreign Currency Considerations

Foreign currency impacts AFS differently than HTM.

Debt instruments measured at amortized cost are monetary assets because their settlement amounts are fixed and do not depend on future prices. When a debt instrument is denominated in a currency other than the holder’s functional currency, any change in exchange rates between the holder’s functional currency and the asset’s currency denomination will impact functional currency cash flows and, therefore, the asset’s amortized cost. ASC Topic 830, *Foreign Currency Matters*, classifies these currency rate changes as foreign currency transaction gains or losses, which impact net income.

Foreign currency transaction gains or losses related to debt instruments measured at amortized cost are recognized in earnings in the period in which exchange rates change. As a result, the current exchange rate is used to measure both the functional-currency-equivalent fair value and the amortized cost basis of the asset when estimating the allowance for expected credit losses.

## Comparison of AFS to HTM Debt Securities—Credit Loss Guidance

	<b>Unit of Account</b>	<b>Credit Loss Measurement</b>	<b>Recognition Timing</b>	<b>Credit Loss Recognition</b>	<b>Write-off Timing</b>
AFS:	Individual debt security	Excess of amortized costs basis over the present value of expected future cash flows	When amortized costs exceeds fair value	Through allowance	When it is deemed uncollectible
HTM:	Pool basis, if similar risk characteristics	Amount needed to reduce the amortized cost basis to reflect the net amount expected to be collected	Upon acquisition of the security	Through allowance	When it is deemed uncollectible

**EXAMPLE**

Allowance for credit losses for a foreign-currency-denominated HTM debt security

- 1/1/20X0 USD Company purchased 5-year, \$10,000 CAD par bond, 5% coupon
- Classified as an HTM debt security
- Spot exchange rate at 1/1/20X0 equals \$1 CAD: \$1 USD
- Spot exchange rate at 12/31/20X0 equals \$1 CAD: \$0.95 USD
- PV of expected cash flows discounted at 5% (original effective rate) at 12/31/20X0 equals \$8,550 CAD
- As of 12/31/20X0, amortized cost basis equals \$10,000 CAD

Solution: Entity E estimates its allowance for expected credit losses using a DCF approach and estimates the cash flows it expects to receive based on historical experience, current conditions and reasonable and supportable forecasts of economic conditions.

Impairment due to credit. Recognize credit loss in earnings through an allowance.

Amortized cost equals \$10,000 CAD – \$8,550 CAD = \$1,450 CAD × \$0.95 / \$1 CAD = \$1,378

Entry at 12/31/X0:

Dr. Credit Loss Expense	\$1,378
Cr. Allowance for Credit Loss	\$1,378

Foreign currency exchange. Recognize the loss in earnings.

Amortized cost at 1/1/20X0 = \$10,000 CAD × \$1 USD / \$1 CAD = \$10,000

Less: amortized cost at 12/31/20X0 = \$10,000 CAD × \$0.95 USD / \$1 CAD = \$9,500

\$10,000 – \$9,500 = \$500 FX loss

Entry at 12/31/20X0:

Dr. Foreign currency loss	\$500
Cr. HTM security – FX adjustment	\$500

The carrying value of the investment as of December 31, 20X0 is as follows:

Amortized cost basis	\$10,000
Less foreign currency loss	<u>\$(500)</u>
New amortized cost basis	\$9,500
Less allowance for credit loss	<u>\$(1,378)</u>
Net carrying value	\$8,122

## ACCOUNTS RECEIVABLE AND OTHER SHORT-TERM FINANCIAL ASSETS

A reporting entity must measure expected credit losses on short-term financing receivables, such as trade accounts receivable. The measurement methods to estimate expected credit losses may differ from the methods used for longer-term financing receivables, such as loans. Not different, however, is still considering the financial asset's contractual life, credit loss risk, and reasonable and supportable forecasts of future economic conditions. Due to their short-term nature, adjusting historical losses to reflect expectation of future economic conditions involves less measurement uncertainty than for longer-term financial assets.

Because Subtopic 326-20 requires an entity's allowance for credit losses to reflect the risk of loss, even when that risk is remote, a reporting entity should have an expected credit loss for most, if not all, receivables, including the following:

- Receivables from borrowers that are current on their payment
- Individually significant receivables from large customers
- Very short-term receivables that are typically settled in a matter of days, such as credit and debit card receivables from banks

As previously noted, entities can use various methods to measure expected credit losses, such as pooling receivables based on age or delinquency pools. The most common pools are current, 0–30 days past due, 31–60 days past due, 61–90 days past due, and more than 90 days past due. The measurement method is applying historical loss rates to each pool.

The example in the “vintage method” discussion earlier in this course describes how to apply ASC Topic 326 to accounts receivable.

### Receivables Resulting From Applying ASC Topic 606, From Revenue Recognition

According to ASC Topic 606, *Revenue from Contracts with Customers*, if a reporting entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable.

A contract asset is the right to consideration in exchange for goods or service that the entity has transferred to a customer. A reporting entity must assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset must be measured, presented, and disclosed.

According to ASC Topic 606, a receivable is the right to consideration that is unconditional, which means only the passage of time is required before consideration payment is due. For

example, a reporting entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with ASC Topic 310, *Receivables*, and Subtopic 326-20.

Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of revenue recognized shall be presented as a credit loss expense.

As part of the five-step revenue recognition process in ASC Topic 606, a reporting entity must determine whether collection of the transaction price, which is adjusted for price concessions, is probable. If collection is probable, record revenue and a receivable or contract asset. If collection is not probable, do not recognize a receivable or a contract asset on the balance sheet.

If a reporting entity determines that collection is probable, that does not mean that the risk of expected lifetime credit loss is zero. Entities need to apply Subtopic 326-20 to estimate expected credit losses on a contract asset or receivables resulting from the application of ASC Topic 606.

Under ASC Topic 606, reporting entities record contract assets which represent the conditional right to consideration for goods or services it has provided when that right is conditioned on something other than the passage of time. Most commonly, this condition is the reporting entity's future performance.

Reporting entities in various industries have long-term contracts with customers that may result in contract assets. Examples would be a contract that provides an asset and the related maintenance to that asset for a specified period of time, like a cell phone that is free for a period of time with the service contract or a contract for a software license and the related customer support for the software.

A reporting entity assesses contract assets for impairment using the CECL model and incorporates reasonable and supportable future economic conditions forecasts into their estimates of expected credit losses, particularly for contract assets that have longer lives. As part of this assessment, a reporting entity distinguishes between expected losses due to credit risk and losses attributable to non-credit other factors, such as the reporting entity's non-performance.

## **Net Investment in a Lease**

ASC Subtopic 326-20 applies to a lessor's net investment in a sales-type or a direct financing lease in ASC Topic 842, *Leases*, which is the new leases standard.

ASC Subtopic 326-20 also applies to a sale and leaseback transaction where the asset transfer is not a sale and the lessor accounts for the transaction as a financing. Lessor amounts paid are a financing receivable.

### **ASU 2018-19, Codification Improvements to Topic 326, clarified that operating lease receivables are not in the scope of ASC Topic 326.**

ASC Subtopic 326-20 requires that a lessor recognize an allowance for credit losses on its net investment in leases. When determining this loss allowance, a lessor takes into consideration the collateral relating to the net investment in the lease. This collateral represents the cash flows the lessor would expect to receive from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.

When measuring expected credit losses on net investment in leases using a discounted cash flow method, use the discount rate measuring the lease receivable (the rate implicit in the lease) and not the effective interest rate.

The lessor's net investment in a lease is a single unit of account for purposes of determining the allowance for credit losses, even though risks other than credit will be incorporated into the credit loss estimate. A lessor estimates a loss allowance on its entire net investment in the lease, including the unguaranteed residual value. It includes the following:

- Lease receivable—includes the following two items discounted at the rate implicit in the lease
  - the lessor's right to receive lease payments
  - any amount a lessor expects to derive from the underlying asset at the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor. This is commonly known as the guaranteed residual asset.
- Unguaranteed residual asset—any amount the lessor expects to derive from the underlying asset at the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted at the rate implicit in the lease.
- Deferred selling profit—this only applies to direct financing leases and is any deferred selling profit. This reduces the lessor's net investment in the lease.

A reporting entity estimates the credit loss allowance for a net investment in a lease, considering both:

- Default risk during the lease term—including lost rental payments risk, the benefits of guaranteed residual assets, and the loss risk on unguaranteed residual assets
- Loss risk if a default does not occur—this relates exclusively to losses on the unguaranteed residual assets due to changes in their value or their obsolescence.

Non-lease components—exist in many contracts that contain a lease coupled with an agreement to purchase or sell other goods or services. For example, a retail space lessor may also provide common area maintenance services to a lessee. If the lessor recognizes receivables for these non-lease components (and the receivables are financial assets measured at amortized cost), the receivables are subject to the CECL model.

The following example shows one approach for determining the loss on a net investment in a lease. The approach uses a  $PD \times LGD$  model which does not discount the losses.

#### **EXAMPLE**

EmCo. sells and leases manufacturing equipment and enters into a 10-year equipment lease with Prod Co. on December 31, 20X3. The equipment has an alternative use to EmCo. at the end of the 10-year lease term and has a useful life of 13 years. The lease terms are:

- Annual lease payments are \$14,000
- Expected residual value of the equipment at the end of the lease term that is included in the net investment in the lease is \$27,000
- Net investment in the lease is \$129,500
- There is no residual value guarantee provided by Prod Co. or any other third party.
- This is a sales-type lease and lease payment collectability is probable.

EmCo. recognizes a net investment in the lease asset (the equipment) and therefore no longer recognizes the equipment. It groups this net investment in the lease with other

10-year equipment leases with similar characteristics to these equipment leases made to borrowers that have similar credit ratings to Prod Co.

EmCo. correlates losses on similar leases to unemployment rates because the demand for products produced by this type of equipment declines when consumers don't have steady employment—meaning when unemployment rates are high. To estimate losses expected during the lease term, EmCo. determines the following:

- Probability of default (PD)—EmCo's historical loss experience indicates that 3% of similar lessees default on the equipment leases when unemployment rates are high because demand for the products the equipment is used to produce declines. As of December 31, 20X3, new unemployment rates are low, but EmCo. believes that rates will increase in 20X4 and will not return to normal until 20X6, resulting in an adjusted expected loss rate of 5% over the life of the leases in this pool.
- Loss given default (LGD)—EmCo. assesses the expected residual value included in the net investment in the lease. Since the unemployment rate drives demand for new products, an unfavorable rate of employment implies that the fair value of the equipment will also decline, due to a decline in the demand for the equipment. As a result, EmCo. adjusts its historical losses upon a default for leases in this pool by 5% from 10% to 15%.

Using the pool-based assumptions above, EmCo. calculates the allowance of lease defaults on this individual lease as follows:

$$\text{Expected credit losses} = \text{Net investment in the lease} \times (\text{PD} \times \text{LGD})$$

$$\text{Expected credit losses} = \$129,500 \times 5\% \times 15\% = \$971$$

EmCo. continues its loss allowance evaluation by also considering the likelihood of a loss on the expected residual value. This assumes the lessee makes all contractual payments on the lease, which means a lease default does not occur. This evaluation includes:

- The \$27,000 residual value in the net investment in the lease
- The probability of default (PD) on the lease will not occur is calculated as follows:
- $100\% - 5\%$  probability of lease default = 95%
- The loss given default (LGD) on the residual value at the end of the lease term is 5%.
- This is based on historical losses adjusted for current conditions and reasonable and supportable forecast of future economic conditions.

EmCo. has historically experienced losses at the end of the lease term averaging 5% of the expected residual value included in the net investment in the lease. Because EmCo. expects unemployment rates to be stable at the end of the lease term, it uses this estimate.

$$\text{Expected loss on the unguaranteed residual value} = \$27,000 \times 95\% \times 5\% = \$1,283$$

$$\text{Therefore, the total loss allowance on this lease} = \$971 + \$1,283 = \$2,254.$$

## ASC TOPIC 460, GUARANTEES, AND ASC SUBTOPIC 326-20 CECL

ASC Topic 460, *Guarantees*, provides accounting guidance for guarantees. A reporting entity that issues guarantees must evaluate whether the guarantee is also in the scope of ASC Subtopic 326-20. This section focuses on guarantor accounting for guarantees that relate to estimated credit losses.



A guarantee contract contingently requires a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Examples of financial guarantees are:

- a. A financial standby letter of credit
- b. A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
- c. A guarantee of the market price of the common stock of the guaranteed party
- d. A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity
- e. A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.
- f. For debt guarantees, it does not matter whether the guaranteed party is the creditor or the debtor, that is, whether the guarantor is required to pay the creditor or the debtor (who would then have the funds to pay its debt to the creditor).

The underlying is the debtor's failure to make scheduled payments or the occurrence of other events of default. The underlying could be related to either the creditor's receivable or the debtor's liability.

Issuing a guarantee obligates the guarantor (the issuer) in two aspects:

1. Non-contingent aspect—the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur.
2. Contingent aspect—the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

For guarantees that are within the scope of ASC Subtopic 326-20, the expected credit losses (the contingent aspect of making payments if a triggering event or condition occurs) are measured and accounted for separately from the fair value of the guarantee (the non-contingent aspect of standing ready to perform).

Issuing a guarantee imposes a non-contingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur. A guarantor may initially recognize a guarantee liability even though it is not probable that payments will be required under that guarantee. Similarly, for guarantees within the scope of ASC Subtopic 326-20, the requirement to measure a guarantor's expected credit loss on the guarantee should not be interpreted as prohibiting a guarantor from initially recognizing a liability for the non-contingent aspect of a guarantee.

To determine the appropriate initial recognition and measurement of a guarantee in the scope of ASC Topic 460, a guarantor must determine whether the guarantee is in the scope of ASC Subtopic 326-20. Not all guarantees in the scope of ASC Topic 460 are also in the scope of ASC Subtopic 326-20.

The CECL model measures expected credit losses on credit exposures, such as the nonpayment of financial obligations. It does not measure exposures to other risks, so not all financial guarantees are in its scope.

Financial guarantees contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity

security of the guaranteed party. An arrangement must have all of the following characteristics to be a financial guarantee:

- The guarantee of payment relates to a change in an underlying
- The underlying must be an asset, liability or equity security. The payment by the guarantor cannot be avoided
- The contingent payment can only flow from the guarantor to the guaranteed party
- The payments must be contingent on changes to the underlying

ASC Subtopic 326-20 includes, in its scope, off-balance-sheet credit exposures not accounted for as insurance. This includes financial standby letters of credit and financial guarantees not accounted for as insurance, except guarantees in the scope of ASC Topic 815, *Derivatives and Hedging*. To be considered a financial guarantee in the scope of ASC Subtopic 326-20, a financial guarantee must relate to the nonpayment of a financial obligation. Examples include the following:

- A financial standby letter of credit

Commercial letters of credit, however, do not meet the definition of a guarantee because the issuing bank makes the payments directly to the beneficiary on behalf of a customer as a primary payment method and does not guarantee payment in the event of a default.

- A guarantee of the collection of scheduled contractual cash flows from a loan

Banks and financial institutions frequently issue irrevocable financial standby letters of credit. These contracts guarantee the payment by a customer to a third party in borrowing arrangements such as the issuance of commercial paper, a bond financing, or a private placement debt.

## Initial Guarantee Measurement

The initial guarantee liability measurement is the fair value of the guarantee at its inception. For example, if a guarantee is issued

- a. in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee shall be the premium received or receivable by the guarantor as a practical expedient;
- b. as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, a guarantor shall consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party as a practical expedient; or
- c. as a contribution to an unrelated party, the liability recognized at the inception of the guarantee shall be measured at its fair value is the contribution fair value.

At the inception of a guarantee within the scope of ASC Subtopic 326-20 on financial instruments measured at amortized cost, the guarantor is required to recognize both of the following as liabilities:

- a. The guarantee fair value under ASC Topic 460
- b. The contingent liability related to the expected credit loss for the guarantee measured under ASC Subtopic 326-20

- c. Reporting entities must measure the expected credit losses arising from the contingent aspect under the CECL model in addition to recognizing the liability for the noncontingent aspect of the guarantee under ASC Topic 460.

The presentation of expected credit losses on financial guarantees in the scope of ASC Subtopic 326-20 differs from the presentation of expected credit losses on financial assets measured at amortized cost.

- For ASC Subtopic 326-20 financial guarantees, a guarantor recognizes a standalone liability representing the amount that it expects to pay on the guarantee related to expected credit losses.
- For financial assets measured at amortized cost, by contrast, a reporting entity recognizes an allowance for expected credit losses (contra-asset) representing the portion of the amortized cost basis of a financial asset that an entity does not expect to collect.

If the guaranteed party agreed to pay a premium in exchange for the guarantee but the premium is not received at the time the guarantee became effective, the guarantor would recognize a premium receivable. This premium receivable would also need to be assessed for expected credit losses (both at initial and subsequent measurement) in accordance with ASC Subtopic 326-20.

#### EXAMPLE

In this example, Bank issues a one-year \$1,000,000 loan to Borrower on January 1, 20X0.

At the same time, Guarantor issues a guarantee to Bank that Borrower will make each quarterly principal and interest payment due to Bank in 20X0. Bank agrees to a premium for the guarantee of \$30,000, payable in 30 days. Guarantor and Bank are unrelated entities, and the guarantee was issued in a standalone arm's length transaction.

Guarantor determines that the guarantee is a financial guarantee in the scope of ASC Topic 460 and ASC Subtopic 326-20 because it is the guarantee of a credit exposure relating to the nonpayment of a financial obligation.

Guarantor recognizes a \$30,000 premium receivable from Bank and a \$30,000 guarantee liability in accordance with ASC Topic 460 for the non-contingent aspect of the guarantee. In accordance with Topic 460, guarantor determines that the FV of the financial guarantee liability recognized at inception is the premium received. This is because the guarantee was issued in a stand-alone arm's-length transaction.

Guarantor determines there is a high likelihood that a contingent payment will not be made on this individual guarantee. However, Guarantor is in the business of issuing these types of guarantees and experience shows that when the Bank guarantee is pooled with other guarantees with similar risk characteristics, some portion of the guarantees in the pool will require payment.

Guarantor includes this guarantee in a pool of similar guarantees and gives consideration to historical experience, current conditions and reasonable and supportable forecasts of future economic conditions. Guarantor estimates the expected credit loss for the guarantee to be \$5,000.

Guarantor also evaluates the credit risk associated with the premium receivable from Bank, considering historical experience, current conditions and reasonable and supportable forecasts of future economic conditions. Based on this information, Guarantor believes a loss should be applied to premiums receivable in this pool and records an allowance of \$1,000.

Guarantor records the following journal entry to account for the guarantee on January 1, 20X0:

Dr. Premium receivable	\$30,000
Dr. Credit loss expense—guarantee	\$5,000
Dr. Credit loss expense—premium receivable	\$1,000
Cr. Guarantee liability—noncontingent aspect	\$30,000
Cr. Guarantee liability—contingent aspect	\$5,000
Cr. Allowance for expected credit losses—receivables	\$1,000

### Subsequent Guarantee Measurement

For the **non-contingent aspect**, ASC Topic 460 does not provide detail for measuring the guarantor's guarantee liability after initial recognition. Reduce the guarantor's initial liability by a credit to earnings as the guarantor is released from risk under the guarantee.

Depending on the nature of the guarantee, guarantor's recognize risk release over the guarantee's term using one of the following three methods. ASC Topic 460 also does not provide comprehensive guidance, which requires significant management judgment.

- Upon either expiration or settlement of the guarantee
- By a systematic and rational amortization method
- As the fair value of the guarantee changes

A guarantor is not free to choose any of the three methods subsequently to measure the guarantee liability. A guarantor shall not use fair value in subsequently accounting for the liability for its obligations under a previously issued guarantee unless the use of that method can be justified under GAAP. For example, fair value is used to subsequently measure guarantees accounted for as derivative instruments under ASC Topic 815.

The guarantee's **contingent aspect** shall be accounted for following ASC Subtopic 450-20, *Loss Contingencies*, unless the guarantee is accounted for as a derivative instrument under ASC Topic 815 or the guarantee is within the scope of ASC Subtopic 326-20 on financial instruments measured at amortized cost.

For guarantees within the scope of ASC Subtopic 326-20, the expected credit losses (the **contingent aspect**) of the guarantee shall be accounted for under ASC Topic 326 in addition to and separately from the fair value of the guarantee liability (the **noncontingent aspect**) accounted for under ASC Topic 460.

#### EXAMPLE

In this continuing example, the same fact pattern exists as the previous example.

The new facts are Borrower has paid in full its first quarterly principal and interest payment to ABC Bank under the terms of the loan agreement on March 31, 20X0.

Guarantor determines the subsequent measurement of the guarantee for purposes of its March 31, 20X0 financial statements as follows:

- For the non-contingent aspect, guarantor recognizes the release from risk as Borrower makes payments. (This is changes in the underlying). During the first quarter of

20X0, Guarantor recognizes \$5,500 in income and the remaining guarantee liability is \$24,500 on March 31, 20X0 (for simplicity, this assumes each quarterly payment includes straight-line amortization of the loan's principal balance).

- For the contingent aspect, guarantor continues to evaluate expected credit losses in accordance with ASC Subtopic 326-20. Based on historical experience, current conditions, and reasonable and supportable forecasts of future economic conditions, guarantor determines that its expected credit losses on the guarantee (after considering pool-based factors) are \$500, down from the \$1,000 recorded at inception.

Guarantor records the following journal entries at March 31, 20X0:

Dr. Guarantee liability—noncontingent aspect	\$5,500
Dr. Guarantee liability —contingent aspect	\$500
Cr. Other income	\$5,500
Cr. Credit loss expense—guarantee	\$500

Note: Bank paid guarantor the premium for the guarantee of \$30,000 when due on 1 February 20X0. At that time, guarantor reversed the allowance for credit losses that was recognized related to that premium receivable.

### EXAMPLE

#### *Applying ASU 2016-13 to Trade Receivables*

For many practitioners, the obvious application of this standard will be to trade accounts receivable. This example illustrates how existing procedures for the allowance for doubtful accounts might be affected when ASU 2016-13 is adopted.

**Facts:** Assume Company A has estimated the allowance for doubtful accounts (now called allowance for credit losses) based on tiered percentages applied to aging categories. The percentages have been based on recent historical experience. Upon adoption, the aging and historical percentages are:

Past Due Status	Amortized Cost	Credit Loss Rate	Expected Credit Loss Estimate
Current	\$3,000,000	0.4%	\$12,000
1–30 days past due	45,000	5.0%	2,250
31–60 days past due	100,000	10.0%	10,000
More than 60 days past due	120,000	40.0%	48,000
Total	\$3,265,000		\$72,250

**Results:** Company A believes that the method it has used in the past remains valid for estimating expected losses because the composition of receivables is consistent with the past (i.e., risk characteristics similar) and its lending practices have remained the same. However, the Company must now also incorporate reasonable and supportable forecast information in developing the estimate.

The Company has observed that economic conditions have worsened slightly; as a result, sales growth has slowed and unemployment has increased somewhat in the geographic regions and industries in which it operates, and this is expected to continue. It therefore adjusts the historical loss rates to reflect these current and future expected changes. Management estimates that, for receivables currently on the books, credit losses are expected to be 10% more than in the recent past.

It would therefore incorporate a 10% increase in the above estimates for credit losses, adjusting each line and the total allowance in the table above. The resulting allowance for credit losses would therefore be \$79,475.

Discussion Points:

- This example makes clear that the allowance for uncollectible accounts represents an estimated credit loss that must change from an incurred loss model to an expected loss model. The ASU's implementation guidance recognizes that application of the CECL model to trade receivables may not differ significantly from past practice. That is certainly the case in this example. The biggest difference is the consideration of future conditions in estimating the allowance.
- The remaining journal entries associated with write-offs and recoveries are unchanged from current practice.
- The current policy note disclosures for receivables will be largely the same, although the description of how the allowance is estimated will require revision.

## NOTES

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