Current Expected Credit Losses

(CECL4)

KAPLAN

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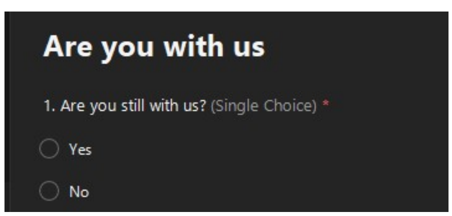

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Program Objectives

- This program's objective is to explain accounting, financial reporting, disclosure, and implementation of the new credit impairment guidance 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 debit assets measured at amortized cost.

Program Topics

1. Introduction to Financial Assets and Credit Losses
2. ASC Section 326-20, The CECL Model

Unit One

Introduction

ASC 326, Financial Instruments – Credit Losses

Learning Objectives - Upon completing this unit, participants will be able to:

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

ASC 326, Financial Instruments – Credit Losses

History

- June 2016 – the Financial Accounting Standards Board ("FASB") issued ASU 2016-13
- Codified into ASC Section 326, *Financial Instruments – Credit Losses*
- Impacts all industries
- Major impact on operations, data management, internal controls, and financial reporting

ASC 326, Financial Instruments – Credit Losses

Significant differences versus legacy guidance

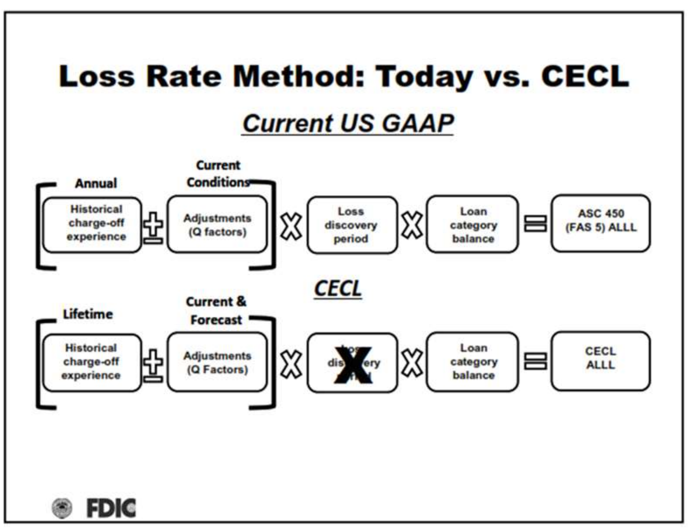
- Recognition threshold – replaced legacy "incurred" losses with "expected" losses
- Unit of measurement – now requires asset "pooling"
- Economic consideration – now consider <u>future</u> economic conditions
- Contract term – was not a factor, now credit loss measurement is over the financial asset's contractual term

ASC 326, Financial Instruments – Credit Losses

Impact of new guidance

- Earlier credit loss recognition
- Increased transparency of credit loss expectations
- Increased transparency of financial asset realizability
- Enhanced comparability of financial asset credit quality

ASC 326, Financial Instruments – Credit Losses



ASC 326, Financial Instruments – Credit Losses

Effective date:

- Public business entities
  - Years beginning after December 15, 2019, including interim periods
  - 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
- Early adoption allowed after December 15, 2018

ASC 326, Financial Instruments – Credit Losses

Effective date:

- Non-public
  - ASU 2019-10, Financial Instruments – Credit Loses (Topic 326), Derivatives and Hedging (Topi 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 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
- Early adoption allowed after December 15, 2018

ASC 326, Financial Instruments – Credit Losses

Transition Methods:

- Modified retrospective approach with a cumulative-effect adjustment to retained earnings as of the beginning of the adoption period
- A prospective approach for Purchased Credit Deteriorated (PCDs) assets held at the time of adoption
    - Immediately record credit loss allowance with the offset debiting the amortized cost
    - Intended to provide transition relief so don't have to determine expected credit losses that would have been booked when the assets were first acquired

ASC 326, Financial Instruments – Credit Losses

Background:

- ASU 2016-01, Financial Instruments – Overall in January 2016
- ASU 2016-13, Financial Instruments – Credit Losses in June 2016
- ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities in August 2017
- ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities

ASC 326, Financial Instruments – Credit Losses

ASU 2016-01 (ASC Topic 825, Financial Instruments – Overall)

- Measure all equity instruments at fair value
- All FV changes flow through ordinary income
- New measurement if FV not readily determinable
- New recognition using FV option
- Effective after December 15, 2017, for PBEs
- Effective after December 15, 2018, for others

ASC 326, Financial Instruments – Credit Losses

ASU 2016-01 (ASC Topic 825, Financial Instruments – Overall)

- Codified into new Topic 321, Investments – Equity Securities
- Defines equity security
- ASC Topic 320 amended now only to cover Investments – Debt Securities

ASC 326, Financial Instruments – Credit Losses

ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities (ASC Topic 815)

- FASB three-prong financial instruments approach
- Simplify hedge effectiveness
- Clarify financial statement presentation
- Expanded hedging risk components
- ASU 2018-16 impacts interest rate hedges
- Simplify hedge documentation and effectiveness assessment
- Disclosures

ASC 326, Financial Instruments – Credit Losses

ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities (ASC Topic 815)

- Effective after December 15, 2018, for PBEs
- Effective after December 15, 2019 (one year more for interim), for all others
- Permits early adoption
- Both modified retrospective and cumulative effective approaches

ASC 326, Financial Instruments – Credit Losses

ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities (ASC Topic 825, Financial Instruments)

- Technical corrections to ASC 2016-01
- Issues 1 and 2 – Equity securities without readily-determinable FV
- Issue 3 – Forward contracts and purchase options
- Issue 4 – Presentation for FV option liabilities
- Issue 5 – FV option liabilities in a foreign currency
- Issue 6 – Transition guidance equity securities

ASC 326, Financial Instruments – Credit Losses

ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities (ASC Topic 825, Financial Instruments)

- Effective date same as ASU 2016-01
- After December 15, 2017, for PBEs
- After December 15, 2018, for others

ASU 2019-04

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:

1. Impact on ASC Topic 326:
   - Accrued interest
   - Recoveries
   - Future interest rate environment projections
   - Prepayment considerations

ASU 2019-04

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:

2. Impact on ASC Topic 815:
   - Partial-term FV hedges
   - FV hedge basis adjustments
   - NFP and private company clarifications
   - First payments—received cash flow hedging
   - Transition requirement changes

ASU 2019-04

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:

3. Impact on ASC Topic 825:
    - Fair value measurement (ASC Topic 820)
    - Equity security without a readily determinable FV
    - Nonrecurring FV measurement disclosures
    - Transition date depends on whether new financial instruments updates not yet adopted

ASU 2019-05

ASU 2019-05, Financial Instruments – Credit Losses (ASC Topic 326) Targeted Transition Relief

- Allows reporting entities to elect irrevocably the fair value option for certain financial instruments, upon adopting ASC Section 326-20
- Reduces complexity – dual measurement methodology
- Improve comparability to other financial instruments measured at amortized cost held by the same reporting entity
- The financial instruments must both be:
    - Within the scope of ASC Section 326-20, the CECL model
    - Eligible for the fair value option in ASC Section 825-10
- Effective with ASC Topic 326 in 2020 for PBEs and 2022 for others

ASU 2020-02

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)

- Amended the accounting guidance in response to SEC Staff Accounting Bulletin Number 119 and provides useful information for applying CECL in Topic 326
- Applies to all entities with transactions within the scope of Topic 326 or Topic 842
- Did not modify the effective dates for these two accounting standards.

ASU 2020-02

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)

- 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 include written policies and procedures

ASU 2022-02

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

- Feedback received during the Post-Implementation Review (PIR) process
- Existing TDR accounting guidance was no longer relevant because Topic 326 required companies account for the entire expected credit losses over the life of the credit instrument investment
- Disclosing gross write-offs and gross recoveries in vintage (year or origination) was no longer relevant

ASU 2022-02

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

- Eliminates previously-existing recognition and measurement guidance on troubled debt restructurings (TDR) in Subtopic 310-40, Receivables
- 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

ASU 2022-02

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

- FASB provided resources to monitor and assist stakeholders implementing Topic 326
- FASB 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
- Performing archival review of financial reports

ASU 2022-02

ASU 2022-02 two issues - Issue 1: Troubled Debt Restructurings by Creditors

- Topic 326 required accounting and disclosures for a TDR loan modification no longer provide decision-useful information
  - because Topic 326 requires recognizing the lifetime expected credit losses upon originating or acquiring a financial instrument
- 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

ASU 2022-02

ASU 2022-02 two issues - Issue 1: Troubled Debt Restructurings by Creditors

- Legacy guidance requires that a lender entity determine whether a loan modification represents a TDR
- 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
- 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

ASU 2022-02

ASU 2022-02 two issues - Issue 1: Troubled Debt Restructurings by Creditors

- 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
- Enhances existing legacy disclosures and introduces new requirements related to certain modifications
  - Types and magnitude of lender modifications
  - 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

ASU 2022-02

ASU 2022-02 two issues - Issue 2: Vintage Disclosures – Gross Write-Offs

- Feedback was inconsistent 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.

ASU 2022-02

ASU 2022-02 two issues - Issue 2: Vintage Disclosures – Gross Write-Offs

- Public companies disclose gross write-offs in the current-period vintage disclosures by year of origination for
    - financing receivables
    - net investments in leases
- Not disclose gross recoveries in the vintage disclosures

ASU 2022-02

ASU 2022-02 Transition and Effective Date

- For companies that have not yet adopted Topic 326
  - same effective dates and transition requirements as Topic 326
- For companies that have adopted Topic 326
  - effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years
- Permits early adoption
- Prospective application applies

ASU 2022-02

ASU 2022-02 Transition and Effective Date

- When adopting Issue 1 for TDRs
- Option to apply a modified retrospective transition and record an adjustment to the opening balance of retained earnings in the adoption period
- Adjustment represents any incremental allowance for credit losses for loans modified in TDRs under ASC 310-40

ASC 326, Financial Instruments – Credit Losses

Summary – ASU 2016-03 codified as ASC Topic 326

- Debt securities
- Amortized cost
- Financial assets

ASC 326, Financial Instruments – Credit Losses

Summary – financial assets measured at amortized cost

- Financing receivables
- HTM debt securities
- Receivables from revenue transactions
- Reinsurance receivables
- Repo receivables

ASC 326, Financial Instruments – Credit Losses

Summary – guidance does not apply to:

- Financial assets measured at fair value through net income (FVNI)
- Available-for-sale (AFS) debt securities
- Defined contribution employee benefit plan loans
- Policy loan receivables of an insurance entity
- Pledges receivable of a not-for-profit entity
- Related-party loans and receivables between entities under common control

ASC 326, Financial Instruments – Credit Losses

Summary – financial assets and the CECL model

- Excluded – utility entity regulated assets
- Included – cash equivalents measured at amortized cost
- Excluded – loans held for sale
- Included – loans and receivables to equity method investees
- Excluded – tax receivables

ASC 326, Financial Instruments – Credit Losses

Financial assets are also:

- A lessor's net investment in leases
- Lease receivable is a financial asset
- Unguaranteed residual
- ASU 2018-19, Codification Improvements to Topic 326 – clarified that operating lease receivables are not in the scope of the CECL model

ASC 326, Financial Instruments – Credit Losses

Financial assets are also:

- Off-balance-sheet credit exposures
- Loan commitments
- Standby letters of credit
- Financial guarantees
- Guarantees are liabilities

ASC 326, Financial Instruments – Credit Losses

Topic	HTM CECL Model ASC 326-20	AFS Debt Security Impairment Model ASC 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 collectibility	DCF

In-Class Learning 1

Which of the following are financial assets according to ASC Topic 826, Financial Investment?

a. Financial investments measured at amortized cost

b. A lessor's net investment in a lease

c. Off-balance-sheet credit exposure

d. All of the above are financial investments

In-Class Learning 1

Which of the following are financial assets according to ASC Topic 826, Financial Investment?

a. Financial investments measured at amortized cost

b. A lessor's net investment in a lease

c. Off-balance-sheet credit exposure

d. All of the above are financial investments

Unit Two

The CECL Model

ASC 326 – The CECL Model

Learning Objectives - Upon completing this unit, participants will be able to:

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

ASC 326-20, The CECL Model

Underlying principle:

- 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.

ASC 326-20, The CECL Model

Underlying principle:

- 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.

ASC 326-20, The CECL Model

CECL estimate:

- Is based on an asset's amortized cost
- Reflects the risk of loss
- Reflects losses expected over the remaining contractual life of a financial asset
- Requires considering available relevant information about cash flow collectability

ASC 326-20, The CECL Model

FASB did not define “deemed uncollectable”:

- 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.
- The borrower has violated several debt covenants.

ASU 2019-04

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

- ASC Topic 326 was unclear about expected recoveries in the CECL estimate.
- Update – include all expected recoveries in its estimate of the allowance for credit losses.
- Losses cannot exceed the aggregate of amounts previously written off and expected to be written off.
- Significant management judgment.
- Don’t write up amortized cost for expected recoveries.

ASC 326-20, The CECL Model

CECL estimate – methodology depends on:

- Data availability and accuracy
- Auditability
- Reasonability
- Cost
- Model reusability

ASC 326-20, The CECL Model

CECL estimate method – DCF:

- Guidance does not require a specific method
- Projecting future principal and interest cash flows
- Contractual interest rate changes
- Difference between the amortized cost basis and the present value of the expected cash flows

ASC 326-20, The CECL Model

CECL estimate – loss-rate method:

- WARM
- Simplest method
- Data required:
  - Pool loan balance
  - Date and amount of loan loss
  - Loan origination date
  - Pool date
- Charge-offs net of recoveries

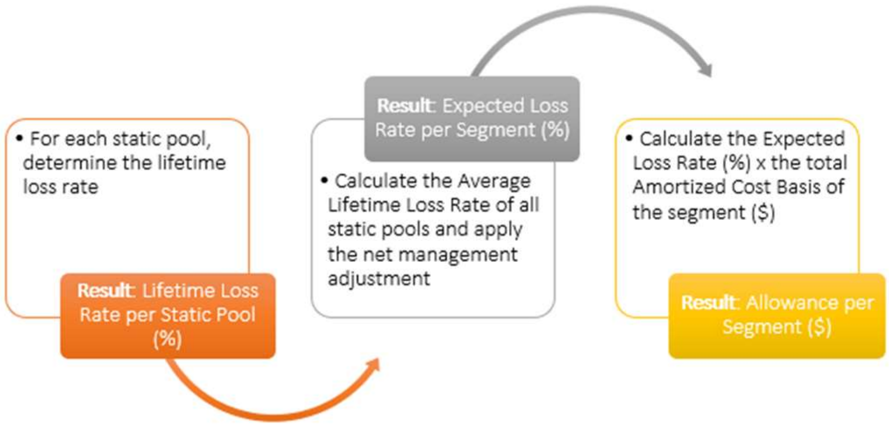
ASC 326-20, The CECL Model

CECL estimate – loss-rate method downsides:

- Stale data
- Economic environment may have changed
- Adjustments increase judgment
- Higher loss rate likely
- Small versus large companies

ASC 326-20, The CECL Model

CECL estimate – loss-rate method:



ASC 326-20, The CECL Model

CECL estimate – roll-rate method:

- Historical roll rates
- Historical loss given default
- Frequency loans transition from one delinquency status to another
- Frequency loans transition from one risk grade to another

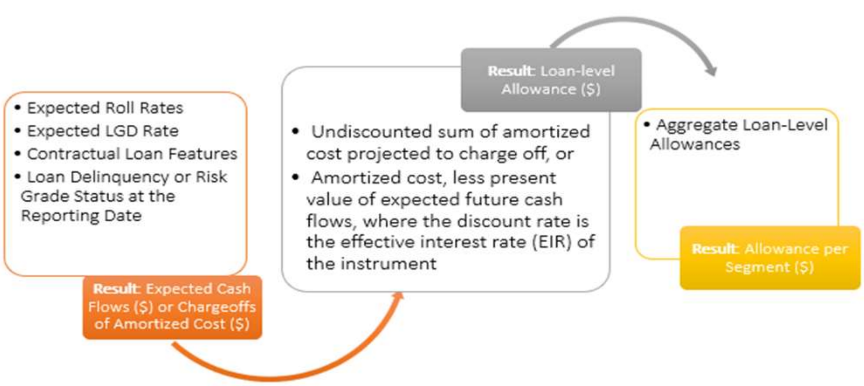
ASC 326-20, The CECL Model

CECL estimate – roll-rate method:

- Management applies adjustments for macroeconomic and other factors
- 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 outside of a cash flow engine to generate expected charge-offs of amortized cost
- Statistical regression techniques to express roll rates as a function of macroeconomic variables, and thus, to condition future roll rates on macroeconomic expectations

ASC 326-20, The CECL Model

CECL estimate – roll-rate method:



ASC 326-20, The CECL Model

CECL estimate method – 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
- Simple models

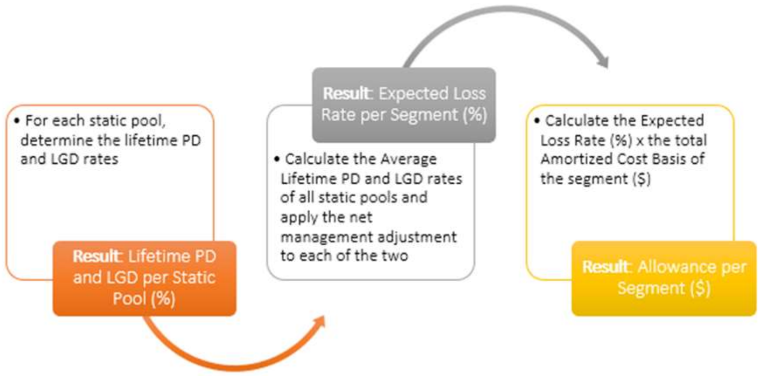
ASC 326-20, The CECL Model

CECL estimate method – PD × LGD:

- Uses same static pool concept at the loss-rate method
- Uses different but related approaches
- Calculation quality control
- The final allowance calculation multiplies the PD times the LGD

ASC 326-20, The CECL Model

CECL estimate method – PD × LGD:



ASC 326-20, The CECL Model

CECL estimate – vintage method:

- Also called the aging method
- Used by most reporting entities to estimate the allowance for bad debts on trade accounts receivable
- Historical losses are tabulated by vintage year and by loan age, as a percentage of origination balances by vintage year

ASC 326-20, The CECL Model

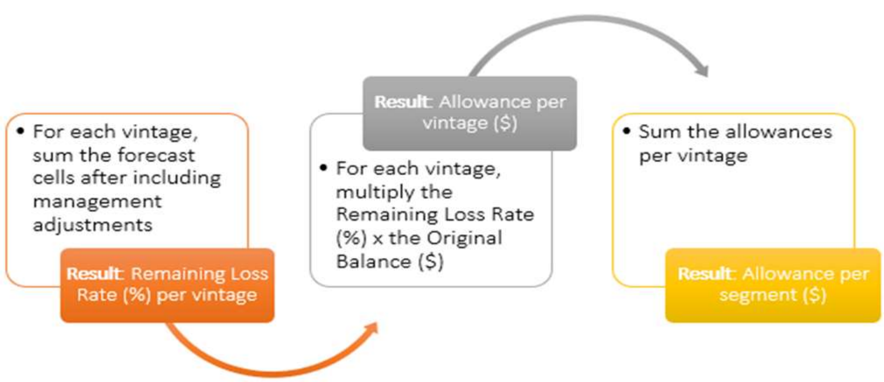
CECL estimate – vintage method:

- Actual historical data appear in the nonshaded cells based on the actual amount 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

ASC 326-20, The CECL Model

CECL estimate – vintage method:



ASC 326-20, The CECL Model

CECL estimate techniques:

- Must be consistently applied
- Must be practical and relevant
- Will vary by financial asset type
- Will vary by ability to predict cash flow timing
- Will vary by data availability

ASC 326-20, The CECL Model

CECL estimate techniques are highly subjective and requires significant management judgment such as:

- The definition of default for default-based statistics
- The approach to measuring the historical loss amount for loss-rate statistics
- 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

ASC 326-20, The CECL Model

CECL estimate techniques are highly subjective and requires significant management judgment such as:

- 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

In-Class Learning 2

The CECL estimate method that is most similar to the aging method that most reporting entities use today for accounts receivable is:

a. Loss-rate method

b. Roll-rate method

c. Vintage method

d. PD × LGD method

In-Class Learning 2

The CECL estimate method that is most similar to the aging method that most reporting entities use today for accounts receivable is:

a. Loss-rate method

b. Roll-rate method

c. Vintage method

d. PD × LGD method

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.

ASC 326-20, The CECL Model

CECL estimate – amortized cost basis:

- Allowance is the portion of amortized cost not expected to be recovered due to credit losses
- Classified as an offset to the amortized cost balance
- 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.

ASC 326-20, The CECL Model

CECL estimate – subsequent measurement:

- Compare the current estimate with the existing amount previously recorded
- Change flows through ordinary income
- Consistent method application
- Also reevaluate pool risk characteristics

ASC 326-20, The CECL Model

CECL estimate – assessing a zero amount:

- Not expected to occur
- Collateral securing the financial asset
- Three-month U.S. T-Bill
- Sovereign country central bank guarantee
- U.S. government agency securities
- Government-sponsored entities (GSEs)

ASC 326-20, The CECL Model

CECL estimate – assessing a zero amount:

- Collateral-dependent financial asset
- Zero allowance when collateral FV > amortized cost
- When collateral FV < amortized cost
- Consider future adverse changes over the term of the financial asset

ASC 326-20, The CECL Model

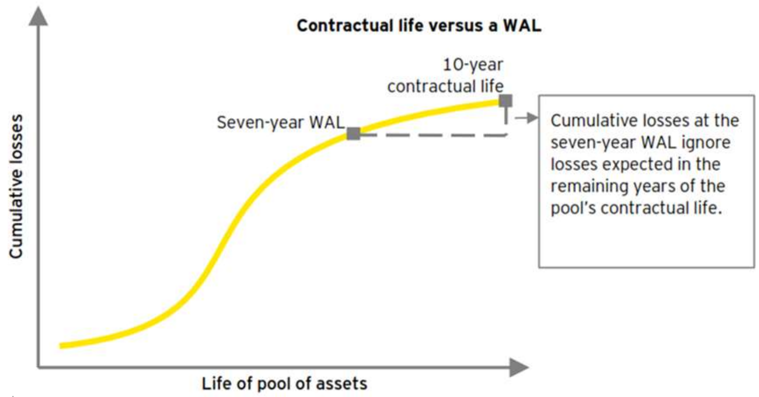
CECL estimate – expectations over asset's contractual life:

- Time horizon of credit risk exposure
- Nonlinear loss rate
- Residential mortgages
- Commercial mortgages
- Consider pooling financial assets based on term to maturity if that characteristic drives credit losses

ASC 326-20, The CECL Model

CECL estimate – expectations over asset's contractual life:

- Contractual life versus weighted-average life



ASC 326-20, The CECL Model

CECL estimate – expectations over asset's contractual life – prepayments:

- Prepayments are early debt settlements
- Generally reduce credit risk
- Used differently depending on the CECL method
- Forecasting difficulty if not contractual
- Don't forecast extensions, renewals, and modifications
- Loan modification guidance in ASC Topic 310, Receivables

ASC 326-20, The CECL Model

CECL estimate – expectations over asset's contractual life – loan change extensions, renewals, modifications:

- Do not extend the financial asset contract term
- Explicit contract terms
- Conditional contract terms
- Modifications that are not TDR

ASC 326-20, The CECL Model

CECL estimate – expectations over asset's contractual life – loan change for troubled debt restructuring (TDR):

- ASC Topic 310, Receivables
- Lender grants a concession that it would not otherwise consider
- Indicators for debtor financial difficulty
- ASC Topic 326 does not prescribe a CECL method for a TDR

ASC 326-20, The CECL Model

CECL estimate – off-balance-sheet commitments:

- Contractual obligations
- Cover the contractual period
- Recognized as a liability, not in CECL allowance
- Factors to consider

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information:

- Relevant to assessing collectability of cash flows
- Reasonably available
- Internal and external
- Historical data and judgmental adjustments
- Asset specific factors
- Current economic conditions
- Economic forecasts
- Borrower’s credit worthiness
- Changes in creditor lending strategy

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information:

- Start with historical loss information
  - Loan characteristics
  - Loss experience charge-offs and recoveries
  - Impact of modifications, prepayments, extensions
  - Macroeconomic conditions
- Historical period adjustments
- Reliable and objective historical data may still require significant management judgment

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information:

- Qualitative factors
- Forecast period < contract term
- Management judgment adjustments

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information

- 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

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information

- 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
  - 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

ASC 326-20, The CECL Model

- CECL estimate – consider available relevant information – historical data considerations for management:
- Are the historical data complete and reliable?
  - Controls over historical data
  - Data gaps related to acquired portfolios
  - Granularity of historical data relative to the requirements of the model
  - Sufficiency of the historical periods relative to asset life

ASC 326-20, The CECL Model (cont.)

- Are the historical data relevant to the current portfolio?
  - Differences in loan terms or structure
  - Differences in the borrower profile or underwriting standards
  - Differences in the correlation of loss and economic factors
  - Time period covered by the historical data
- Do the historical data reflect current conditions?
  - Changes to market, regulatory, or technological environment affecting the borrower or the receivable
  - Consistency of current economic conditions with the historical period used

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information:

- Economic variables that most significantly affect cash flow collectability
- Analyze how historic economic patterns differ
- GAAP provides no guidance on forecasting methods
- Forecasting reliability decreases with longer term
- Quantify adjustments
- Regression analysis
- Significant management judgment

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information – reversion method:

- No zero CECL for periods unable to reasonably and supportably forecast economic conditions
- 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

ASC 326-20, The CECL Model

CECL estimate – consider available relevant information – reversion method:

- Consider both financial-asset-specific characteristics and economic factors that affect cash flow collectability
- Adjust historical loss information 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
- Management judgment considers historical period relevance

ASC 326-20, The CECL Model

CECL estimate – purchased financial assets with credit deterioration (PCDs):

- Purchasing credit-impaired loans
- Add to the CECL allowance at acquisition date
- Gross-up approach
- Future CECL allowance changes impact ordinary income, whether plus or minus

ASC 326-20, The CECL Model

CECL estimate – credit enhancements – guarantees or insurance:

- Credit guarantees or insurance mitigate credit risk
- CECL reflects this for nondetachable (embedded) items
- Detachable items are separate assets
- Legally detachable
- Separately exercisable
- Insurance recovery accounting

ASC 326-20, The CECL Model

CECL estimate – credit enhancements – collateralized financial assets:

- Evaluate collateral FV when foreclosure is probable
- Deduct collateral FV from asset's amortized cost
- CECL allowance may become zero

ASC 326-20, The CECL Model

CECL estimate – credit enhancements – collateralized financial assets:

- Practical expedient for measuring collateral FV
    - Repayment comes from operating the collateral
    - Repayment comes from selling the collateral
- Costs to sell

ASC 326-20, The CECL Model

CECL estimate – credit enhancements – collateralized financial assets:

- Collateral-dependent financial asset
- The entity expects repayment of the financial asset to be provided substantially through collateral operation or sale
- The entity has determined that the borrower is experiencing financial difficulty
- Reevaluate at each reporting date
- Collateral FV

ASC 326-20, The CECL Model

CECL estimate – credit enhancements – collateralized financial assets:

- Collateral maintenance provisions
- Continually adjust collateral for FV changes
- Second practical expedient
- Amortized cost basis nonpayment expectation may be zero
  - 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
- Repurchase arrangements

In-Class Learning 3

A collateral-dependent financial asset exists when which repayment depends on:

a. Operating the collateral asset

b. Selling the collateral asset

c. Leasing the collateral asset

d. Both a and b

In-Class Learning 3

A collateral-dependent financial asset exists when which repayment depends on:

a. Operating the collateral asset

b. Selling the collateral asset

c. Leasing the collateral asset

d. Both a and b

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

ASC 326-20, The CECL Model

Interest income and non-accrual policies:

- ASC Section 310-20
- ASC Section 835-30
- Amortized Cost × Effective Interest Rate = Interest Income
- Cash basis
- Cost recovery basis

ASU 2019-04

Interest income and non-accrual policies:

- ASU 2019-04, Codification Improvements to Topic 326 (and other Topics)
- Accounting policy election to separately measure an allowance for credit losses on accrued interest receivables from other components of the amortized cost basis
- Accounting policy election about where to present and disclose accrued interest receivables and the related allowance for credit losses
- Accounting policy election not to measure an allowance on the accrued interest receivable if write-off uncollectible accrued interest receivables in a timely manner

ASC 326-20, The CECL Model

<table>
<tr><th>Non-accrual policy</th><th>Some, but not all contractual interest collected</th><th>No contractual interest collected</th></tr>
<tr><td>Cash basis</td><td>Lower interest income and write-offs would be recognized than if the entity didn’t apply a nonaccrual policy, but those amounts would be more than the entity would recognize using a cost recovery method.</td><td rowspan="2">Write-offs and interest income would be lower than if the entity didn’t apply a nonaccrual policy.</td></tr>
<tr><td>Cost recovery</td><td>Interest collections would be applied to the asset’s amortized cost basis, resulting in lower write-offs and interest income than an entity would recognize using the cash basis.</td></tr>
<tr><td>None</td><td colspan="2">Contractual interest would continue to accrue and increase the asset’s amortized cost basis. As a result, write-offs would be higher than if a nonaccrual policy had been applied.</td></tr>
</table>

ASC 326-20, The CECL Model

Foreign currency impacts AFS differently than HTM:

- Debt instruments at amortized cost are monetary assets
- 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 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
- Use current exchange rate to measure both the functional-currency-equivalent fair value and the amortized cost basis when estimating the allowance for expected credit losses
- Example

ASC 326-20, The CECL Model

Accounts Receivable and Other Short-Term Financial Assets:

- Expected credit losses on short-term financing receivables, such as trade accounts receivable
- Estimate measurement may differ from the methods used for longer-term financing receivables, such as loans
- Not different – still considering 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 assets

ASC 326-20, The CECL Model

Accounts Receivable and Other Short-Term Financial Assets:

- Expected credit losses estimate should reflect the loss risk, even if management believes no loss has been incurred
- Result in estimating an expected credit loss for most, if not all, receivables, including:
    - 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

ASC 326-20, The CECL Model

Accounts Receivable and Other Short-Term Financial Assets:

- Use various methods to measure expected credit losses – pooling receivables based on age or delinquency pools
- 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
- Measurement method – apply historical loss rates to each pool
- The example in the “vintage method” discussion in this document describes how to apply ASC Topic 326 to accounts receivable

ASC 326-20, The CECL Model

Receivables resulting from ASC Topic 606, revenue recognition:

- Contract asset – right to consideration in exchange for goods or services that the entity transferred to a customer
- Assess a contract asset for credit losses on financial instruments measured at amortized cost
- A contract asset credit loss – measure, present, and disclose
- Receivable – right to unconditional consideration – only the passage of time is required before consideration payment is due
- Receivable accounting – ASC 310, Receivables, and ASC 326-20
- Any difference between the receivable measurement per Subtopic 326-20 and the amount of revenue recognized is credit loss expense

ASC 326-20, The CECL Model

Receivables resulting from ASC 606, Revenue Recognition:

- Determine whether collection of the transaction price, which is adjusted for price concessions, is probable
  - If probable, record revenue and a receivable or contract asset
  - If not probable, do not recognize a receivable or contract asset
- If collection is probable, that does not mean that the risk of expected lifetime credit loss is zero
  - Estimate expected credit losses on a contract asset or receivables resulting from ASC Topic 606

ASC 326-20, The CECL Model

Receivables resulting from ASC 606, revenue recognition:

- Reporting entities in various industries have long-term contracts with customers that may result in contract assets
  - A telecom entity recognizes a contract asset for a free or discounted phone it transferred to a customer.
  - The monthly payments for the phone are conditioned on the entity providing service under the two-year agreement.
- 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
- Distinguish between expected losses due to credit risk and non-credit other factors, such as the reporting entity's nonperformance

ASC 326-20, The CECL Model

Investment in a lease:

- A lessor's net investment in a sales-type or a direct financing lease per ASC Topic 842
- 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 operating lease receivables are excluded
- ASC Section 326-20 requires that a lessor recognize an allowance for credit losses on its net investment in leases
- Lessor considers collateral representing the cash flows the lessor would expect to receive from the lease receivable and the unguaranteed residual asset
- If measure using a discounted cash flow method, use the discount rate implicit in the lease and not the effective interest rate

ASC 326-20, The CECL Model

Investment in a lease:

- 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. It includes:
  - 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
- 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 – direct financing leases only – reduces the lessor's net investment in the lease

ASC 326-20, The CECL Model

Investment in a lease:

- Estimate credit loss allowance for a net investment in a lease, using 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
  - Many lease contracts coupled with agreement to purchase or sell other goods or services
  - A retail space lessor providing common area maintenance services
  - Non-lease component receivables that are financial assets measured at amortized cost are subject to the CECL model
- Example PD × LGD model which does not discount the losses

ASC 326-20, The CECL Model

ASC 460, Guarantees:

- Evaluate whether the guarantee is also in the scope of ASC Section 326-20
- 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
- Financial guarantee examples:
  a. Financial standby letter of credit
  b. Market value on either a financial asset (security) or a nonfinancial asset owned by the guaranteed party
  c. Market price guarantee of the common stock of the guaranteed party
  d. Collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity
  e. Granted to a business or its owner(s) that the revenue for a specified period of time will be at least a specified amount

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees:

- Debt guarantees – does not matter whether the guaranteed party is the creditor or the debtor
- 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. Noncontingent aspect – the guarantor obligation to stand ready to perform
  2. Contingent aspect – the guarantor contingent obligation to make future payments if those triggering events or conditions occur

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees:

- 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 noncontingent aspect of standing ready to perform)
- Issuing a guarantee imposes a noncontingent 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.
  - 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 noncontingent aspect of a guarantee.

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees:

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

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees:

Types of guarantees in the scope of ASC 460	Examples	In scope of CECL ASC 326-20
Financial guarantees	Financial standby letter of credit, certain guarantees of a borrower's repayment in a lending agreement	Yes
Performance guarantees	Performance standby letters of credit, performance bonds, bid bonds	No
Indemnification agreements	Lessee's indemnification of a lessor for adverse tax consequences, seller's indemnification of income tax or legal liabilities in a business combination	No
Indirect guarantees of the indebtedness of others	An agreement that requires the guarantor to transfer funds to the borrower in order for the borrower to repay the lender	No

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees:

- 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
- Must have all of the following characteristics:
  - 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 326-20, The CECL Model

ASC Topic 460, Guarantees:

- Off-balance-sheet credit exposures not accounted for as insurance
- A financial guarantee must relate to the nonpayment of a financial obligation, such as:
  - 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 loan cash flows
  - Irrevocable financial standby letters of credit

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – initial measurement:

- 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 is 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, the liability is an estimate of the guarantee's fair value

  c. Guarantor considers same premium in a standalone arm's-length transaction with an unrelated party as a practical expedient

  d. As a contribution to an unrelated party, the liability recognized at its fair value is the contribution fair value

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – initial measurement:

- Guarantor recognizes both of the following as liabilities:
    a. The guarantee fair value under ASC 460
    b. The contingent liability related to the expected credit loss for the guarantee measured under ASC 326-20
- 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

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – initial measurement:

- Presentation of expected credit losses on financial guarantees in the scope of ASC 326-20 differs from the presentation of expected credit losses on financial assets measured at amortized cost
    - For ASC Section 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
- Guarantor assesses premium receivable for expected credit losses (both at initial and subsequent measurement)
- Example

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – subsequent measurement:

- For the **noncontingent** aspect, ASC Topic 460 does <u>not</u> describe how to measure the guarantor's guarantee liability after initial recognition
- Reduce the initial liability by a credit to earnings as the guarantor is released from risk under the guarantee
- ASC Topic 460 does not provide guidance, which requires significant management judgment

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – subsequent measurement:

- For the **noncontingent** aspect, guarantor recognizes risk release over the term of the guarantee using one of the following three methods:
  1. Upon either expiration or settlement of the guarantee
  2. By a systematic and rational amortization method
  3. As the fair value of the guarantee changes
- A guarantor is not free to choose any of the three methods
  - Cannot use fair value in subsequently accounting for the liability under a previously-issued guarantee unless the use of that method can be justified under GAAP
  - For example, use fair value to subsequently measure guarantees accounted for as derivatives under ASC Topic 815

ASC 326-20, The CECL Model

ASC Topic 460, Guarantees – subsequent measurement:

- For the **contingent aspect**, following ASC Section 450-20, Loss Contingencies
  - Unless the guarantee is accounted for as a derivative instrument under ASC Topic 815 or ASC Section 326-20 on financial instruments measured at amortized cost
- For ASC Section 326-20 guarantees, the expected credit losses (the contingent aspect) follow ASC Topic 326 in addition to and separately from the fair value of the guarantee liability (the **noncontingent** aspect) following ASC Topic 460
- Example

ASU 2016-13, Accounts Receivable Example

Discussion Points:

- Applying the CECL model to trade receivables may not differ significantly from past practice
  - The biggest difference is considering future conditions in estimating the allowance
- The allowance for uncollectible accounts represents an estimated credit loss that must change from an incurred loss model to an expected loss model
- The remaining journal entries associated with write-offs and recoveries are unchanged from current practice
- The current receivables policy note disclosure is largely the same
  - Except revise allowance estimation method

In-Class Learning 4

Which is true about a guarantee's contingent aspect and noncontingent aspect?

a. The contingent aspect is the fair value of the guarantee liability.

b. The contingent aspect is the expected credit losses.

c. The noncontingent aspect is the expected credit losses.

d. The noncontingent aspect is not measured at fair value.

In-Class Learning 4

Which is true about a guarantee's contingent aspect and noncontingent aspect?

a. The contingent aspect is the fair value of the guarantee liability.

b. The contingent aspect is the expected credit losses.

c. The noncontingent aspect is the expected credit losses.

d. The noncontingent aspect is not measured at fair value.

For guarantees within the scope of ASC Section 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.

Reminders

❑ **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!