

Financial reporting developments

A comprehensive guide

Credit impairment for short-term receivables under ASC 326

September 2022

To our clients and other friends

This Financial reporting developments (FRD) publication is designed to help you understand the requirements and financial reporting implications of applying the credit impairment guidance that is codified in Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*, to short-term accounts receivable and contract assets.

The guidance, which was issued as Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, makes significant changes to the accounting for credit losses on financial assets and disclosures about them. The Financial Accounting Standards Board (FASB or Board) developed the guidance in response to concerns that credit losses were identified and recorded “too little, too late” in the period leading up to the global financial crisis of 2008. The guidance affects all entities in all industries and applies to a wide variety of financial assets, including trade receivables. Public business entities (PBEs) that are Securities and Exchange Commission (SEC) filers that are not smaller reporting companies (SRCs) were required to begin applying the standard in 2020. All other entities are required to adopt the standard in 2023.

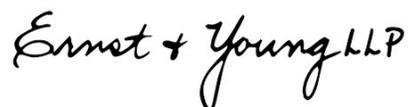
This FRD addresses how the guidance on the current expected credit loss (CECL) impairment model (ASC 326-20) applies to short-term receivables and contract assets relating to goods or services an entity sells to its customers. For a discussion on all other assets in the scope of ASC 326, including long-term financing receivables and debt securities, refer to our comprehensive ASC 326 FRD.

The CECL impairment model requires an estimate of expected credit losses, measured over the contractual life of an asset, that considers forecasts of future economic conditions in addition to information about past events and current conditions. It requires entities to consider the risk of loss even if it is remote, which will result in the recognition of credit losses on assets that do not have evidence of credit deterioration. The standard provides entities with significant flexibility in how to pool financial assets with similar risk characteristics, determine the contractual term and obtain and adjust the relevant historical loss information that serves as the starting point for developing the estimate of expected lifetime credit losses. As a result, significant judgment will be required to apply the guidance.

For entities that have not adopted the guidance in ASC 326, implementation is likely to require adjustments to accounting policies, processes, controls and documentation. While the level of effort needed to adopt the guidance will vary significantly by entity, successful implementation will require effective communication with stakeholders and a detailed plan for managing the change. Entities that successfully implemented the standard focused on obtaining and enhancing the required data and enhancing their processes to analyze their information about credit losses and the impacts of economic conditions.

This FRD includes excerpts from and references to the Accounting Standards Codification. The content reflects the activities of the Transition Resource Group for Credit Losses (TRG), discussions at FASB meetings and regulatory developments through September 2022. We encourage preparers and users of financial statements to read this publication carefully, consider the potential effects of the standard and monitor standard setting developments.

The views we express in this publication may continue to evolve as implementation continues and additional questions are identified. We expect to periodically update our guidance to provide the latest implementation insights.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

September 2022

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or the Board) Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

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What has changed?

Summary

The guidance the Financial Accounting Standards Board (FASB or Board) issued in ASU 2016-13 significantly changed how entities account for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard superseded the legacy guidance and applies to all entities.

ASC 326-20 replaces the legacy “incurred loss” model with an “expected credit loss” model that requires consideration of a broader range of information to estimate expected credit losses over the lifetime of the asset. This can be challenging for many entities. For entities that have not adopted the standard, one big change will be estimating lifetime expected losses for short-term receivables and contract assets that are current with respect to their payment terms. To estimate losses over the life of a receivable, entities will likely need to use data that they have not previously collected or was not subject to robust controls. Entities will need to change or enhance their policies, processes and controls, including controls over historical credit loss data that will be necessary to perform key computations and to satisfy the additional disclosure requirements. Entities may also need to implement new information technology (IT) systems or enhance their existing systems.

Key changes

The table below summarizes the key differences between legacy US GAAP and the CECL model:

	Key differences		Financial statement and process related effects
	Legacy GAAP	CECL (ASC 326-20)	
Recognition threshold	When a loss is incurred as of the balance sheet date	When lifetime credit losses are expected, considering the risk of loss even if it is remote (i.e., in virtually all cases)	<ul style="list-style-type: none"> ▶ Will likely recognize credit losses earlier and record credit losses on assets that may not have had an allowance under legacy GAAP (such as receivables that are current with respect to their payment terms) ▶ May require additional or enhanced processes and controls
Unit of measurement	Pooling permitted but not required	Pooling required when assets share risk characteristics	<ul style="list-style-type: none"> ▶ Need to reconsider whether assets grouped in a pool continue to share similar risk characteristics at each measurement date
Consideration of economic conditions	Consider current economic conditions	Consider current economic conditions and management’s expectations of future economic conditions	<ul style="list-style-type: none"> ▶ May make credit loss expense more volatile ▶ Need to evaluate data availability and integrity and consider the use of external data to address incomplete or insufficient internal data ▶ May require additional or enhanced processes and controls
Consideration of the contractual term	Not part of the calculation of incurred losses at the balance sheet date	Measure expected credit losses over the asset’s contractual term	<ul style="list-style-type: none"> ▶ May be challenging to determine the life of receivables without specific payment terms or those for which customers frequently provide payment after the stated due date

While the standard does not define the term “expected credit loss,” it says the allowance for expected credit losses should represent the portion of the amortized cost basis of a financial asset that an entity does not expect to collect. It also says the allowance is intended to result in the financial asset being reflected on the balance sheet at the “net amount expected to be collected.” The standard also does not define what is meant by the phrase “net amount expected to be collected.”

The guidance is complex and the TRG created by the FASB to address implementation issues raised by stakeholders continues to be available to address issues as they arise.

Preparers, auditors and users may submit issues for the TRG to discuss. TRG members share their views, but their views do not represent authoritative guidance. After each meeting, the FASB determines what action, if any, it should take on each issue.

Given the significance of the changes, entities that have not adopted the standard will need to develop detailed plans to implement the standard. A registrant will also be expected to comply with SEC Staff Accounting Bulletin (SAB) Topic 11.M¹ and provide disclosures addressing its progress in implementing the standard and the expected effect on the entity’s financial statements.

Effective date and transition

PBEs that are SEC filers but aren’t SRCs have already adopted the standard. All other entities are required to adopt it in annual periods beginning after 15 December 2022 and interim periods therein.

¹ SEC SAB Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*.

1 Scope and scope exceptions

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Overall

Overview and Background

326-10-05-1

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

326-10-05-2

Topic 326 includes the following Subtopics:

- a. Overall
- b. Financial Instruments – Credit Losses – Measured at Amortized Cost
- c. Financial Instruments – Credit Losses – Available-for-Sale Debt Securities

Scope and Scope Exceptions

Entities

326-10-15-1

The guidance in this Subtopic applies to all entities.

ASC 326 applies to all entities and provides guidance on the following topics:

- ▶ The CECL impairment model (ASC 326-20) for financial assets measured at amortized cost, net investments in leases, reinsurance receivables accounted for under ASC 944 and off-balance-sheet credit exposures not accounted for as insurance
- ▶ The available-for-sale (AFS) debt security impairment model (ASC 326-30)
- ▶ The initial recognition of what are called purchased financial assets with evidence of credit deterioration or PCD assets
- ▶ The impairment of beneficial interests in securitized financial assets in the scope of ASC 325-40

The graphic below lists the instruments to which the CECL impairment model applies.

Current expected credit loss model	
All entities	<ul style="list-style-type: none"> ▶ Financial assets measured at amortized cost: <ul style="list-style-type: none"> ▶ Financing receivables (loans) ▶ Held-to-maturity (HTM) debt securities ▶ Trade receivables ▶ Receivables that relate to repurchase and securities lending agreements ▶ Net investment in leases recognized by a lessor ▶ Off-balance-sheet credit exposures not accounted for as insurance ▶ Reinsurance recoverables
	The model requires an allowance 'gross-up' in the initial recognition of PCD assets

This publication focuses on accounting considerations for short-term receivables and contract assets (i.e., those that will be collected in one year or less) that are in the scope of ASC 326-20. For a discussion of all other assets in the scope of ASC 326, including long-term financing receivables and debt securities, refer to our FRD, *Credit impairment under ASC 326*, which we refer to as our comprehensive ASC 326 FRD.

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

Excerpt from Accounting Standards Codification

Master Glossary

Financial asset

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:

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

Revenue from Contracts with Customers – Overall

Other Presentation Matters

606-10-45-3

If an 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 an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall 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 shall be measured, presented and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

The CECL model applies to all financial assets measured at amortized cost. The focus of this FRD is on receivables that result from revenue transactions within the scope of ASC 606. These are receivables from customers, including short-term trade receivables that result from the sale of goods and services. They include all amounts due, even if a third party will make payment on the customer's behalf.

The CECL model also applies to certain financial assets not measured at amortized cost, such as receivables held by investment companies that are measured at net realizable value and reinsurance receivables. The FASB clarified that all reinsurance receivables accounted for under ASC 944 are in the scope of ASC 326, including those measured on a discounted basis.

In addition, ASC 606-10-45-3 states that contract assets should be assessed for impairment in accordance with ASC 326-20. Contract assets represent an entity's conditional right to consideration for goods or services it has provided if that right is conditioned on something other than the passage of time. For example, an entity may have a contract to deliver Products A and B to a customer that requires it to deliver both products before payment is due. In this case, the entity recognizes a contract asset when it delivers Product A because the payment is conditioned on the entity's delivery of Product B.

1.2 Items excluded from the scope of the model

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Scope and Scope Exceptions

Instruments

326-20-15-3

The guidance in this Subtopic does not apply to the following items:

- Financial assets measured at **fair value** through net income
- Available-for-sale debt securities
- Loans** made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Promises to give (pledges receivable) of a not-for-profit entity
- Loans and receivables between entities under common control.
- Receivables arising from operating leases accounted for in accordance with Topic 842.

The following items generally carried at amortized cost are excluded from the scope of the CECL model:

Item excluded from scope	Considerations
Related party loans and receivables between entities under common control	The Board decided to exclude related party loans and receivables between entities under common control from the scope of Subtopic 326-20. The Board noted in paragraph BC31 of the Background Information and Basis for Conclusions in ASU 2016-13 that this exclusion addresses concerns raised by the Private Company Council (PCC) that some related party loans may be viewed as a capital contribution rather than a loan to be repaid. At the June 2018 TRG meeting, the FASB staff said that in response to a technical inquiry it received, it concluded that the scope exception for loans and receivables between entities under common control applies to all of these assets, regardless of whether they are held by the parent or a subsidiary.
Pledges receivable of a not-for-profit entity	These instruments are accounted for in accordance with the guidance for not-for-profit entities in ASC 958.

For items excluded from the scope of ASC 326-20, impairment is recognized and measured in accordance with other US GAAP that may apply to the financial asset, or if no other US GAAP applies, in accordance with ASC 450-20.

Question 1-1

Are regulatory assets of a power and utility entity in the scope of the CECL model?

No. A power and utility entity with regulated operations may recognize regulatory assets for costs it incurred if those costs are deemed probable of being recovered from customers through future rate increases. Although regulatory assets are not explicitly excluded from the scope of the standard, they do not meet the definition of a financial asset or any of the other items included in the scope of the model.

Question 1-2 Are cash equivalents in the scope of the CECL model?

Yes. Cash equivalents that are measured at amortized cost are in the scope of the CECL model. Entities need to consider the nature and terms of these instruments when determining the approach to measuring expected credit losses. In some cases (e.g., a three-month US Treasury bill), entities may conclude that losses approximate zero.

Question 1-3 Are loans and receivables to equity method investees in the scope of the CECL model?

Yes. When an entity makes an equity investment that is accounted for under the equity method of accounting, the investor may provide other financial support to the investee, such as loans or an investment in debt securities of the investee. When the entity provides a loan to the investee or holds an investment in a debt security of the investee that is classified as HTM, the entity recognizes an allowance for credit losses in accordance with ASC 326-20. Consistent with legacy guidance, an entity's share of investee losses that exceed the carrying amount of the equity method investment may need to be recorded (by reducing the cost basis of the loan or HTM debt security) after the carrying amount of the equity method investment has been reduced to zero. Refer to our [comprehensive ASC 326 FRD](#) for more information on applying ASC 326 to loans.

Question 1-4 Are tax receivables from taxing authorities in the scope of the CECL model?

Generally, no. Tax receivables and other tax-related assets due from taxing authorities are not in the scope of the CECL model because they do not meet the definition of a financial asset (i.e., they generally do not represent a contractual obligation on the part of the taxing authority).

Question 1-5 How should entities evaluate whether a loan or receivable is between entities under common control?

The term common control appears in several topics in US GAAP, but it is not defined in the Master Glossary. The Emerging Issues Task Force (EITF) discussed how to determine whether separate entities are under common control in EITF Issue No. 02-5² but did not reach a consensus. Instead, the EITF summarized the criteria an SEC staff member cited in a 1997 speech.³ Although EITF 02-5 was not codified, the guidance from this speech has been applied in practice by SEC registrants, and the SEC observer to the EITF noted that SEC registrants are expected to continue to apply that guidance. That is, common control exists between (or among) separate entities only in the following circumstances:

- ▶ An individual or enterprise holds more than 50% of the voting ownership interest of each entity.
- ▶ Immediate family members hold more than 50% 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).
- ▶ Immediate family members include a married couple and their children, but not the married couple's grandchildren.
- ▶ When entities are owned by various combinations of siblings and their children, careful consideration of the substance of the ownership and voting relationships is required.
- ▶ A group of shareholders holds more than 50% 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.

² [EITF Issue 02-5](#), *Definition of "Common Control" in Relation to FASB Statement No. 141*.

³ Comments by Donna L. Coallier, Professional Accounting Fellow, at the 1997 AICPA National Conference on SEC Developments.

Additionally, when finalizing the 2015 amendments to ASC 810, the Board noted that its intent was for the term common control to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.⁴ Entities should consider these factors when determining whether a loan and/or receivable is between entities under common control and is therefore excluded from the scope of the CECL model.

Question 1-6 Are loans with officers in the scope of the CECL model?

Yes. Loans to officers are not loans between entities under common control and are in the scope of the CECL model. The scope exception in ASC 326 was intended to address concerns by the PCC that some related party loans may be viewed as capital contributions rather than loans to be repaid. A loan between an entity and an officer would not be viewed as a capital contribution, and the scope exception for loans between entities under common control does not apply. Loans to officers or other employees who hold significant equity interests in an entity may require additional consideration. Refer to our [comprehensive ASC 326 FRD](#) for more information on applying ASC 326 to loans.

Question 1-7 Are employee forgivable loans in the scope of the CECL model?

Possibly. Employee forgivable loans are in the scope of the CECL model if they meet the definition of a financial asset (i.e., the employer has the right to receive payment for the loan from the employee, including in circumstances where employment is terminated). However, an employer wouldn't include in its estimate for credit losses amounts it expects to forgive when employees meet the conditions for forgiveness (e.g., continued employment over a specified time period). The employer would only include amounts it doesn't expect to collect due to credit (e.g., uncollectible amounts from a terminated employee who defaults on the loan).

⁴ Paragraph BC69 of ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*.

2 The current expected credit loss model

2.1 Objective

ASC 326-20 gives entities a significant amount of flexibility in how they estimate expected credit losses for all types of financial assets in its scope. As a result, applying the standard requires a significant amount of judgment.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-1

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

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

326-20-30-1

The allowance for credit losses is a valuation account that is deducted from, or added to, the **amortized cost basis** of the **financial asset(s)** to present the net amount expected to be collected on the financial asset. Expected recoveries of amounts previously written off and expected to be written off shall be included in the valuation account and shall not exceed the aggregate of amounts previously written off and expected to be written off by an entity. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

The overarching principle of ASC 326-20 is that an entity will recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset. The allowance is based on the asset's amortized cost. That is, it represents the portion of the receivable's amortized cost basis that an entity does not expect to collect due to credit over the receivable's contractual life, considering past events, current conditions, and reasonable and supportable forecasts of future economic conditions. Expected losses related to risks other than credit risk, such as operational risk, dispute risk or legal risk, should not be included in the allowance for credit losses.

Under the CECL model, the allowance for credit losses is measured and recorded upon the initial recognition of a financial asset, regardless of whether it is originated or purchased.

How we see it

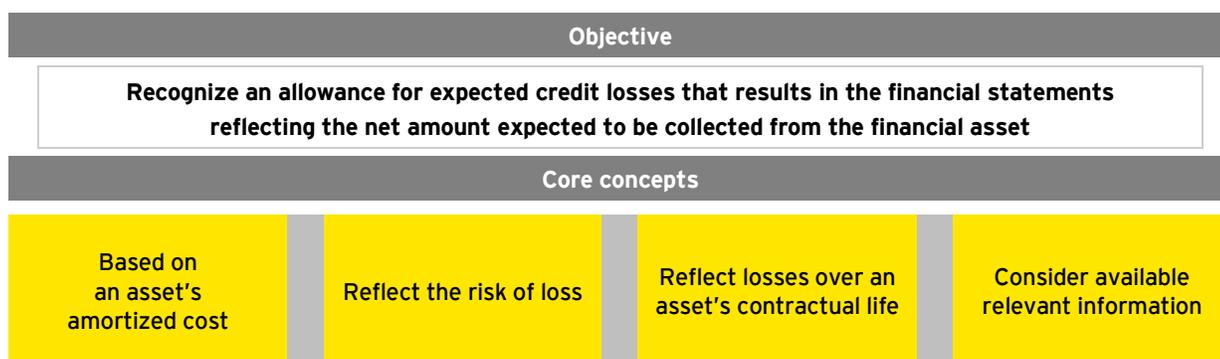
Under the CECL model, the assumption is that all financial assets are exposed to credit losses that may occur over the course of their lives. There is no threshold for recognizing expected credit losses.

For short-term receivables and contract assets, entities will need to recognize an allowance when a receivable or contract asset is established, regardless of whether there has been an incurred loss. This will result in entities recognizing a credit loss in the income statement earlier than under the legacy guidance. This has the potential to increase earnings volatility in periods when sales volumes change significantly. It may be necessary for entities to enhance their financial statement disclosures and, for public companies, the management's discussion and analysis in Form 10-Q and/or 10-K, to help users understand why their credit loss expense is changing.

The estimate of current expected credit losses should:

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

The following illustration summarizes the objective of the CECL model and its core concepts:



The standard requires entities to consider reasonable and supportable forecasts of future economic conditions in the estimate of expected credit losses. While the standard also requires entities to revert to historical information when they can no longer reliably forecast future economic conditions, we don't expect entities to do this for short-term receivables and contract assets. That is, we generally believe that entities will be able to forecast future economic conditions for the entire contractual life of a short-term receivable and will not need to revert to historical information.

Notwithstanding this point, both the reasonable and supportable forecast of future economic conditions and reversion periods are components of the overall CECL estimate and must be supported.

These concepts are explained further in the sections below.

2.1.1 Methods available to estimate expected credit losses

ASC 326-20 gives entities the flexibility to select an appropriate method to measure management's estimate of expected credit losses. That is, entities are permitted to use estimation techniques that are practical and relevant to their circumstances, as long as they are applied consistently over time and aim to faithfully estimate expected credit losses using the concepts listed above.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-3

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

Implementation Guidance and Illustrations

Implementation Guidance

Developing an Estimate of Expected Credit Losses

326-20-55-7

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

The guidance lists, but does not define, several common credit loss methods that are acceptable (other methods may also be acceptable):

Approach	Description
Methods that use an aging schedule	Impairment is calculated based on how long a receivable has been outstanding (e.g., under 30 days, 30–60 days). This method is commonly used to estimate the allowance for credit losses on trade accounts receivable.
Loss-rate methods	Impairment is calculated using an estimated loss rate and multiplying it by the asset's amortized cost at the balance sheet date.
Roll-rate methods	Expected losses are projected using historical trends in credit quality indicators (e.g., delinquency).
Probability of default (PD) and loss given default (LGD) methods	Impairment is calculated by multiplying the PD (probability the asset will default within a given timeframe) by the LGD (percentage of the asset not expected to be collected due to default).
Discounted cash flow (DCF) methods	Impairment is determined by comparing the asset's amortized cost to the present value of estimated future principal and interest cash flows. The FASB staff has clarified that if an entity intends to incorporate discounting into its credit loss estimate, it must discount all inputs to the estimate and the effect of discounting should be measured as of the reporting date. ⁵

⁵ 1 November 2018 TRG meeting. [See meeting minutes](#).

For short-term accounts receivable, we generally believe entities use an aging method to estimate credit losses.

Entities also need to have controls over the allowance calculation method and key assumptions used in the credit loss estimate. Management should consider whether the existing control environment, including governance and tone at the top, is adequate to support the formation and enforcement of sound judgments that will be necessary to execute control activities or determine whether methods and other judgments continue to be appropriate.

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

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Implementation Guidance and Illustrations

Implementation Guidance

Developing an Estimate of Expected Credit Losses

326-20-55-6

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

- a. The definition of default for default-based statistics
- b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest
- c. The approach to determine the appropriate historical period for estimating expected credit loss statistics
- d. The approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period
- e. The methods of utilizing historical experience
- f. The method of adjusting loss statistics for recoveries
- g. How expected prepayments affect the estimate of expected credit losses
- h. How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses
- i. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.

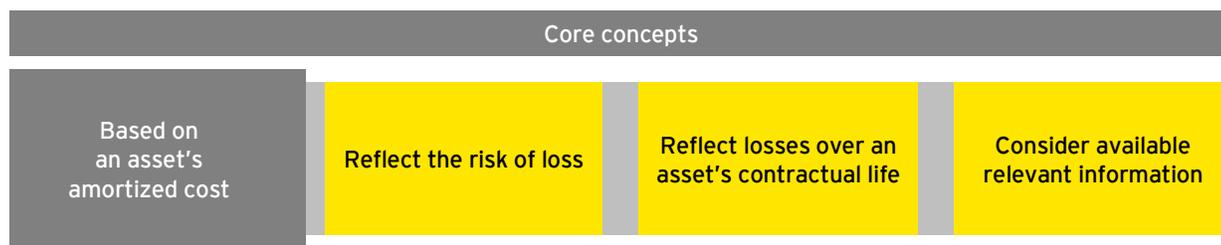
This list illustrates the highly subjective nature of the estimate. It is also important to remember that the list is not all inclusive, and management may need to make other key judgments based on the entity's facts and circumstances.

Entities need to consider each of the factors in ASC 326-20-55-6 individually and in conjunction with all of the estimation techniques and key assumptions that contribute to management's CECL estimate. That is, management must support its estimate of expected credit losses for each individual asset or pool of assets in its entirety.

The judgments listed above are discussed in detail in other sections of this publication.

2.2

Based on an asset's amortized cost (updated April 2020)



The standard requires the allowance for expected credit losses to be based on the underlying financial asset's amortized cost basis. That is, the allowance represents the portion of the receivable's amortized cost basis that the entity doesn't expect to recover due to credit losses, and it is presented as an offset to the amortized cost basis.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Master Glossary

Amortized Cost Basis

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

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-5

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

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

Pending content:

Transition Date: (P) December 16, 2022; (N) December 16, 2023 | **Transition Guidance:** 815-20-65-6

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

- a. Amortized cost basis, excluding applicable accrued interest, premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance).
- b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge.
- c. Applicable accrued interest. See paragraph 326-20-30-5A for guidance on excluding accrued interest from the calculation of the allowance for credit losses.

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

326-20-30-5A

An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an allowance for credit losses for accrued interest receivables if the entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-35-8A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

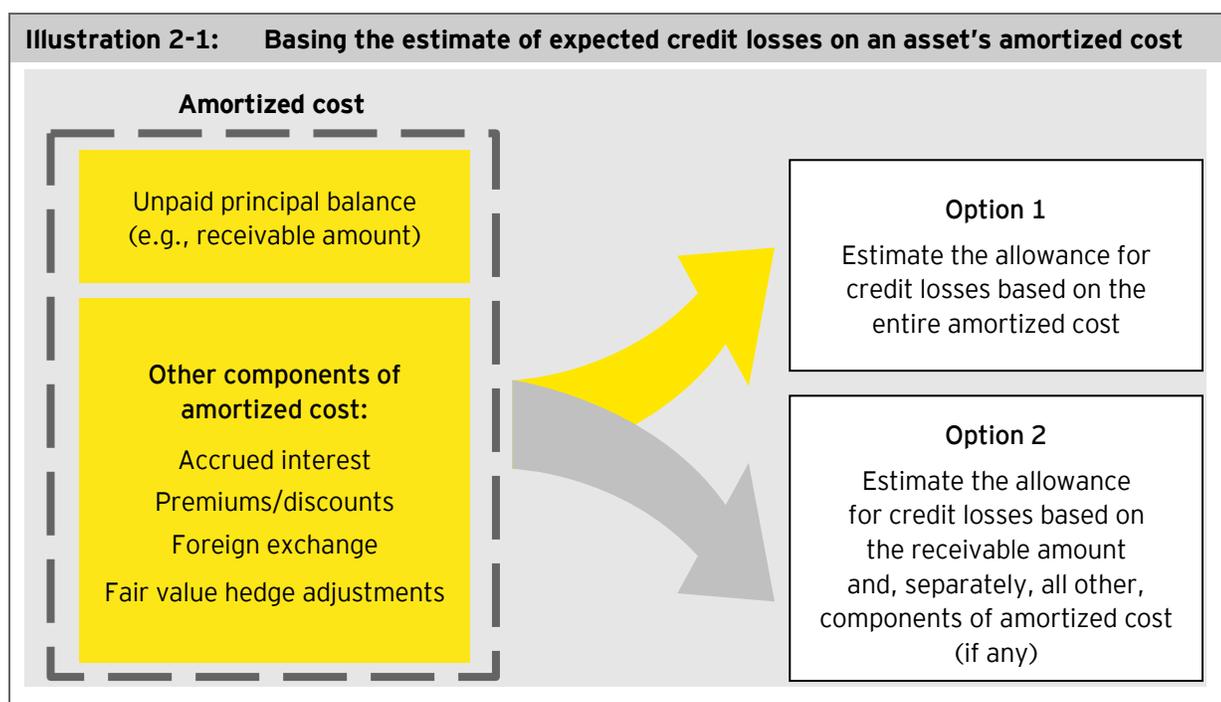
The amortized cost basis of a financial asset contains various components that are described further below:

Component of amortized cost basis	Definition
Unpaid principal balance (UPB)	UPB is the par or face amount of a financing receivable, adjusted for cash collections applied to principal.
Accrued interest	<p>Accrued interest represents the interest on a financing receivable that has accumulated since the principal investment or since the previous coupon payment if there has been one already.</p> <p>Contractual interest expected to be earned in the future should not be considered part of the amortized cost balance.</p> <p>Entities may make certain policy elections related to the measurement, presentation and disclosure of the allowance for credit losses on accrued interest and the reversal of uncollectible accrued interest. Refer to section 2.2 of our comprehensive ASC 326 FRD for details.</p>

Component of amortized cost basis	Definition
Premium or discount	A premium represents the excess of the acquisition or origination price of a financing receivable over its face or par amount due at maturity. Premiums are generally amortized over time using the effective interest method. A discount represents the amount of the acquisition or origination price of a financing receivable below its face or par amount due at maturity. Discounts are generally accreted over time using the effective interest method.
Write-offs	Write-offs represent the amount of a financial asset deemed uncollectible. Write-offs, therefore, reduce the amortized cost basis of a financial asset.
Foreign exchange adjustment	A foreign exchange adjustment reflects the effect on functional-currency-equivalent cash flows of changes in foreign currency exchange rates when a financial asset is denominated in a currency other than the entity's functional currency.
Fair value hedge accounting adjustment	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 particular hedged risk, such as interest rate risk.

The standard requires the allowance to reflect the expected credit losses inherent in an asset's entire amortized cost basis, including each of the components described above, as applicable. For short-term receivables and contract assets, the amortized cost will generally be the same as the carrying value of the asset, excluding the allowance for credit losses. However, entities should consider whether the components above are applicable to a specific asset (e.g., for receivables denominated in a foreign currency, foreign exchange adjustments must be considered in the allowance estimate).

Because entities take different approaches to tracking historical loss information, the standard permits an entity to develop an estimate of expected credit losses by measuring all components of the amortized cost separately or combined or by measuring accrued interest separately from UPB and all other components when a non-DCF approach is used, as highlighted in ASC 326-20-30-5 and illustrated below.



Regardless of which method an entity uses to estimate expected credit losses, the entity will need to understand which of the above components of the amortized cost basis are considered in historical loss rates. An entity's loss history could include only write-offs of the UPB, or it could include all components

of amortized cost (e.g., premiums, discounts, foreign exchange). If only write-offs of the UPB are considered in an entity's loss history, adjustments would need to be made to loss data to make sure all elements of amortized cost are considered in the allowance estimate (e.g., what amount of discounts is unamortized when a credit loss is expected to occur).

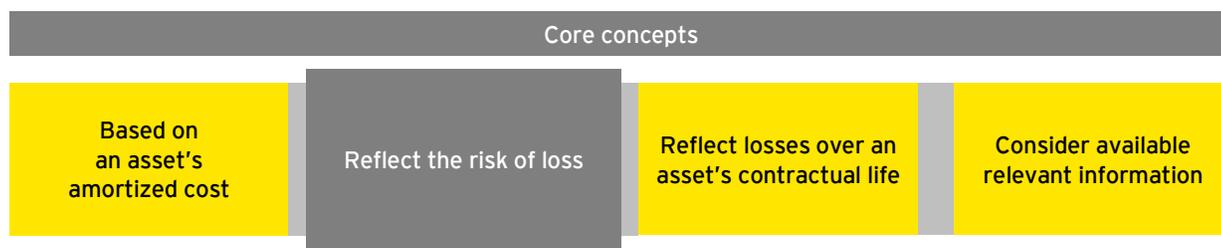
Question 2-1 Are entities required to record an allowance for credit losses on assets acquired in a business combination that are measured at their acquisition-date fair values?

Yes. An acquirer must record an allowance for credit losses on all acquired assets in the scope of ASC 326, including assets that are recorded at their acquisition-date fair values in accordance with ASC 805-20-30-4A. For non-PCD assets, an allowance is recorded with a charge to credit loss expense. For PCD assets, ASC 805-20-30-4B requires an entity to record an allowance with a corresponding increase to the amortized cost basis of the acquired asset as of the acquisition date. Further, a discount embedded in the purchase price of an asset cannot offset an allowance for credit losses.

Question 2-2 If an entity has receivables and payables with the same counterparty and the legal right of setoff exists, is it permitted to estimate expected credit losses on the net exposure to the counterparty?

Yes. If there is a legal right of setoff, we believe an entity may estimate the allowance for credit losses on its net exposure to the counterparty. We believe an entity should consider its ability to withhold amounts due to the counterparty in the event of default as an expected recovery in accordance with ASC 326-20-30-1.

2.3 Reflect the risk of loss



The standard requires the allowance for expected credit losses to reflect the risk of loss, even when that risk is remote. For example, if an entity estimates that an asset has a 99% chance of full collection and a 1% chance of a total loss, the expected loss estimate should reflect the 1% chance of a total loss. The requirement to reflect even a remote risk of loss means that the allowance for expected credit losses should not solely be based on the most likely outcome if such an outcome ignores potential loss scenarios. This requirement will result in an allowance for expected credit losses greater than zero for most assets in the scope of ASC 326-20 even if management believes no loss has been incurred as of the measurement date. This will result in an entity estimating an expected credit loss for most, if not all, receivables, including:

- ▶ Receivables from customers that are current on their payment
- ▶ Individually significant receivables from large customers (e.g., sales to large wholesale customers) that have always paid on time
- ▶ Very short-term receivables that are typically settled in a matter of days (e.g., credit and debit card receivables from banks)

The requirement to reflect a risk of loss does not necessarily require complex modeling techniques that consider multiple outcomes.⁶ This concept is further discussed in section 2.3.2.

⁶ See ASU 2016-13, paragraph BC68.

2.3.1 Level of assessment – unit of measurement

To appropriately measure expected credit losses, an entity must determine the level at which to perform the assessment.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-2

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

The standard requires an entity to assess whether financial assets share similar risk characteristics and, if so, group such assets in a pool. If similar risk characteristics exist, an entity must measure expected credit losses on a pool basis, considering the risk associated with the designated pool. If similar risk characteristics do not exist, an entity must measure the allowance on an individual asset basis. The determination of whether a particular financial asset should be included in a pool can change over time. If an asset's risk characteristics change, it should be evaluated to determine whether it is appropriate to continue to keep the asset in its existing pool, or move it to a different pool that may be more consistent with its current risk characteristics. Entities should have processes to evaluate whether assets should continue to be grouped with other assets if risk characteristics change.

The standard requires entities to measure expected credit losses based on the risk associated with the pool of financial assets to provide a mechanism to estimate losses on assets that are not experiencing a deterioration in credit quality (i.e., higher credit quality assets). Estimating expected losses for a pool of financial assets presumes that, within the pool, there is some probability that a portion of the assets will experience credit deterioration, including a default, over the life of the instruments.

An individual assessment is more likely to be used for assets that have deteriorated in credit quality. This is because assets that have deteriorated in credit quality likely no longer share similar risk characteristics with other assets, since collection often depends on factors that are more specific to the individual customer's circumstances. If an asset no longer shares similar risk characteristics with other assets in that pool, an entity should remove that asset from the pool, determine the allowance for the pool without the asset included and calculate an allowance for the asset based on its individual risk characteristics (or include the asset in a different pool if that asset shares similar risk characteristics with that different pool).

Estimating expected credit losses on individual assets that have not yet experienced a deterioration in credit quality is inherently more difficult, given the challenges of identifying assumptions that reflect the risk of loss on that specific asset. Entities that are required to estimate allowances for these types of assets may find that using pool-based assumptions (e.g., past experience with similar assets) would best reflect the risk of loss.

2.3.1.1

Segmentation of financial assets**Excerpt from Accounting Standards Codification****Financial Instruments – Credit Losses – Measured at Amortized Cost***Implementation Guidance and Illustrations**Implementation Guidance**Developing an Estimate of Expected Credit Losses***326-20-55-5**

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

- a. Internal or external (third-party) credit score or credit ratings
- b. Risk ratings or classification
- c. Financial asset type
- d. Collateral type
- e. Size
- f. **Effective interest rate**
- g. Term
- h. Geographical location
- i. Industry of the borrower
- j. Vintage
- k. Historical or expected credit loss patterns
- l. Reasonable and supportable forecast periods.

The standard requires entities to pool financial assets but allows them to choose which risk characteristics to use. That is, ASC 326-20-55-5 says that an entity should aggregate based on “any one or a combination” of the characteristics listed in that paragraph.

An entity needs to assess, at each reporting period, whether assets in a pool continue to display similar risk characteristics. If particular assets no longer display risk characteristics that are similar to those of the pool, an entity may decide to revise its pools or perform an individual assessment of expected credit losses. For example, a broadcasting entity with trade receivables from advertising revenue may conclude that it is appropriate to create two pools of trade receivables, one for national customers (e.g., large public companies) and one for local customers (e.g., small businesses). This entity would need to reassess at each measurement date whether its trade receivables in each of the two pools continue to share similar risk characteristics.

Since pools are generally maintained to allow entities to track and manage credit losses, it is expected that an entity would pool assets based on the key drivers of credit risk. Defining a pool using more granular risk characteristics may result in a more precise estimate of expected credit losses. The following illustrations show how pooling might work for an entity with trade receivables:

Illustration 2-2: Pooling trade receivables by customer type

Manufacturer M is a producer of industrial equipment, which it sells both to wholesalers and to retailers. It requires payment within 30 days and provides no other financing.

Manufacturer M notes that its historical credit loss experience correlates with delinquency status. Manufacturer M also notes that historical credit losses for wholesalers differ from those for retailers. Based on this historical experience, Manufacturer M pools the trade receivables first by customer type, then by delinquency status. Manufacturer M pools its \$4 million in outstanding trade receivables as of 31 December 20X2 into the following eight pools:

Customer type	Current	1-30 days delinquent	31-90 days delinquent	90+ days delinquent
Wholesalers	\$2,500,000	\$100,000	\$80,000	\$45,000
Retailers	\$1,200,000	\$40,000	\$30,000	\$5,000

Illustration 2-3: Pooling trade receivables by customer type and geography

Assume the same facts as in Illustration 2-2 except Manufacturer M operates in several locations around the world and determines that credit losses vary by geography.

Based on this historical experience, Manufacturer M pools the trade receivables first by geography and customer type, then by delinquency status. Manufacturer M pools its \$4 million in outstanding trade receivables as of 31 December 20X2 into the following pools:

Geography	Customer type	Current	1-30 days delinquent	31-90 days delinquent	90+ days delinquent
US	Wholesalers	\$ 1,100,000	\$ 40,000	\$ 25,000	\$ 3,000
	Retailers	\$ 700,000	\$ 20,000	\$ 18,000	\$ 5,000
Europe	Wholesalers	\$ 900,000	\$ 50,000	\$ 30,000	\$ 8,000
	Retailers	\$ 600,000	\$ 15,000	\$ 14,000	\$ 10,000
Asia	Wholesalers	\$ 300,000	\$ 10,000	\$ 15,000	\$ 15,000
	Retailers	\$ 100,000	\$ 5,000	\$ 8,000	\$ 9,000

Given the flexibility the standard gives entities for segmenting a portfolio, there will be many acceptable approaches to establishing pools.

2.3.1.2**Reassessing the level of aggregation****Excerpt from Accounting Standards Codification****Financial Instruments – Credit Losses – Measured at Amortized Cost***Subsequent Measurement**Reporting Changes in Expected Credit Losses***326-20-35-2**

An entity shall evaluate whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in the pool. For example, there may be changes in credit risk, borrower circumstances, recognition of writeoffs, or cash collections that have been fully applied to principal on the basis of nonaccrual practices that may require a reevaluation to determine if the 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.

An entity needs to assess at each reporting period whether assets in a pool continue to display similar risk characteristics. If particular assets no longer display risk characteristics that are similar to those of the assets in the pool, an entity may determine that it needs to move those assets to different pools or perform individual assessments of expected credit losses for specific assets.

Illustration 2-4: Reassessing the level of aggregation

Historically, Manufacturer M pools trade receivables by customer type, then by delinquency status. However, when estimating credit losses for 31 March 20X3, it identifies a \$1,000,000 current receivable from a wholesale customer that recently declared bankruptcy. Manufacturer M concludes that this receivable no longer shares risk characteristics with other assets and moves the receivable into a separate new pool. As a result, Manufacturer M has nine pools as of 31 March 20X3 as follows:

Customer type	Current	1-30 days delinquent	30-90 days delinquent	90+ days delinquent	Bankruptcy
Wholesalers	\$1,500,000	\$100,000	\$80,000	\$45,000	\$1,000,000
Retailers	\$1,200,000	\$40,000	\$30,000	\$5,000	

Question 2-3 Is an entity required to use the credit rating associated with the asset (e.g., S&P credit rating, Fair Isaac Company (FICO) score) as the basis for pooling?

No. An entity is not required to pool based on internal or external credit ratings. However, the risk characteristic or characteristics an entity chooses should be based on the characteristic's ability to predict expected credit losses. Entities should, therefore, identify the key drivers of credit risk associated with the assets in their portfolios.

Question 2-4 If an entity aggregates financial assets into pools with relatively few assets (e.g., 10 or fewer assets), is it appropriate to group those assets into larger pools? What other factors should such an entity consider?

It would be appropriate to group the assets in a small pool with those in a larger pool if the larger pool would still be made up of assets with similar risk characteristics. However, an entity should not group assets into larger pools merely because a pool has only a few assets. If a pool contains relatively few assets (e.g., fewer than 10 assets), an entity should consider whether it is appropriate to continue to pool these assets, or whether the assets should be assessed individually.

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

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-10

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

collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

2.3.2.1 Assessing the risk of loss to be zero

The standard requires an entity to consider some possibility of a default, even if that risk is remote. Therefore, an entity's assessment of the instrument's loss upon a default needs to be zero to arrive at an allowance of zero. For example, while an entity may have no history (or expectation) of loss for a particular corporate customer, corporate bond default studies generally demonstrate that there is a risk of loss or a probability of default, even for highly rated customers. When a highly rated customer defaults, a loss will generally occur. As a result, it would be challenging for an entity to establish a "zero loss" expectation, even for a receivable due from a highly rated customer, since the loss upon a default is likely to be greater than zero.

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

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Implementation Guidance and Illustrations

Illustrations

Example 8: Estimating Expected Credit Losses When Potential Default Is Greater Than Zero, but Expected Nonpayment Is Zero

326-20-55-48

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

326-20-55-49

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

326-20-55-50

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

As discussed in the guidance above, US Treasury securities have the following characteristics that support an expectation of zero loss in the current environment:

- ▶ Consistent high credit rating by rating agencies
- ▶ Long history with no credit losses
- ▶ Explicitly guaranteed by a sovereign entity, which can print its own currency
- ▶ Currency is routinely held by central banks, used in international commerce and commonly viewed as a reserve currency

In addition, the market interest rate for a US Treasury security is widely recognized as a risk-free rate.

We believe the FASB provided this example to outline a framework that an entity may use to evaluate whether an expectation of zero loss is appropriate. In fact, the introduction to the example indicates that the considerations included in the example are not intended to apply only to US Treasury securities. That is, an entity could apply this framework to assets other than US Treasury securities. The following illustrates how an entity might estimate credit losses on receivables from the US government:

Illustration 2-5: Assessing receivables from the US government for expected credit losses

The US government enters into an agreement with Entity A to purchase military uniforms. Entity A records a receivable from the US government for the purchase.

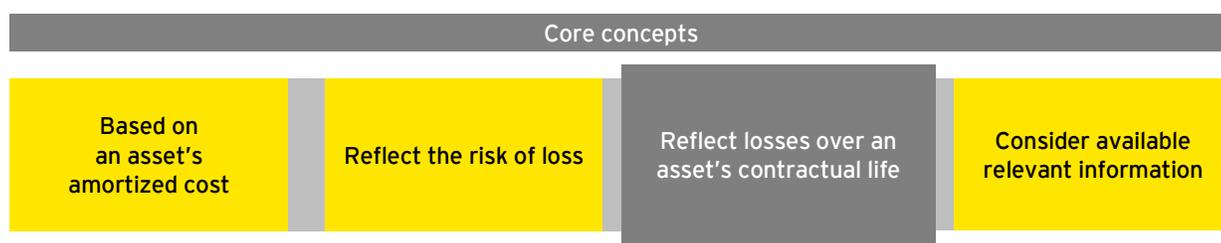
Entity A considers the following in assessing the risk of loss related to its receivable from the US government:

- ▶ The US government has a long history with no credit losses, and Entity A has never experienced a credit loss on its receivables from the US government.
- ▶ Government expenditures are generally subject to the federal budgeting and appropriations process. Therefore, funds have been allocated for the purchase.
- ▶ The US government can print its own currency.

Based on these considerations, Entity A determines that the loss given default on the receivable is zero. Accordingly, Entity A does not record expected credit losses associated with this receivable. Entity A must reassess these considerations at every reporting period to continue to support its estimate of no expected credit losses.

Further, we believe entities need to continually challenge the conditions that they use to support an expectation of zero loss for all periods that the entity holds that instrument. That is, entities will need to have processes and controls in place to continually evaluate these conditions.

2.4 Reflect losses over an asset's contractual life (updated April 2020)



Determining the contractual life of the asset is a key part of estimating expected credit losses because it is the time horizon over which an entity will be exposed to credit risk related to a particular financial asset. Longer time horizons generally present more uncertainty in expected cash flows. This uncertainty will affect the estimate of expected credit losses. Credit losses on a financial asset can happen at any point during the financial asset's life. For some financial assets, credit losses tend to occur early in an asset's life while for others, credit losses tend to occur closer to maturity. To accurately estimate an entity's expected credit losses, entities must use historical data that reflects the timing and pattern of historical lifetime credit losses. For short-term receivables and contract assets, estimating the timing of expected credit losses will be a less significant factor in the credit loss estimate, given the short-term nature of the assets.

How we see it

Entities that use a historical annual loss-rate approach when estimating credit losses for certain shorter-duration instruments (i.e., trade receivables) will need to adjust the loss rates for the economic conditions expected to be in place over the instrument's remaining life.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-6

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

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless either of the following applies:

- a. The entity has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.
- b. The extension or renewal options (excluding those that are accounted for as derivatives in accordance with Topic 815) are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

Pending content:

Transition Date: (P) December 16, 2022; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-5

326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless the following applies:

- a. Subparagraph superseded by Accounting Standards Update No. 2022-02.
- b. The extension or renewal options (excluding those that are accounted for as derivatives in accordance with Topic 815) are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

If there are no explicit contractual terms that can affect the timing of repayment, determining the contractual life of a financial asset is straightforward. The entity simply uses the payment terms.

However, if payment terms aren't specified or customers routinely make payments after the stated due date, an entity will need to determine the period of time over which it will be exposed to credit losses (i.e., the expected life). The expected life of such a receivable should be determined based on historical experience, current conditions, and reasonable and supportable forecasts of future economic conditions.

How we see it

Entities must estimate credit losses over the entire period they are exposed to credit risk. For example, if an entity requests payment within 30 days but expects customers to pay within 90 days, the entity should incorporate a reasonable and supportable forecast for a period of 90 days rather than 30 days.

Further, if there are terms that can affect the timing of repayment (e.g., prepayment options, extension options), the entity may need to consider them in determining an asset's contractual life.

ASC 326-20 says prepayments reduce expected losses because they shorten the time period over which the seller is expected to be exposed to credit losses to a period of time less than the full contractual term. Prepayments could arise as a result of a discount provided by the seller for early payment. The guidance also says the life of an asset 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 (TDR) with the customer. In most cases, this TDR exception has little effect on determining the life of short-term receivables because most accounts receivables will not be affected by reasonably expected TDRs. Entities that have already adopted the credit losses guidance should be aware that they only need to apply this TDR exception until they adopt ASU 2022-02,⁷ which eliminates the TDR recognition and measurement guidance for creditors along with this TDR exception in ASC 326. All other entities will adopt ASU 2022-02 at the same time as they adopt the credit losses guidance, and they won't have to consider this TDR exception in determining the contractual life of an asset.

⁷ ASU 2022-02 also requires PBEs to present current-period gross write-offs (on a current year-to-date basis for interim-period disclosures) by year of origination in their vintage disclosures. See sections 2.4.2.4 and 6.3.1.2.2 of our comprehensive ASC 326 FRD for details on the requirements of this ASU, its effective date and transition.

ASC 326 also says that extensions and renewal options that are part of the original or modified arrangement at the reporting date and are not unconditionally cancelable by the seller may indicate that the contractual maturity date alone does not determine the contractual life of the lending arrangement. These extension and renewal options should be evaluated when determining the contractual life, including evaluating the likelihood that the customer will request the extension or exercise the renewal option and the probability that the customer will meet any prerequisite conditions to extend or renew the arrangement (e.g., government approval of a contract). For more information, see our [comprehensive ASC 326 FRD](#).

2.5

Consider available relevant information

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

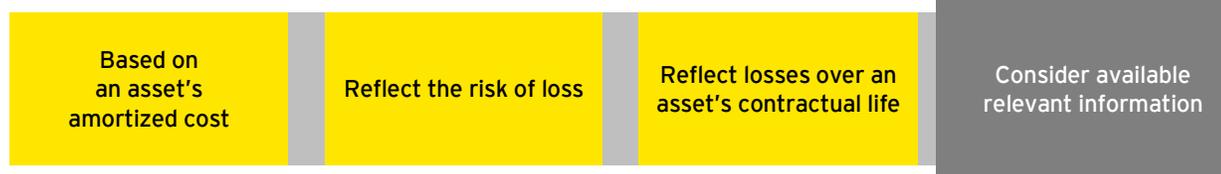
Initial Measurement

Developing an Estimate of Expected Credit Losses

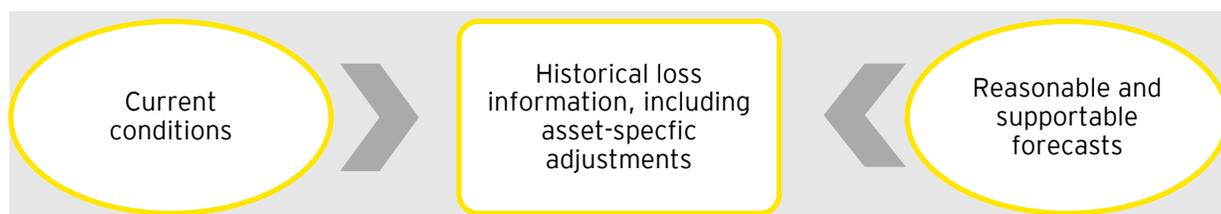
326-20-30-7

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

Core concepts



ASC 326 requires an entity's estimate of expected credit losses to reflect available information that is relevant to assessing the collectibility of cash flows. That information should include historical loss information adjusted for current conditions and forecasts about future economic conditions that are reasonable and supportable. The guidance requires entities to revert to historical loss information when they can no longer develop a reasonable and supportable forecast.



Significant judgment will be required to determine the historical data that should be used and the adjustments that may need to be made to historical loss information. When an entity prepares the estimate, it is important to understand the interaction between the historical loss data chosen, the application of current conditions and the reasonable and supportable forecast of future economic conditions, the data used during the reversion period and the method of reversion. ASC 326-20 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. Historical information may require adjustments for the following:

Adjustment	Description
Asset-specific characteristics	Asset-specific adjustments are required if the historical loss information relates to a different type of asset or customer than the current portfolio of receivables. For instance, historical data would need to be adjusted if it represented loss experience on receivables related to wholesale customers if the entity currently has receivables related to a mix of wholesale and retail customers.
Current conditions	Many entities will use historical information that reflects losses through an entire credit cycle. Adjustments to this data may be required if economic conditions at the measurement date reflect stronger or weaker economic performance than the historical data implies.
Reasonable and supportable forecasts of economic conditions expected to exist throughout the contractual life of the receivable	To determine the expected credit losses over the contractual life of the asset, entities must consider the effect of the economic conditions that will exist through the contractual life of the financial asset. To accomplish this objective, the entity will create a reasonable and supportable forecast of future economic conditions, as described in ASC 326-20-30-7. For receivables with lives of less than one year, changes to economic conditions may not have a significant effect on the estimate of the allowance for expected credit losses because it is less likely that the economic conditions will change significantly enough to influence expected credit losses. However, in more volatile economic environments, it is possible that the estimate could be affected.

2.5.1

Obtaining relevant historical loss information

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-8

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

Implementation Guidance and Illustrations

Implementation Guidance

Information Considered When Estimating Expected Credit Losses

326-20-55-2

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

326-20-55-3

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

The guidance states that historical information about losses generally provides a basis or a starting point for the estimate of expected credit losses. That is, historical credit loss experience for similar assets is likely a relevant data point for estimating the credit losses that will emerge for assets currently held by the entity. The following categories of historical information may be required to satisfy the requirements of the standard:

- ▶ Asset characteristics (e.g., life, customer type)
- ▶ Loss experience, including migration statistics, write-offs and recoveries
- ▶ The effect of modifications (including TDRs before adoption of ASU 2022-02),⁸ prepayments and extensions on loss experience
- ▶ Macroeconomic conditions that correlate with historical loss experience

The standard doesn't specify a particular approach for determining what historical credit loss information should be used. However, the implementation guidance indicates that it is important that the historical loss information (after adjustments for asset-specific characteristics, current conditions, and reasonable and supportable forecasts of future economic conditions) be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed. The FASB staff has noted that entities may use historical loss information from different time periods that are nonsequential in the credit loss estimate. Entities also do not have to use historical losses from the most recent periods if prior periods have information that better represents the specific risk characteristics of the entity's current portfolio.⁹

Entities should consider historical information from various sources (i.e., internal, entity-specific data and external data) to produce an accurate estimate of expected credit losses. Regardless of whether internal or external information is deemed more relevant, management should assess the reliability of the information and the entity's ability to support its conclusions.

Internal information may be more relevant than external information if it more closely aligns with the financial assets for which the estimate of expected credit losses is being made. For example, a privately owned manufacturer with trade receivables relating to a consistent customer base in a specific geography may find that its own historical loss information is more relevant than externally available loss or credit information (e.g., external ratings, reports or statistics, changes in credit spreads) because external data would not reflect the specific risk characteristics of its customers or contract terms. However, if internal information is insufficient to determine the collectibility of the assets being evaluated or the data is not complete or has not been adequately controlled in such a way that it can provide a reliable estimate, entities should consider using external information to supplement their data.

⁸ In March 2022, the FASB issued ASU 2022-02 amending ASC 310 to eliminate the recognition and measurement guidance for a TDR for creditors that have adopted the credit losses guidance in ASC 326. The ASU also requires PBEs to present current-period gross write-offs (on a current year-to-date basis for interim-period disclosures) by year of origination in their vintage disclosures. See sections 2.4.2.4 and 6.3.1.2.2 of our comprehensive ASC 326 FRD for details on the requirements of this ASU, its effective date and transition.

⁹ FASB Staff Q&A, Topic 326, No. 2: *Developing an Estimate of Expected Credit Losses on Financial Assets*.

Most of the necessary historical data to be obtained will be relatively objective. However, since macroeconomic conditions will drive adjustments to the historical data for both current conditions and reasonable and supportable forecasts of future economic conditions, more judgment is required. Entities will need to identify the macroeconomic variables that are most relevant to evaluating and predicting expected credit losses. These macroeconomic variables will vary by product, geography and customer type. Additionally, entities may use one or many economic variables to adjust for current conditions and reasonable and supportable forecasts of future economic conditions.

Illustration 2-6: Developing available relevant historical loss information

Company A is a manufacturing startup and does not possess internal historical loss information.

Company A could consider external information such as market data relating to credit loss experience for a similar customer base. Company A would need to assess whether this external data requires adjustments to reflect the specific characteristics of its customer payment terms and credit risk associated with its customers.

Developing an estimate of expected credit losses involves considerable judgment. Company A would need to continually reassess those judgments and refine its estimate as more information becomes available, and Company A builds its experience with customers.

2.5.2

Adjustments to historical loss information (updated April 2020)

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

326-20-30-9

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

Implementation Guidance and Illustrations

Implementation Guidance

Information Considered When Estimating Expected Credit Losses

326-20-55-4

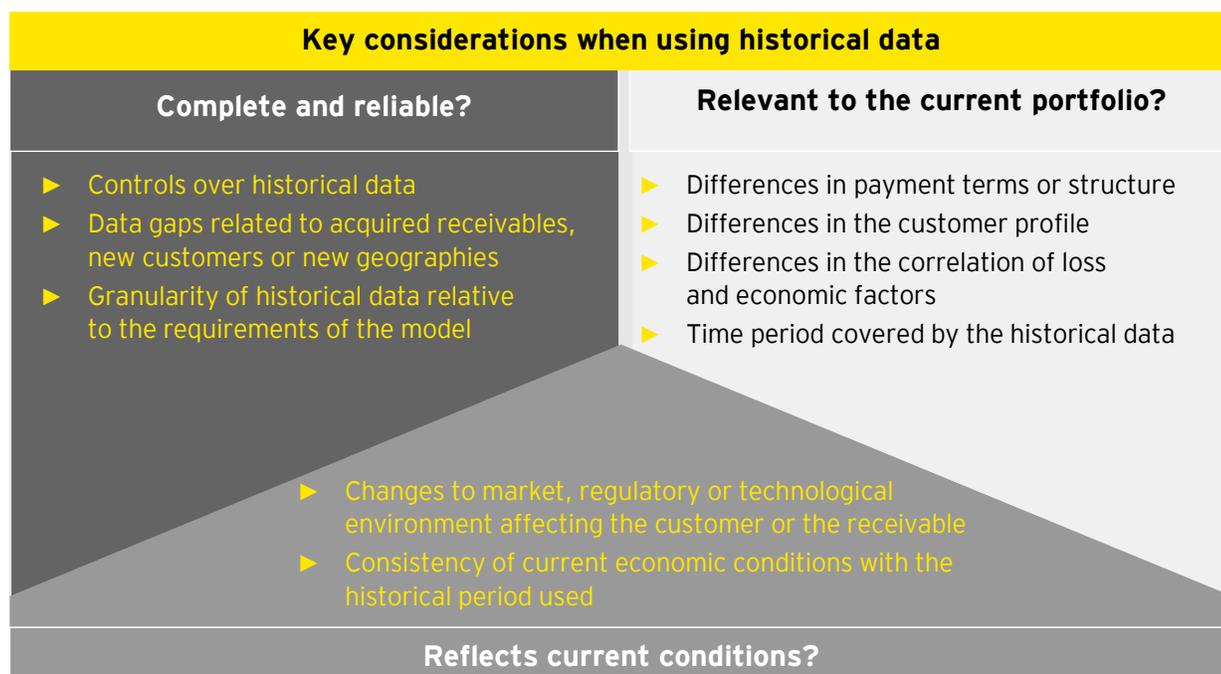
Because historical experience may not fully reflect an entity's expectations about the future, management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information. In making this determination, management should consider characteristics of the financial assets that are relevant in the circumstances. To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility. Examples of factors an entity may consider include any of the following, depending on the nature of the asset (not all of these may be relevant to every situation, and other factors not on the list may be relevant):

- a. The borrower's financial condition, credit rating, credit score, asset quality, or business prospects
- b. The borrower's ability to make scheduled interest or principal payments
- c. The remaining payment terms of the financial asset(s)
- d. The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)
- e. The nature and volume of the entity's financial asset(s)
- f. The volume and severity of past due financial asset(s) and the volume and severity of adversely classified or rated financial asset(s)
- g. The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been utilized
- h. The entity's lending policies and procedures, including changes in lending strategies, underwriting standards, collection, writeoff, and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- i. The quality of the entity's credit review system
- j. The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- k. The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as:
 1. Regulatory, legal, or technological environment to which the entity has exposure
 2. Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
 3. 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.

2.5.2.1

Adjustments for asset-specific factors and current economic conditions

When using historical information to estimate credit losses, 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. In doing so, management should consider the factors in the graphic below:



Although the standard provides examples of factors an entity may consider, there is little implementation guidance on how an entity should adjust its historical credit loss information for asset-specific characteristics, current conditions or reasonable and supportable forecasts of future economic conditions. As noted above, adjustments may be needed to make the historical information relevant to the pool of financial assets for which an entity is estimating expected lifetime credit losses. For example, if an entity is estimating expected credit losses on a pool of receivables relating to customers with AA credit ratings and management's historical loss information relates to receivables from customers with BBB credit ratings, the historical loss information would generally require adjustment to make it relevant.

With respect to adjustments for economic factors, we expect most entities to focus on the economic variables that management believes most significantly affect the collectibility of cash flows. Management can use historical loss information that reflects the current economic conditions or can start with historical loss information that represents a full credit cycle (i.e., average loss experience or loss experience through a full economic cycle) and adjust it for current conditions. Management can also use different historical data. The length of the period selected may also vary. That is, management may select a period that aligns with the expected remaining life of the portfolio, a period that includes all of the entity's historical losses or a period that captures one or more credit cycles.

An entity will need to consider how historical loss patterns differ from current expectations (including both current conditions and reasonable and supportable forecasts of future economic conditions). When performing this analysis, entities will likely compare the economic factors inherent in the historical loss data to current information about those factors (as well as reasonable and supportable forecasts of those factors). The standard requires an entity to then adjust its historical credit loss experience, as necessary, for its current expectations (and reasonable and supportable forecasts of future economic conditions, as discussed in section 2.5.2.2).

How we see it

To make adjustments to historical loss information, management will need to estimate the current point in the economic cycle and correlate it with information about previous economic cycles. If the entity doesn't have relevant and reliable internal data to make this estimate, management may need to use external data and/or peer benchmarking to make adjustments to the entity's historical loss information.

2.5.2.2

Reasonable and supportable forecasts of future economic conditions

The standard requires an entity to incorporate reasonable and supportable forecasts of future economic conditions into the estimate of expected credit losses, considering factors that are asset- or customer-specific. Entities have flexibility to determine the relevant economic indicators, length of the forecast period and sources of forecasted information. We believe less-complex entities that have shorter-term assets do not need to use complex modeling techniques in order to incorporate a reasonable and supportable forecast in the credit loss estimate.

For short-term receivables and contract assets, we generally believe that entities will be able to forecast future economic conditions for the entire contractual life. However, the forecast period depends on the economic variables being forecast and the entity's ability to forecast the variables over time. Forecasting economic variables, including determining the appropriate forecast period, will require significant judgment. There are no bright lines on the appropriate length of a forecast period. Factors to consider include:

- ▶ Availability and reliability of information – The availability and reliability of information may limit an entity's ability to develop a reasonable and supportable forecast of future economic conditions for the full contractual life of an asset.
- ▶ Relevance of the economic conditions to entity's portfolio – The forecasted economic variables must be relevant to the portfolio based on factors such as asset type, geography and whether a variable truly correlates with losses. Entities may determine that one or more variables are relevant to their forecast of future economic conditions, and these choices may differ from entity to entity.

What is reasonable and supportable will be a matter of judgment. Paragraph BC52 in ASU 2016-13 states "as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses also increases." That is, the reliability of the forecast and the evidence supporting the forecast may diminish further out in the forecast period. Entities should apply their estimation process for the allowance for expected credit losses consistently and in a systematic manner and clearly document the judgments they make.

The FASB staff has noted that entities should reevaluate the reasonable and supportable forecast period at each measurement date.¹⁰

Due to the amount of judgment involved, different entities are likely to have different reasonable and supportable forecast periods.

2.5.2.2.1

Quantifying the effect of the reasonable and supportable forecast of future economic conditions

One way an entity may quantify the effect of the reasonable and supportable forecast of future economic conditions is by observing how its historical loss experience has reacted to economic variables that affect expected collectibility, as illustrated below.

¹⁰ FASB Staff Q&A, Topic 326, No. 2: *Developing an Estimate of Expected Credit Losses on Financial Assets*.

Illustration 2-7: Quantifying adjustments that affect collectibility in the reasonable and supportable period

Company A began selling goods in Country A in 20X2. Soon thereafter, management noticed that any time the unemployment rate in Country A increased, the Company's cumulative losses on its receivables rose.

In estimating Company A's 31 December 20X8 allowance for expected credit losses, management determined that unemployment was the primary driver affecting collectibility and gathered the following data:

Year	Country A unemployment rate	Cumulative loss experience
20X2	4.0%	1.0%
20X3	4.5%	1.5%
20X4	5.0%	3.0%
20X5	5.5%	3.5%
20X6	6.0%	4.0%
20X7	6.5%	5.0%

Since 20X2, management has not experienced a change in its customer base or changed the payment terms for its products.

When estimating the allowance for expected credit losses at 31 December 20X8, management concludes that it needs to make adjustments for the effect that the unemployment rate will have on its receivables. Management expects the unemployment rate in 20X8 to decrease to 6.0%. As a result, Company A uses a cumulative loss rate of approximately 4.0%, based on the data it observed showing the correlation between an unemployment rate of 6.0% and cumulative losses.

Adjustments to historical loss experience may be required for qualitative or environmental factors. For example, business confidence surveys may suggest that there is a perception that the economy is weakening and payments could be delayed. This may indicate that the estimate of expected credit losses should be increased. The practical challenge for management is to support adjustments for qualitative factors like these.

An entity may use different methods to quantify adjustments. Simpler methods may be used, as long as they result in an estimate of expected credit losses that is reasonable and supportable. The method an entity uses is affected by the availability of relevant historical loss information and systems currently in place. An 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.

How we see it

Quantifying the adjustment to historical credit loss rates is one of the more challenging aspects of applying the standard and there is diversity in practice in how entities do this. Entities need to make sure they document their methodology and judgments appropriately.

Question 2-5 **Is it possible for different entities to have different views of the future when establishing their allowances?**

Yes. While we believe entities may have different views of the future when estimating expected credit losses, forecasts of future economic conditions need to be reasonable and supportable in all cases. For example, if one entity's forecast predicts unemployment rates will increase over a period but another entity's economic forecast predicts that unemployment rates will decrease, both forecasts may be acceptable as long as they are reasonable and supportable.

Judgment must be used in considering conflicting forecasts about the future. The guidance permits management to use internal information to establish its allowance and acknowledges that internal information may be more relevant than external information. However, management needs to consider observable market data or external information when developing its estimate. Regardless of whether management takes a contrarian view, it must be able to support its view.

Question 2-6 **Are entities required to probability weight multiple economic scenarios when developing their reasonable and supportable forecast of future economic conditions?**

No. An entity is not required to use multiple probability-weighted economic scenarios when developing a reasonable and supportable forecast of future economic conditions. As noted in the Basis for Conclusions, the FASB chose to neither require nor preclude the use of probability-weighted economic scenarios. In any case, it is important to remember that the reasonable and supportable forecast is intended to reflect management's expectation about future economic conditions.

Question 2-7 **May an entity use different forecast periods for different types of receivables?**

Yes. The macroeconomic factors that drive losses may differ depending on the type of receivable, geography of the customer, the collateral or other factors. Management must determine the factors that most closely correlate with its loss experience for each receivable type. This may result in the entity using different economic forecasts of future economic conditions and potentially different forecast periods for different assets.

Question 2-8 **Are entities required to use consistent forecasts of future economic conditions throughout the organization?**

It depends. Forecasts across an organization may differ depending on the factors that would affect those forecasts. For example, in its capital planning process, an entity will use macroeconomic factors relevant to the entity and the industry in which it operates. But when the same entity estimates its allowance for credit losses, it will use factors that are relevant to the receivables for which it is estimating credit losses. Entities need to evaluate the consistency of the forecasts they use for estimating credit losses with the forecasts they use for other purposes (e.g., goodwill impairment testing, going concern analysis, deferred tax asset valuation allowance analyses, capital planning, budgeting) and make sure they can explain any differences. We believe that if the forecasts of future economic conditions are inconsistent, the entity should evaluate the differences and support and document the reasons for any differences.

Question 2-9 **Are entities required to perform backtesting on their reasonable and supportable forecasts of future economic conditions?**

The standard is silent on whether entities are required to backtest the reasonable and supportable forecast of future economic conditions, and the FASB staff has noted that estimates of expected credit losses often will not predict with precision actual future events.¹¹ While we do not believe that backtesting will provide evidence that will be relevant to estimating an allowance in all cases, we do believe comparing actual economic results to the reasonable and supportable forecast may enhance an entity's forecasting process.

¹¹ Ibid

Question 2-10 What should management consider in assessing whether obtaining additional information would require undue cost and effort?

The standard states that an entity is required to use only information that is “reasonably available without undue cost and effort.” ASC 326 does not define “undue cost and effort.”

Management should assess how important the information is to users based on the entity’s facts and circumstances. Considerations may include:

- ▶ Sensitivity of the estimate to the data
- ▶ Other weaknesses in the data or the modeling that may be exacerbated by the lack of certain data
- ▶ Frequency of financial reporting
- ▶ Significance of the allowance to the overall financial statements

Determining what constitutes undue cost and effort requires judgment of the specific facts and circumstances at each measurement date. Likewise, the point at which an entity’s efforts to obtain data require undue cost and effort will differ by entity. However, all entities will consider the benefit that the information would provide to the estimate and, ultimately, to the users of the financial statements. Since available information may change over time, what constitutes undue cost and effort may change over time. What constitutes undue cost and effort also may be different for different financial assets held by the same entity.

Question 2-11 Can entities make qualitative adjustments to the expected credit loss estimate?

Yes, they can; however, qualitative adjustments should be appropriately supported with quantitative-based documentation. In addition, when making qualitative adjustments, entities should not double-count adjustments that are made quantitatively.

2.6 Credit enhancements

Credit risk is sometimes mitigated by guarantees, such as letters of credit, or insurance. When estimating credit losses, an entity considers the mitigating effects of credit enhancements that aren’t freestanding but is prohibited from considering the credit risk mitigating effects of freestanding guarantees and insurance. If the credit enhancement is freestanding, an entity accounts for the credit enhancement as a separate asset.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Initial Measurement

Developing an Estimate of Expected Credit Losses

Credit Enhancements

326-20-30-12

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

Master Glossary**Freestanding contract**

A freestanding contract is entered into either:

- a. Separate and apart from any of the entity's other financial instruments or equity transactions
- b. In conjunction with some other transaction and is legally detachable and separately exercisable

If a contract is entered into concurrently with or in contemplation of another transaction, it is important to assess whether the two contracts are (1) legally detachable and (2) separately exercisable. If both conditions are met, these contracts are considered freestanding.

For a credit enhancement arrangement to be considered in the estimate of expected credit losses, it must be embedded in the financial asset and cannot be a separate freestanding contract. The determination of whether a contract is freestanding or embedded in another instrument or contract requires an understanding of both the form and substance of the transaction. It also requires judgment. A contract is not freestanding solely because it is documented in a separate document. Similarly, rights and obligations documented in a single agreement may be treated as separate freestanding instruments.

If a contract is entered into separately from any other transaction, it suggests that the contract may be freestanding. For example, if a credit enhancement arrangement is entered into after the origination or acquisition of the underlying financial asset with a sufficient period of time between the two transactions, the credit enhancement would generally be considered "separate and apart" from the financial asset and therefore a freestanding contract.



Purchased credit-default swaps are examples of instruments that are freestanding.

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.

Receivables are sometimes secured by letters of credit or accounts receivable insurance that guarantees payment in the event of a customer default. Entities will need to evaluate whether such credit enhancements are freestanding because a freestanding credit enhancement would not be considered in the assessment of expected credit losses.

How we see it

The determination of whether a credit enhancement is freestanding may involve significant judgment. The accounting for a credit enhancement will be based on the specific facts and circumstances of the arrangement and should generally follow the contractual terms of the arrangement, not the intent of the parties. In certain cases, legal counsel may need to be engaged to interpret the contractual terms.

Illustration 2-8: Letters of credit

Entity B seeks to purchase a computer processor from Entity A for \$1,000,000. As part of the sale agreement for the processor, Entity A requires Entity B to obtain a letter of credit from a bank, guaranteeing the \$1,000,000 receivable. Under the letter of credit, the bank will reimburse Entity A (the beneficiary) for a loss of up to \$1,000,000 if Entity B defaults on the receivable. The letter of credit is structured such that if the receivable is transferred to a third party, the third party also becomes the beneficiary of the letter of credit. Entity B pays all charges related to the letter of credit.

Should Entity A consider the letter of credit in its estimate of expected credit losses on the \$1,000,000 receivable?

Analysis

Yes. The letter of credit does not meet either of the two criteria to be a freestanding contract.

Criterion 1 – Contract is entered into separate and apart from another transaction.

The letter of credit was obtained as a condition of the sale of the computer processor, not in a transaction separate and apart from the sale. Entity A would not have sold this product to Entity B without the letter of credit.

Criterion 2 – Contract is entered into in conjunction with another transaction and is legally detachable and separately exercisable.

Because the letter of credit was entered into in conjunction with the sale transaction, Entity A assesses whether the letter of credit is legally detachable and separately exercisable. The letter of credit is not “legally detachable” from the receivable because the letter of credit specifies that the guarantee is for Entity’s B’s purchase of the \$1,000,000 computer processor and if the receivable is transferred to a third party, the third party automatically becomes the beneficiary of the letter of credit. As such, the letter of credit cannot be legally separated from the receivable and transferred so that the receivable and letter of credit are held by two different parties. Additionally, the letter of credit is not separately exercisable because payment by the bank is contingent upon nonpayment by Entity B, and the letter of credit could not be exercised if Entity B pays the \$1,000,000.

Based on this analysis, Entity A concludes that the letter of credit does not meet either of the conditions to be a freestanding contract. As a result, Entity A should consider the letter of credit when determining expected credit losses.

Refer to section 2.6.1 of our FRD, [Credit impairment under ASC 326](#), for a discussion on freestanding credit insurance.

How we see it

Letters of credit that guarantee the full amount of a receivable and are not freestanding generally do not support a zero loss conclusion on the receivable. Although an entity's loss from a receivable may be reimbursed in full by the letter of credit, the entity must still consider the risk of loss related to the issuer of the letter of credit. This will generally result in a credit loss estimate greater than zero.

2.7 Write-offs and recoveries

At some point during the life of a financial asset, an entity may conclude that the asset is no longer collectible and should be written off. After a write-off occurs, cash may be received from the customer as a recovery of that write-off. An entity's estimate of expected credit losses should consider its history of write-offs and recoveries because those events affect the entity's loss given default experience.

2.7.1 Write-offs

A write-off should be recorded when an entity concludes that all or a portion of a financial asset is no longer collectible, and a recovery should be recorded when it occurs.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Subsequent Measurement

Writeoffs and Recoveries of Financial Assets

326-20-35-8

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

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

Writeoffs of Financial Assets

326-20-35-8

Writeoffs of **financial assets**, which may be full or partial writeoffs, shall be deducted from the allowance. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible.

326-20-35-8A

An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, to write off accrued interest receivables by reversing interest income or recognizing credit loss expense or a combination of both. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-30-5A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

When an entity deems all or a portion of a receivable to be uncollectible, it should reduce the allowance for expected credit losses by the same amount as the portion that is being written off.

The standard, however, does not define what “deemed uncollectible” means. Entities need to apply judgment to determine when a financial asset is “deemed uncollectible.” An asset is generally considered uncollectible no later than when all efforts at collection have been exhausted.

Examples of factors an entity may consider include the following:

Example factors an entity would consider when assessing whether an asset is 'deemed uncollectible'

- ▶ The entity has sufficient information to determine that the customer (or issuer of the security) is insolvent.
- ▶ The entity has received notice that the customer (or issuer of the security) has filed for bankruptcy, and the collectibility of the asset is expected to be adversely affected by the bankruptcy.
- ▶ Amounts have been past due for a specified period of time with no response from the customer.
- ▶ The entity has received correspondence from the customer indicating that it doesn't intend to pay the outstanding amount.

2.7.2

Recoveries (updated April 2020)

When measuring the allowance for credit losses, entities should incorporate an estimate of expected recoveries. An entity's estimate of recoveries needs to be supportable. When an entity receives consideration (e.g., cash) in satisfaction of some or all of the amounts it previously wrote off, the recovery may be recognized by either (1) increasing the allowance for expected credit losses or (2) increasing earnings directly. Entities in some industries record recoveries by debiting cash and crediting credit loss expense, while financial institutions typically debit cash and credit the allowance for expected credit losses. Ultimately, if an entity recognizes a recovery by immediately increasing the allowance for expected credit losses and then determines at the end of the reporting period that the increase in the allowance was not necessary, the same credit to earnings will occur (i.e., the entity would debit the allowance for expected credit losses with a corresponding credit to credit loss expense).

The entity should include recoveries in the historical data it uses to determine expected credit losses. Entities need to track both historical write-offs and recoveries to be able to appropriately evaluate historical loss experience.

The following examples from the standard illustrate how entities may evaluate and recognize write-offs and recoveries. Although the example is in the context of a banking entity and involves a loan, the example illustrates how the guidance on write-offs and recoveries should be applied for all receivables, including trade receivables.

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Implementation Guidance and Illustrations

Illustrations

Example 9: Recognizing Writeoffs and Recoveries

326-20-55-51

This Example illustrates how an entity may implement the guidance in paragraphs 326-20-35-8 through 35-9 relating to writeoffs and recoveries of expected credit losses on financial assets.

326-20-55-52

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 326-20-35-8, 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 in accordance with paragraph 326-20-35-8, as follows:

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

326-20-55-53

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.

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

326-20-55-52

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 considers all available information that is relevant and reasonably available, without undue cost or effort, and determines that the information does not support an expectation of a future recovery in accordance with paragraph 326-20-30-7. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance in accordance with paragraph 326-20-35-8, 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 in accordance with paragraph 326-20-35-8, as follows:

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

As noted in the example above, under the alternative treatment, Bank K would record the recovery of \$50,000 directly as a reduction to credit loss expense when it receives the partial payment in March 20X6:

Cash	\$ 50,000	
Credit loss expense		\$ 50,000

No additional journal entries would be necessary under this approach.

Question 2-12

How should expected recoveries be included in an entity's estimate of expected losses?

Expected recoveries on pools of assets or individual assets that have been fully or partially charged off should be included in the measurement of the allowance for credit losses as long as the estimate of expected recoveries is reasonable and supportable, even if the recognition of such recoveries results in a negative allowance. For PCD assets, if an entity estimates expected credit losses using a method other than a DCF method, expected recoveries should not include any amounts that result in the accelerated recognition of the noncredit discount. The estimate of losses in the event of default should capture the entity's expectation of recoveries based on the entity's historical experience. The expected recoveries cannot exceed the aggregate of amounts previously written off and expected to be written off. Depending on the method used to estimate expected credit losses, entities may track recoveries separately from write-offs or include them in the loss statistics. Regardless of the method used, management needs to consider net write-offs (i.e., write-offs minus recoveries) in its estimate of expected credit losses.

We believe recoveries can include, but are not limited to, the following sources:

- ▶ Cash flows from the customer, including those arising from the customer's bankruptcy estate
- ▶ Cash flows resulting from the operation or sale of any collateral securing an asset
- ▶ Proceeds from the sale of nonperforming receivables
- ▶ Payments from guarantors on a receivable, as long as the guarantee was not freestanding

The FASB has clarified that recoveries should be included in the allowance, should not be treated as an adjustment to the amortized cost and should not be presented as a separate asset.

Question 2-13

Should an entity "write up" an asset's amortized cost for an expected recovery?

No. Entities should not "write up" an asset's amortized cost for expected recoveries. These amounts should be recognized in the allowance for credit losses. Further, the receipt of consideration (e.g., cash) should be recorded as either an increase to the allowance or an offset to credit loss expense. Entities should not increase the amortized cost basis of the financial instrument that was previously written off.

2.8

Interaction with ASC 606

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Other Presentation Matters

606-10-45-3

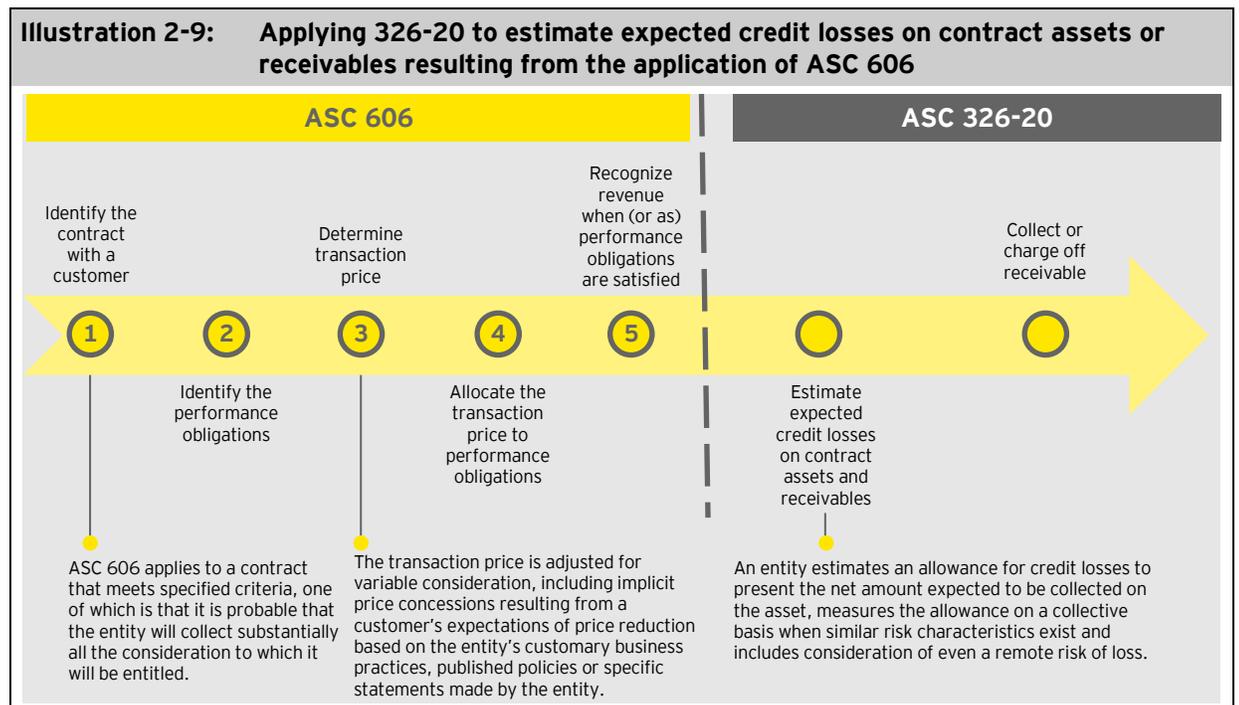
If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a **contract asset**, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall 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 shall be measured, presented and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

606-10-45-4

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an 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 Topic 310 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 determining that a contract with a customer exists, an entity is required to determine whether collection of the transaction price, which is adjusted for price concessions and other variable consideration, is probable. If collection is deemed probable, an entity will apply the revenue recognition model in ASC 606 and record revenue and a receivable or contract asset when control of a good or service transfers to a customer. If an entity determines that collection is not probable, it does not recognize revenue or record a receivable or a contract asset on the balance sheet. As illustrated in the graphic below, if an entity determines that collection is probable, that does not mean that the risk of expected lifetime credit loss is zero. Entities need to apply ASC 326-20 to estimate expected credit losses on a contract asset or receivables resulting from the application of ASC 606.



Under ASC 606, entities record contract assets, which represent an entity's conditional right to consideration for goods or services it has provided when that right is conditioned on something other than the passage of time (e.g., the entity's future performance). Entities in various industries have long-term contracts with customers that may result in contract assets. For example, a telecom entity would recognize a contract asset for a free or discounted phone it transferred to a customer at the beginning of a two-year, noncancelable service agreement because the monthly payments for the phone are conditioned on the entity providing service under the two-year agreement.

To estimate an allowance for credit losses on contract assets, an entity will generally follow the same methodology as it does to estimate an allowance on accounts receivable. Additional areas of consideration for contract assets include the following:

Factor	Considerations
Contractual life	The contractual life of a contract asset includes both the period when the entity accounts for it as a contract asset and the period when the entity accounts for it as a receivable. That is, the contractual life is the period up until the receivable is collected or written off. This may result in a contractual life of over one year. If that's the case, the entity will need to develop a reasonable and supportable forecast for a longer period. Refer to our comprehensive ASC 326 FRD for guidance on applying ASC 326 to assets with a contractual life greater than one year.
Credit risk of related receivables	If an entity has both contract assets and receivables with the same customer, it should consider the credit risk related to the receivables when estimating credit losses on the contract assets. For example, if a receivable is delinquent, this information should be considered in the credit loss estimate for a contract asset from the same customer.

As part of the CECL assessment, entities will need to distinguish between expected losses due to credit risk and losses attributable to other factors, such as the entity's nonperformance. Further, entities will need to distinguish between modifications that are accounted for as contract modifications under ASC 606 and those that are accounted for as TDRs because TDRs are required to be considered in the estimate of expected credit losses under ASC 326-20 before adoption of ASU 2022-02.¹²

2.9 Examples

2.9.1 Aging method

As previously noted, entities can use various methods to measure expected credit losses, such as pooling receivables based on the levels of delinquency (e.g., current, 0-30 days past due, 31-90 days past due, more than 90 days past due) and applying historical loss rates, adjusted for current conditions and reasonable and supportable forecasts, to each pool.

The following example describes how an entity could apply the standard to its trade receivables balance using an aging method. We believe most entities will use a similar method for receivables.

Illustration 2-10: Estimating expected credit losses for trade receivables using an aging schedule

Company A manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days. Company A has tracked historical loss information for its trade receivables on an amortized cost basis, using a life of 90 days resulting in the following historical credit loss percentages:

- 0.27% for receivables that are current
- 7.20% for receivables that are 1-30 days past due

¹² In March 2022, FASB issued ASU 2022-02, amending ASC 310, to eliminate the recognition and measurement guidance for a TDR for creditors that have adopted the credit losses guidance in ASC 326. The ASU also requires PBEs to present current period gross write-offs (on a current year-to-date basis for interim-period disclosures) by year of origination in their vintage disclosures. See sections 2.4.2.4 and 6.3.1.2.2 of our comprehensive ASC 326 FRD for details on the requirements of this ASU, its effective date and transition.

- 23.40% for receivables that are 31–60 days past due
- 52.20% for receivables that are 61–90 days past due
- 73.80% for receivables that are more than 90 days past due

Company A believes that this historical loss information is a reasonable basis on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the risk characteristics of its customers and its credit practices have not changed significantly over time).

Company A believes that unemployment is the key economic driver of losses on its accounts receivable. Company A has determined that current economic conditions are worse than the economic conditions that existed during the historical period and that reasonable and supported forecasted economic conditions will continue to worsen. Specifically, Company A has observed that the unemployment rate is higher as of the current reporting date, and Company A expects the rate to continue to increase over the next year. Company A believes a higher unemployment rate will drive a higher loss rate over the life of the receivables.

To adjust the historical loss rates to reflect the effects of the differences in current conditions and reasonable and supportable forecasts, Company A estimates the loss rate will increase by approximately 11% in each age bucket. Company A developed this estimate based on its past experience when there were similar increases in unemployment.

At the reporting date, Company A develops the following aging schedule to estimate expected credit losses:

Past-due status	Amortized cost basis	Historical credit-loss rate	Expected credit-loss rate	Allowance for expected credit losses
Current	\$ 5,984,698	0.27%	0.30%	\$ 17,954
1-30 days past due	8,272	7.20%	8.00%	662
31-60 days past due	2,882	23.40%	26.00%	749
61-90 days past due	842	52.20%	58.00%	488
Over 90 days past due	1,100	73.80%	82.00%	902
Total	\$ 5,997,794			\$ 20,755

2.9.2

Loss rate method

The following example describes how an entity could apply the standard to its trade receivables balance using a loss rate method.

Illustration 2-11: Estimating expected credit losses for trade receivables using a loss rate method

Company B manufactures and sells one product to wholesale customers. The customers operate in the same industry and geography. Customers typically are provided with payment terms of one year. Company B has tracked historical loss information for its trade receivables on an amortized cost basis, using the contractual life of one year, and compiled the following historical credit loss percentages:

	20X1	20X2	20X3	20X4
Annual net write-offs	\$ 320,000	\$ 350,000	\$ 375,000	\$ 380,000
Annual average receivables	22,000,000	24,500,000	26,500,000	27,000,000
Annual loss rate	1.45%	1.43%	1.42%	1.41%
Average annual loss rate 1.43%				

At 31 December 20X5, all of Company B's receivables are current. Company B believes that its trade receivables are homogenous and concludes that they can be grouped into one pool. It determines that historical loss information is a reasonable basis on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the risk characteristics of its customers and its credit practices have not changed significantly over time).

Company B believes that unemployment is the key economic driver of losses on its accounts receivable. Company B has determined that both current economic conditions are worse than the economic conditions during the historical period and that reasonable and supportable forecasted economic conditions will continue to worsen. Specifically, Company B has observed that the unemployment rate is higher as of the current reporting date, and Company B expects the rate to continue to increase over the next year. Company B believes a higher unemployment rate will drive a higher loss rate over the life of the asset.

To calculate expected credit losses at 31 December 20X5, Company B first calculates the average historical loss rate from the past four years (1.43%). Next, Company B adjusts the average historical loss rate to reflect the effects of those differences in current and forecasted conditions. Company B estimates the average loss rate will increase by approximately 0.05% based on its past experience when there were similar increases in unemployment.

Company B applies the average loss rate of 1.48%, which is adjusted for current conditions and reasonable and supportable forecasts, to its 31 December 20X5 receivables balance of \$27,500,000 and calculates an estimated expected credit loss of \$407,000.

2.10

Foreign currency considerations

Receivables are generally considered monetary assets because their settlement amounts are fixed and do not depend on future prices. When a receivable is denominated in a currency other than the holder's functional currency, any change in exchange rates between the functional currency of an entity and the currency in which the receivable is denominated will cause an increase or decrease in expected functional currency cash flows and, therefore, the receivable's amortized cost. In accordance with ASC 830-20-35-1, these changes are considered foreign currency transaction gains or losses, which should generally be included in net income for the period in which the exchange rate changes.

Because foreign currency transactions gains or losses related to a receivable are recognized in earnings in the period in which the exchange rate changes, the current exchange rate is used to measure both the allowance for credit losses and the amortized cost basis of the receivable.

Illustration 2-12: Estimating the allowance for expected credit losses for a receivable denominated in a foreign currency

Assume that Entity E recorded a receivable from a foreign customer for €10,000 on 1 November 20X0 that is due by 1 February 20X1. The spot exchange rate at 1 November 20X0 is €1 to \$1. The spot exchange rate at 31 December 20X0 is €1 to \$0.95. Entity E's functional currency is the US dollar.

At 31 December 20X0, Entity E estimates an expected credit loss rate of 3% for the receivable based on historical experience, current conditions, and reasonable and supportable forecasts of economic conditions.

Entity E measures the allowance for credit losses in the local currency to isolate the loss due to credit and then remeasures the allowance in the functional currency:

Receivable amount	€ 10,000
Expected credit loss rate	X <u> .03</u>
Allowance for credit losses in local currency	€ 300
31 December 20X0 spot euro exchange rate	X\$ <u> .95</u>
Allowance for credit losses in functional currency	\$ 285

Entity E remeasures the receivable in the functional currency to determine the foreign currency loss:

Amortized cost on 11/1/20X0 (€10,000 x \$1)	\$ 10,000
Amortized cost on 12/31/20X0 (€10,000 x \$0.95)	<u> 9,500</u>
Foreign currency loss	\$ 500

Illustration 2-13: Recognizing the allowance estimated in Illustration 2-12

Entity E would make the following journal entries as of 31 December 20X0, which are simplified to exclude income taxes:

Credit loss expense	\$ 285	
Allowance for expected credit losses		\$ 285

To recognize the expected credit losses in earnings through an allowance.

P&L – Foreign currency loss	\$ 500	
Accounts receivable – foreign exchange adjustment		\$ 500

To recognize the foreign exchange loss in earnings.

As a result, the carrying value of the receivable as of 31 December 20X0 is calculated as follows:

Amortized cost basis on 11/1/20X0	\$ 10,000
Less foreign currency loss	<u> (500)</u>
New amortized cost basis on 12/31/20X0	9,500
Less allowance for expected credit losses	<u> (285)</u>
Net carrying value	\$ 9,215

At 31 December 20X0, Entity E's balance sheet would reflect \$9,215 as the carrying value of the receivable. The allowance of \$285 is presented separately as a deduction from the receivable's amortized cost of \$9,500.

2.11

Purchased assets (added April 2020)

Excerpt from Accounting Standards Codification

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

Initial Measurement

Measuring the Fair Values of Particular Identifiable Assets and a Noncontrolling Interest in an Acquiree

Assets with Uncertain Cash Flows (Valuation Allowances)

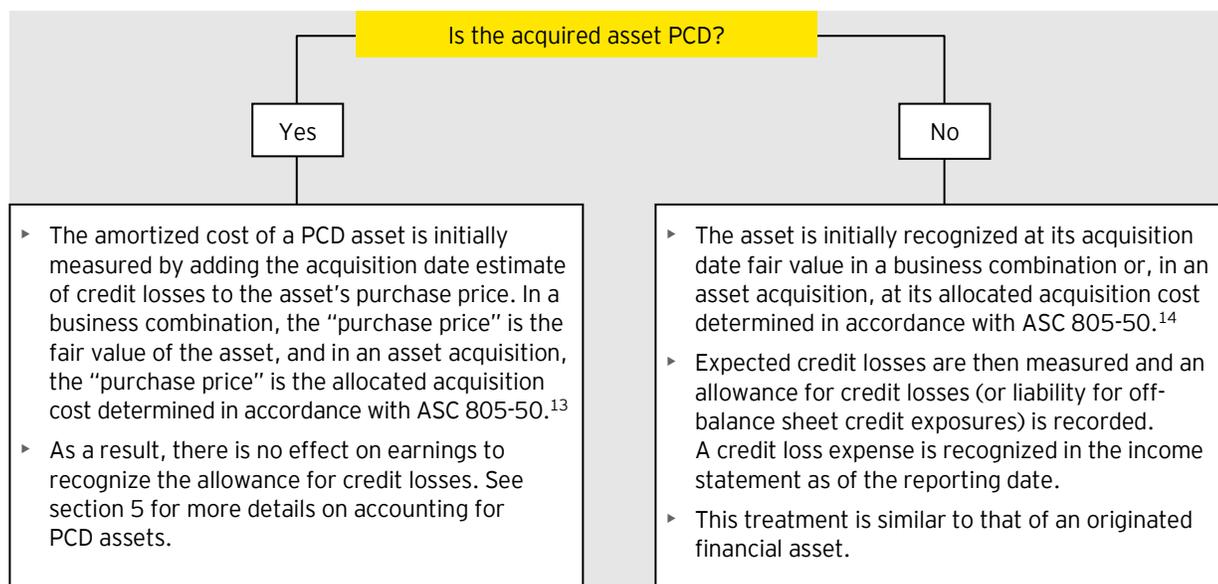
805-20-30-4A

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

805-20-30-4B

For assets accounted for as purchased financial assets with credit deterioration (which includes beneficial interests that meet the criteria in paragraph 325-40-30-1A), an acquirer shall recognize an allowance in accordance with Topic 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the acquisition date.

How an entity measures a financial asset in the scope of ASC 326 purchased in a business combination or an asset acquisition depends on whether the asset has experienced more-than-insignificant deterioration in credit quality since its origination (i.e., whether the asset is determined to be PCD). See section 5.2 of our [comprehensive ASC 326 FRD](#) for a discussion on determining whether an asset is considered to be PCD.

**How we see it**

Under ASC 326, an entity is required to record lifetime expected losses on assets in the scope of ASC 326-20. For PCD assets, this results in Day 1 gross up of the assets' amortized cost, with no effect on earnings. For non-PCD assets, the recognition of the initial allowance for credit losses results in an income statement charge for the initial estimate of lifetime credit losses on the assets acquired. Additionally, a discount cannot offset an entity's estimate of expected credit losses and delay the recognition of a credit loss.

As part of post-implementation review of the standard, the FASB added a project to its technical agenda to address the accounting for acquired financial assets under ASC 326. In its initial deliberations, the FASB tentatively decided to:

- ▶ Expand the scope of the PCD accounting model to all acquired assets (even if not credit deteriorated), whether acquired in a business combination or an asset acquisition, with exceptions for certain assets (credit cards and arrangements where the borrower has active borrowing privileges at the time of acquisition and available-for-sale debt securities)

¹³ Refer to section A.4.1 of our FRD, *Business combinations*, for further guidance.

¹⁴ Ibid.

- ▶ Incorporate an element of “seasoning” into the PCD accounting model for acquired assets to identify those that are in-substance originations and therefore should not be accounted for under the PCD accounting model

The FASB directed the staff to perform additional research and outreach on the accounting for acquired financial assets. We encourage readers to monitor developments.

3 Presentation and disclosure

3.1 Overview

The presentation and disclosures required by ASC 326 are intended to provide information that helps users analyze an entity's exposure to credit risk and understand how management estimates the allowance for credit losses. Entities are required to provide disclosures by portfolio segment or class of financial asset. Entities should use judgment in determining the appropriate level of detail to provide financial statement users with sufficient information to understand the credit risk related to the portfolio without providing unnecessary detail.

In March 2022, the FASB issued ASU 2022-02, amending ASC 310, to eliminate the recognition and measurement guidance for a TDR for creditors that have adopted the credit losses guidance in ASC 326. The ASU also requires PBEs to present current-period gross write-offs (on a current year-to-date basis for interim-period disclosures) by year of origination in their vintage disclosures. See sections 2.4.2.4 and 6.3.1.2.2 of our comprehensive ASC 326 FRD for details on the requirements of this ASU, its effective date and transition.

The following sections provide guidance on the presentation and disclosure requirements for financial assets within the scope of ASC 326.

3.2 Presentation of financial assets measured at amortized cost

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Other Presentation Matters

326-20-45-1

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

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

326-20-45-5

An entity may make an accounting policy election, at the class of financing receivable or major security-type level, to present separately on the statement of financial position or within another statement of financial position line item the accrued interest receivable balance, net of the allowance for credit losses (if any). An entity that presents the accrued interest receivable balance, net of the allowance for credit losses (if any), within another statement of financial position line item shall apply the disclosure requirements in paragraph 326-20-50-3A.

The table below summarizes the presentation requirements in ASC 326 for financial assets measured at amortized cost.

	Financial assets measured at amortized cost
Balance sheet presentation	Amortized cost
Allowance for credit loss presentation	Presented separately as a contra-asset deducted from asset's amortized cost
Income statement presentation	Credit loss expense

Entities may make certain policy elections related to the presentation and disclosure of the allowance for credit losses on accrued interest and the reversal of uncollectible accrued interest. Refer to our [comprehensive ASC 326 FRD](#) for details.

The illustration below is an example statement of financial position incorporating the presentation requirements in ASC 326.

Illustration 3-1: Example statement of financial position	
Company XYZ	
Statement of Financial Position	
	At December 31, 20X1
Assets	
Current assets:	
Cash and due from banks	\$ 40
Accounts receivable	500
Less: Allowance for credit losses	<u>(2)</u>
Accounts receivable, net	498
Inventory	<u>80</u>
Total current assets	618
Goodwill	20
Property and equipment	70
Other assets	<u>388</u>
Total assets	\$ 1,096
Liabilities	
Current liabilities:	
Accrued expenses	\$ 150
Accounts payable	<u>400</u>
Total current liabilities	550
Deferred taxes	140
Long-term debt	210
Other liabilities	<u>100</u>
Total liabilities	1,000
Shareholder's equity	
Common stock (authorized 9,000, issued 2,000)	3
Additional paid-in capital	66
Retained earnings	30
Accumulated other comprehensive income (loss)	<u>(3)</u>
Total shareholder's equity	<u>96</u>
Total liabilities and shareholder's equity	\$ 1,096

3.3 Disclosures for financial assets measured at amortized cost

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Disclosure

326-20-50-1

For instruments within the scope of this Subtopic, this Section provides the following disclosure guidance on credit risk and the measurement of expected credit losses:

- a. Credit quality information
- b. Allowance for credit losses
- c. Past-due status
- d. Nonaccrual status
- e. **Purchased financial assets with credit deterioration**
- f. Collateral-dependent **financial assets**
- g. Off-balance-sheet credit exposures.

326-20-50-2

The disclosure guidance in this Section should enable a user of the financial statements to understand the following:

- a. The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio
- b. Management's estimate of expected credit losses
- c. Changes in the estimate of expected credit losses that have taken place during the period.

326-20-50-3

For **financing receivables**, the disclosure guidance in this Subtopic requires an entity to provide information by either **portfolio segment** or **class of financing receivable**. Net investment in leases are within the scope of this Subtopic, and the disclosure requirements for financing receivables shall be applied to net investment in leases (including the unguaranteed residual asset). For held-to-maturity **debt securities**, the disclosure guidance in this Subtopic requires an entity to provide information by major security type. Paragraphs 326-20-55-10 through 55-14 provide implementation guidance about the terms *portfolio segment* and *class of financing receivable*. When disclosing information, an entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements in this Section. An entity must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial assets and associated risks.

Master Glossary

Class of Financing Receivable

A group of financing receivables determined on the basis of both of the following:

- a. Risk characteristics of the financing receivable
- b. An entity's method for monitoring and assessing credit risk.

See paragraphs 326-20-55-11 through 55-14 and 326-20-50-3.

Financing Receivable

A financing arrangement that has both of the following characteristics:

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

See paragraphs 310-10-55-13 through 55-15 for more information on the definition of financing receivable, including a list of items that are excluded from the definition (for example, debt securities).

Portfolio Segment

The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. See paragraphs 326-20-50-3 and 326-20-55-10.

The disclosure requirements for financial assets measured using the CECL model are designed to enable a user of the financial statements to understand:

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

For financing receivables, the disclosures are required by either portfolio segment or class of financing receivable as defined in ASC 326. The following chart describes these categories:

Portfolio segment	Class of financing receivables
<ul style="list-style-type: none"> ▶ This category is the level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. Examples include: <ul style="list-style-type: none"> ▶ Type of financing receivable ▶ Industry sector of the customer 	<ul style="list-style-type: none"> ▶ This category is generally a level of disaggregation beyond a portfolio segment that an entity uses when assessing and monitoring the risk and performance of the portfolio, though an entity may assess and monitor risks at the level of a portfolio segment. This category is determined on the basis of both of the following: <ul style="list-style-type: none"> ▶ Risk characteristics of the financing receivable ▶ An entity's method for monitoring and assessing credit risk ▶ In determining classes of financing receivables, the entity should consider characteristics such as: <ul style="list-style-type: none"> ▶ Type of customer ▶ Type of financing receivable ▶ Industry ▶ Geography

Entities should exercise judgment to determine the appropriate level of disclosure for portfolio segments and classes of financing receivables. The objective is to present information at a level that provides sufficient detail for a user to understand the credit risk associated with the portfolio without being overwhelmed by insignificant data.

Classes of financing receivables are generally a disaggregation of a portfolio segment and the portfolio segment is generally used as the starting point in determining whether further disaggregation is necessary. For example, a portfolio segment may be wholesale customers, and classes of financing receivables in that portfolio segment may include geographies such as the US, Europe and Asia.

There are numerous factors entities may consider when determining what level of disclosure is appropriate. The CECL disclosure requirements are described in the sections that follow. Certain disclosure requirements that do not apply to receivables that are due in one year or less are excluded from the discussion below. These include disclosures related to credit quality, past-due status and nonaccrual status. Refer to our [comprehensive ASC 326 FRD](#) for discussion on these disclosures.

3.3.1

Allowance for credit losses and management's estimation process

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Disclosure

Allowance for Credit Losses

326-20-50-10

An entity shall provide information that enables a financial statement user to do the following:

- a. Understand management's method for developing its allowance for credit losses
- b. Understand the information that management used in developing its current estimate of expected credit losses
- c. Understand the circumstances that caused changes to the allowance for credit losses, thereby affecting the related credit loss expense (or reversal) reported for the period.

326-20-50-11

To meet the objectives in paragraph 326-20-50-10, an entity shall disclose all of the following by **portfolio segment** and major security type:

- a. A description of how expected loss estimates are developed
- b. A description of the entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
 1. Past events
 2. Current conditions
 3. Reasonable and supportable forecasts about the future.
- c. A discussion of risk characteristics relevant to each portfolio segment
- d. A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- e. Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, its rationale for those changes, and the quantitative effect of those changes
- f. Reasons for significant changes in the amount of writeoffs, if applicable

- g. A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period
- h. The amount of any significant purchases of **financial assets** during each reporting period
- i. The amount of any significant sales of financial assets or reclassifications of **loans** held for sale during each reporting period.

ASC 326 requires an entity to provide information that allows users to understand the methods and key assumptions it used to develop its allowance for credit losses and the circumstances that caused any changes in those estimates in the period. The disclosures should allow a user to understand the key drivers for credit loss expense recognized in the current period. ASC 326 indicates that a user should also be able to compare multiple entities with similar portfolios of financial assets and understand why they reported or should report different estimates of credit loss expense. A key disclosure will be the assumptions the entity used to forecast future conditions and how these assumptions affected management's estimate of expected credit losses.

How we see it

When entities disclose the assumptions they use in their forecast of future economic conditions, they may provide information about management's expectations that is not presented elsewhere in the financial statements. If such information is provided, members of the board of directors and individuals responsible for investor relations, business line management and other functions beyond accounting and risk management may want to review these disclosures.

3.3.1.1

Rollforward of the allowance for credit losses

Excerpt from Accounting Standards Codification

Financial Instruments – Credit Losses – Measured at Amortized Cost

Disclosure

Allowance for Credit Losses

Rollforward of the Allowance for Credit Losses

326-20-50-13

Furthermore, to enable a financial statement user to understand the activity in the allowance for credit losses for each period, an entity shall separately provide by **portfolio segment** and major security type the quantitative disclosures of the activity in the allowance for credit losses for **financial assets** within the scope of this Subtopic, including all of the following:

- a. The beginning balance in the allowance for credit losses
- b. Current-period provision for expected credit losses
- c. The initial allowance for credit losses recognized on financial assets accounted for as **purchased financial assets with credit deterioration** (including beneficial interests that meet the criteria in paragraph 325-40-30-1A), if applicable
- d. Writeoffs charged against the allowance
- e. Recoveries of amounts previously written off, if applicable
- f. The ending balance in the allowance for credit losses.

Pending content:

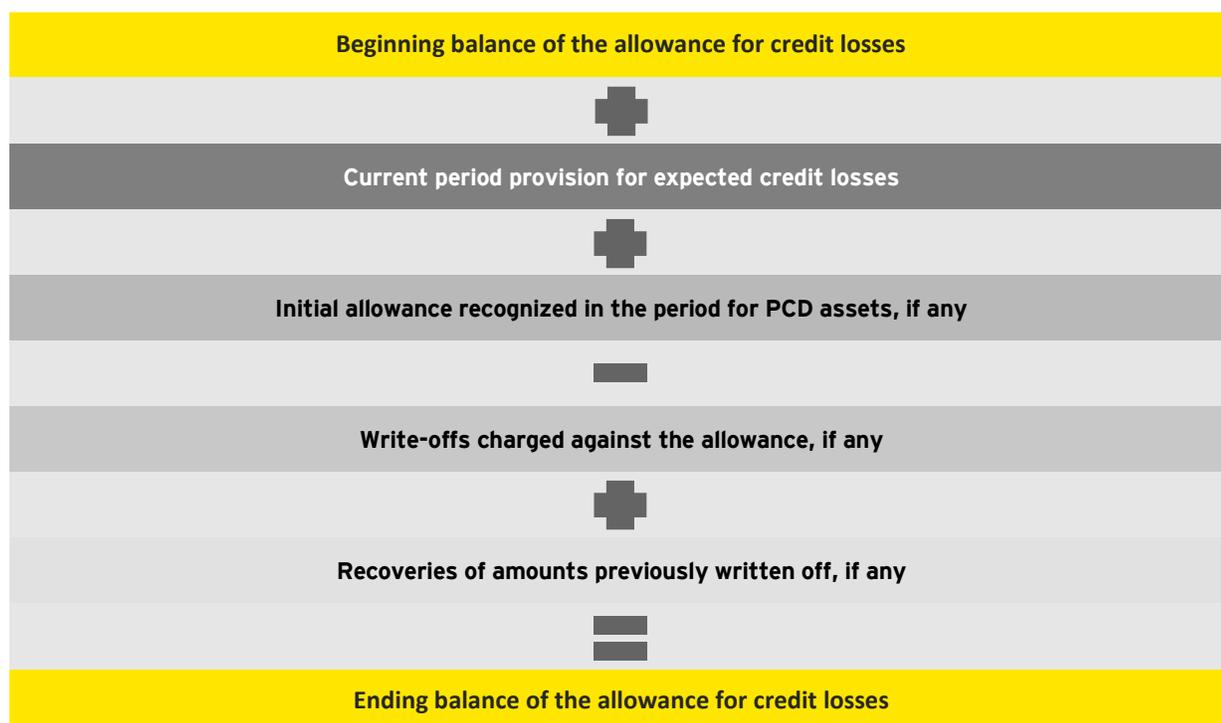
Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-2

326-20-50-13

Furthermore, to enable a financial statement user to understand the activity in the allowance for credit losses for each period, an entity shall separately provide by **portfolio segment** and major security type the quantitative disclosures of the activity in the allowance for credit losses for **financial assets** within the scope of this Subtopic, including all of the following:

- a. The beginning balance in the allowance for credit losses
- b. Current-period provision for expected credit losses
- c. The initial allowance for credit losses recognized on financial assets accounted for as **purchased financial assets with credit deterioration** (including beneficial interests that meet the criteria in paragraph 325-40-30-1A), if applicable
- d. Writeoffs charged against the allowance
- e. Recoveries collected
- f. The ending balance in the allowance for credit losses.

To enable users to understand changes in the allowance for expected credit losses in each period, ASC 326 requires an entity to disclose, for each portfolio segment, all of the amounts depicted in the following graphic:



3.3.2 Receivables resulting from the application of ASC 606, including contract assets

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers – Overall

Disclosure

Contracts with Customers

606-10-50-4

An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

- a. **Revenue** recognized from **contracts with customers**, which the entity shall disclose separately from its other sources of revenue
- b. Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or **contract assets** arising from an entity's contracts with customers, which the entity shall disclose separately from credit losses from other contracts.

4 Effective date and transition

4.1 Effective date (updated April 2020)

Excerpt from Accounting Standards Codification

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-4

Financial Instruments – Credit Losses – Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Updates No. 2016-13, Financial Instruments–Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, No. 2019-04, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, No. 2019-05, Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief, No. 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, No. 2019-11, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, and No. 2022-02, Financial Instruments–Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

326-10-65-1

The following represents the transition and effective date information related to Accounting Standards Update No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, No. 2019-05, *Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief*, No. 2019-10, *Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, No. 2019-11, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*, and No. 2022-02, *Financial Instruments–Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*:

- a. The pending content that links to this paragraph shall be effective as follows:
 1. For **public business entities** that meet the definition of a **Securities and Exchange Commission (SEC) filer**, excluding entities eligible to be smaller reporting companies as defined by the SEC, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company shall be based on an entity's most recent determination as of November 15, 2019, in accordance with SEC regulations.
 2. Subparagraph superseded by Accounting Standards Update No. 2019-10.
 3. For all other entities, for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.
- b. Early application of the pending content that links to this paragraph is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Master Glossary

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, **securities** that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Securities and Exchange Commission (SEC) Filer (SEC)

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

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

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

SEC filers that are not SRCs have already adopted the standard. The FASB issued ASU 2019-10 to defer the effective dates of the standard for all entities except SEC filers that are not SRCs as defined by the SEC.

The standard is effective:		
SEC filers, excluding SRCs	All other entities	Early adoption?
For annual periods beginning after 15 December 2019 and interim periods therein	For annual periods beginning after 15 December 2022 and interim periods therein	Yes, for annual periods beginning after 15 December 2018 and interim periods therein

4.1.1 Smaller reporting companies (added April 2020)

The term “smaller reporting company” is defined in Part 230.405 of the SEC’s general rules and regulations, Securities Act of 1933. SRCs are included in the second bucket in the FASB’s two-bucket approach for adopting major standards and have three more years to implement the standard than other SEC filers have.¹⁵ The determination of whether an entity is an SRC for purposes of adopting the credit losses standard is based on an entity’s most recently completed assessment in accordance with SEC regulations as of 15 November 2019, the date of issuance of ASU 2019-10.

SEC regulation

Part 230.405 – General rules and regulations, Securities Act of 1933

As used in this part, the term smaller reporting company means an issuer that is not an investment company, an asset-backed issuer (as defined in §229.1101 of this chapter), or a majority-owned subsidiary of a parent that is not a smaller reporting company and that:

- (1) Had a public float of less than \$250 million; or
- (2) Had annual revenues of less than \$100 million and either:
 - (i) No public float; or
 - (ii) A public float of less than \$700 million.
- (3) Whether an issuer is a smaller reporting company is determined on an annual basis.

Question 4-1 If an entity was not an SEC filer on 15 November 2019 (the date of issuance of ASU 2019-10) but subsequently becomes an SEC filer and is not an SRC, is it required to adopt the new credit losses standard in accordance with the effective dates for SEC filers that are not SRCs?

Yes. Entities that become SEC filers that are not SRCs after 15 November 2019, are required to adopt the credit losses standard in accordance with the effective date for SEC filers that are not SRCs.

Question 4-2 If an entity was not an SEC filer on 15 November 2019 (the date of issuance of ASU 2019-10) but subsequently becomes an SEC filer and is an SRC, when is it required to adopt the new credit losses standard?

ASU 2019-10 states that companies should determine whether they are SRCs for purposes of adopting the credit losses standard based on its most recently completed assessment in accordance with SEC regulations as of 15 November 2019. An entity that is not yet public on 15 November 2019 would not have made an SRC determination by that date. However, the SEC staff stated that it would not object to a newly public company that qualified as an SRC at the time of its initial public offering deferring adoption of the credit losses standard until the effective date for SRCs (i.e., 2023 for a calendar-year end company).¹⁶

¹⁵ As discussed in ASU 2019-10, *Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

¹⁶ Remarks by Lindsay McCord, SEC Deputy Chief Accountant, Division of Corporation Finance, at the 2019 AICPA National Conference on Current SEC and Public Company Accounting Oversight Board Developments, 10 December 2019

4.2 Transition (updated April 2020)

Excerpt from Accounting Standards Codification

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-4

Financial Instruments – Credit Losses – Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments–Credit Losses, No. 2019-04, Codification Improvements to Topic 326, Financial Instruments–Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-10, Financial Instruments–Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, No. 2019-11, Codification Improvements to Topic 326, Financial Instruments–Credit Losses, and No. 2022-02, Financial Instruments–Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

326-10-65-1(c)

An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period in which the pending content that links to this paragraph is effective.

326-10-65-1(f)

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

1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
2. The method of applying the change.
3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is effective.

326-10-65-1(i)

An entity may irrevocably elect the fair value option in accordance with Subtopic 825-10 for financial instruments within the scope of Subtopic 326-20, except for those financial assets in paragraph 326-20-15-2(a)(2), that also are eligible items in Subtopic 825-10.

Transition Related to Accounting Standards Updates No. 2019-05, Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief

326-10-65-3

The following represents the transition and effective date information related to Accounting Standards Update No. 2019-05, *Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief*:

- a. An entity that has not yet adopted the pending content that links to paragraph 326-10-65-1 shall apply the pending content that links to this paragraph when the entity first applies the pending content that links to paragraph 326-10-65-1.
- b. An entity that has adopted the pending content that links to paragraph 326-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- c. Early adoption, including adoption in any interim period is permitted, provided that an entity has adopted the pending content that links to paragraph 326-10-65-1.
- d. For items measured at **fair value** in accordance with paragraph 326-10-65-1(i), the difference between the carrying amount and the fair value shall be recorded by means of a cumulative-effect adjustment to the opening retained earnings balance as of the beginning of the first reporting period that an entity has adopted the pending content that links to paragraph 326-10-65-1. Those differences may include, but are not limited to:
 1. Unamortized deferred costs, fees, premiums, and discounts
 2. Valuation allowances (for example, allowance for loan losses)
 3. Accrued interest.

The ASU requires a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. Periods prior to the adoption date that are presented for comparative purposes are not adjusted.

- ▶ A calendar-year PBE that is an SEC filer, that is not an SRC, will record the cumulative-effect adjustment on 1 January 2020 and provide the related transition disclosures in all of its 2020 Form 10-Qs and its 2020 Form 10-K, as applicable.
- ▶ A calendar-year non-SEC filer or an SEC filer that is an SRC will record the cumulative-effect adjustment on 1 January 2022 and provide the related transition disclosures in its 2022 annual financial statements. If the entity prepares interim financial statements, it will also provide the transition disclosures in its 2023 interim financial statements.

The FASB issued an amendment that allows entities to elect to measure assets in the scope of ASC 326-20, except HTM securities, using the fair value option (FVO) when they adopt the credit impairment standard. Entities may elect the FVO on an instrument-by-instrument basis.

4.3

Disclosures

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

Excerpt from Accounting Standards Codification

Pending content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-4

Financial Instruments – Credit Losses – Overall

Transition and Open Effective Date Information

Transition Related to Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, No. 2019-04, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, No. 2019-05, Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief, No. 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, No. 2019-11, Codification Improvements to Topic 326, Financial Instruments – Credit Losses, and No. 2022-02, Financial Instruments–Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

326-10-65-1(f)

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

1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
2. The method of applying the change.
3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is effective.

326-10-65-1(g)

An entity that issues interim financial statements shall provide the disclosures in (f) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

PBEs that issue interim financial statements are required to provide the above transition disclosures in each of the interim and the annual financial statements in the year of adoption.

A

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326-10-05-2	1	Scope and scope exceptions
326-10-15-1	1	Scope and scope exceptions
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B Abbreviations used in this publication

Abbreviation	Full title of guidance reference
ASC 325	FASB ASC Topic 325, <i>Investments – Other</i>
ASC 326	FASB ASC Topic 326, <i>Financial Instruments – Credit Losses</i>
ASC 450	FASB ASC Topic 450, <i>Contingencies</i>
ASC 606	FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 830	FASB ASC Topic 830, <i>Foreign Currency Matters</i>
ASC 944	FASB ASC Topic 944, <i>Financial Services – Insurance</i>
ASC 958	FASB ASC Topic 958, <i>Not-for-Profit Entities</i>
ASU 2015-02	FASB ASU 2015-02, <i>Consolidation (Topic 810): Amendments to the Consolidation Analysis</i>
ASU 2016-13	FASB ASU 2016-13, <i>Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments</i>
ASU 2019-10	FASB ASU 2019-10, <i>Financial Instruments – Credit Losses (Topic 326)</i>
EITF 02-5	EITF Issue No. 02-5, <i>Definition of “Common Control” in Relation to FASB Statement No. 141</i>
SAB Topic 11.M	Codified SEC Staff Accounting Bulletin Topic 11.M, <i>Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period</i>
Statement No. 141	FASB Statement No. 141, <i>Business Combinations</i>
Abbreviation	Miscellaneous
AICPA	American Institute of Certified Public Accountants
AFS	Available for sale
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BC	Background Information and Basis for Conclusions
CECL	Current expected credit losses
DCF	Discounted cash flow
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board
FICO	Fair Isaac Company
FRD	Financial reporting developments
GAAP	Generally Accepted Accounting Principles
HTM	Held to maturity
IT	Information technology
LGD	Loss given default
PBE	Public business entity
PCC	Private Company Council
PCD	Purchased financial asset with credit deterioration

Abbreviation	<i>Miscellaneous</i>
PD	Probability of default
P&L	Profit and loss
SAB	Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SRC	Smaller reporting company
TDR	Troubled debt restructuring
TRG	Transition Resource Group for Credit Losses
UPB	Unpaid principal balance

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- Question 2-2 If an entity has receivables and payables with the same counterparty and the legal right of setoff exists, is it permitted to estimate expected credit losses on the net exposure to the counterparty?
- Question 2-3 Is an entity required to use the credit rating associated with the asset (e.g., S&P credit rating, Fair Isaac Company (FICO) score) as the basis for pooling?
- Question 2-4 If an entity aggregates financial assets into pools with relatively few assets (e.g., 10 or fewer assets), is it appropriate to group those assets into larger pools? What other factors should such an entity consider?
- Question 2-5 Is it possible for different entities to have different views of the future when establishing their allowances?
- Question 2-6 Are entities required to probability weight multiple economic scenarios when developing their reasonable and supportable forecast of future economic conditions?
- Question 2-7 May an entity use different forecast periods for different types of receivables?
- Question 2-8 Are entities required to use consistent forecasts of future economic conditions throughout the organization?
- Question 2-9 Are entities required to perform backtesting on their reasonable and supportable forecasts of future economic conditions?
- Question 2-10 What should management consider in assessing whether obtaining additional information would require undue cost and effort?
- Question 2-11 Can entities make qualitative adjustments to the expected credit loss estimate?
- Question 2-12 How should expected recoveries be included in an entity's estimate of expected losses?
- Question 2-13 Should an entity "write up" an asset's amortized cost for an expected recovery?

4. Effective date and transition

- Question 4-1** If an entity was not an SEC filer on 15 November 2019 (the date of issuance of ASU 2019-10) but subsequently becomes an SEC filer and is not an SRC, is it required to adopt the new credit losses standard in accordance with the effective dates for SEC filers that are not SRCs?
- Question 4-2** If an entity was not an SEC filer on 15 November 2019 (the date of issuance of ASU 2019-10) but subsequently becomes an SEC filer and is an SRC, when is it required to adopt the new credit losses standard?

D Summary of important changes

The following highlights important changes to this FRD publication since the June 2021 edition. Non-substantive or clarifying changes are not listed:

- ▶ Section 2.11 was updated for FASB's tentative decisions on its project on accounting for acquired financial assets under ASC 326.
- ▶ Multiple sections were updated to address the issuance of ASU 2022-02, Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures.

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