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Technical Line

FASB — final guidance

What's changing under the new standard on credit losses?

In this issue:

What you need to know

- The new standard on credit losses will significantly change how entities account for credit losses for most financial assets and certain other instruments. It will apply to all entities.
- For trade receivables, loans and held-to-maturity debt securities, entities will be required to estimate lifetime expected credit losses. This will result in the earlier recognition of credit losses.
- For available-for-sale debt securities, entities will be required to recognize an allowance for credit losses rather than a reduction to the carrying value of the asset. If expected cash flows improve, an entity will reduce the allowance and reverse the expense through income.
- Entities will have to make significantly more disclosures, including disclosures by year of origination for certain financing receivables.
- The new guidance is effective for calendar-year public business entities that are SEC filers, excluding entities that are smaller reporting companies, in the first quarter of 2020. Early adoption is permitted beginning in 2019.

Overview

The guidance the Financial Accounting Standards Board (FASB or Board) issued in Accounting Standards Update (ASU) 2016-13[1] significantly changes how entities will account for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The new standard will supersede today's guidance and apply to all entities.

Building a better working world

The ASU requires entities to estimate an expected lifetime credit loss on financial assets ranging from short-term trade accounts receivable to long-term financings. This will be challenging for all entities. They 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. They also may need to implement new information technology (IT) systems or enhance their existing systems.

Given the significance of the changes, entities will need to develop detailed plans to implement the standard. In the period leading up to adoption, Securities and Exchange Commission (SEC) registrants also will need to comply with SEC Staff Accounting Bulletin (SAB) Topic 11.M,[2] which requires disclosures about the expected effect of a new accounting standard on the company's financial statements.

The views we express in this publication may continue to evolve as implementation continues and additional questions are identified.

Key considerations

The table below summarizes the impairment models, key changes from current US GAAP and the effects of those changes:

	Financial assets measured at amortized cost	Available-for-sale (AFS) debt securities	Beneficial interests in the scope of ASC 325-40
Examples of affected instruments	Accounts receivable, held-to-maturity (HTM) debt securities, financing receivables and net investments in leases (i.e., for a sales-type lease, the lease receivable and the unguaranteed residual asset; for a direct finance lease, the lease receivable and the unguaranteed residual asset less any deferred selling profit)	AFS debt securities	Residual interests and other subordinated tranches of securitizations
Impairment model to be applied	Current estimate of expected lifetime credit losses (CECL) model in ASC 326-20	AFS debt security model in ASC 326-30	The CECL model for HTM securities (ASC 326-20) or the model for AFS debt securities (ASC 326-30)
Key changes from current US GAAP	‣ Estimate losses over the contractual life using pool-based assumptions to capture the risk of loss, even if remote ‣ Consider reasonable and supportable forecasts of economic conditions ‣ Record an allowance on all components of the instrument's amortized cost	‣ No longer consider the length of time an instrument has been impaired ‣ Record an allowance for credit losses rather than a reduction of the amortized cost basis ‣ Limit credit losses to the excess of amortized cost over fair value	‣ Record an allowance rather than a reduction of the amortized cost basis ‣ Record an allowance at acquisition or origination (but not a credit loss expense) for PCD assets, including those for which there is a significant difference between estimated and contractual cash flows

Entities should monitor developments as the TRG, regulators and others continue to discuss implementation topics.

	Financial assets measured at amortized cost	Available-for-sale (AFS) debt securities	Beneficial interests in the scope of ASC 325-40
	‣ Record an allowance at acquisition (but no credit loss expense) for purchased instruments that have experienced more-than-insignificant credit deterioration since origination (PCD assets) ‣ Make significant new disclosures	‣ Reduce the allowance for improvements in expected cash flows and reverse credit loss expense in the income statement ‣ Record an allowance at acquisition (but not a credit loss expense) for PCD assets	‣ Recognize changes in expected credit losses (both positive (up to the amount of the allowance) and negative) in the allowance
Financial statement and process-related effects	‣ May recognize credit losses earlier and record on instruments that may not have had an allowance under legacy GAAP ‣ May make credit loss expense and, therefore, earnings more volatile ‣ May require additional processes and controls and financial modeling capabilities ‣ May need to collect external data to support existing data gaps	‣ Will likely require enhancements to existing systems and processes ‣ May recognize credit losses earlier because an entity may not consider the amount of time an AFS debt security is impaired when determining whether an allowance is required	‣ Same effects as for other securities classified as either HTM or AFS because they follow the CECL or AFS impairment model, respectively ‣ Will require adjustments to yield less frequently because positive changes in expected credit losses will first be recognized in the allowance for credit losses, if any, and will be reflected immediately in the income statement

The new guidance is complex and introduces a number of new concepts, many of which have continued to generate significant discussion well after the standard's issuance. We expect the FASB and the Transition Resource Group for Credit Losses (TRG) it formed to address implementation issues raised by stakeholders to continue 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.

Effective date and transition

The standard has staggered effective dates, as shown in the table below.[3]

SEC filers, excluding smaller reporting companies (SRCs)[4]	All other entities	Early adoption?
15 December 2019, and interim periods therein	15 December 2022, and interim periods therein	Yes, for annual periods beginning after 15 December 2018, and interim periods therein

See section 7.1.1 of our Financial reporting developments (FRD) publication, ***Credit impairment under ASC 326***, for guidance on the definition of an SRC.

How we see it

Even though certain entities have until 2023 to implement the standard, those entities should be taking steps now to prepare for the potentially significant changes they will need to make, including addressing resource issues (e.g., engaging third-party service providers), obtaining required data, making system changes and planning for multiple dry runs.

Although financial institutions will likely experience the most change, virtually all entities will be affected.

Entities will need to decide how to identify information (internal or external) that can be used to develop the "reasonable and supportable" forecast to estimate expected credit losses on receivables, loans, HTM debt securities and other instruments. Entities will need to modify their policies and processes, regardless of whether their allowance is expected to change significantly.

This publication provides an overview of the ASU. For a more in-depth discussion of the guidance, refer to our FRD publication, ***Credit impairment under ASC 326***.

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

ASC 326-20 replaces today's "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. The table below summarizes the key differences between legacy US GAAP and the CECL model:

	Key differences	
	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 (i.e., in virtually all cases)
Unit of measurement	Pooling permitted but not required	Pooling required when assets share risk characteristics
Consideration of economic conditions	Consider current economic conditions	Consider current economic conditions and management's expectations of future economic conditions
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

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."

Key principles and potential implementation considerations

The following table lists key principles in the CECL model and the implementation considerations identified to date:

<table>
<tr><th></th><th>Description</th><th>Key implementation considerations</th></tr>
<tr><td>Based on an asset's amortized cost</td><td>The components of amortized cost include unpaid principal balance (UPB), accrued interest, unamortized discounts and premiums, foreign exchange adjustments and fair value hedge accounting adjustments.
The ASU requires the estimate to be based on a financial asset's amortized cost. An entity is not permitted to avoid recording an allowance because a discount exists (i.e., the ASU prohibits "accrete to impair" policies where an entity would not record an allowance if the allowance amount is less than the discount).</td><td>▸ Limited historical loss information may be readily available for components of amortized cost other than the UPB.
▸ Nonaccrual policies may affect loss history for accrued interest.
▸ Entities will need to develop processes and controls to capture the expected credit losses on those components of amortized cost that may not have historically been addressed.</td></tr>
<tr><td>Reflect the risk of loss</td><td>Assets should be evaluated collectively based on similar risk characteristics. The risk of loss, even if remote, should be captured.</td><td>▸ Defining pools as precisely as possible will increase the precision of the estimate.
▸ Assets that historically had a zero allowance will likely require an allowance under CECL.
▸ Entities need to reconsider whether assets grouped in a pool continue to share similar risk characteristics at each measurement date.</td></tr>
<tr><td>Reflect losses over an asset's contractual life</td><td>Contractual life should consider expected prepayments but should not consider expected extensions, renewals and modifications unless there is a reasonable expectation that a troubled debt restructuring will be executed with the borrower or the lender has no control over whether a contractual extension option will be exercised by the borrower (i.e., the option is not unconditionally cancelable by the lender).</td><td>▸ Entities may find it challenging to:
  ▸ Determine the life of instruments with no stated maturity date (e.g., accounts receivable, credit card receivables)
  ▸ Evaluate whether loans refinanced with the same lender are prepayments
  ▸ Obtain sufficient support for prepayment adjustments
▸ Entities may find the modeling of contractual extension and renewal options challenging.</td></tr>
<tr><td>Consider available relevant information</td><td>Historical loss data should provide the basis for determining the allowance for credit losses. This data should be adjusted for asset-specific considerations, current economic conditions and reasonable and supportable forecasts.</td><td>▸ Significant judgment will be required to:
  ▸ Select key economic variable(s)
  ▸ Develop the reasonable and supportable forecast period and model the effect on loss rates
  ▸ Determine whether to use a single best estimate or probability-weighted scenarios
  ▸ Support adjustments to historical loss information and the reversion methodology
▸ Entities need to evaluate data availability and integrity and consider the use of external data to address incomplete or insufficient internal data.</td></tr>
</table>

Modeling and data issues associated with estimating expected credit losses

Methods

The Board decided that an entity should have the flexibility to use its judgment to develop an approach that faithfully reflects expected credit losses for the financial assets in question and can be applied consistently over time. The standard lists, but does not define, several common credit loss methods that should continue to be acceptable under the new guidance, including:

- Discounted cash flow (DCF) methods
- Loss-rate methods
- Roll-rate methods
- Probability of default (PD) and loss given default methods
- Methods that use an aging schedule (commonly used for bad debts on trade accounts receivable)

While all of these methods are used today, an entity will need to make adjustments to account for the differences between an incurred loss model and the CECL model (i.e., to provide an estimate of expected credit losses over the remaining contractual life of an asset and incorporate reasonable and supportable forecasts about future economic conditions into the calculation).

Entities have significant flexibility to develop an approach to estimate expected credit losses.

How we see it

One implementation challenge we anticipate is determining whether certain modeling approaches are too simple to satisfy the Board's objective. While the new guidance provides significant flexibility, an entity's chosen approach must faithfully represent its estimate of expected credit losses given that entity's facts and circumstances.

Data

ASC 326-20 requires historical loss data to be adjusted to reflect changes in asset-specific considerations, current conditions and reasonable and supportable forecasts of future economic conditions. The changes to the impairment model from current US GAAP will likely require the use of data that has not previously been collected or was not subject to robust controls.

Financial assets secured by collateral

If a financial asset is collateralized, the CECL model requires an entity to consider the effects of the collateral arrangement, including the nature of the collateral, potential future changes in the collateral values and historical loss information for financial assets secured with similar collateral.

In the situations presented in the table below, entities are required to or can choose to measure the allowance for credit losses using the current fair value of the collateral (i.e., the fair value at the measurement date with no consideration of future changes in the fair value).

	Requirement or practical expedient	Measurement of the allowance
Foreclosure is probable	Requirement to measure the allowance based on collateral	Entities must measure the allowance as the difference between the amortized cost of the financial asset and the fair value of the collateral, less the estimated costs to sell the collateral, if any, when the entity intends to sell, rather than operate, the collateral.
Repayment is expected through sale or operation of collateral and the borrower is experiencing financial difficulty[5]	Practical expedient	Entities can elect to measure the allowance as the difference between the amortized cost of the financial asset and the fair value of the collateral. When repayment or satisfaction of the financial asset is expected through the sale of the collateral, the fair value should be reduced by the estimated costs to sell, if any.
Receivable is secured by collateral subject to a collateral maintenance provision	Practical expedient	Entities can elect to apply a practical expedient to measure the allowance for credit losses based on the fair value of the collateral. If the fair value of the collateral held exceeds the amortized cost and the borrower is expected to continue to replenish the collateral (as needed), no allowance is required. If the fair value of collateral is less than amortized cost and the borrower is expected to continue to replenish the collateral (as needed), the CECL model is applied only to the shortfall between the fair value of the collateral and amortized cost.

An entity will no longer be able to consider the length of time a security has been in an unrealized loss position as a factor in assessing whether a credit loss exists for an AFS security.

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

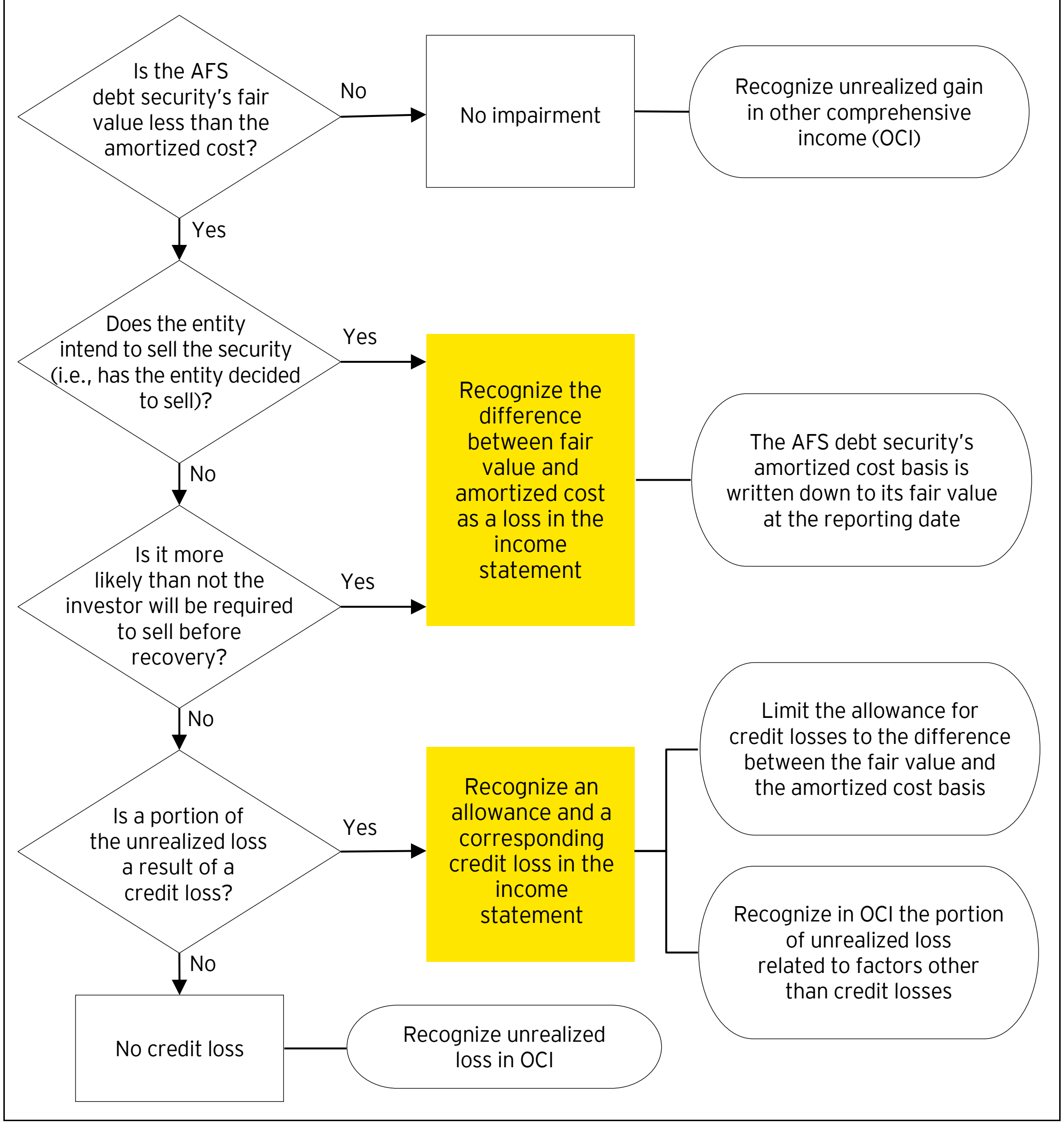
An entity will recognize an allowance for credit losses on AFS debt securities rather than an other-than-temporary impairment (OTTI) that reduces the cost basis of the investment. Further, an entity will recognize any improvements in estimated credit losses on AFS debt securities immediately in earnings. Today, a recovery of an impairment loss on an AFS debt security is recognized prospectively as interest income.

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

Finally, the FASB decided that the CECL model should not apply to AFS debt securities because they are carried at fair value. Instead, the Board made targeted amendments to the existing AFS debt security impairment model. As a result, different impairment models will exist for debt securities that are classified as AFS and those classified as HTM.

The following graphic illustrates the new model.

Illustration 1: Impairment decision tree for AFS debt securities



Purchased financial assets

The standard eliminates today's separate model in ASC 310-30[6] for purchased credit impaired (PCI) assets, which applies to both loans and securities. In its place, the standard provides a special Day 1 accounting model for PCD assets.

	Key differences	
	PCI assets	**PCD assets**
Definition and application of definition	Purchased financial assets for which it is probable that contractual cash flows will not be collected	Purchased financial assets for which there has been a more-than-insignificant deterioration in credit quality since origination For AFS debt securities, this condition is met when an indicator of a credit loss is present For securities subject to ASC 325-40 that don't otherwise meet the definition of a PCD asset, determine whether there is a significant difference between expected and contractual cash flows and if so, apply the PCD gross-up approach
Unit of assessment for scoping	Individual instrument for securities and loans	Individual instrument for AFS debt securities and pool level or individual instrument for assets subject to the CECL model
Initial recognition	Apply PCI guidance in ASC 310-30 and account for the excess of cash flows expected to be collected over the purchase price as accretable yield	Establish an allowance for credit losses at inception and add it to the purchase price to arrive at the amortized cost of the instrument Reflect the noncredit discount (the difference between the amortized cost and the par value of the instrument) in the effective interest rate
Subsequent recognition	Recognize the accretable yield as interest income over the life of the instrument For interest income recognition and measurement of the allowance for credit losses, maintain the PCI pool throughout the instrument's life For loans, increase the allowance to recognize adverse changes in cash flows and reduce the allowance to recognize positive changes in cash flows; when the allowance is exhausted, adjust interest income prospectively For securities, recognize OTTI and reflect positive changes in cash flows by prospectively adjusting interest income	After initial recognition, treat PCD assets like all other assets and apply one of these impairment models: ‣ ASC 326-20 (CECL model) for instruments measured at amortized cost ‣ ASC 326-30 (AFS model) for debt securities classified as AFS ‣ ASC 325-40 model for certain beneficial interests May elect to maintain PCI pools established under legacy guidance Amortize the noncredit discount into interest income over the life of the instrument

How we see it

We believe that the FASB intended to create a very low threshold for applying the new PCD asset guidance (see paragraph BC90 in the Background Information and Basis for Conclusions of ASU 2016-13 and section 5.2.1.2 of our FRD, ***Credit impairment under ASC 326***, for detail). This will result in the Day 1 gross-up being applied to a much larger population of purchased loans and securities than under today's PCI guidance.

The new PCD guidance also applies to more loan and security types than the PCI guidance. For example, the new guidance applies to purchased loans drawn under revolving credit agreements, such as credit card and home equity loans that, at the date of acquisition, have experienced more-than-insignificant deterioration in credit quality since origination. Entities will need to change their processes, systems, reporting and documentation to reflect this change in scope.

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

The guidance in ASC 325-40 continues to apply to certain beneficial interests that are (1) not of high credit quality or (2) expose the holder to the risk that they will not recover substantially all of the initial investment. HTM, AFS and trading securities[7] are in scope. The model provides guidance on recognizing both interest income and credit losses for such investments.

The PCD gross-up will be applied to a larger population of assets.

	Key differences	
	Legacy GAAP	**ASC 325-40 after adoption of ASU 2016-13**
Initial recognition — not PCI or PCD	Recognize at relative fair value upon transfer (if acquired in a transaction subject to ASC 860) or purchase price	Recognize at fair value upon transfer (if acquired in a transaction subject to ASC 860) or purchase price Recognize an allowance for credit losses through earnings determined using the ASC 326-20 (CECL) model for HTM securities or the ASC 326-30 model for AFS debt securities
Initial recognition — PCI or PCD	Apply PCI guidance in ASC 310-30; no allowance for credit losses is recognized for expected credit losses at origination or purchase Recognize the excess of cash flows expected to be collected over the purchase price (i.e., the accretable yield) as interest income over the life of instrument	Establish an allowance for estimated credit losses at inception and add it to the purchase price or relative fair value ("gross up") to arrive at the amortized cost of the instrument Recognize the difference between the new amortized cost and the par value of the instrument as the noncredit discount
Subsequent recognition	Recognize the accretable yield as interest income over the expected life of the beneficial interest Recognize OTTI and reflect positive changes in cash flows by prospectively adjusting interest income	Amortize the noncredit discount into interest income over the contractual life of the beneficial interest Recognize all changes in expected cash flows due to credit as an adjustment to the allowance, subject to the fair value floor for AFS securities; if expectations of cash flows result in a reduction of the allowance to zero, prospectively adjust the effective interest rate for any additional improvements in expected cash flows

The interaction of ASC 325-40 and PCD accounting

Many beneficial interests that are currently in the scope of ASC 325-40, including residual interests and interest-only strips, will likely be classified as PCD assets. That's because a significant difference between contractual cash flows and expected cash flows at the date of recognition of an asset in the scope of ASC 325-40 would require PCD accounting.

TRG members generally agreed that if contractual cash flows of a security are not specified, an entity should look through to the contractual cash flows of the underlying assets and include an estimate of prepayments to determine whether the security should be considered a PCD asset.[8] The TRG members said this approach would appropriately isolate credit risk and make sure that credit risk alone drives the determination of whether beneficial interests in the scope of ASC 325-40 should be accounted for as PCD assets. See section 4.2.1.1 of our FRD, ***Credit impairment under ASC 326***, for more information.

The TRG also discussed how prepayments should be considered in determining the initial allowance for purposes of the Day 1 gross-up of the amortized cost basis of the beneficial interest. TRG members generally agreed that the initial allowance should reflect only credit-related factors and not estimated prepayments.

While TRG members acknowledged that reflecting only credit-related factors would result in a smaller Day 1 allowance for assets accounted for as PCD, all changes in cash flows (resulting from either prepayment or credit) will be reflected in the subsequent measurement of the allowance. As described above, when cash flows improve, changes should be reflected in the allowance until the allowance is exhausted. After that, any changes would be reflected as a yield adjustment.

Interest income

ASU 2016-13 does not explicitly change interest income recognition principles, except for PCD assets as discussed below.

The amount of interest income recognized for debt securities may change. This is because interest income accruals are calculated using the amortized cost basis of the security as the base and entities will now record an allowance for credit losses instead of directly reducing the amortized cost basis of the debt security (except for an AFS debt security that an entity intends to sell or more likely than not the entity will be required to sell before recovery).

If a DCF method is used to measure the allowance for credit losses, the allowance will be a discounted amount, and the higher interest income will generally be offset in the income statement by the accretion of the discount on the allowance.

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

Interest income recognition on PCD assets

Interest income for a PCD asset should be recognized by accreting the amortized cost basis of the instrument to its contractual cash flows. The discount related to estimated credit losses on acquisition (that is, the allowance recognized at the date of purchase through the gross-up accounting) will not be accreted into interest income. Only the noncredit-related discount will be accreted.

Presentation and disclosure

The illustration below summarizes the requirements in ASC 326 for new or enhanced disclosures.

Loans and receivables	▸ Vintage disclosures of credit quality indicators, disaggregated by year of origination (public business entities (PBEs) only) ▸ Additional disclosures to help users of the financial statements understand management's assumptions used in the estimate of expected credit losses
Debt securities	▸ HTM – Same disclosure requirements as loans ▸ AFS – New disclosures related to allowance
PCD assets	▸ Disclosures only for assets acquired in the current reporting period
Collateral-dependent assets	▸ Disclosures about type of collateral and extent to which collateral secures assets

How we see it

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

If an entity agrees to modify a loan, it will need to consider whether the modification results in a new loan or the continuation of an old loan (i.e., apply the guidance in ASC 310-20-35-9 through 35-11) for purposes of providing the new vintage disclosures (i.e., disclosures by year of origination) for financing receivables. See section 6.3.1.2.1 of our FRD, ***Credit impairment under ASC 326***, for further discussion.

Endnotes:

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

[2] 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*.

[3] ASU 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, deferred the effective date of ASU 2016-13 for all entities except SEC filers that are not SRCs.

[4] This term is defined in Part 230.405 of the SEC's general rules and regulations, Securities Act of 1933.

[5] Legacy GAAP provides a similar practical expedient but defines "collateral dependent" as a loan for which the repayment is expected to be provided "solely by the underlying collateral." In the new standard, the FASB modified this definition to say "substantially through the operation or sale of the collateral" and to emphasize the financial difficulty criterion.

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

[7] Trading securities subject to ASC 325-40 include beneficial interests measured at fair value with changes recognized in earnings (except for certain hybrid beneficial interests measured that way because of the fair value option in ASC 815-15) held by an entity that is required to separately present as interest income the portion of the change in fair value related to interest income determined pursuant to ASC 325-40.

[8] 12 June 2017 Credit Losses TRG meeting, memos #2 and #6.