

AN ACCOUNTING GUIDE: CECL

FASB TOPIC 326, FINANCIAL INSTRUMENTS –
CREDIT LOSSES

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INTRODUCTION

As a result of the 2007-2008 financial crisis, there were concerns regarding the adequacy of loan loss reserves given that entities, including financial institutions, were restricted under U.S. GAAP from recording “expected” credit losses that did not yet meet the “probable” threshold as required at that time.

In response, the FASB and its counterpart, the London-based International Accounting Standards Board (IASB), set out to develop a new accounting standard that incorporated forward-looking information to determine future losses. The IASB and FASB could not agree on a converged standard. IASB issued International Financial Reporting Standards (IFRS) 9 in July 2014, while the FASB developed a framework to replace the existing incurred loss methodology in U.S. GAAP.

In June 2016, the FASB issued Accounting Standards Update (ASU or Standard) 2016-13, codified within Accounting Standards Codification (ASC) Topic 326 (ASC 326 or Topic 326). The ASU significantly changes the impairment model for most financial assets that are measured at amortized cost (and certain other instruments) from an incurred loss model to an expected loss model that will be based on an estimate of current expected credit loss (CECL). The ASU also provides targeted improvements on evaluating impairment and recording credit losses on available-for-sale (AFS) debt securities through an allowance account. The standard also requires certain incremental disclosures. Subsequently, the FASB issued ASU 2018-19, ASU 2019-04, ASU 2019-05, ASU 2019-10, ASU 2019-11, ASU 2020-03 and ASU 2022-02 to clarify and improve ASU 2016-13.

Additionally, the FASB established a Transition Resource Group (TRG) for credit losses.

CECL reflects management’s estimate of all credit losses that they expect from the financial assets as of the balance sheet date (and on certain off-balance sheet commitments). Said differently, the standard requires lifetime losses to be recorded on the date of origination or acquisition. The estimate is not a worst-case scenario nor a best-case scenario, but rather should be based on an entity’s assessment of current conditions and reasonable and supportable forecasts about the future. The FASB expects that an entity’s estimate of expected credit losses would be informed by historical loss experience for similar assets, coupled with adjustments for current conditions and reasonable and supportable forecasts about the future that inform management’s judgment about how the current conditions may differ from its historical experience. There are no minimums or triggering events.

Legacy incurred loss methodology recognizes credit losses when it is probable such losses have been incurred. CECL removes the concept of “probable” and requires recognition of credit losses when such losses are “expected.”

ASC 326 does not require an entity to probability weight multiple economic scenarios when developing an estimate of expected credit losses. An entity may determine that a probability weighted approach is appropriate; however, the standard allows flexibility for entities to evaluate and reach a conclusion on the best approach to use.



	EXISTING GUIDANCE	NEW CECL MODEL
When to recognize credit losses	When probable that loss has been incurred, generally after initial recognition of the asset	When losses are expected, in almost all cases upon initial recognition of the asset
Period to consider	Not an explicit input to incurred loss model	Contractual term
Information to consider	Historical loss and current economic conditions	Historical loss, current economic conditions, reasonable and supportable forecasts about future conditions (with reversion to historical loss information for future periods beyond those that can be reasonably forecast)
Unit of account	Pooling generally not required, but permitted	Pooling required when assets share similar risk characteristics

SCOPE

ASC 326 applies to all entities. ASC 326-20 is applicable to financial assets measured at amortized cost, net investments in leases recognized by a lessor and off-balance sheet credit exposures not accounted for as insurance.

EXAMPLE OF SCOPED-IN FINANCIAL ASSETS PER ASC 326-20-15-2A:

- Financing receivables
- Held-to-maturity debt securities
- Receivables that result from revenue transactions within the scope of ASC 605 on revenue recognition, ASC 606 on revenue from contracts with customers, and ASC 610 on other income
- Receivables that relate to repurchase agreements and securities lending agreements within the scope of ASC Topic 860 – Transfers and Servicing

The scope of CECL is broad and includes the following:

ITEM	NATURE
Loan Receivables/Notes Receivable	Financial Assets measured at amortized cost
Held-to-maturity debt securities	Financial Assets measured at amortized cost
Trade receivables and contract assets that result from revenue transactions or other income	Financial Assets measured at amortized cost
Receivables that relate to repurchase agreements and securities lending agreements	Financial Assets measured at amortized cost
Loans to officers and employees	Financial Assets measured at amortized cost
Cash equivalents	Financial Assets measured at amortized cost
Receivables arising from time-sharing activities	Financial Assets measured at amortized cost
Receivables resulting from sales-type or direct financing leases	Net investments in leases recognized by a lessor
Loan commitments, standby letters of credit, financial guarantees and other similar instruments	Off-balance-sheet credit exposures not accounted for as insurance or derivatives
All reinsurance recoverables, regardless of the measurement basis of those recoverables	Reinsurance recoverables

A financing receivable is a financing arrangement that has both of the following characteristics:

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

Credit card receivables may require a CECL reserve on the outstanding balance and a CECL reserve on the unfunded portion of the line based on probability of funding if they are not unconditionally cancellable by the entity.

ASC 326-20 also applies to net investments in leases recognized by a lessor in accordance with ASC 842 – Leases, off-balance-sheet credit exposures not accounted for as insurance and reinsurance recoverables that result from insurance transactions within the scope of ASC 944 – Financial Services – Insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments, except for instruments within the scope of ASC 815 – Derivatives and Hedging .

Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor is a debt security for accounting purposes, regardless of its legal form. Therefore, the CECL model would apply if such preferred stock is carried at amortized cost by the investor, and irrespective of how it is classified by the issuer. In practice, to be considered redeemable at the option of the investor, that investor must have a unilateral right to redeem.

ASC Subtopic 326-30 applies to debt securities classified as available-for-sale, including loans that meet the definition of debt securities and are classified as available-for-sale.

ASC 326 does not apply to:

- Loans held for sale
- Operating lease receivables
- Policy loan receivables of an insurance entity
- Promises to give of a not-for-profit entity
- Financial assets measured at fair value through net income
- Loans and receivables between entities under common control

OBSERVATION: Although operating leases appear to meet the definition of financial assets within the scope of the ASU, the FASB clarified that operating lease receivables accounted for by a lessor in accordance with the new leasing guidance in Topic 842 are not in the scope of the CECL model. Impairment of receivables from operating leases should be accounted for in accordance with Topic 842, Leases. Further, being an operating lease, the leased asset remains on the lessor's books and is assessed for impairment like any other similar asset under Topic 360, Property, Plant and Equipment.

Additionally, while CECL is not applicable to an equity method investment, other financial support that may be provided to the investee e.g., loans to equity method investees are within the scope of the CECL model.



RECORDING EXPECTED CREDIT LOSSES

The objective of CECL is to provide financial statement users with an estimate of the net amount the entity expects to collect on its financial assets. In determining these estimates of expected losses, the calculation should include consideration of historical experience, current conditions as well as reasonable and supportable forecasts.

Expected recoveries should be included when estimating the expected credit loss at each reporting period and should not exceed the aggregate amounts previously written off and/or expected to be written off by the entity.

ASC 326-20 does not mandate a model to determine CECL reserves. Entities can choose a model that makes sense for their specific facts and circumstances and based on the data available to the entity. Examples of models that result in a CECL-compliant reserve are discussed further in this publication.

EXCERPT FROM ASC 326-20

ASC 326-20-30-1 STATES: 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).

ASC 326-20-30-7 STATES: 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.

Changes to the expected credit losses reserve are recognized in the current period net income as either credit loss expense or a reversal of credit loss expense depending on the movement of the reserve from the previous period.

OBSERVATION: In general, since ASC 326-20 is focused on recording the lifetime expected credit losses at the point of origination, or at acquisition, the associated reserve balances are generally expected to be higher under an expected credit losses model as compared to the legacy incurred loss model. If the calculations result in less allowance under the expected loss model compared to the incurred loss model, entities should be mindful of whether this is contradictory evidence that requires further investigation related to assumptions being used.

POOLING FINANCIAL ASSETS WITH SIMILAR RISK CHARACTERISTICS

ASC 326-20 requires in scope assets sharing similar risk characteristics to be grouped in pools for applying the methodology selected and estimating the lifetime expected credit losses. In situations where a specific asset does not share the same risk characteristics with other assets, entities are to separate and measure that asset individually. A similar pooling approach should be used when estimating the expected credit losses for off-balance sheet credit exposures.

EXCERPT FROM ASC 326

ASC 326-20-30-2 STATES: 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.

ASC 326-20-55-5 STATES: 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):

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

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

ASC 326-20-35-2 STATES: 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 write-offs, 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.

Determining pools of assets does not only occur upon adoption or when new assets are originated/acquired post-adoption. Entities are expected to continuously evaluate pooling decisions for financial assets and adjust as needed as risk characteristics change.

OBSERVATION: Management will need to clearly define the risk characteristics used in determining the pooling decisions and periodically reassess whether facts and circumstances have changed that require revisiting how pools are determined. Assets can migrate between pools.

The following example provides an illustration from the standard when an entity might pool certain assets and evaluate others individually. As time passes and circumstances change assets may move from being evaluated collectively to being evaluated individually, and vice versa.

EXCERPT FROM ASC 326

55-32: This Example illustrates a situation in which loans with credit deterioration are evaluated individually because they no longer exhibit risk characteristics similar to other loans. There is no requirement to evaluate financial assets individually when a certain level of credit deterioration has occurred. However, the assessment of whether financial assets exhibit similar risk characteristics should be based on the relevant and appropriate facts and circumstances.

55-33: An entity may estimate expected credit losses for some financial assets on a collective (pool) basis and may estimate expected credit losses for other assets on an individual basis when similar risk characteristics do not exist. As a result, the method used to estimate expected credit losses for a financial asset may change over time. For example, a pool of homogeneous loans may initially use a loss-rate method, but certain individual loans no longer may have similar risk characteristics because of credit deterioration. When a financial asset no longer shares similar risk characteristics with the original pool of financial assets, an entity should evaluate that financial asset to determine whether it shares risk characteristics similar to other pools of loans. Expected credit losses of that financial asset should be measured individually if there are no similar risk characteristics with other loans. A discounted cash flow approach is one method to estimate expected credit losses of individual loans, but it is not a required method. Paragraphs 326-20-55-34 through 55-36 illustrate those concepts.

55-34: One loan program from Bank D provides unsecured commercial loans of up to \$75,000 to small businesses

and entrepreneurs. Given the relative homogeneity of the borrowers (in terms of credit risk) and loans (in terms of type, amount, and underwriting standards) in the program, Bank D manages this loan program on a collective basis. However, Bank D concludes that the loss estimates for loans with credit deterioration is based on borrower-specific facts and circumstances because the repayment of those loans depends on facts and circumstances unique to each borrower. Therefore, Bank D estimates expected credit losses on an individual basis for loans that no longer exhibit similar risk characteristics because of credit deterioration. A loss-rate method for estimating expected credit losses on a pooled basis is applied for the loans in the portfolio segment that continue to exhibit similar risk characteristics.

55-35: To estimate expected credit losses for individual loans without similar risk characteristics, Bank D uses a discounted cash flow method for each loan. Frequently, Bank D has insight into the likelihood of a credit loss as a result of information provided by the borrower and recent discussions with the borrower given the elevated credit risk for these loans. Under a discounted cash flow method, the allowance for credit losses is estimated as the difference between the amortized cost basis and the present value of cash flows expected to be collected.

55-36: To estimate expected credit losses for the remainder of the loans that continue to exhibit similar risk characteristics, Bank D considers historical loss information (updated for current conditions and reasonable and supportable forecasts that affect the expected collectibility of the amortized cost basis of the pool) using a loss-rate approach.

CONTRACTUAL TERM

EXCERPT FROM ASC 326

ASC 326-20-30-6 STATES: 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 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.

Credit losses are required to be estimated over the contractual term of the financial asset (considering estimated prepayments) from the date of initial recognition of that instrument. Prepayment assumptions should be considered as they reduce the estimated contractual term. For example, prepayment assumptions may result in a 30-year mortgage having an expected 10-year term.

Any extension or renewal options (except those recognized as derivatives) that are not unconditionally cancellable by the entity and included in the original agreement or subsequent modifications should be considered in the contractual term. For example, there may be situations where a lender or borrower can extend or renew the term of the financial asset through an option within the terms of the agreement. Entities should consider how these contractual options impact their determination of the contractual term.

The determination of prepayment assumptions is not only determined as part of the initial adoption of ASC 326 but should be updated periodically as facts

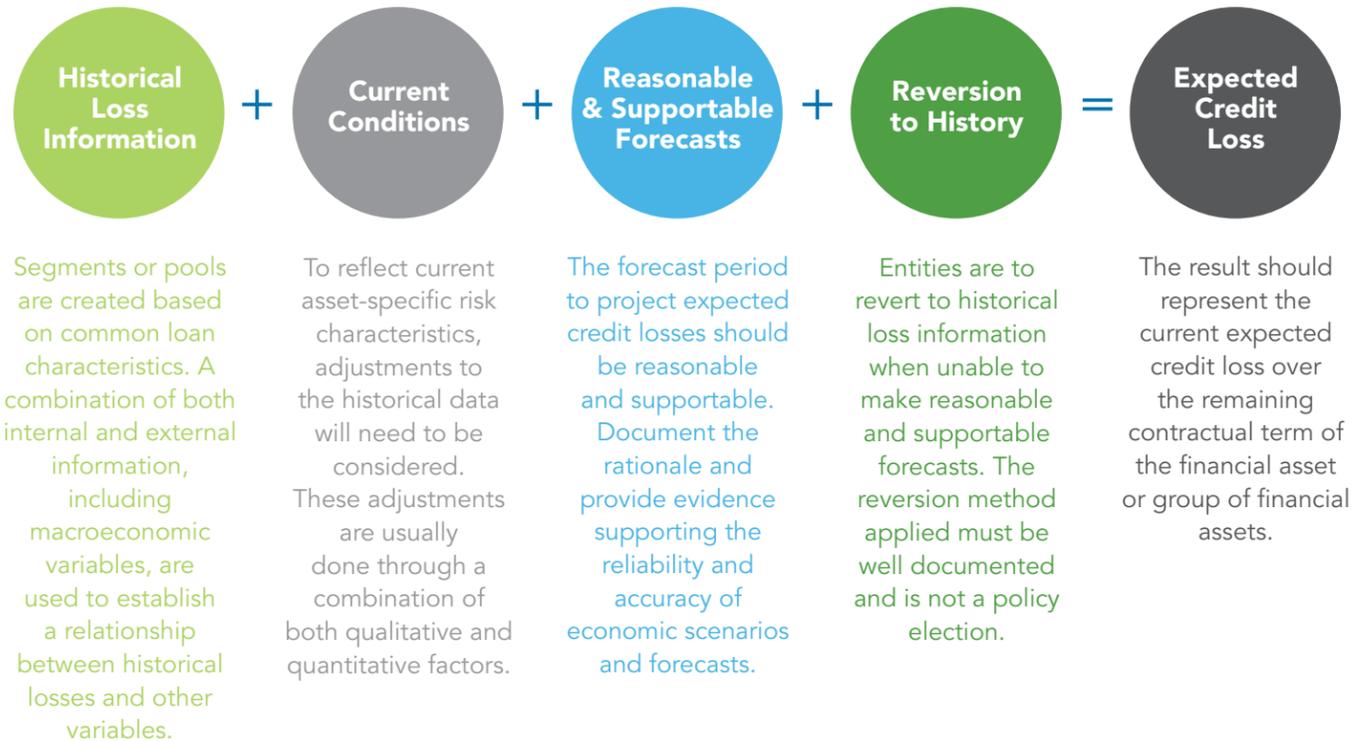
and circumstances change and as actual prepayment information deviates from expectations. As changes arise, an entity should adjust the prepayment assumptions used, including in determining the effective interest rate(s) for the discounted cash flows model. Furthermore, if an entity has reason to believe that future prepayment conditions are likely to change, revision should be made to the prepayment assumptions used. In either situation, it is critical to ensure that these assumptions are reasonable and supportable and sufficient evidence to support the assumptions used is maintained.

Credit card receivables generally do not have a contractual term and customer payments can relate to interest, principal, fees or subsequent purchases. Allocating the payments is therefore a key input when estimating the contractual life of the receivable. The FASB concluded that entities will need to make a policy election how they will allocate expected future payments when estimating the contractual life of the receivable. Entities can choose to include all payments expected to be collected from the borrower as paydowns on the period end outstanding balance, to include a portion of the payments as paydowns on the period end outstanding balance or apply another reasonable method as long as it is consistent with the objectives in the ASC and is applied consistently.

OBSERVATION: Determining the appropriate contractual term and any relevant prepayment assumptions requires judgment. The level of judgment may increase or decrease depending on the specifics of the financial assets evaluated. When significant judgment is associated with making a significant estimate, it is important that management maintain support for the conclusions, including consideration of contradictory evidence.

COMPONENTS OF CECL MODEL

The following illustrates the components in the estimate for expected credit losses:



HISTORICAL LOSS INFORMATION

Estimating expected lifetime credit losses should start by considering relevant past events, which will most often be accomplished by considering historical loss information. This serves as the baseline for which other adjustments will be made to arrive at the estimate for expected credit losses. The FASB has indicated that historical loss information alone will not be sufficient to determine the estimate for expected credit losses. The historical period(s) used for the respective pools, will impact the nature and magnitude of adjustments that are required to adjust the historical information for current events, reasonable and supportable forecasts, and any other qualitative and quantitative adjustments that may be deemed necessary.

An entity must first analyze the available historical loss information and identify the period(s) that is representative of the relevant historical loss information for the specific pool(s). An entity does not have to use historical information from the most

recent periods and may also use historical losses that are nonsequential. The appropriate historical loss period can vary between asset portfolios, products, pools and inputs.

An entity should consider both the appropriate historical period and the appropriate length of the period when developing those estimates. Further, application of the new guidance may result in the creation of new or revised pools due to the ASU's requirement that an entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristics exist. Therefore, an entity may further need to consider how to correlate historical loss information for assets earlier assessed individually, or that were in another pool, to those new or revised pools. When there is no historical loss information present, such as a new class of asset type, it may be appropriate that the entity look to external historical loss information.



EXCERPT FROM ASC 326

ASC 326-20-30-8 STATES: 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.

ASC 326-20-30-9 STATES: 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.

To assist entities with their implementation efforts and help further their understanding of the CECL model, the FASB staff issued a series of Q&As, available on the designated Credit Losses page on the FASB website, addressing questions related to using historical loss information, making reasonable and supportable forecasts and reversion to historical loss information (Q&A2). The following Q&A relates to determining which historical loss information to use when estimating expected credit losses.

EXCERPT FROM FASB Q&A2

QUESTION 4: How should an entity determine which historical loss information to use when estimating expected credit losses?

RESPONSE: In determining what historical loss period information best represents the financial assets, an entity may use historical loss information that is nonsequential (such as historical loss percentages based for each year since origination as opposed to an average 5-year historical loss percentage). The appropriate historical loss period can vary between loan portfolios, products, pools, and inputs. An entity should consider both the appropriate historical period and the appropriate length of the period when developing those estimates.

An entity should use judgment in determining which period or periods to consider when determining which historical loss information is most appropriate for estimating expected credit losses. An entity does not have to use historical losses from the most recent periods. For example, an entity may determine that the historical loss information that best represents the specific risk characteristics of the entity's current portfolio relates to periods from 20X2–20X5. Using the historical loss information from 20X2–20X5 as an input to the measurement of expected credit losses, an entity would then consider how current conditions and reasonable and supportable forecasts affect the estimate of expected credit losses. Once the historical period has been chosen, an entity should consider

adjustments to historical loss information for differences in current asset specific risk characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information does not reflect the contractual term of the financial asset or group of financial assets. For periods beyond the reasonable and supportable forecast period, an entity should revert to historical loss information that may not be from the same period used to estimate its reasonable and supportable forecast and should reflect the contractual term of the financial asset or group of financial assets. In other words, an entity should use historical loss information that is more reflective of the remaining contractual term of the financial assets for periods beyond the reasonable and supportable forecast period.

OBSERVATION: Whenever external data is used there is added risk related to the relevance and reliability of the data. Careful consideration should be given each time external data is used either in place of, or to supplement, internal data to ensure such external data is relevant to the entity. In instances when external data is used, an entity should evaluate the sufficiency of internal data as asset pools mature. For example, if the entity has a new pool of assets where there is no historical loss information available internally, it may look to peer group data for similar entities. As the pool of assets matures and as historical loss information becomes available, an entity will need to periodically reevaluate whether external data is still more relevant than internal data. Additionally, if external data is being used because internal data was not previously tracked and maintained, entities will need to evaluate when the internal data is able to be tracked, analyzed and used prospectively.



CURRENT CONDITIONS

Historical loss information used in the pool(s) must then be adjusted for current conditions specific to the entity for developing an estimate for expected future losses. These adjustments can be quantitative or qualitative in nature. Adjustments made to reflect current asset-specific risk characteristics may be influenced by the periods selected for the historical loss data. Examples of current conditions that may require adjustment to historical losses follow (not meant to be all inclusive):

- Updates to previous underwriting standards that may have contributed to historical losses
- Changes in terms of existing assets as compared to those in the periods where the historical losses existed
- Shifts in the mix of assets that exist presently compared to concentrations that may have existed during the periods when the historical losses were recorded

The excerpt below lists relevant factors for entities to consider. Reasonable and supportable forecasts are discussed further in the publication.

EXCERPT FROM ASC 326

ASC 326-20-55-4 STATES: 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):

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

Entities may continue to consider the nine qualitative factors set forth in the 2006 Interagency Policy Statement on each loan pool to reflect current asset-specific risk characteristics that are not otherwise captured within the historical data for the period(s) selected. Like many of the other decisions in the model development process, determining which adjustments are needed and the amount of the adjustments will require significant judgment by management. These will need to be updated each reporting period to reflect the current asset-specific risk characteristics.

Adjustments to the historical losses should be reflective of adjustments relevant to those respective pools. For example, if an entity that was in the financial services industry had a significant change to its underwriting practices for commercial loans, these changes in underwriting practices may not be relevant to residential mortgages, unless there were similar changes to underwriting policies in those respective segments as well (even then, the impact of such changes may have different impacts on expected losses given the difference in loan products and the borrowers). There is the potential for double counting based on what the historical loss information represents. If it includes elements of the economic forecast or other potential qualitative considerations, then a subsequent adjustment to further account for those items may not be necessary. For example, if management had a period of time with significant turnover in the lending group and higher losses in those periods and those periods are not included in the historical loss component, we would not generally expect management to further adjust the historical loss information to reflect the improvement in the lending resources since it is already factored into the historical loss information.

Depending on the period(s) selected, there may be a need to make negative adjustments to the historical loss information. An example of this would be when the entity is using a peak loss period and reducing the historical losses based on the expectation that the current environment is not in the same state of deterioration as the historical losses in the period selected.

OBSERVATION: Management will need to give careful consideration to the data that is used within the historical loss information and what, if any, asset-specific risk characteristics not present within that data that would need to be factored so the historical loss information represents management's expectation for the current environment.

REASONABLE AND SUPPORTABLE FORECASTS

The forecast period represents the period from the current period end through the point in time management can reasonably forecast and support entity and environmental factors (e.g., economic indicators such as unemployment data) that are expected to impact the asset or pool of assets being measured. As the contractual term increases, the ability to prepare a forecast that is considered reasonable and supportable and that would cover the entire contractual term becomes more difficult or may not be possible. While an entity may be unlikely to develop forecasts for the entire contractual term (as adjusted for estimated prepayments) for longer-term assets, there should be a period of time when the entity can reasonably estimate and support their forecast. For example, considering the short-term nature of the trade receivables, it is expected that entities will generally have reasonable and supportable forecasts over the entire period of the receivable. Other assets may have longer durations, depending on the nature of the arrangement. For example, an entity may be able to reasonably estimate and forecast a 30-year mortgage with a 10-year expected term, for two years. In this example the reasonable and supportable period would be two years, and the remaining eight years would be in the reversion period (explained later in this publication).

OBSERVATION: Significant judgment will be needed to determine the entity's reasonable and supportable forecast period. Management will need to document their rationale for the period(s) determined to be appropriate. Additionally, significant judgment will be required to determine what, if any, adjustment (upward or downward) is needed to the historical loss information, as adjusted for current conditions for the effects of the reasonable and supportable forecast(s).

The following FASB Q&As relates to reasonable and supportable forecasts when estimating expected credit losses from Q&A2.

EXCERPT FROM FASB Q&A2

QUESTION 8: May the length of reasonable and supportable forecast periods vary between different portfolios, products, pools, and inputs?

RESPONSE: Yes. The duration or length of the reasonable and supportable forecast period is a judgment that may vary based on the entity's ability to estimate economic conditions and expected losses. The reasonable and supportable forecast may vary between portfolios, products, pools, and inputs. However, specific inputs (such as unemployment rates) should be applied on a consistent basis between portfolios, products, and pools, to the extent that the same inputs are relevant across products and pools. It also is acceptable to have a single reasonable and supportable period for all of an entity's products. An entity is to disclose information that will enable users to understand management's methods for developing its expected credit losses, the information used in developing its expected credit losses, and the circumstances that caused changes to the expected credit losses among other disclosures about the allowance for credit losses.

QUESTION 9: Does an entity need to include the full contractual period (adjusted for prepayments) in its estimate of the reasonable and supportable forecast period?

RESPONSE: No. Some entities may be able to apply reasonable and supportable forecasts over the estimated contractual term (that is, the contractual term adjusted for prepayments). However, the guidance does not require an entity to develop forecasts over the contractual term (adjusted for prepayments) of the financial asset or group of financial assets (paragraph 326-20-30-9).

For example, three separate lenders, each based in three different communities, loaned money to borrowers employed by a manufacturer that has operations in three separate communities. Many borrowers in each of the three communities are employed by one of the manufacturing plants in their community. The manufacturer has announced plans to close one of its manufacturing plants in 18 months. However, it is not yet known which plant the manufacturing company will close. Each entity should apply judgment in developing reasonable and supportable forecasts when considering the effect of a possible plant closure on its ability to collect any principal and interest on outstanding loan balances from those borrowers who work at this plant. Each of the three entities may have different estimates of expected credit losses, including the inputs, assumptions, or durations for their reasonable and supportable forecast period. For example, entities may be able to reasonably forecast losses beyond the period of the plant closure or may determine that their forecasts are reasonable only up to the period of the plant closure.

Another example is when a wholesaler has short-term receivables from a retailer in a local mall that is experiencing financial difficulty. This wholesaler may be able to forecast all expected credit losses on the receivable, and, therefore, the reasonable and supportable forecast period would include the contractual term of the receivable.

The reasonable and supportable forecast period should be reevaluated at each reporting period.

EXCERPT FROM FASB Q&A2

QUESTION 10: Should an entity reevaluate its reasonable and supportable forecast period each reporting period?

RESPONSE: Yes. An entity should consider the appropriateness of its reasonable and supportable forecast period, as well as other

judgments applied in developing estimates of expected credit losses each reporting period. If the reasonable and supportable period does not cover the full expected contractual term (adjusted for prepayments), an entity should consider the appropriateness of the duration of its reversion period (that is, the periods beyond the reasonable and supportable period) and the methodology applied when reverting back to historical loss information. For example, an entity may determine that it is appropriate to shorten or lengthen its reasonable and supportable forecast period from prior periods because of changes in the uncertainty of some or all of the inputs and assumptions used to measure expected credit losses.

The FASB Q&A2 also addressed questions raised related to a perceived requirement to include macroeconomic data.

EXCERPT FROM FASB Q&A2

QUESTION 11: Is an entity required to correlate reasonable and supportable forecasts to macroeconomic data, such as nationwide or statewide data?

RESPONSE: No. An entity is not required to correlate or reconcile reasonable and supportable forecasts to macroeconomic data, such as the national unemployment rate. Instead, when developing an estimate of expected credit losses on financial assets, the entity should consider available information relevant to assessing the collectibility of cash flows.

For example, a business closure may not correlate to any macroeconomic phenomena. Instead, an entity may decide to move to another state to receive a more lucrative tax treatment. In this instance, the macroeconomic factors may indicate a very strong job market with low nationwide or statewide unemployment rates, but the business closure may have a significant

effect for the entity in the local economic environment when assessing the collectability of amounts owed by its borrowers. In this instance, correlating a local economic event to macroeconomic data may not be appropriate because the macroeconomic data are not relevant.

In other instances, an entity may consider whether a national trade agreement will have a favorable or unfavorable effect on its ability to collect contractually owed cash flows from its borrowers. The entity may decide to review its internal information that has not indicated any changes in employment to date, but based on a government decision, there may be an effect on the entity's local economy that will result in a change to expected credit losses.

OBSERVATION: Determining the relevance and reliability of the data being used in the forecasting process may be challenging for entities.

Developing a forecast that is both reasonable and supportable may consider both publicly available information and involve subject matter experts which may be from internal or external third-party resources. Internal controls will vary depending on how the information is derived. For third-party provided data, management may consider control activities to validate its integrity, relevance and reliability. Understanding the source of the data and how the data will be used in developing the forecast will be critical to avoid placing inadvertent reliance.

REVERSION TO HISTORY

Entities are to revert to historical loss information when they are unable to make reasonable and supportable forecasts over the contractual term, adjusted for prepayments. The reversion technique applied must be well documented and may not be a policy election. Therefore, the entity must separately evaluate each pool of assets when determining which reversion technique is most appropriate.

Examples of reversion techniques that might be used are immediate reversion and straight-line reversion. Immediate reversion is accomplished by reverting to the full historical loss rate at the point that forecasts are no longer reasonable and supportable. Whereas straight-line reversion is done by adjusting the reasonable and supportable forecasted loss rate in increments to revert back to the historical loss rate and will require judgment as to the length of time over which the straight-line period should be. Other reversion techniques may be used as long as they are rational and systematic.

Regardless of the reversion technique selected, it is important to note that the historical loss rates being reverted to may only be adjusted for differences in current asset-specific risk characteristics such as:

- Updates to previous underwriting standards that may have contributed to historical losses

- Changes in terms of existing assets as compared to those in the periods where the historical losses existed
- Shift in the mix of assets that exist presently compared to concentrations that may have existed during the periods when the historical losses were recorded

While the standard does not indicate the point at which an entity should revert to historical loss information it does indicate that it is not appropriate to revert to historical loss information for periods that can be reasonably forecasted.

OBSERVATION: Reversion methods, like many of the judgments and assumptions in the CECL methodology, are not one size fits all. Depending on the risk characteristics of the asset pools, the reversion methods may differ for each pool. Supporting the considerations for the most appropriate time to revert to historical loss information is essential not only to comply with the standard but also to support the specific disclosures required on reversion approaches. The reversion method is not a policy election; an entity should support the reversion methodology.

The FASB Staff Q&A2 publication highlights specific matters related to reversion to historical information.

EXCERPT FROM FASB Q&A2

QUESTION 14: What should an entity do if it cannot forecast estimated credit losses over the entire contractual term (adjusted for prepayments)?

RESPONSE: An entity is not required to develop forecasts over the entire contractual term (adjusted for prepayments) of the financial asset or group of financial assets. For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it is required to revert to historical loss information that reflects expected credit losses during the remainder of the contractual term (adjusted for prepayments) of the financial asset or group of financial assets.

Update 2016-13 provides entities with flexibility to determine the expected credit losses and does not require an entity to develop reasonable and supportable forecasts for the entire expected remaining life of a loan (that is, contractual term adjusted for prepayments), such as a 30-year mortgage. Therefore, the Board included guidance on how an entity should estimate expected credit losses for those periods beyond the reasonable and supportable forecast period. The periods after the reasonable and supportable forecast periods are often referred to as the “reversion period” and “post-reversion period,” as applicable. When reverting to historical loss information, an entity should (1) consider whether the historical loss information is still relevant to estimating expected credit losses (that is, in accordance with paragraph 326-20-30-8, an entity may consider adjusting its historical loss information for differences in current asset-specific risk characteristics) and (2) not adjust historical loss information in the reversion period and post-reversion periods for existing economic conditions or expectations of future economic conditions.

QUESTION 15: Can an entity adjust the historical loss information used in the reversion period for existing economic conditions or expectations of future economic conditions when developing estimates of expected credit losses?

RESPONSE: No. For periods beyond which an entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it should revert to historical loss information determined in accordance with paragraph 326-20-30-8 that reflects expected credit losses during the remainder of the contractual term (adjusted for prepayments) of the financial asset or group of financial assets. The entity should 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.

The Board decided to require that an entity revert to historical loss information without adjusting historical loss information for economic conditions beyond the reasonable and supportable period to simplify the estimation process. However, this historical loss information should be adjusted for differences in current asset-specific risk characteristics in accordance with paragraph 326-20-30-8. The Board understands that an entity may need additional guidance on how to measure expected credit losses as it estimates losses in periods of increasing uncertainty and decreasing precision. The reversion to an entity’s historical loss information emphasizes the relevance of known loss experience that has occurred in the past on similar financial assets or groups of financial assets and addresses preparers’ concerns about the reliability of estimating those credit losses in periods of declining precision.



EXCERPT FROM FASB Q&A2

QUESTION 16: Is an entity required to revert to historical loss information on a straight-line basis?

RESPONSE: No. Although an entity is required to revert to historical loss information for periods that cannot be forecasted based on reasonable and supportable information, the Board did not prescribe a single methodology for reverting to historical loss information. Instead, the Board stated that an entity may revert to historical loss information immediately on a straight-line basis or using another rational and systematic basis. In addition, the guidance permits an entity to apply different reversion methods for different inputs and asset classes.

The Board understands that an entity may need additional guidance on how to measure expected credit losses as it estimates losses in periods of increasing uncertainty and decreasing precision. The reversion to an entity's historical loss information emphasizes the relevance of known loss experience that has occurred in the past on similar financial assets and addresses preparers' concerns about the reliability of estimating those credit losses in periods of declining precision.



Ultimately, an entity should use judgment in determining which reversion technique is most appropriate at the reporting date. For example, an entity identifies that a factory in its local economy will be closing in two years. As part of the entity's reasonable and supportable forecast, it considers the effect the closure will have on collecting its outstanding loan balances.

The expected contractual term (adjusted for prepayments) of remaining loans exceeds the two-year reasonable and supportable forecast period, and, therefore, the entity will need to revert to historical loss information. The entity decides to apply a straight-line technique when reverting to historical loss information because the factory closing will continue to affect the collectibility of outstanding loan balances for periods beyond the reasonable and supportable forecast period. In this instance, it may not be appropriate to immediately revert to historical loss information because there may be a prolonged effect on the entity's ability to collect on contractually owed cash flows because employees of the factory may be unemployed for a long time. Alternatively, an entity may capture the extended impact of the closure in its qualitative adjustments.

In contrast, an immediate reversion methodology could be appropriate when an entity may be able to develop a reasonable and supportable forecast only for a market-based input (such as home prices) that covers one year.

The reversion method is not a policy election but rather a component of the overall estimate of expected credit losses. Like other components used to measure expected credit losses, an entity should support the reversion methodology and period it uses to develop its estimates of expected credit losses. Additionally, reversion to historical loss information, whether immediately or on a straight-line basis or using another reasonable methodology, is required only for periods that cannot be forecasted based on reasonable and supportable information.

METHODOLOGIES UNDER ASC 326-20

EXCERPT FROM ASC 326

ASC 326-20-55-7 STATES: Because of the subjective nature of the estimate, this Subtopic does not require specific approaches when developing the estimate of expected credit losses. Rather, an entity should use judgment to develop estimation techniques that are applied consistently over time and should faithfully estimate the collectibility of the financial assets by applying the principles in this Subtopic. An entity should utilize estimation techniques that are practical and relevant to the circumstance. The method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity.

The standard does not provide prescriptive guidance for an entity to follow when developing its estimate for expected credit losses. The FASB instead has provided entities with the ability to use judgment in developing a methodology that is able to be applied on a consistent basis from one period to the next and considered reasonable and supportable. The method(s) used to estimate expected credit losses may vary based on the type of financial asset, the entity's ability to predict the timing of cash flows and the information available to the entity.

However, the FASB highlighted several potential models, which include discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods or methods that utilize an aging schedule. ASC 326-20-55 provides illustrative guidance for many of these models:

MODEL	EXAMPLE REFERENCE IN ASC 326-20-55
Loss-rate approach (collective evaluation)	ASC 326-20-55-18 through 55-22
Loss-rate approach (individual evaluation)	ASC 326-20-55-23 through 55-27
Vintage-Year Basis	ASC 326-20-55-28 through 55-31
Expected credit losses using both a collective method and an individual asset method (includes discounted cash flows example)	ASC 326-20-55-32 through 55-36
Trade receivables using an aging schedule	ASC 326-20-55-37 through 55-40
Practical expedient for collateral-dependent financial assets	ASC 326-20-55-41 through 55-44
Practical expedient for financial assets with collateral maintenance provisions	ASC 326-20-55-45 through 55-47
Potential default is greater than zero, but expected nonpayment is zero	ASC 326-20-55-48 through 55-50
Recognizing write-offs and recoveries	ASC 326-20-55-51 through 55-53
Unconditionally cancellable loan commitments	ASC 326-20-55-54 through 55-56
Recognizing purchased financial assets with credit deterioration	ASC 326-20-55-61 through 55-65
Loss rate approach on purchased financial assets with credit deterioration	ASC 326-20-55-66 through 55-71
Discounted cash flows approach on purchase financial assets with credit deterioration	ASC 326-20-55-72 through 55-78
Identifying similar risk characteristics in reinsurance receivables	ASC 326-20-55-81 through 55-85

EXCERPT FROM ASC 326

ASC 326-20-30-3 STATES: 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.

ASC 326-20-55-6 STATES: 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:

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

reasonable and supportable forecasts of expected credit losses.

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

The following information relates to two common methodologies:

DISCOUNTED CASH FLOW

Based on the present value of expected future cash flows discounted at an effective interest rate applicable to the asset/asset pool. Expected cash flow assumptions used should be based on best estimates of reasonable and supportable assumptions and projections.

The effective interest rate includes the accretion or amortization of premiums and discounts.

The FASB provides several examples within ASC 326-20-55 "Implementation Guidance and Illustrations" that have been presented below when applying discounted cash flows to existing financial assets as well as assets purchased with credit deterioration.

LOSS RATE

The average charge-off method is an approach commonly used for evaluating impairment on pools of financial assets under the incurred loss model. This method is used for calculating an estimate of losses based primarily on experience, and the data needs of this method are modest compared to those of other methods.

The FASB provides several examples within ASC 326-20-55 "Implementation Guidance and Illustrations" that are presented below when applying a loss rate approach to a normal pool of assets on a collective, individual and vintage method as well as assets purchased with credit deterioration.

EXCERPT FROM ASC 326

ASC 326-20-30-5 STATES: 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:

- 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).

- 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.
- Applicable accrued interest. See paragraph 326-20-30-5A for guidance on excluding accrued interest from the calculation of the allowance for credit losses.

ASC 326-20-55-2 STATES: 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.



The next two sections take a deeper look at two of the more common CECL methodologies: discounted cash flows and loss-rate.

DISCOUNTED CASH FLOWS METHOD

EXCERPT FROM ASC 326

ASC 326-20-30-4 STATES: If an entity estimates expected credit losses using methods that project future principle and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial assets effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If a financial asset is modified and is considered to be a continuation of the original asset, an entity shall use the post-modification contractual interest rate to derive the effective interest rate when using a discounted cash flow method. See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge. If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in the timing) of expected cash flows resulting from

expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables-nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

ASC 326-20-30-4A STATES: As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments.

The effective interest rate is the rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. Although the concept of the effective interest rate exists in legacy U.S. GAAP as part of ASC 310 for the purpose of recognizing interest income in financial assets, the rate that was applicable for the purpose of accounting for financial assets under ASC 310 may not be the same rate as required for the purpose of discounting projected future principal and interest cash flows for the purpose of estimating expected credit losses for the same financial asset under ASC 326. One of the more common variables that will result in a different effective interest rate under ASC 326 as compared to legacy U.S. GAAP is the ability of an entity to include assumptions regarding estimated prepayments when determining the effective interest rate under ASC 326. ASC 326, however, does put some restriction on the use of prepayment assumptions. Regarding variable rate instruments, the ASC allows, but does not require, entities to forecast changes in interest rates when determining an appropriate effective interest rate. If an entity does forecast changes in future interest rates, it should use the same assumptions in determining the effective interest rate used to discount the expected cash flows.

LOSS-RATE METHOD

Certain entities may find that using a loss-rate approach is more appropriate for estimating credit losses by starting with historical loss information and adjusting for certain factors that may exist but not be reflected in the historical loss information for the respective period selected. The key difference is the loss-rate approach under CECL will require an element of forward-looking considerations to capture expected losses.

EXCERPT FROM ASC 326

EXAMPLE 1: Estimating Expected Credit Losses Using a Loss-Rate Approach from ASC 326-20-55-18 through 55-22:

55-18: This Example illustrates one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

55-19: Community Bank A provides 10-year amortizing loans to customers. Community Bank A manages those loans on a collective basis based on similar risk characteristics. The loans within the portfolio were originated over the last 10 years, and the portfolio has an amortized cost basis of \$3 million.

55-20: After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A's historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5%. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts but determined none were necessary.

55-21: In accordance with paragraph 326-20-55-4, Community Bank A considered significant

factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date.

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

55-22: The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65%, the sum of the historical loss rate of 1.5% and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be \$49,500.

Inputs used, and adjustments within the calculation, should be made in a manner that reflects the estimate of expected lifetime credit losses. This is key in properly designing a methodology that will comply with the requirements of CECL. Adjustments to historical loss information to reflect current conditions as well as those representative of expected future conditions will require significant judgment. The forward-looking analysis should be derived from forecasted information that is both reasonable and supportable. The reversion technique used above is specific to the fact pattern presented; an entity's actual technique should reflect its specific facts and circumstances.

VINTAGE MODEL METHOD

A vintage model would also constitute an available loss rate model under ASC 326-20. The following example is found within the standard related to estimating expected credit losses using a vintage-year basis.

EXCERPT FROM ASC 326

EXAMPLE 3: Estimating Expected Credit Losses on a Vintage-Year Basis from ASC 326-20-55-28 through 55-31:

55-28: The following Example illustrates one way an entity might estimate the expected credit losses on a vintage-year basis.

55-29: Bank C is a lending institution that provides financing to consumers purchasing new or used farm equipment throughout the

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

55-30: Bank C tracks those loans on the basis of the calendar year of origination. The following pattern of credit loss information has been developed (represented by the nonshaded cells in the table below) based on the amount of amortized cost basis in each vintage that was written off as a result of credit losses.

55-31: In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, Bank C considers its historical loss information. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans. It notes that historical loss experience has worsened since 20X3 and that loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5 despite the fact that the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5. In considering current conditions and reasonable and supportable forecasts, Bank C notes that there is an oversupply of used farm equipment in the

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

resale market that is expected to continue, thereby putting downward pressure on the resulting collateral value of equipment. It also notes that severe weather in recent years has increased the cost of crop insurance and that this trend is expected to continue. On the basis of those factors, Bank C determines adjustments to historical loss information for current conditions and reasonable and supportable forecasts. The remaining expected losses (represented by the shaded cells in the table in paragraph 326-20-55-30 in each respective year) reflect those adjustments, and Bank C arrives at expected losses of \$60, \$260, \$430, and \$510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively. Therefore, the allowance for credit losses for the reporting period date would be \$1,260.

AGING SCHEDULE METHOD

ASC 326-20 also presents an example specific to trade receivables, using an aging schedule methodology.

EXCERPT FROM ASC 326

EXAMPLE 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule from ASC 326-20-55-37 through 55-40:

55-37: This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

55-38: Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2% discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

- 0.3% for receivables that are current
- 8% for receivables that are 1–30 days past due

- 26% for receivables that are 31–60 days past due
- 58% for receivables that are 61–90 days past due
- 82% for receivables that are more than 90 days past due

55-39: Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10% in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

55-40: At the reporting data, Entity E develops the following aging schedule to estimate expected credit losses.

While the following example provides a straight-forward approach to the estimation of expected losses for trade receivables that have standard terms, an entity should carefully evaluate the different contractual terms for customers and the impact on estimating credit losses under CECL. For example, customers may need to be further disaggregated based on the credit terms extended in addition to the aging of the receivables.

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

Additionally, entities must also consider contracts with customers that offer credit commitment terms that may qualify as off-balance-sheet provisions, or other types of guarantees to be evaluated (i.e., in-scope vs. out-of-scope) under the terms of ASC 326-20. Consultation with legal resources may be necessary for more complex contractual arrangements. Refer to the off-balance sheet credit exposure section for further discussion.

WEIGHTED-AVERAGE REMAINING MATURITY METHOD

The weighted average remaining maturity method (WARM) uses an average annual charge-off rate and includes historical loss experience over several vintages that are weighted. The average annual charge-off rate is applied to the contractual term, adjusted for prepayment considerations, to arrive at the unadjusted historical charge-off rate for the remaining balance of the financial assets. The entity then adjusts for current conditions and reasonable and supportable forecasts as deemed necessary to arrive at an estimate for expected credit losses.

In response to questions whether this method is in accordance with ASC 326-30 the FASB staff issued a Q&A document titled Topic 326, no. 1: whether the weighted-average remaining maturity method is an acceptable method to estimate expected credit

losses. This publication has five questions specific to the WARM method.

The first question addressed by the FASB Q&A was whether WARM is an acceptable method to estimate allowance for credit losses under ASC 326-20. The answer is it may be acceptable. The FASB states “The WARM method is one of many methods that could be used to estimate an allowance for credit losses for less complex financial asset pools under Subtopic 326-20.”

The FASB Q&A also addresses the types of factors to consider when determining whether to use the WARM method. In summary, it will be based on facts and circumstances for each entity when choosing the best model to estimate expected credit losses. The complexity and resources of the credit risk management processes should be commensurate with the loss estimate model(s) employed. In less complex entities, the use of the WARM method may be appropriate for some or all of the pools of assets.

The FASB Q&A cited the following challenges that exist when using the WARM method, but notes that these challenges are present regardless of the model(s) selected:

“Certain common challenges can exist regardless of the loss rate method selected by an entity. These include, but are not limited to, situations involving minimal loss history, losses that are sporadic with no predictive patterns, low numbers of loans in each pool, data that is only available for a short historical period, a composition that varies significantly from historical pools of financial assets, or changes in the economic environment.”

The FASB Q&A includes an illustrative example of a credit loss estimate using the WARM method, which has been summarized below:

Step 1: Calculate the annual charge-off rate, which is done by taking the actual net charge-offs divided by the average amortized cost for the specific year (e.g., Actual charge-offs of \$15 on an average balance for two years of \$1,500 would be an annual charge-off rate of 1.00%). Take the sum of the annual charge-off rates for all periods in scope and determine the average.

Step 2: Estimate the allowance for credit losses by applying the average annual charge-off rate from Step 1 to the projected amortized cost over the expected term and projected amortized cost amounts (e.g., Average annual charge-offs from Step 1 for five years is 0.67% multiplied by the projected amortized cost of \$15,000 for 2020 would be an allowance for credit

losses of \$100.5 for the first year, which would then get added to the other periods to determine the total unadjusted allowance associated with historical charge-off information).

Step 3: Take the amount calculated using the WARM method and then further adjust for reasonable and supportable forecasts as well as other qualitative and quantitative adjustments that may be necessary to determine the estimate for expected credit losses for that specific pool. If multiple pools are using the WARM method, the steps would be repeated until the total allowance for expected credit losses has been estimated.

TROUBLED DEBT RESTRUCTURINGS

ASU 2022-02 removed the TDR accounting model for creditors under ASC 310-40. Consistently, the guidance in ASC 326-20-30-6 regarding reasonably expected TDR was also removed. Consequently, expected extensions, renewals and modifications are not included in the contractual term unless the extension or renewal options are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

FINANCIAL ASSETS SECURED BY COLLATERAL

A financial asset is collateral-dependent when the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral.

When foreclosure of the collateral is probable, ASC 326-20-35-4 requires that an entity measure the expected credit losses by comparing the fair value of the collateral with the amortized cost at each respective reporting period, regardless of the asset’s initial measurement method for estimating credit losses. If repayment is dependent upon the sale of the collateral, then the fair value would need to be adjusted for the undiscounted estimated costs to sell. However, if it is based on continuing operation of the collateral rather than sale, estimated costs to sell should be excluded. Any embedded credit

enhancements, as defined at 326-20-30-12, should be considered as well.

When foreclosure is not probable, but repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty as of the reporting date, ASC 326-20-35-5 provides entities with a practical expedient election to follow the same reserve methodology as outlined when foreclosure is probable.

FINANCIAL ASSETS SECURED BY COLLATERAL MAINTENANCE PROVISIONS

The FASB provided another practical expedient (ASC 326-20-35-6) when the borrower has a contractual obligation to continually adjust the amount of collateral securing a financial asset due to changes in the fair value of the collateral. These agreements are commonly referred to as collateral maintenance provisions.

An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary.

The FASB clarified that an entity may apply the practical expedient only if it reasonably expects that the borrower will be able to continually replenish the collateral necessary to secure the financial asset.

If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, the allowance for credit losses is limited to the unsecured portion (i.e., the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset).

OBSERVATION: Management will need to maintain adequate documentation to support the requirement in the standard to have a reasonable expectation that the borrower will continue to provide collateral as needed to maintain the necessary collateral coverage required by the agreement.

EFFECT OF CREDIT ENHANCEMENTS ON EXPECTED CREDIT LOSSES

Under ASC 326, consideration is to be given to the nature of the credit enhancements. The key distinction that will determine what, if any, impacts credit enhancements will have on an entity's estimated expected credit losses rests on the whether the credit enhancement is a "freestanding contract" as defined within the standard.

An example of a common credit enhancement that may not be a "freestanding contract" is private mortgage insurance (PMI) associated with a mortgage loan that is a requirement under the loan agreement as a condition of making the loan and, therefore, not separable from the loan agreement. On the other hand, an example of a "freestanding contract" would be a purchased credit default swap since it is entered into separate from the loan to help mitigate credit losses, but it does not reduce the credit risk of the loan itself. Instead, it mitigates the potential exposure through a separate arrangement.

EXCERPT FROM ASC 326-20

ASC 326-20-30-12 STATES: 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).

GLOSSARY

Freestanding contract

A freestanding contract is entered into either:

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

For those credit enhancements that are not "freestanding contracts," an entity will need to identify the loss mitigation provided by the enhancement to determine the impact on the overall estimate for expected credit losses. It is expected that credit enhancements would generally reduce the reserve.

In reaching the determination of whether a credit enhancement is "freestanding," entities should use the two criteria within the definition above to apply a decision matrix for each enhancement and:

1. Determine whether the enhancement is part of a contract that was entered into separately and apart from the asset, or
2. Determine whether the contract was entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

If the answer is "yes" to either of these criteria, then the contract is freestanding and should not be included in the entity's estimate for expected credit losses model. The expected benefits from freestanding credit enhancements may be recognized at the same time as the loss is recognized in earnings; however, the expected benefit should not be reported as a reduction to the provision for credit losses. Rather, the benefit should be reported in other income.

OBSERVATION: Those responsible for the CECL modeling process may need to seek legal advice from internal or external resources in reaching the conclusion on whether the contract is freestanding.

PURCHASED FINANCIAL ASSETS WITH CREDIT DETERIORATION

Subtopic 326-20 replaces the legacy U.S. GAAP concept of purchase credit impaired (PCI) assets with a new term, purchased financial assets with credit deterioration (PCD).

A PCD asset is an acquired individual financial asset (or acquired group of financial assets with similar risk characteristics) that as of the date of acquisitions have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by the acquirer's assessment. Financial assets in-scope include loans and debt securities classified as HTM or AFS. ASC 326 does not define "more-than-insignificant deterioration in credit quality since origination." The entity will need to use judgment to determine whether a purchased asset meets the definition of a PCD asset.

The following table provides the primary distinctions between legacy U.S. GAAP and ASC 326-20.

PCI	PCD
Narrowly focused on those assets acquired that have evidence of impairment indicators that meet the "probable" threshold, at acquisition, that the acquirer will not be able to collect all contractually required payments receivable	PCD assets include any acquired asset that as of the date of acquisition has experienced a more-than insignificant deterioration in credit quality since origination based on the acquirer's assessment at acquisition.
Assets are evaluated individually for whether they meet the definition a PCI and can be either pooled or evaluated individually for impairment.	Assets may be evaluated individually or at the portfolio level for whether they meet the definition of a PCD. If the evaluation is at the portfolio level the assets should have similar risk characteristics.
No allowance measured at acquisition	The allowance recorded at acquisition results in a gross-up of both the amortized cost basis of the asset and the associated allowance. After identification, assets should be pooled based on similar risk characteristics for evaluating impairment or individually if there are no other assets with similar risk characteristics to allow for pooling.
Credit loss model based on discounted cash flows	Expected credit losses are estimated under any of the available methods in Subtopic 326-20.
Subsequent favorable adjustments are recorded on an effective yield basis, whereas subsequent unfavorable adjustments are recorded in the period of identification via an additional reserve.	Subsequent changes (favorable or unfavorable) in assumptions are recognized in the period they are identified as part of the overall adjustment to the estimate for expected credit losses (i.e., immediate recognition of the change).

The SEC staff clarified in December 2018 that upon the adoption of the standard entities would not be able to apply the PCD accounting model to non-PCD assets by analogy as they were able to do under the legacy PCI model. There are also distinct differences in the accounting treatment for PCD assets when compared to how legacy U.S. GAAP treated those assets identified as PCI.

The allowance for credit losses for PCD assets should reflect expected recoveries of amounts previously written off and expected to be written off by the entity, not exceeding the aggregate amounts of amortized cost basis previously written off and expected to be written off. If a method other than a discounted cash flow method is used to estimate expected credit losses, expected recoveries should exclude any amounts that result in an acceleration of the noncredit discount and entities may include increases in expected cash flows after acquisition.

Following is the ASC excerpt related to the initial measurement of the PCD allowance.

EXCERPT FROM ASC 326

ASC 326-20-30-13, 30-13A & 30-14 STATE:

30-13: An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration in accordance with paragraphs 326-20-30-2 through 30-10 and 326-20-30-12. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

30-13A: The allowance for credit losses for purchased financial assets with credit deterioration shall include expected recoveries of amounts previously written off and expected to be written off by the entity and shall not exceed the aggregate of amounts previously written off and expected to be written off by the entity. a. If the entity estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4, expected recoveries shall not include any amounts that result in an acceleration of the noncredit discount. b. The entity may include increases in expected cash flows after acquisition. (See Examples 18 and 19 in paragraphs 326-20-55-86 through 55-90.)

30-14: If an entity estimates expected credit losses using a discounted cash flow method, the entity shall discount expected credit losses at the rate that equates the present value of the purchaser's estimate of the asset's future cash flows with the purchase price of the asset. If an entity estimates expected credit losses using a method other than a

discounted cash flow method, the entity shall estimate expected credit losses on the basis of the unpaid principal balance (face value) of the financial asset(s).

After the adoption of ASC 326, one key difference between the treatment of PCD and non-PCD assets at the time of acquisition is that PCD assets will require a gross-up for the estimated expected credit losses for those assets as of the acquisition date. The initial credit loss for the gross-up is not recognized in income. The measurement of the allowance at acquisition should be determined using any model that results in lifetime expected credit losses.

Conversely, similar to acquisition accounting today, non-PCD asset credit related adjustment is incorporated into the fair value of the assets acquired. The difference between the amortized cost and the fair value of the non-PCD asset must be amortized/accredited to income over the life of the asset.

After initial recognition, the accounting model for PCD assets will align with the CECL model for assets carried at amortized cost. Any change to the allowance in future periods will be immediately reflected in net income as a credit loss expense or reversal of a credit loss expense. The effective interest rate established at initial recognition should not change in future periods. The CECL reserve model applied initially should be applied consistently over the life of the assets.

The following is an example of the accounting for an asset that is acquired after the adoption of ASC 326 and determined to be a PCD asset:

ABC Corp pays \$1,600,000 for a loan with a par amount of \$2,000,000. This loan meets the definition of a PDC asset and is measured at amortized cost. At the time of purchase, the expected credit loss on the loan is estimated to be \$300,000.

The journal entry to record the loan as part of the initial acquisition accounting is:

Dr Loan – Par	\$2,000,000
Cr Loan – Noncredit discount	\$100,000
Cr Allowance for credit losses	\$300,000
Cr Cash	\$1,600,000

At the purchase date, the statement of financial position would reflect an amortized cost basis for the financial asset of \$1,900,000, which represents the amount paid (\$1,600,000) plus the gross-up effect of the allowance for credit losses noted previously (\$300,000). The difference between the par amount and the amortized cost amount is the noncredit discount that will be accreted using the effective interest method over the term of the financial asset.

The \$300,000 allowance for credit losses should be remeasured at each reporting. Any change to the allowance balance would be immediately reported through net income.

OFF-BALANCE-SHEET CREDIT EXPOSURES

An estimate for expected credit losses related to off-balance-sheet credit exposures shall be recorded as a separate liability within the entity's balance sheet based on the same principles as previously discussed. Off-balance-sheet credit exposures include contingent elements of financial guarantees otherwise within the scope of ASC 460. Entities should estimate expected credit losses over the contractual term of the loan that will be originated because of the off-balance-sheet commitment.

EXCERPT FROM ASC 326

ASC 326-20-30-11 STATES: In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate

of expected credit losses on off-balance-sheet credit exposures. For that period of exposure, the estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life. If an entity uses a discounted cash flow method to estimate expected credit losses on off-balance-sheet credit exposures, the discount rate used should be consistent with the guidance in Section 310-20-35.

ASC 326-20-30-11 STATES: An entity shall adjust at each reporting period its estimate of expected credit losses on off-balance-sheet credit exposures. An entity shall report in net income (as credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures at each reporting date.

The following example illustrates the accounting considerations for an off-balance-sheet commitment that is not unconditionally cancelable:

ABC Corp enters into an agreement with a customer that includes an irrevocable loan commitment of \$2,500,000. As of the reporting date, \$500,000 of that loan commitment has been funded. For the \$2,000,000 that is not funded, ABC Corp would be required to evaluate what the expected credit losses would be on this unfunded amount (in addition to evaluating the need for a reserve on the funded portion separately). Any liability for expected credit losses on this unfunded balance would be presented as a liability on the statement of financial position.

The reserve would be based on the expectation of the unfunded amount being funded (i.e., the likelihood of funding) and eventually result in a credit loss. The methodology for determining the amount of expected credit losses on this unfunded commitment is using the CECL model described previously.

The following example from the standard is an illustration for unconditionally cancellable loan commitments:

EXCERPT FROM ASC 326

EXAMPLE 10: Application of Expected Credit Losses to Unconditionally Cancellable Loan Commitments from ASC 326-20-55-54 through 56:

55-54: This Example illustrates the application of the guidance in paragraph 326-20-30-11 for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer.

55-55: Bank M has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. Bank M's card holder agreements stipulate that the available credit may be unconditionally cancelled at any time.

55-56: When determining the allowance for credit losses, Bank M estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank M does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present contractual obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability.

OBSERVATION: Engaging a legal expert to perform a legal analysis may be necessary to determine if the commitment is unconditionally cancellable by the issuing entity.

ZERO-RISK OF LOSS VERSUS REMOTE RISK OF LOSS

ASC 326 requires an entity to estimate expected credit losses even with the risk of loss is remote. However, an entity does not need to determine a reserve when the risk of nonpayment is zero. This is an extremely narrow scope exception for measuring credit losses for a financial asset where even if a technical default occurs, the expectation of nonpayment is zero.

The example provided in the ASC is of U.S. Treasury Securities, which are explicitly guaranteed by the sovereign U.S. Government, which can print its own currency. Cash equivalents may also meet the scope exception from measuring credit losses. However, most other types of instruments, including AAA-rated corporate bonds and trade receivables, are not expected to meet this scope exception considering that upon a

default the loss is likely to be more than zero. However, the Accounting Standards Codification indicates that the provisions of the Codification need not be applied to immaterial items. Entities would still be required to document the basis for concluding that CECL does not have a material impact.



NET INVESTMENT IN LEASES

ASC 326-20 requires the unguaranteed residual asset to be included with the lease receivable when measuring the CECL reserve for sales-type and direct financing leases. The lessor should not separately evaluate the unguaranteed residual asset for impairment unless it sells the lease receivable and retains the unguaranteed residual asset. While this unguaranteed residual asset is not a financial asset, the FASB determined it would be overly complex and provide little benefit to separately measure it for impairment from the lease receivable financial asset.

When a discounted cash flow method is used to measure the CECL reserve, an entity should use the same discount rate used to measure the related lease receivable.

EXCERPT FROM ASC 326

This Subtopic requires that an entity recognize an allowance for credit losses on net investment in leases recognized by a lessor in accordance with Topic 842 on leases. An entity should include the unguaranteed residual asset with the lease receivable, net of any deferred selling profit, if applicable (that is, the net investment in the lease). When measuring expected credit losses on net investment in leases, the lease term should be used as the contractual term. When measuring expected credit losses on net investment in leases using a discounted cash flow method, the discount rate used in measuring the lease receivable under Topic 842 should be used in place of the effective interest rate.

OBSERVATION: Engaging a legal expert to perform a legal analysis may be necessary to determine if the commitment is unconditionally cancellable by the issuing entity.



AVAILABLE FOR SALE DEBT SECURITIES

While not in the scope of the CECL model (ASC 326-20) applicable to assets carried at amortized cost (and certain other items), targeted amendments were made to the existing impairment model for AFS debt securities (ASC 326-30). The existing guidance that requires an estimate of credit losses only when the securities are considered impaired (i.e., fair value is less than its amortized cost basis) did not change, nor has the requirement to recognize in income the credit losses and in other comprehensive income any noncredit losses. Further, if there is an intent by the entity to sell the impaired security or more likely than not will be required to sell the security prior to recovery of its amortized cost basis, the security's basis should be written down to its fair value through net income in accordance with existing guidance.

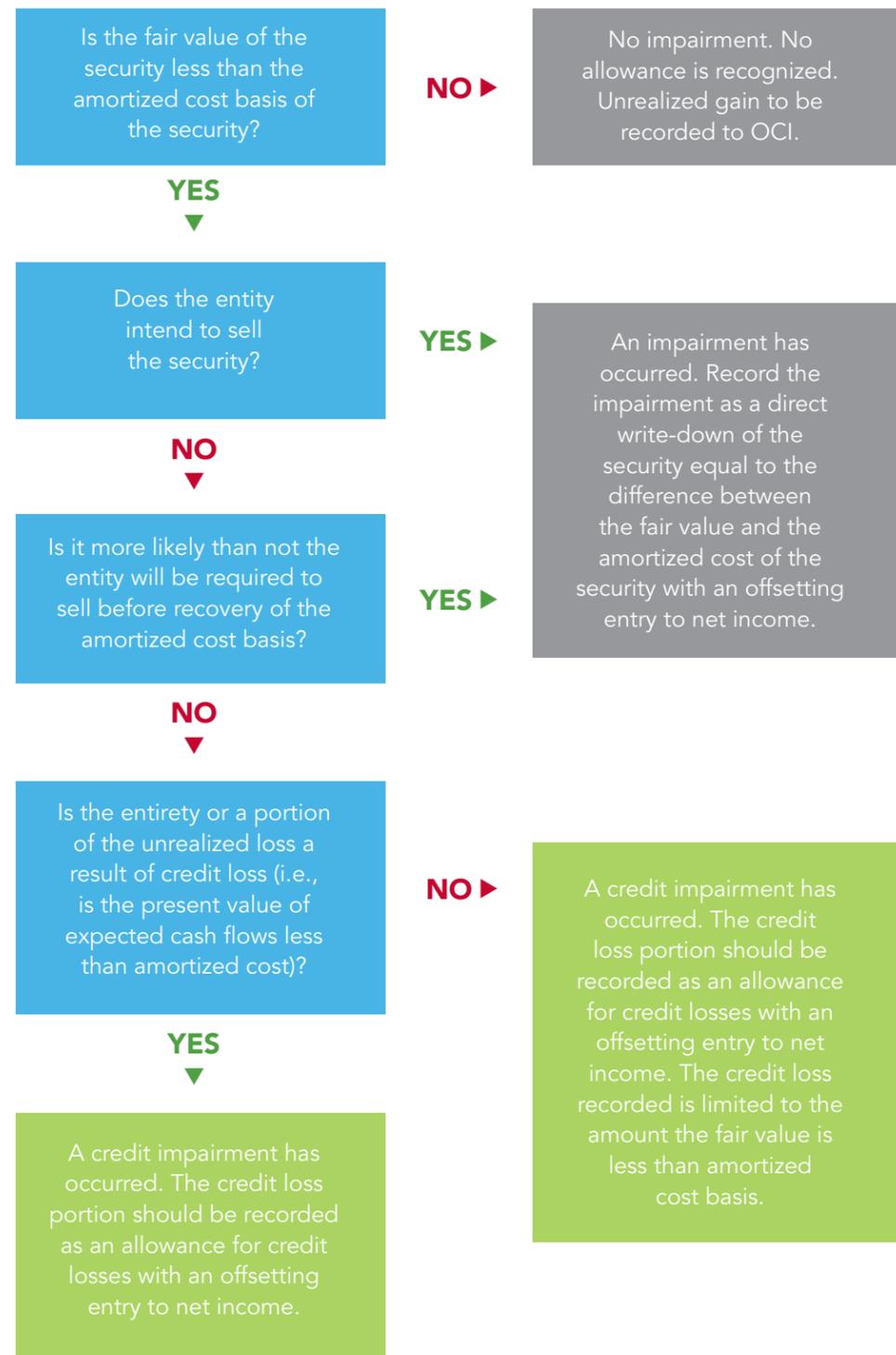
However, for an impaired AFS debt security for which there is neither an intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a reduction of the amortized cost basis. As a result, entities will be able to record reversals of credit losses in current period income as they occur, which is prohibited under existing GAAP. Additionally, the allowance is limited by the amount that the fair value is less than the amortized cost basis, considering that an entity can sell its investment at fair value to avoid realization of credit losses.

An entity should not consider the length of time that the security has been in an unrealized loss position to avoid recording a credit loss. In determining whether a credit loss exists, the historical and implied volatility and recoveries or additional declines in the fair value after the balance sheet date should no longer be considered. As a result, whether the impairment is other-than-temporary (OTTI) is no longer a consideration in recording credit losses. Further, unlike the CECL model that required pooling of assets with similar risk characteristics, credit losses for AFS debt securities must be determined on an individual basis and use a discounted cash flow model.

After initial recognition of a reserve on AFS securities, the entity should report changes in the allowance for credit losses in net income as credit loss expense (or reversal of credit loss expense).

OBSERVATION: Judgment regarding management's intent and ability to hold the impaired asset will be required for determining whether to record an allowance or recognize a direct write-down.

The following decision tree can be used in determining whether an allowance is needed to reflect an impairment of an available-for-sale security (amounts recorded to OCI would be net of any applicable income tax considerations):



PURCHASED AFS WITH CREDIT DETERIORATION

Purchased AFS securities must be evaluated to determine if they meet the definition of a purchased financial asset with credit deterioration. An AFS security is considered to be PCD if there are indicators of a credit loss at the time of acquisition. The allowance for credit losses for PCD AFS securities must be measured at the individual security level using a discounted cash flow analysis. The discount rate used should equal the present value of the estimate of the future cash flows with the purchase price of the security. Like the PCD model discussed above, the purchase price of the acquired asset should be grossed up by the reserve on acquisition and subsequent changes to the allowance in future periods will be immediately reflected in net income as a credit loss expense or reversal of a credit loss expense. Unrealized gains and losses, other than the allowance reserve, should be recorded in other comprehensive income, net of applicable taxes.

ACCRUED INTEREST RECEIVABLE

Entities have the option to measure the CECL reserve on accrued interest receivable separately from the amortized cost basis, or in the case of AFS securities, excluded from both the fair value and the amortized cost basis of the related financial asset.

Entities can also make the following policy elections relating to accrued interest receivable at the class of financing receivable or major security-type level:

- To write off accrued interest amounts by reversing interest income or by recognizing a credit loss expense (e.g., provision for credit losses), or a combination of both;

- To present accrued interest receivable balances and the related CECL reserve separately from the related financial asset on the balance sheet; or
- To not measure a CECL reserve on accrued interest receivable if the entity writes off the uncollectable accrued interest receivable in a “timely manner” via a policy election. The FASB has not defined “timely manner” for the reasons outlined in the basis for conclusions to ASU 2019-04:

ASU 2019-04 BC20

ASC 326-20-30-11 STATES: The Board decided not to provide a specific time period for what is considered timely when applying the accounting policy election to exclude accrued interest from the calculation of expected credit losses. The Board understands that accounting policies for writing off financial assets may vary depending on the types of financial assets and industry practices. The Board believes that a specific time period would not provide entities with the intended flexibility to set their write-off accounting policies by the class of financing receivable or major security type. Instead, an entity should apply judgment based on specific facts and circumstances to determine whether the time period of when the accrued interest receivable balance is deemed uncollectible and written off is timely.

DISCLOSURES PRIOR TO ADOPTION OF CECL

FASB Accounting Standards Codification (ASC) 250, Accounting Changes and Error Corrections, paragraph 10-S99-5 and Staff Accounting Bulletin (SAB) No. 74 (Topic 11M), Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period, indicate that “registrants should discuss the potential effects of adoption of recently issued accounting standards... [and] that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material.”

While SAB 74 disclosures are both qualitative and quantitative, they should become more robust and quantitative as the effective date for a new accounting standard draws near. The following types of SAB 74 disclosures are expected in the periods before new accounting standards are effective:

- A comparison of accounting policies: Registrants should compare their current accounting policies to the expected accounting policies under the new accounting standard(s).
- Status of implementation: The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging.
- Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement: A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments.
- Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated.
- Disclosure that the expected financial statement impact of the new accounting standard cannot be reasonably estimated.
- Qualitative disclosures: When the expected financial statement impact is not yet known by the entity, a qualitative description of the effect of the new accounting standard on the entity's accounting policies should be disclosed.



EFFECTIVE DATES AND TRANSITION

The ASU, as amended, has the following effective dates for calendar year-end entities:

SEC Filers excluding Smaller Reporting Companies (SRCs)

Jan-20 effective date

All Other Entities (including SRCs)

Jan-23 effective date

All entities may elect to early adopt CECL.

An entity will determine its effective date based on its most recent SRC determination as of November 15, 2019, in accordance with SEC regulations. The effective date for that entity will not change even if the entity subsequently loses its SRC status.

TRANSITION

The transition requirements for the adoption of ASC 326 are as follows:

- A cumulative effect adjustment shall be recorded to retained earnings as of the beginning of the year of adoption to reflect the impact on the estimate for expected credit losses as of the adoption date versus the legacy accounting treatment for credit losses.
- Prospective application is required for debt securities when OTTI was recognized before the adoption date.

- Prospective application required for financial assets for which Subtopic 310-30 (loans and debt securities acquired with deteriorated credit quality—previously referred to as purchase credit impaired assets under legacy US GAAP) was applied prior to the adoption of ASC 326.
- Accounting policy election to maintain pools of financial assets previously accounted for under Subtopic 310-30 on an ongoing basis
- Allow for companies to elect to use the fair value option under Subtopic 825-10 on an instrument-by-instrument basis for assets that are eligible for fair value election under Subtopic 825-10 but also otherwise within the scope of ASC 326. This transition guidance is not applicable for available-for-sale securities or held-to-maturity debt securities.
- Regardless of whether a vintage model is used by PBEs, credit quality indicators by year of origination is a disclosure that will be required to be included in the first period of adoption, which will be the March 31, 2020 Form 10-Q for calendar year-end SEC Registrants.
- Accounting policy election on accrued interest and whether to bifurcate it from the associated loans for separate estimation of expected credit losses

ASC 326 does not provide an option to adopt the standard using a retrospective transition method as the FASB determined that it would be impracticable for companies to apply in prior periods because the use of hindsight would be necessary in making estimates of expected credit losses.

TAX IMPLICATIONS

While there are no specific changes to ASC 740 included within ASC 326, entities will still need to properly plan for the tax impact of adopting ASC 326 since it will impact certain accounts that have temporary tax differences (e.g., any deferred tax asset that currently exists related to the allowance for loan losses for entities within the financial services industry). With most entities expected to see an increase in the allowance accounts that currently exist, there will be a corresponding increase to the associated deferred tax asset. Other notable changes that will occur upon the adoption of the standard is that the PCD assets will contribute to the entity's deferred tax asset fluctuations since the PCD assets will have an associated allowance balance that will be updated each period, with a corresponding impact to the deferred tax asset account. As with any tax consideration, entities should also be thinking of whether the expected increase in the deferred tax assets related to adoption of ASC 326 also has a corresponding impact on valuation allowance considerations.

OTHER CONSIDERATIONS

DATA DUE DILIGENCE

The process to comply with the new standard is arguably as much about technology, data and information governance as it is about technical accounting. To put it into perspective, the estimated loss model may require 1,000 times more data than historical loss models. The availability, accessibility and integrity of that data—some of which will be generated internally, some of which may need to be sourced from third parties—is essential to a CECL-compliant estimate.

As noted previously the CECL standard is designed to be flexible and does not prescribe the use of specific estimation methods. Accordingly, the volume of data and complexity of the analysis will vary. Data needs may, in part, be driven by the approach taken to CECL modeling, which is why robust planning is necessary up front to avoid issues arising during implementation related to lack of relevant and reliable data.

Despite the flexibility set forth within the standard, data gathering and related analysis for CECL will require significant time and resources, especially for those entities within the financial services industry. The adoption effort of ASC 326 could be further hindered for entities with less than adequate information governance. As part of the implementation planning efforts, it is critical to reevaluate current data retention and disposition strategies and make necessary modifications, to meet the CECL model demands.

PLANNING AND PROGRAM DESIGN

Adoption of ASC 326 will necessitate adequate planning and implementation over an adequate length of time allowing the adoption to be executed thoughtfully and carefully. An implementation timeline is highly encouraged to accomplish an effective execution strategy.

Planning considerations should include the following:

- Gain an understanding of the accounting and reporting requirements by reading the new standard.
- Determine which financial assets are within the scope of ASC 326.
- Review existing allowance and impairment models being used and compare to changes required in the standard.
- Evaluate and select a CECL model(s) that meets the requirements within the standard. This will entail determining the data needed for the CECL model(s) and assessing available data sources.
- Determine the capability of the entity's current IT applications to provide the necessary data for the desired model (note: some of the data may not be currently available).
- Evaluate current internal control structure and determine needs for enhanced and/or additional internal controls over the implementation phase and ongoing monitoring.
- Determine how the adoption will impact the users of the entity's financial information and evaluate how required disclosures may change in the entity's financial statements and accompanying notes.

DETERMINE DATA REQUIREMENTS, INCLUDING STORAGE SOLUTIONS

Many entities will face challenges when compiling necessary historical information. Data demands may be more prevalent within the financial services industry whereas commercial entities may find it

easier to access the necessary historical information needed to allow for a seamless adoption of ASC 326. For example, a statistic from the American Bankers Association indicated that most existing data systems only store the last 12 to 13 months of loan information, but under CECL, historical data requirements may span as much as five years or even longer creating challenges that entities should plan for both in adopting ASC 326 and collecting relevant information on a go forward basis. Moreover, entities will need to ensure that sufficient storage space is available for the additional data than had previously been retained under the incurred loss model that may in turn require the use of remote storage solutions. The collection of this additional data will bring about new challenges such as data security and could result in additional expenses to maintain/capture necessary data.

Most organizations already have measures in place to ensure data is protected yet accessible; however, entities should take the opportunity to take a fresh look at the existing enterprise-wide information governance programs in place and make necessary enhancements in response to the demands upon the adoption of CECL and the ongoing accounting under ASC 326 post-adoption. In doing so, entities should:

- Consider due diligence and planning for changes to be made;
- Preserve and/or create safeguards surrounding security, integrity and privacy of the data being retained;
- Design procedures to ensure that the data is accessible by those whose responsibilities require it;
- Develop policies and procedures to manage data throughout the time it will be retained by the organization; and
- Make sure that the use of data is aligned with business functions and employs technologies that are aligned with the organization and its needs.

Another challenge that entities may face is the assimilation of data across a broad range of business functions. Again, this issue is likely to be more pervasive in the financial services industry because of disparate data management systems which may provide a fragmented view of the data retained, and potentially restrictive to the development of data scenarios to facilitate the adoption of ASC 326.

Those entities that lack a unified data management system may find it necessary to perform an extensive data mapping exercise, which in turn could extend the lead time necessary to allow for a successful adoption



of ASC 326. During the design phase, entities may find that they need to supplement historical information with third-party data to fill gaps in various data fields. This exercise may prove to be difficult and time consuming, thus early and careful attention to integration of third-party data into the existing IT infrastructure is essential.

Data should be available in usable and exportable formats and stored in a secured database that can be updated and backed up frequently and that can be integrated into a spreadsheet environment or a more sophisticated analytics platform, depending on the adoption strategy in place.

CHOOSING THE RIGHT TOOLS

Identification and collection of data is only one of the many challenges to conforming with ASC 326. The tools used to obtain, retain and utilize the data (e.g., perform mathematical calculations) may vary based upon the complexity of the chosen model(s) as well as the quantity of data used. For example, less complex scenarios may allow the use of Excel spreadsheets while more complex circumstances may need to design and/or acquire additional tools or IT solutions.

Because of the large volume of data required, there are a number of third-party software solutions that can integrate data from all core business functions into a single repository to facilitate a more streamlined and consistent decision-making process. Regardless of the industry, when making the decision to partner with service providers, it is important to consider all inter-departmental needs to achieve the CECL adoption strategies. Entities should continue to follow the existing protocols and checkpoints in place when selecting vendors or business partners to ensure that they are qualified and have the necessary competency to contribute to achieve the adoption of CECL. The reliance on a service provider enhances the need to effectively establish timelines that are realistic, as delays from a service provider can have significant impact on the adoption of CECL. Regardless of which tool is chosen, success is predicated on having an organized team, a disciplined process and clean data.

EXAMINE FINANCIAL REPORTING RISKS AND UPDATE INTERNAL CONTROLS

The impact of the CECL standard is far more reaching than just the presentation on the balance sheet and income statement. For example, for financial institutions regulatory capital ratios will

be impacted and may result in a change in status (e.g., well capitalized to adequately capitalized or to undercapitalized). Anytime there is a significant change in the accounting standards, entities should be mindful of the downstream impact that might occur on any relevant bank covenants. Those organizations should have conversations with lenders early if they believe there might be a potential for a covenant violation because of adopting the standard.

Those responsible for overseeing the adoption should have proactive and routine conversations with members of senior management and the board of directors to ensure there is sufficient transparency of the adoption efforts and potential impact. Regardless of whether the entity is subject to the provisions of Sarbanes-Oxley, the added elements in the standard will have a reciprocal impact on the internal control environment. Taking a fresh look at the internal control environment is key and should be done early in the adoption process and throughout the various implementation phases.

We encourage those charged with oversight of CECL implementation to read the publication issued by the Financial Executives International's (FEI) Committee on Corporate Reporting (CCR) publication on Internal Control over Financial Reporting for the Current Expected Credit Loss (CECL) Standard released in November 2018 as well as the Center for Audit Quality's (CAQ) publication related to Preparing for the New Credit Losses Standard, which was published in May 2019 as a tool to be used by Audit Committees.

TESTING AND EXECUTION

As stated previously, the standard allows for a great deal of flexibility and as such, it is expected that a wide variety of models will be used across all industries ranging from the most simplistic approaches to more sophisticated and complex models. More complex entities will likely choose to employ predictive models leveraging advanced data analytics, whereas less complex entities will be faced with the challenge of determining just how much sophistication is needed to allow for an accurate portrayal of expected credit losses that is in alignment with the principles set forth in ASC 326.

The spectrum of sophistication will range between those that are more complicated and based on a specific model, (i.e., those that leverage predictive scenarios to forecast future behavior of an asset or asset group based on statistical analysis of historical

loss information and experience) and those that are more analytical based (i.e., largely dependent on individuals identifying trends and developing forward looking expectations using subjective judgment).

Regardless of the method used, the objectives are the same—relevant variables should be identified, the relationship between the variables and losses should be estimated and the entire end-to-end process should be evaluated for the existence of sufficient control points.

ONGOING MONITORING AND GOVERNANCE

Ongoing monitoring each reporting period (e.g., quarterly or annually) is necessary to ensure the chosen model(s) is updated to reflect both internal and external changes in data (e.g., changes in the portfolio or changes in the economy), make appropriate adjustments to assumptions and to identify any other significant judgments that have changed (or should have changed) from prior periods. Note that this is no different than what is required under current GAAP.

Model validation, which is the progression of corroborating that the model is correctly applied with respect to the conceptual model, is often overlooked. Incorporating model validation into the implementation plan and ongoing monitoring is key. The validity of the CECL model selected depends on the integrity of the underlying data.

Model governance review takes an in-depth look at model validation policies, the documentation supporting the model and the existence and effectiveness of controls. The conceptual validation looks deeper at the design and methodology and specifications, verifying and validating key assumptions (e.g., economic assumptions or parameter estimates) and an overall performance evaluation (e.g., verifying the accuracy of the performance and review of the model diagnostics). Process validation evaluates data integrity (e.g., completeness and accuracy of the data), model execution such as ensuring accurate transition of models from development to production, re-performance and calibration, output reasonableness, back testing and benchmarking. Management's continuous oversight in this space often translates to an effective estimation process and result.

CONTACT US

For more information about the new standard
or questions about how your organization should approach
CECL implementation, please contact:

JEFF BURLESON

Financial Services
Industry Leader
205.769.3351
Jeff.Burleson@warrenaverett.com

CHAD HAMILTON

Financial Services
Audit Member
850.275.1232
Chad.Hamilton@warrenaverett.com

JOSHUA BOWEN

Financial Services
Audit Member
334.260.2364
Joshua.Bowen@warrenaverett.com



Alabama | Florida | Georgia
www.warrenaverett.com