Credit Losses on Financial Instruments

4 CPE Hours

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Table of Contents

Course Overview........ 1
Learning Objectives........ 1
Introduction........ 1
Background........ 1
Main Provisions of the ASU........ 4
Assets Measured at Amortized Cost........ 4
Review Questions........ 5
Initial Measurement of Expected Losses........ 6
Review Questions........ 13
Subsequent Measurement of Expected Credit Losses........ 14
Presentation........ 15
Illustrative Examples........ 15
Review Questions........ 26
Financial Statement Disclosures........ 26
Review Questions........ 32
Available-for-Sale Debt Securities........ 33
Subsequent Measurement........ 35
Review Questions........ 39
Financial Statement Disclosures........ 40
Transition........ 43
Recent Developments........ 46
Comparison to IFRS 9........ 47
Review Questions........ 50
Solutions to Review Questions........ 51
Final Examination Questions........ 57
Glossary........ 60
Index of Key Terms........ 61

Credit Losses on Financial Instruments

Course Overview

This course provides an in-depth overview of Accounting Standards Update (ASU) No. 2016-13, *Measurement of Credit Losses on Financial Instruments*, issued by the Financial Accounting Standards Board (FASB) in June 2016. The new standard will apply to nearly all entities, not just those in the financial services industry, and will change how entities document and account for credit impairment on their respective financial instruments. This new standard is effective for public business entities for annual periods beginning after December 15, 2019 and interim periods therein. As such, this means that calendar-year SEC filers will have to apply the new requirements starting in first quarter 2020.

Learning Objectives

Upon completion of this course, you will be able to:

- Identify the key provisions as it relates to ASU No. 2016-13
- Recognize key background information as it relates to the development of ASU No. 2016-13
- Recognize the credit loss measurement requirements for assets measured at amortized cost and available-for-sale debt securities
- Identify the incremental financial statement disclosure requirements as a result of ASU No. 2016-13
- Identify the effective date and transition requirements
- Differentiate the requirements prescribed by ASU No. 2016-13 and IFRS 9
- Recognize recent developments affecting entities who are required to apply the amendments in ASU No. 2016-13

Introduction

The FASB issued final guidance that significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. By issuing the new amendments outlined in Accounting Standards Codification (ASC) Topic 326, the FASB responded to criticism that current accounting and reporting guidance delays recognition of credit losses. As a result, the new standard will replace the current "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost and require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount, as they do today under the other-than-temporary impairment (OTTI) model. The new standards also simplifies the accounting model for purchased credit-impaired debt securities and loans.

Background

As the FASB notes within its Basis for Conclusions (BCs) included within ASU No. 2016-13, the objective of the update, which is based on the objective of general purpose financial reporting, is to provide financial statement users with more decision-useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date (BC3). This is based on the fact that users were critical of previous GAAP based on the fact that the thresholds required to recognize credit losses delayed the recognition until the credit losses were probable, even if an entity may have had an expectation of a future loss. In other words, the current model resulted in a credit loss happening too late. Refer to Exhibit 1 below which provides additional insight from the FASB with respect to need for these updates.

Exhibit 1: Benefits and Costs of New Standard (BC3)

The objective of this Update, which is based on the objective of general purpose financial reporting, is to provide financial statement users with more decision-useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date. Users criticized previous GAAP because the thresholds required to recognize credit losses delayed the recognition until the credit losses were probable, even if an entity may have had an expectation of a future loss. Diversity also existed in application of when the "probable" threshold had been reached. The combined effect of delayed recognition and diversity resulted in a misalignment between accounting standards and the market's perception of credit risk as evidenced by a significant disparity in market value as compared with book value of creditors, most evident in stressed economic environments. As a result, users supported an approach for the allowance for credit losses based on management's expectations of credit losses over the contractual life of the financial assets (considering the effect of prepayments) with an explanation of inputs and assumptions and changes in those inputs and assumptions from the prior reporting period. Also, recognizing the subjective nature of estimating credit losses, users supported additional disclosures that would facilitate users' assessment of management's initial credit loss estimate for newly originated loans as well as subsequent changes to those estimates.

The development of the new credit loss standard was a long time in the making. While a comprehensive discussion of all of the background leading to the release of this new standard is outside the scope of this course, it is important to touch on a few of the key milestones to have a better appreciation for the new requirements and how they were developed by the FASB.

In October 2008, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis, the FASB and the International Accounting Standards Board (IASB) created the Financial Crisis Advisory Group (FCAG). Simply put, the FCAG considered how improvements in financial reporting could enhance investors' confidence in financial markets. In its report issued on July 28, 2009, the FCAG identified delayed recognition of losses associated with loans (and other financial instruments) and the complexity of multiple impairment approaches as primary weaknesses in accounting standards and application of those standards (BC14). As a result of these identified weaknesses, the FCAG recommended exploring alternatives to the incurred loss model that would use more forward-looking information because the incurred loss model, as previously noted, delays recognition of credit losses until it is probable a loss has been incurred.

On account of the above, the FASB issued an exposure draft in 2010 which included proposals on classification and measurement, credit impairment, and hedge accounting. By releasing this exposure draft, the objective was to ensure that the allowance balance reflected all estimated credit losses for the remaining life of a financial instrument. In order to accomplish this objective, the FASB proposed that an entity should measure credit impairment when the entity does not expect to collect all contractual amounts due (BC17). In summary, the credit loss would not need to be considered "probable" as is the case with the current guidance. Instead, when an entity is measuring a credit impairment, the entity is required to do so assuming the economic conditions existing at the reporting date would remain unchanged for the remaining life of the financial assets.

Based on the 2010 exposure draft, the FASB performed extensive outreach to obtain feedback from the various stakeholders. Refer to Exhibit 2 below which provides an overview of this type of outreach.

Exhibit 2: Outreach Activities by the FASB (BC18)

The Board performed extensive outreach to obtain feedback on the May 2010 Exposure Draft from all stakeholders, including users, preparers, auditors, and regulators. Stakeholders provided feedback through public comment letters, investor questionnaires, field visits with preparers, in-person meetings, and public roundtable meetings. More than 2,800 comment letters were received and posted on the FASB's website. Approximately 2,000 of those comment letters were submitted by banking institutions. The Board and staff completed eight field visits with various entities to discuss the operability and the costs and benefits of the Exposure Draft. Field visit participants included banking institutions of various sizes, nonfinancial entities, and an insurance company. The Board and staff received feedback from 120 investors and other users of financial statements employed by more than 60 firms through in-person meetings and calls with individual investors and groups of investors representing a variety of perspectives. Users included buy-side analysts employing long-only and long short strategies, sell-side analysts specializing in either the bank- or insurance related sectors, as well as analysts from ratings agencies. The Board and staff also received feedback on the Exposure Draft through 5 public roundtable meetings held with more than 65 participants, including users, preparers, regulators, auditors, and others representing various perspectives.

While a significant number of respondents to the exposure draft agreed with recording the entire credit loss in the period estimated, many stakeholders noted that with the proposed amendments, there were three different impairment models (one for pools, one for individual assets, and one for purchased assets). As a result, there were significant concerns from stakeholders that this update failed to meet the objective of a single impairment model.

The FASB went back to the drawing table and continued to engage with the IASB in developing a new standard for credit losses on financial instruments that met the objectives set out initially. Fast forward to 2012, the FASB released a second exposure draft that more closely met the single measurement objective. After further extensive outreach with various stakeholders, the FASB observed that investors and other users strongly preferred a model that records the full amount of expected credit losses (as opposed to maintaining a threshold that must be met before all expected credit losses are recognized or permitting the recognition of only some of the expected credit losses before the threshold is met) (BC28). The original requirement in the first exposure draft noted that an entity should assume that economic conditions will continue through the life of the financial instrument. This requirement was amended significantly in the second exposure draft. As a result, the new requirement in the second exposure draft prescribed the use of a past, current, and reasonable and supportable forecast be used to develop the loss estimate to make the measurement of expected credit losses operable (BC29).

Based on the extensive due process and significant input received from financial statement users and preparers, the FASB concluded that the guidance in its final ASU No. 2016-13 provides users of financial statements with more decision-useful information about the credit risk inherent in financial assets and the change in expected credit losses occurring during the period (BC7). As a result of the issuance of this ASU, the FASB expects that the updated guidance will accomplish the following: (BC7)

- Result in an earlier measurement of credit losses
- Result in greater transparency about the extent of expected credit losses on financial assets held at the reporting date
- Improve a user's ability to understand the realizability of assets held at each reporting period
- Improve a user's ability to understand changes in expected credit losses that have taken place during the period
- Improve a user's ability to understand purchased financial assets with credit deterioration by enhancing the comparability of the reporting with that of originated assets, while also reducing the cost and complexity of accounting for those assets

- Provide greater transparency to the user in assessing the credit quality indicators of a financial asset portfolio and changes in composition of the financial asset portfolio over time

Main Provisions of the ASU

The FASB notes that the main objective of this ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. In order to achieve this objective, the amendments replace the current incurred loss impairment methodology with an updated methodology that reflects expected credit losses and requires entities to consider a broader range of reasonable and supportable information with respect to credit loss estimates.

More specifically, the ASU affects the following two types of assets:

- Assets measured at amortized cost
- Available-for-sale debt securities

With respect to assets measured at amortized costs, the amendments within the ASU require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The net amount expected to be collected is determined by using a valuation account that is deducted from the amortized cost basis. Regarding available for sale debt securities, the amendments in the ASU require that credit losses relating to these types of financial instruments should be recorded through an allowance for credit losses.

Assets Measured at Amortized Cost

Current accounting principles include multiple credit impairment objectives for certain financial instruments. As we previously mentioned, the current objectives generally delayed recognition of the full amount of credit losses until the loss was probable of occurring. Based on the FASB's summary of the ASU, the FASB noted that the amendments in this ASU are an improvement because they eliminate the probable initial recognition threshold in current GAAP and, instead, reflect an entity's current estimate of all expected credit losses. Previously, when credit losses were measured under GAAP, an entity generally only considered past events and current conditions in measuring the incurred loss. As a result of this ASU, the changes broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. Furthermore, the FASB notes that the use of forecasted information incorporates more timely information in the estimate of expected credit loss, which will be more decision useful to users of the financial statements.

Available-For-Sale Debt Securities

Currently, credit losses on available-for-sale debt securities are required to be measured and presented as a write-down. The amendments in this ASU do not change the requirement to measure these credit losses, however, the amendments require that the losses be presented as an allowance rather than as a write-down. The FASB notes that this is an improvement to current accounting principles because an entity will be able to record reversals of credit losses (in situations in which the estimate of credit losses declines) in current period net income, which in turn should align the income statement recognition of credit losses with the reporting period in which changes occur. This is in contrast with current GAAP which prohibits reflecting those improvements in current period earnings.

Assets Measured at Amortized Cost

In this section of the course, we will explore the ASU amendments in more detail and focus in specifically on the provisions for assets measured at amortized cost. This section of the course serves to summarize the key guidance included within ASC Topic 326, subtopic 20 (Measured at Amortized Cost).

What is in Scope?

One of the more basic elements to understanding the new amendments is to have a good understanding of the

types of transactions that are and are not in scope. As with other ASC topics on various other accounting issues, the transactions that are and are not in scope are prescribed within Section 15 (Scope and Scope Exceptions) of subtopic 20.

To that end, the guidance with respect to assets measured at amortized costs applies to the following instruments (ASC 326-20-15-2):

- Financial assets measured at amortized cost basis, including the following:
  - Financing receivables
  - Held-to-maturity debt securities
  - Receivables that result from revenue transactions within the scope of Topic 605 on revenue recognition, Topic 606 on revenue from contracts with customers, and Topic 610 on other income
  - Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance
  - Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860
- Net investments in leases recognized by a lessor in accordance with Topic 842 on leases
- Off-balance-sheet credit exposures not accounted for as insurance.

While the above items are included within the scope of the topic, the following items are specifically excluded from the scope of the topic (ASC 326-20-15-3):

- Financial assets measured at fair value through net income
- Available-for-sale securities
- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Promises to give (pledges receivable) of a not-for-profit entity
- Loans and receivables between entities under common control

Review Questions

1. Which of the following ASUs released in 2016 will change how entities document and account for credit impairment on their respective financial instruments?
    a. ASU No. 2016-02.
    b. ASU No. 2016-05.
    c. ASU No. 2016-09.
    d. ASU No. 2016-13.

2. The amendments within ASU No. 2016-13 included amendments for each of the following financial instruments, except?
    a. Assets measured at amortized cost.
    b. Fair value hedges.
    c. Available-for-sale debt securities.
    d. Purchased financial instruments with credit deterioration.

3. Which of the following financial instruments are within the scope of ASC 326-20?
    a. Financial assets measured at amortized costs.
    b. Available-for-sale debt securities.
    c. Loans made to participants by defined contribution employee benefit plans.
    d. Policy loan receivables of an insurance entity.

4. The FASB identified each of the following as being accomplished by the amendments in ASU No. 2016-13, except?

a. Earlier measurement of credit losses.
b. Greater transparency about the extent of credit losses on financial assets.
c. Improvement in user's ability to understand changes in expected credit losses.
d. Increase the significance of quantitative disclosures with respect to credit losses.

Initial Measurement of Expected Losses

As you recall from the earlier discussions, the amendments within this ASU replaced the current "incurred loss" model and replaces it with more of an "expected loss" type model. Because of the use of an expected loss model, entities are now required to consider a broader range of information in order to estimate expected credit losses over the lifetime of the assets that are within scope. Refer to Exhibit 3 which provides some additional insight from the FASB on the intent of the amendments.

Exhibit 3: Recognition vs. Measurement (BC10)

Some stakeholders may interpret Topic 326 as recognition guidance; however, Topic 326 is measurement guidance. The recognition event occurs when the financial asset is recognized on the statement of financial position through origination or purchase. Recognition is limited to assets and liabilities because the conceptual framework places primacy on those accounts. Expenses and losses in the Conceptual Framework are secondary because they represent changes in balance sheet accounts. Therefore, an expense is a remeasurement of an asset after its recognition. The amendments in this Update provide guidance for the measurement of expected credit losses for recognized financial assets and off-balance-sheet commitments. Following the Conceptual Framework, the measurements of credit losses for recognized financial assets are reported in the income statement as an expense.

The names used to describe the former and future models are fairly self-explanatory. However, the key principles of each model are worth reemphasizing. The incurred model in the current day recognizes a loss only when an event has occurred that leads the entity to conclude that a loss is probable. By contrast, the expected loss model recognizes credit losses based on the expectation or anticipation of a certain future event, or events, which will ultimately lead to a loss being recognized. This expected loss model can be analogized to accounting for a customer's accounts receivable where an entity has setup an allowance for doubtful accounts.

In the end, the FASB ultimately concluded that the use of a current expected credit loss, or CECL, model should be used for those assets that are measured at amortized cost. It's important to note that the FASB considered, but ultimately rejected, various alternatives to the CECL model when considering the feedback from stakeholders that primarily advocated for the gross-up model and models that were an abbreviated version of the CECL model (BC36). Refer to Exhibit 4 for additional insight into the FASB's conclusions regarding the use of this model.

Exhibit 4: Use of the CECL Model (BC35)

Stakeholders provided extensive feedback on whether the credit loss measurement for performing assets should differ from the credit loss measurement for assets that exhibited credit deterioration. Some stakeholders stated that the credit losses that an entity anticipated at acquisition or origination should be recorded in a pattern similar to the recognition of the related revenue (that is, interest income) on the basis that this compensates the entity for undertaking this risk. Those individuals often support a proportionate or time-based approach to recording credit losses or noted that no credit losses should be recorded until credit deterioration has occurred. Others stated that instruments measured using an amortized cost measurement attribute should be reflected in the balance sheet at each reporting date at an amount that reflects the present value of cash flows expected to be collected, discounted at the original effective interest rate. They noted that for instruments measured at amortized cost, it is potentially misleading to investors to allow the balance sheet to reflect an amount greater than the amount expected to be collected.

Simply put, the allowance for expected credit losses represents the portion of the amortized cost of a financial asset that an entity does not expect to collect. The FASB prescribes its overall objective with respect to this allowance for credit losses through ASC 326-20-30-1. Based on the paragraph, the FASB states that the allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. Furthermore, at the reporting date, an entity is required to record an allowance for credit losses on financial assets. As a result, an entity is required to 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). Said another way, the allowance for credit losses should represent the portion of the amortized cost basis of a financial asset that an entity does not expect to collect.

It's important to note that the FASB concluded that an entity should present the allowance for credit losses as a contra-asset account to reduce the net amortized cost of the asset to an amount that is expected to be collected. When the FASB considered truncated models or other models that limited the measurement of credit losses to a specific time period, it observed that the allowance for credit losses would not represent a complete estimate of an entity's expectations (BC42). The FASB also noted that if the measurement objective is based on a trigger for recording expected credit losses, an added layer of subjectivity and complexity would be added when identifying the assets that met a particular trigger. As a result of those operability concerns for financial assets, the net amortized cost basis (net of allowance) would be measured at an amount greater than the amount expected to be collected (BC42).

Estimating the Credit Loss

The FASB notes that an allowance for credit losses may be determined using various methods. In other words, it does not require a single method be used for estimating credit losses. Acceptable methods outlined by the FASB include the following types of methods (ASC 326-20-30-3):

- Discounted cash flow methods
- Loss-rate methods
- Roll-rate methods
- Probability-of-default methods
- Methods that use an aging schedule

Refer to Exhibit 5 below which provides an expanded discussion on the use of various models and considerations of the FASB.

Exhibit 5: Methods of Estimating Credit Losses (BC50)

The Board acknowledges that any approach to estimating the collectibility of financial assets is subjective. The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations. The Board recognizes that different methods may result in a range of acceptable outcomes. Given the subjective nature of this estimate and certain fact patterns, one methodology's consideration of time value may have a more direct impact on the estimate of expected credit losses than other methods. Some entities may be able to forecast over the entire estimated life of an asset, while other entities may forecast over a shorter period. The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in approaches with varying degrees of sophistication. Because entities may have different levels of sophistication, the Board did not prescribe one type of methodology for measuring expected credit losses for financial assets measured at amortized cost. The Board concluded that different outcomes for expected credit losses due to these and other factors are acceptable under the amendments in this Update. Furthermore, using terms such as reasonable and supportable does not imply a single conclusion or methodology upon which an entity must base its estimate. Different parties using different methodologies do not make a particular estimate unreasonable. While the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will only be one acceptable choice in estimating credit losses. Estimates of credit losses may not precisely predict actual future events and, therefore, subsequent events may not be indicative of the reasonableness of those estimates.

While the FASB does not prescribe a specific method be used by all entities, it should be noted that the measurement requirements can vary depending on whether an entity elects to use a discounted cash flow method or not. For example, if an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity should discount expected cash flows at the financial asset's effective interest rate (ASC 326-20-30-4). Furthermore, when a discounted cash flow method is applied, the allowance for credit losses should reflect the difference between the amortized cost basis and the present value of the expected cash flows. 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 should be calculated based on the factor as it changes over the life of the financial asset (ASC 326-20-30-4).

Alternatively, if an entity estimates expected credit losses using a method other than a discounted cash flow method, the allowance for credit losses should reflect an entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date (ASC 326-20-30-5). 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.

It's also important to note that an entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including both of the following (ASC 326-20-30-5):

- 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.

Based on the requirements in the ASU, entities are required to estimate credit losses over the contractual term

of the financial asset. In the Board's BCs, the FASB acknowledged that estimating expected credit losses over longer periods of time (such as the contractual term of financial assets) requires a significant amount of professional judgment, especially when using discounted cash flow techniques. Although an entity must estimate credit losses over the entire contractual term of the financial assets (considering the effect of prepayments), the FASB recognized that as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses also increases because the availability of detailed inputs to estimates for periods in the future decreases. Refer to Exhibit 6 for an overview of the FASB's view on the use of credit loss estimates of zero.

Exhibit 6: Estimating Credit Losses (BC53)

The Board concluded that it is not decision useful to assign a credit loss estimate of zero to certain periods merely because an entity is unable to precisely estimate future economic conditions for those periods. Rather, historical information about losses is a relevant metric upon which to base an entity's current estimate of credit losses for those periods beyond which the entity believes it is able to develop or obtain reasonable and supportable forecasts. Furthermore, an approach that does not record some expected losses (for example, those that are expected to occur after some prescribed forecast period) would fail to reflect the amount that an entity expects to collect, which is the Board's measurement objective for financial assets. Additionally, that approach would introduce noncomparability in expected credit losses across instrument types, time periods, and entities. Therefore, the Board decided to provide additional guidance on how to measure expected credit losses as an entity moves into periods of increasing uncertainty and decreasing precision. The reversion to an entity's historical loss information emphasizes the relevance of known losses that have occurred in the past on similar financial instruments and addresses preparer's concerns about the reliability of measuring those credit losses in periods of declining precision. Stakeholders informed the Board that some entities will use this reversion technique, while others may have the systems and processes in place to forecast over the estimated life of the financial asset on a reasonable and supportable basis.

Considering Available Information

ASC 326-20-30-7 requires that when developing an estimate of expected credit losses on financial asset(s), an entity should consider available information relevant to assessing the collectibility of cash flows. As a result, this information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. Furthermore, an entity should also consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). However, it's important to note that 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. While 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.

As previously noted, the amendments within the ASU do not prescribe a specific methodology for developing an expectation about the collectibility of a financial asset. However, the FASB does note that an entity's expectations about the collectibility of a financial asset should consider available information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that inform the entity about the estimated collectibility of the asset (BC47). With respect to historical loss information, ASC 326-20-55-6 notes that historical loss information generally provides a basis for an entity's assessment of expected credit losses. As a result, an entity may use historical periods that represent management's expectations for future credit losses. The important point to note is that when determining historical loss information in estimating expected credit losses, the information about historical credit loss data, after adjustments for current conditions and reasonable and supportable forecasts, should be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed (ASC 326-20-55-3).

While we have noted in the previous paragraph that historical loss can serve as a good benchmark for estimating credit losses, it's important to note that historical loss experience may not fully reflect an entity's expectations about the future and an entity should, as a consequence, adjust historical loss information to reflect the current conditions using reasonable and supportable forecasts not already reflected in the historical loss information (ASC 326-20-55-4).

Included within the implementation guidance to ASC 326-20 is a listing of significant factors an entity should consider depending on the nature of the asset. It's important to note that not all of these may be relevant to every situation. As a result, the below listing of significant factors is not an exhaustive listing.

Examples of significant factors an entity may consider include the following (ASC 326-20-55-4):

- 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 or the borrower's standing in the community
- The quality of the entity's credit review system
- The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- The environmental factors of a borrower and the areas in which the entity's credit is concentrated, such as:
    - Regulatory, legal, or technological environment to which the entity has exposure
    - Changes and expected changes in the general market condition of either the geographical area or the industry 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.

Estimating Credit Losses

As was previously noted, the actual estimation of credit losses, no matter the type of model utilized by an entity, can be highly judgmental and will undoubtedly be based on entity-specific factors. When we say entity-specific factors and judgments, examples of these include the following (ASC 326-20-55-6):

- 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 important points to note with respect to estimating losses is that 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 (ASC 326-20-55-7). Furthermore, an entity should utilize estimation techniques that are practical and relevant to the circumstance while recognizing the fact that 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. Refer to Exhibit 7 which provides additional insight from the FASB with respect to the measurement of credit losses.

Exhibit 7: Measurement of Credit Losses (BC46)

The Board concluded that the measurement of credit losses should be based on an entity's expectations about the collectibility of financial assets held at the reporting date. Even though an entity must estimate credit losses over the entire contractual term of the financial assets (recognizing that expected prepayments affect the estimated life), the Board decided not to characterize expected credit losses as "lifetime" expected credit losses. The use of the term lifetime is interpreted in many different ways and may lead some to believe that an entity must identify the exact amount and timing of uncollectible cash flows in each year of the asset's life for use in a discounted cash flow technique to estimate expected credit losses. For others, the term lifetime suggests the measurement of a stress-case (or worst-case) credit loss scenario after a default has occurred. Also, the term lifetime may lead some to believe that estimating expected credit losses must be done on an individual asset basis rather than having the ability to estimate expected credit losses on a collective (pool) basis.

Using Pools

The new guidance for developing estimates on credit losses requires that entities measure expected losses of financial assets on a collective, or pool, basis when similar risk characteristics exist (ASC 326-20-30-2). As you might have guessed, if an entity determines that a pool of assets do not have similar risk characteristics, then they are to be evaluated on an individual basis. This leads to the next obvious question of what is considered a pool?

Simply put, an entity should aggregate financial assets on the basis of similar risk characteristics, which may include any one or a combination of the following (ASC 326-20-55-5):

- Internal or external (third-party) credit score or credit ratings
- Risk ratings or classification
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods

The FASB noted that it considered including specific guidance that would have prescribed when credit losses should be estimated on an individual asset basis (such as a triggering event) or on a collective (or pool) basis.

However, the FASB decided not to specify the unit of measurement or require certain methods to be followed in specific circumstances. Instead, the FASB decided to provide a consistent set of measurement principles that could be implemented for both individual assets and groups of similar assets, understanding that estimation techniques might differ (BC54).

Loss is Remote

The new credit loss standards also require an entity's allowance for credit losses to reflect the risk of loss, even when that risk is remote. This is the case whether the entity is estimating the allowance for an individual asset or a group of assets as noted above. Refer to Exhibit 8 below for an overview of the accounting requirements when the risk of loss is remote and/or there are not expectations of nonpayment.

Exhibit 8: Measuring Credit Losses (ASC 326-20-30-10)

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

Use of a Valuation Allowance

As you recall, the amendments require that expected credit losses be reflected through a valuation allowance account instead of a direct adjustment to the cost basis of the asset. However, there are certain instances where an actual write-off of a financial asset, or a portion, is required. For example, this is the case when the entity determines that it is uncollectible. Refer to Exhibit 9 which provides additional insight from the FASB's BCs with respect to this use of a valuation allowance and the situation when a direct write-off is required.

Exhibit 9: Use of a Valuation Allowance (BC73)

The Board retained the requirements to write off assets if they are deemed uncollectible. The December 2012 Exposure Draft proposed that the assets be written off when there is no reasonable expectation of recovery. The Board received feedback that writing off an asset when there is no reasonable expectation of recovery could be considered to be a significant delay from the point when an asset is deemed uncollectible. This concern was due in part to regulatory guidance that stated that the designation as an uncollectible asset does not mean that it has no recovery or salvage value. The Board did not intend to delay the point at which assets are written off and, therefore, decided to retain the requirement that assets are written off if they are deemed to be uncollectible.

Purchased Financial Assets with Credit Deterioration

Purchased financial assets with credit deterioration, as defined by the ASC Master Glossary, are those individual financial assets that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by the acquirer's assessment. The FASB concluded that the allowance for purchased assets with more than-insignificant credit deterioration since origination should be added to the purchase price upon recognition of those assets (commonly referred to as the gross-up approach). Recording the amortized cost as the sum of the allowance and the purchase price enhances comparability and prevents the accretion of the credit discount into interest income (BC86).

As a result of the FASB's conclusions, an entity is required to 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 (ASC 326-20-30-13). Furthermore, any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration should be allocated to each individual asset. To that end, at the acquisition date, the initial allowance for credit losses determined on a collective basis should be allocated to individual assets to appropriately allocate any noncredit discount or premium. Refer to Exhibit 10 below for additional insight from the FASB with respect to purchased financial assets with credit deterioration.

Exhibit 10: Purchased Financial Assets with Credit Deterioration (BC85 thru 86)

The Board concluded that purchased assets and originated assets should follow the same model, to the extent possible. At the same time, recognizing interest revenue on the basis of contractual cash flows for all purchased assets could result in situations in which an entity accretes to an amount that it does not expect to collect, which would result in artificially inflated yields. For this reason, the Board concluded that when recognizing interest income on certain assets, it is inappropriate to accrete from the purchase price to the contractual cash flows. Specifically, when a purchased asset has deteriorated more than insignificantly since origination, it is more decision useful to exclude the credit discount from the amount accreted to interest income. As a result, the discount embedded in the purchase price that is attributable to credit losses at the date of acquisition of a purchased financial asset with credit deterioration should not be recognized as interest income.

The Board decided that the allowance for purchased assets with more than-insignificant credit deterioration since origination should be added to the purchase price upon recognition of those assets (commonly referred to as the gross-up approach). Recording the amortized cost as the sum of the allowance and the purchase price enhances comparability and prevents the accretion of the credit discount into interest income. The Board favors this approach because changes in the allowance for credit losses for all assets, including purchased financial assets with credit deterioration, will be reflected in net income in the period of change. The Board understands that those decisions will allow preparers to utilize the same tools and methodology for estimating credit losses for purchased.

Review Questions

5. If an entity estimates expected credit losses using a discounted cash flow method, the entity should discount expected cash flows using which of the following?
    a. Weighted average cost of capital.
    b. Effective interest rate.
    c. LIBOR rate.
    d. Cost of equity.

6. An entity is required to add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for which of the following financial instruments?
    a. Purchased financial assets with credit deterioration.
    b. Available-for-sale debt securities.
    c. Cash flow hedges.
    d. Off-balance-sheet commitments.

7. Based on the amendments of ASU No. 2016-13, the FASB ultimately concluded that which of the following models should be used for those assets that are measured at amortized cost?
    a. CECL model.
    b. Discounted cash flow model.
    c. Probable loss model.

d. Incurred loss model.

Subsequent Measurement of Expected Credit Losses

At each reporting date, an entity is required to record an allowance for credit losses on financial assets (including purchased financial assets with credit deterioration). As a result, an entity should compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded. By doing this, an entity should report in net income (as a credit loss expense or a reversal of 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 326-20-35-1).

In addition to the subsequent measurement requirement prescribed above, an entity should also evaluate whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in the pool (ASC 326-20-35-2). As an 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. This reevaluation may be used 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 (ASC 326-20-35-2).

Financial Assets Secured By Collateral

With respect to financial assets secured by collateral, ASC 326-20 notes that regardless of the initial measurement method, an entity is required to measure expected credit losses based on the fair value of the collateral when the entity determines that foreclosure is probable (ASC 326-20-35-4). Furthermore, when an entity determines that foreclosure is probable, the entity is required to remeasure the financial asset at the fair value of the collateral so that the reporting of a credit loss is not delayed until actual foreclosure.

However, it's important to note that the FASB allowed for two practical expedients that entities can elect when measuring expected credit losses on financial assets secured by collateral even when foreclosure is not probable. One expedient is applicable to collateral-dependent financial assets whereas the second expedient is applicable to financial assets secured by collateral maintenance provisions.

For collateral-dependent financial assets, an entity is permitted to estimate credit losses on certain collateral-dependent financial assets as the difference between the collateral's fair value and the amortized cost basis of the financial asset. However, entities are only allowed to use this practical expedient if repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date (ASC 326-20-35-5). Refer to Exhibit 11 which provides additional insight from the FASB with respect to this practical expedient.

Exhibit 11: Practical Expedient for Collateral-Dependent Financial Assets (BC64 thru 65)

The Board decided that measurement approaches for collateral-dependent financial assets (assets whose collection is substantially from the sale or operation of the collateral when the borrower is experiencing financial difficulty) in which expected credit losses are estimated by comparing the amortized cost basis with the fair value of collateral are acceptable practical expedients for estimating expected credit losses because fair value reflects the amount expected to be collected.

The Board also understands that to some stakeholders, the collateral-dependent practical expedient should be based on liquidation value rather than fair value. However, the Board decided to retain the fair value measurement concept because fair value is well understood and applied in current practice. The Board concluded that an additional measurement method of liquidation value would add complexity. In addition, in many situations the fair value of collateral is not significantly different from the amount that the entity would receive upon the sale of the collateral, even in situations in which the collateral is a foreclosed property. The Board concluded that when measuring fair value, an entity should consider the characteristics that a market participant would take into account when valuing the asset. Therefore, in the case of foreclosed property, the fair value should reflect the fact that it is a foreclosed property. As a result, the fair value of a foreclosed property may not be significantly different from the estimated cash an entity would collect upon the sale of the foreclosed property.

For financial assets with collateral maintenance provisions, an entity may be able to elect a practical expedient to compare the amortized cost basis of the financial asset with the fair value of collateral at the reporting date to measure the allowance for expected credit losses. This practical expedient can be used if the financial asset includes a collateral maintenance provision that requires the borrower to continually adjust the amount of collateral securing the financial asset.

Presentation

Under the new amendments, the presentation of the estimate of expected credit losses for recognized assets on the balance sheet differs from the estimate of expected credit losses for off-balance-sheet exposures. To that end, the estimate of expected credit losses for recognized financial assets is presented on the balance sheet as an allowance that reduces the amortized cost basis of the asset. Alternatively, estimates of expected credit losses for off-balance-sheet credit exposures should be presented as a liability.

Illustrative Examples

In this section of the course, we walk through several of the illustrative examples included within the implementation guidance of ASC 326-20. The intent of presenting these examples is to illustrate the initial and subsequent measurement guidance discussed up to this point in the course.

Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation)

Example 1 (ASC 326-20-55-18 thru 22)

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.

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.

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 percent. 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 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts, but determined none were necessary.

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 percent 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-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment rates beyond the reasonable and supportable forecast period. Under this loss-rate method, the incremental credit losses for the current conditions and reasonable and supportable forecast (the 15 basis points) is added to the 1.5 percent 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 percent loss rate where it has immediately reverted into historical losses reflective of the contractual term. This approach reflects an immediate reversion technique for the loss-rate method.

The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent 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 calculated as $3 million x 1.65 percent.

Estimating Expected Credit Losses Using a Loss-Rate Approach (Individual Evaluation)

Example 2 (ASC 326-20-55-23 thru 27)

This example illustrates one way an entity may estimate expected credit losses on an individual loan using a loss-rate approach when no loans with similar risk characteristics exist. This is different from the previous example wherein estimated credit losses were calculated based on a portfolio of loans with similar risk characteristics.

Community Bank B principally provides residential real estate loans to borrowers in the community. In the current year, Community Bank B expanded a program to originate commercial loans. Community Bank B has a few commercial loans outstanding at period end. In evaluating the loans, Community Bank B determines that one of the commercial loans does not share similar risk characteristics with other loans outstanding; therefore, Community Bank B believes that it is inappropriate to pool this commercial loan for purposes of determining its allowance for credit losses. This commercial loan has an amortized cost of $1 million. Historical loss information for commercial loans in the community with similar risk characteristics shows a 0.50 percent loss rate over the contractual term.

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

Community Bank B is able to reasonably forecast local unemployment rates and borrower-specific financial

results for one year only. Community Bank B's reasonable and supportable forecasts of those factors indicate that local unemployment rates are expected to remain stable (based on the main employer in the community continuing to operate normally) and that there will be a deterioration in the borrower's financial results (based on an evaluation of rent rolls). Management determines that no adjustment is necessary for local unemployment rates because they are expected to be consistent with the conditions in the 0.50 percent loss-rate estimate. However, the current and forecasted conditions related to borrower-specific financial results are different from the conditions in the 0.50 percent loss-rate estimate, based on borrower-specific information. Community Bank B determines that an upward adjustment of 10 basis points that is incremental to the historical lifetime loss information is appropriate based on those factors. Management estimates the 10-basis-point adjustment based on its knowledge of commercial loan loss history in the community when borrowers exhibit similar declines in financial performance. Management is unable to support its estimate of expectations for local unemployment and borrower-specific financial results beyond the reasonable and supportable forecast period. Under this loss-rate method, Community Bank B applies the same immediate reversion technique as in Example 1, where Community Bank B has immediately reverted into historical losses reflective of the contractual term.

The historical loss rate to apply to the amortized cost basis of the individual loan would be adjusted an incremental 10 basis points to 0.60 percent. The allowance for expected credit losses for the reporting period date would be $6,000.

Estimating Expected Credit Losses on a Vintage-Year Basis

Example 3 (ASC 326-20-55-28 thru 31)

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

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.

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 accompanying table) based on the amount of amortized cost basis in each vintage that was written off as a result of credit losses.

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

In estimating expected credit losses on the remaining outstanding loans 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 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 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.

Estimating Expected Credit Losses Using both a Collective Method and an Individual Asset Method

Example 4 (ASC 326-20-55-32 thru 36)

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.

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.

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.

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.

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.

Estimating Credit Losses for Trade Receivables Using an Aging Schedule

Example 5 (ASC 326-20-55-37 thru 40)

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

aging schedule.

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

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

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 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

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

Estimating Expected Credit Losses – Practical Expedient for Collateral-Dependent Financial Assets

Example 6 (ASC 326-20-55-41 thru 44)

This example illustrates one way an entity may implement for estimating expected credit losses on a collateral-dependent financial asset for which the borrower is experiencing financial difficulty based on the entity's assessment.

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

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

After analyzing Developer G's financial condition and the operating statements for the apartment building, Bank F believes that it is unlikely Developer G will be able to repay the loan at maturity in 20X9. Therefore, Bank F believes that repayment of the loan is expected to be substantially through the foreclosure and sale (rather than the operation) of the collateral. As a result, in its financial statements for the period ended December 31, 20X7, Bank F utilizes the practical expedient and uses the apartment building's fair value, less costs to sell, when developing its estimate of expected credit losses.

Estimating Expected Credit Losses – Practical Expedient for Financial Assets with Collateral Maintenance Provisions

Example 7 (ASC 326-20-55-45 thru 47)

This example illustrates one way an entity may implement the guidance for estimating expected credit losses on financial assets with collateral maintenance provisions.

Bank H enters into a reverse repurchase agreement with Entity I that is in need of short-term financing. Under the terms of the agreement, Entity I sells securities to Bank H with the expectation that it will repurchase those securities for a certain price on an agreed-upon date. In addition, the agreement contains a provision that requires Entity I to provide security collateral that is valued daily, and the amount of the collateral is adjusted up or down to reflect changes in the fair value of the underlying securities transferred. This collateral maintenance provision is designed to ensure that at any point during the arrangement, the fair value of the collateral continually equals or is greater than the amortized cost basis of the reverse repurchase agreement.

At the end of the first reporting period after entering into the agreement with Entity I, Bank H evaluates the reverse repurchase agreement's collateral maintenance provision to determine whether it can use the practical expedient for estimating expected credit losses. Bank H determines that although there is a risk that Entity I may default, Bank H's expectation of nonpayment of the amortized cost basis on the reverse repurchase agreement is zero because Entity I continually adjusts the amount of collateral such that the fair value of the collateral is always equal to or greater than the amortized cost basis of the reverse repurchase agreement. In addition, Bank H continually monitors that Entity I adheres to the collateral maintenance provision. As a result, Bank H uses the practical expedient and does not record expected credit losses at the end of the first reporting period because the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Bank H performs a reassessment of the fair value of collateral in relation to the amortized cost basis each reporting period.

Estimating Expected Credit Losses When Potential Default is Greater Than Zero, but Expected Nonpayment is Zero

Example 8 (ASC 326-20-55-48 thru 50)

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

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

Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J's management still believes that there is a possibility of default, even if that risk is remote. However, Entity J concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity's currency is

routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its U.S. Treasury securities at the end of the reporting period.

Recognizing Write-offs and Recoveries

Example 9 (ASC 326-20-55-51 thru 53)

This example illustrates how an entity may implement the guidance relating to write-offs and recoveries of expected credit losses on financial assets.

Bank K currently evaluates its loan to Entity L on an individual basis because Entity L is 90 days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio. At the end of December 31, 20X3, the amortized cost basis for Entity L's loan is $500,000 with an allowance for credit losses of $375,000. During the first quarter of 20X4, Entity L issues a press release stating that it is filing for bankruptcy. Bank K determines that the $500,000 loan made to Entity L is uncollectible. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance.

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

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

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

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

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

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

Applying Expected Credit Losses to Unconditionally Cancellable Loan Commitments

Example 10 (ASC 326-20-55-54 thru 56)

This Example illustrates the application of the guidance for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer.

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.

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.

Identifying Purchased Financial Assets with Credit Deterioration

Example 11 (ASC 326-20-55-57 thru 60)

This example illustrates factors that may be considered when assessing whether the purchased financial assets have more than an insignificant deterioration in credit quality since origination.

Entity N purchases a portfolio of financial assets subsequently measured at amortized cost basis with varying levels of credit quality. When determining which assets should be considered to be in the scope of the guidance for purchased financial assets with credit deterioration, Entity N considers the factors in paragraph 326-20-55-4 that are relevant for determining collectibility.

Entity N assesses what is more-than-insignificant credit deterioration since origination and considers the purchased assets with the following characteristics to be consistent with the factors that affect collectibility. Entity N records the allowance for credit losses for the following assets:

- Financial assets that are delinquent as of the acquisition date
- Financial assets that have been downgraded since origination
- Financial assets that have been placed on nonaccrual status
- Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in its policy.

Judgment is required when determining whether purchased financial assets should be recorded as purchased financial assets with credit deterioration. Entity N's considerations represent only a few of the possible considerations. There may be other acceptable considerations and policies applied by an entity to identify purchased financial assets with credit deterioration.

Recognizing Purchased Financial Assets with Credit Deterioration

Example 12 (ASC 326-20-55-61 thru 65)

This example illustrates application of the guidance to an individual purchased financial asset with credit deterioration.

Under paragraphs 326-20-30-13 and 310-10-35-53B, for purchased financial assets with credit deterioration, the discount embedded in the purchase price that is attributable to expected credit losses should not be recognized as interest income and also should not be reported as a credit loss expense upon acquisition.

Bank O records purchased financial assets with credit deterioration in its existing systems by recognizing the amortized cost basis of the asset, at acquisition, as equal to the sum of the purchase price and the associated allowance for credit loss at the date of acquisition. The difference between amortized cost basis and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the credit-related discount is not accreted to interest income after the acquisition date.

Assume that Bank O pays $750,000 for a financial asset with a par amount of $1 million. The instrument is measured at amortized cost basis. At the time of purchase, the allowance for credit losses on the unpaid principal balance is estimated to be $175,000. At the purchase date, the statement of financial position would reflect an amortized cost basis for the financial asset of $925,000 (that is, the amount paid plus the allowance for credit loss) and an associated allowance for credit losses of $175,000. The difference between par of $1 million and the amortized cost of $925,000 is a non-credit-related discount. The acquisition-date journal entry is as follows:

Loan—par amount	$1,000,000	
Loan—noncredit discount		$ 75,000
Allowance for credit losses		175,000
Cash		750,000

Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the financial asset consistent with other Topics. The $175,000 allowance for credit losses should be updated in subsequent periods consistent with the guidance in Section 326-20-35, with changes in the allowance for credit losses on the unpaid principal balance reported immediately in the statement of financial performance as a credit loss expense.

Using a Loss-Rate Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

Example 13 (ASC 326-20-55-66 thru 71)

This example illustrates the application of the guidance to determine the expected credit loss using a loss rate for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses. This does not mean that the application of a loss-rate approach is an irrevocable election.

Bank P purchases a $5 million amortizing nonprepayable loan with a 6 percent coupon rate and original contract term of 5 years. All contractual principal and interest payments due of $1,186,982 for each of the first 3 years of the loan's life have been received, and the loan has an unpaid balance of $2,176,204 at the purchase date at the beginning of Year 4 of the loan's life. The original contractual amortization schedule of the loan is as follows.

Original Amortization Table

Period	Beginning Balance	Total Payment	Interest	Principal	Ending Balance
1	$ 5,000,000	$ 1,186,982	$ 300,000	$ 886,982	$ 4,113,018
2	4,113,018	1,186,982	246,781	940,201	3,172,817
3	3,172,817	1,186,982	190,369	996,613	2,176,204
4	2,176,204	1,186,982	130,572	1,056,410	1,119,794
5	1,119,794	1,186,982	67,188	1,119,794	-
Totals		$ 5,934,910	$ 934,910	$ 5,000,000	

At the purchase date, the loan is purchased for $1,918,559 because significant credit events have been discovered. The purchaser expects a 10 percent loss rate, based on historical loss information over the contractual term of the loan, adjusted for current conditions and reasonable and supportable forecasts, for groups of similar loans. As a result of the expected credit losses, the allowance is estimated as $217,620 by multiplying the 10 percent loss rate by the unpaid principal balance, or par amount, of the loan (see beginning balance in Year 4 in the table above). The following journal entry is recorded at the acquisition of the loan:

Loan	$ 2,176,204	
Loan—noncredit discount		$ 40,025
Allowance for credit losses		217,620
Cash		1,918,559

The contractual interest rate is adjusted for the noncredit discount of $40,025 to determine the discount rate of 7.33 percent, which excludes the purchaser's assessment of expected credit losses at the acquisition date. The 7.33 percent (rounded from 7.3344 percent) is computed as the rate that equates the amortized cost of $2,136,179 (computed by adding the purchase price of $1,918,559 to the gross-up adjustment of $217,620) with

the net present value of the remaining contractual cash flows on the purchased asset ($1,186,982 in each of Years 4 and 5).

A default occurs in the last year of the loan's life. The amortization of the purchased loan would be recorded as follows for the periods after the purchase date in Years 4 and 5 of the loan's life.

Book Amortization

Period	Beginning Balance[a]	Total Payment[b]	Writeoff [c]	Accrued Interest[d]	Reduction [e]	Ending Balance[f]
4	$ 2,136,179	$1,186,982		$156,676	$1,030,306	$1,105,873
5	1,105,873	969,362	$ 217,620	81,109	1,105,873	-
Totals		**$ 2,156,344**	**$ 217,620**	**$ 237,785**	**$ 2,136,179**	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $217,620.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 7.33 percent (as determined in accordance with paragraph 326-20-55-69).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

The rollforward of the allowance would be as follows.

Beginning allowance for credit losses	$ 217,620
Plus, credit loss expense	-
Less, writeoffs	(217,620)
Ending allowance for credit losses	$ -

Using a Discounted Cash Flow Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

Example 14 (ASC 326-20-55-72 thru 78)

This example (which uses the same assumption as those in Example 13) illustrates the application of the guidance to determine the expected credit loss using a discounted cash flow approach for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses for financial assets. This does not mean that the application of a discounted cash flow approach is an irrevocable election.

To determine the discount rate, the expected cash flows would be estimated and discounted at a rate that equates the purchase price with the present value of expected cash flows. The expected cash flows, including the considerations for current conditions and reasonable and supportable forecasts, are expected to be $1,186,982 in Year 4 and $969,362 in Year 5. The discount rate that equates the purchase price with the cash flows expected to be collected is 8.46 percent (rounded from 8.455 percent). This also is the same rate that

equates the amortized cost basis (purchase price plus the acquisition date allowance for credit losses) with the net present value of the future contractual cash flows.

To determine the allowance for credit losses at the purchase date, the expected credit loss (that is, the contractual cash that an entity does not expect to collect) is discounted using the discount rate of 8.46 percent. The expected credit loss is $217,620 in Year 5, as determined by finding the difference between the contractual cash flows of $1,186,982 and the expected cash flows of $969,362. The present value of the expected loss at the purchase date is $185,012. The journal entry to record the purchase of this loan is as follows:

	Debit	Credit
Loan	$ 2,176,204	
Loan—noncredit discount		$ 72,633
Allowance for credit losses		185,012
Cash		1,918,559

The amortization of the loan in the years following the purchase date is as follows.

Book Amortization

Period	Beginning Balance [a]	Total Payment [b]	Writeoff [c]	Accrued Interest [d]	Reduction [e]	Ending Balance [f]
4	$ 2,103,571	$ 1,186,982		$ 177,857	$ 1,009,125	$ 1,094,446
5	1,094,446	969,362	$ 217,620	92,536	1,094,446	-
Totals		**$ 2,156,344**	**$ 217,620**	**$ 270,393**	**$ 2,103,571**	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $185,012.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 8.46 percent (as determined in accordance with paragraph 326-20-55-74).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

The Day 1 allowance established at the purchase date was $185,012. The allowance for credit losses was estimated on a discounted cash flow approach and, therefore, the allowance for credit losses needs to be adjusted for the time value of money. The rollforward of the allowance for credit losses is shown below.

Beginning allowance for credit losses	$ 185,012	
Plus, credit loss expense	15,643	(a)
Less, writeoffs	-	
Ending allowance for credit losses (Year 4)	200,655	
Plus, credit loss expense	16,965	(a)
Less, writeoffs	(217,620)	(b)
Ending allowance for credit losses (Year 5)	$ -	

(a) The provision for credit losses in Years 4 and 5 is determined by multiplying the beginning allowance for credit losses by the discount rate of 8.46 percent to adjust for the time value of monev.

(b) The writeoff represents the default in Year 5. The default is the difference between the Year 5 contractual cash flows of $1,186,982 and the actual cash flows received of $969,362.

The net income effect of a loss-rate approach illustrated in Example 13 and of a discounted cash flow approach illustrated in this Example is the same ($237,785 net income). The difference between the two approaches is that the Day 1 allowance for credit losses under a discounted cash flow approach explicitly reflects the time value of money. Therefore, it needs to be accreted to the future value of the loss that ultimately will occur. The change in the allowance for credit losses associated with the time value of money can be presented either as credit loss expense or as an adjustment to interest income. Therefore, the discounted cash flow approach, over the life of the asset, presents interest income as $270,393 but will require $32,608 ($15,643 in Year 4 plus $16,965 in Year 5) of credit loss expense to be recorded for the time value of money, resulting in net interest income after credit loss expense of $237,785. Under a loss-rate approach as illustrated in Example 13, interest income over the life of the asset is $237,785 but does not require credit loss expense to be recognized.

Review Questions

8. Which of the preceding illustrative examples presented discussed the practical expedient for financial assets with collateral maintenance provisions?
   a. Example 5.
   b. Example 7.
   c. Example 9.
   d. Example 11.

Financial Statement Disclosures

The required disclosures with respect to credit losses of financial instruments measured at amortized cost are prescribed to accomplish three specific objectives. This includes providing information that enables users of an entity's financial statements to understand each of the following (ASC 326-20-50-2):

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

It's important to note that the financial statement disclosures required by this ASU retains many of the existing disclosures prescribed by ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. Refer to Exhibit 12 below which provides more insight into the FASB's conclusions on the respective financial statement disclosures prescribed by ASU No. 2016-13.

Exhibit 12: Development of Financial Statement Disclosures (BC107 thru 108)

The financial statement disclosures required by this Update retain many of the existing disclosures of Accounting Standards Update No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, particularly those about an entity's credit risk exposures and its evaluation of the appropriateness of the allowance for credit losses. The amendments in this Update continue to require an entity to provide information either by portfolio segments or by classes of financial assets. The Board concluded that when disclosing information by portfolio segment or class of financial asset, an entity should determine, in light of the facts and circumstances, how much detail it must provide and how it disaggregates information into segments or classes for assets with different risk characteristics. An entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial assets and allowance for expected credit losses.

While the Board chose to retain many existing financial statement disclosures about an entity's allowance for credit losses, the change from an incurred to an expected loss model introduces the need for additional disclosures, most notably those about the inputs used to estimate expected credit losses. Requiring an entity to use expected loss data when determining expected credit losses will require the entity to incorporate new types of information into its measurement of expected credit losses and increase the significance of forward-looking information and its judgment in calculating the allowance for expected credit losses on its financial assets. As a result, the Board concluded that users will benefit from understanding how an entity derives and uses this information.

As you can note from the Exhibit above, while the FASB elected to maintain many of the existing financial statement disclosures, the change in the credit loss from an incurred to an expected loss resulted in the need for additional disclosures.

The disclosure requirements outlined within ASC 326-20-50 are broken out between major categories, as is the case with other ASC topics. This includes the following categories:

- Credit quality information
- Allowance for credit losses
- Past-due status
- Nonaccrual status
- Purchased financial assets with credit deterioration
- Collateral-dependent financial assets
- Off-balance-sheet credit exposures

For certain types of financial instruments, entities may need to consider aggregation when developing disclosures. For example, financing receivables should be presented by either portfolio segment or class of financing receivable whereas held-to-maturity debt securities should be provided by major security type (ASC 325-20-50-3). With respect to portfolio segments, this includes all of the following (ASC 326-20-55-10):

- Type of financing receivable
- Industry sector of the borrower
- Risk rating

As far as the class of financing receivables for purposes of determining the appropriate level of disclosure, there are several factors that an entity should consider. These include any of the following (ASC 326-20-55-12):

- Categorization of borrowers, such as any of the following:
    - Commercial loan borrowers

  - Consumer loan borrowers
  - Related party borrowers
- Type of financing receivable, such as any of the following:
  - Mortgage loans
  - Credit card loans
  - Interest-only loans
  - Finance leases.
- Industry sector, such as either of the following:
  - Real estate
  - Mining
- Type of collateral, such as any of the following:
  - Residential property
  - Commercial property
  - Government-guaranteed collateral
  - Uncollateralized (unsecured) financing receivables
- Geographic distribution, including both of the following:
  - Domestic
  - International

In cases where certain financial instruments are aggregated for disclosure purposes, there is an inherent risk that excessive detail may obscure important financial information useful to users of the financial statements. As a result, the FASB notes that an entity must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses (ASC 326-20-50-3). Examples of this include an entity obscuring important information by including it with a large amount of insignificant detail or an entity disclosing information that is so aggregated that it obscures important differences between the different types of financial assets and associated risks.

Credit Quality Information

With respect to credit quality information, entities are required to provide information that enables a financial statement user to do both of the following (ASC 326-20-50-4):

- Understand how management monitors the credit quality of its financial assets
- Assess the quantitative and qualitative risks arising from the credit quality of its financial assets

In order to meet the above objectives, an entity is required to provide both quantitative and qualitative information by class of financing receivable as well as major security type about the credit quality of financial assets (ASC 326-20-50-5). This includes disclosing all of the following:

- A description of the credit quality indicator(s)
- The amortized cost basis by credit quality indicator (public business entities only)
- For each credit quality indicator, the date or range of dates in which the information was last updated for that credit quality indicator.

So what is exactly meant by a "credit quality indicator"? Well, included within the implementation guidance of ASC 326-20, there are several examples of these credit quality indicators. These examples include the following (ASC 326-20-55-15):

- Consumer credit risk scores
- Credit-rating-agency ratings
- An entity's internal credit risk grades
- Debt-to-value ratios
- Collateral

- Collection experience
- Other internal metrics.

It's important to note that when disclosing credit quality indicators of financing receivables and net investment in leases (except for reinsurance recoverables and funded or unfunded amounts of line-of-credit arrangements such as credit cards), an entity is required to present the amortized cost basis within each credit quality indicator by year of origination (commonly referred to as vintage year) (ASC 326-20-50-6). Alternatively, for purchased financing receivables and net investment in leases, an entity should use the initial date of issuance to determine the year of origination, not the date of acquisition.

For origination years before the fifth annual period, an entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate (ASC 326-20-50-6). Furthermore, for interim-period disclosures, the current year-to-date originations in the current reporting period are considered to be the current-period originations.

Allowance for Credit Losses

The disclosures with respect to an entity's allowance for credit losses are lengthy. Like the overall objectives of disclosures previously noted, so too are there specific objectives outlined for the disclosures related to allowance for credit losses. Specifically, an entity should provide information that enables a financial statement user to understand (ASC 326-20-50-10):

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

In order to meet the above objectives, entities are required to disclose all of the following by both portfolio segment and major security type (ASC 326-20-50-11):

- A description of how expected loss estimates are developed
- A description of the entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
    - Past events
    - Current conditions
    - Reasonable and supportable forecasts about the future.
- A discussion of risk characteristics relevant to each portfolio segment
- A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, its rationale for those changes, and the quantitative effect of those changes
- Reasons for significant changes in the amount of write-offs, if applicable
- A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period
- The amount of any significant purchases of financial assets during each reporting period
- The amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period.

In addition to the above disclosures, entities are now also required to present a rollforward schedule of the allowance for credit losses. This is one of the key changes brought about as a result of ASU No. 2016-13. This rollforward schedule helps to enable users of an entity's financial statement to understand the activity in the

allowance for credit losses for each period. Specifically, an entity is required to disclose the following activity in a rollforward schedule (ASC 326-20-50-13):

- The beginning balance in the allowance for credit losses
- Current-period provision for expected credit losses
- The initial allowance for credit losses recognized on financial assets accounted for as purchased financial assets with credit deterioration (including certain beneficial interests), if applicable
- Write-offs charged against the allowance
- Recoveries of amounts previously written off, if applicable
- The ending balance in the allowance for credit losses.

Past-Due Status

In addition to the previous disclosures discussed thus far, entities are also required to disclose certain information with respect to financial assets that are past-due. Specifically, an entity is required to provide an aging analysis of the amortized cost basis for financial assets that are past-due as of the reporting date, disaggregated by class of financing receivable and major security type (ASC 326-20-50-14). This is not a new requirement based on ASU No. 2016-13, however, what is new is that an entity is required to disclose its policy for determining when a financial asset is past-due.

Included within the implementation guidance is an illustration of how an entity can meet the past-due disclosure requirements prescribed above. Refer to this table presented below from ASC 326-20-55-80.

Age Analysis of Past-Due Financial Assets
As of December 31, 20X5, and 20X4

	Past Due						
	30–59 Days	60–89 Days	Greater Than 90 Days	Total	Current	Total	Amortized Cost > 90 Days and Accruing
20X5							
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate:							
Commercial real estate—construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer—credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer—auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential:							
Residential—prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential—subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
20X4							
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate:							
Commercial real estate—construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer—credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer—other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer—auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential:							
Residential—prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential—subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Nonaccrual Status

There are also specific disclosure requirements prescribed for those financial assets with a nonaccrual status. Specifically, an entity is required to disclose the following, aggregated by class of financing receivable and major security type (ASC 326-20-50-16):

- The amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period
- The amount of interest income recognized during the period on nonaccrual financial assets
- The amortized cost basis of financial assets that are 90 days or more past due, but are not on nonaccrual status as of the reporting date
- The amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses as of the reporting date.

Additionally, there are incremental disclosure requirements regarding the significant accounting policies for these financial assets. Entities are required to disclose nonaccrual policies, including the policies for discontinuing accrual of interest, recording payments received on nonaccrual assets (including the cost recovery method, cash basis method, or some combination of those methods), and resuming accrual of interest, if applicable (ASC 326-20-50-17).

Purchased Financial Assets with Credit Deterioration

There are also specific disclosure requirements for purchased financial assets with credit deterioration. Specifically, an entity is required to disclose a reconciliation of the difference between the purchase price of financial assets and the par value of those assets, including the following (ASC 326-20-50-19):

- The purchase price
- The allowance for credit losses at the acquisition date based on the acquirer's assessment
- The discount (or premium) attributable to other factors
- The par value.

Collateral-Dependent Financial Assets

For a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty, an entity should disclose each of the following by class of financing receivable and major security type (ASC 326-20-50-20):

- The type of collateral
- Qualitative description of the extent to which collateral secures its collateral-dependent financial assets, and if applicable, significant changes in the extent to which collateral secures its collateral-dependent financial assets, whether because of a general deterioration or some other reason.

Off-Balance-Sheet Credit Exposures

When we talk about off-balance-sheet credit exposures, this 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 (other than derivative instruments).

With respect to these, an entity is required to disclose a description of the accounting policies and methodology the entity uses to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures. Specifically, the description should identify the following (ASC 326-20-50-21):

- The factors that influenced management's judgment
  - For example, historical losses, existing economic conditions, and reasonable and supportable forecasts
- A discussion of risk elements relevant to particular categories of financial instruments.

Review Questions

9. An entity is permitted to estimate, as a practical expedient, credit losses as the difference between a collateral's fair value and the amortized cost basis of which of the following financial assets?
   a. Purchased financial assets with credit deterioration.
   b. Available-for-sale debt securities.
   c. Certain collateral-dependent financial assets.
   d. Held-to-maturity securities.

10. The financial statement disclosures for assets measured at amortized cost retain many of the existing disclosures prescribed by which of the following ASUs?
    a. ASU No. 2010-20.
    b. ASU No. 2011-07.
    c. ASU No. 2012-07.
    d. ASU No. 2014-09.

11. Entities are required to disclosure which of the following through the use of a rollforward schedule?
    a. Purchase price.
    b. Write-offs charged against the allowance.

c. Past-due status.
d. Par value of purchased financial assets.

Available-for-Sale Debt Securities

In this next section of the course, we will explore the ASU amendments in more detail and focus in specifically on those requirements for available-for-sale debt securities. As a refresher, an available-for-sale security is a type of investment that is not classified as either a trading security or as held-to-maturity security. As a result, this section of the course serves to summarize the key guidance included within ASC Topic 326, subtopic 30 whereas the previous section addressed those requirements prescribed within subtopic 20 (Measured at Amortized Cost).

Overall, the amendments within the ASU are fairly consistent in principle with the current GAAP requirements for available-for-sale debt securities. The key difference is that the amendments require that credit losses be presented as an allowance rather than as a write-down. The FASB notes in the ASU summary that this approach is an improvement to current GAAP because an entity will be able to record reversals of credit losses (in situations in which the estimate of credit losses declines) in current period net income, which in turn should align the income statement recognition of credit losses with the reporting period in which changes occur. This is in stark contrast to current GAAP requirements that prohibit reflecting those improvements in current period earnings.

Background

In the final ASU, the FASB concluded that the CECL model should not apply to available-for-sale debt securities. Instead, the FASB made more specific amendments to the existing available-for-sale debt security impairment model and reorganized the guidance in a new subtopic within ASC 326. On account of the final amendments, there will be a different impairment model for those debt securities that are held to maturity versus those debt securities that are available-for-sale. The development of these final amendments is worth exploring in more detail. Refer to Exhibit 13 below for additional insight from the FASB.

Exhibit 13: Development of Available-for-Sale Debt Security Model (BC76 thru 77)

The December 2012 Exposure Draft proposed that available-for-sale debt securities utilize the same credit loss measurement model as financial assets that are measured at amortized cost. However, the Board recognized that expected credit losses for available-for-sale debt securities may be measured more frequently on an individual asset basis because the business model involves selling individual assets. Therefore, in an effort to minimize the cost of compliance when expected credit losses are insignificant, the December 2012 Exposure Draft stated that if an entity meets two conditions, then it may apply the practical expedient and would not be required to apply the model to the available-for-sale debt security being evaluated. The two conditions were (a) the fair value of the financial asset is greater than or equal to its amortized cost basis and (b) credit losses on the financial asset are expected to be insignificant.

Respondents acknowledged the Board's intent to develop a single impairment model for all financial assets. However, some respondents stated that the OTTI model is well understood by investors and is applied consistently by preparers. Some suggested that applying the credit losses model in the proposed Update would result in less decision-useful information as compared with the information resulting from applying the OTTI model. They noted that the OTTI model was an improvement in light of the financial crisis of 2007 and 2008 by removing the probability threshold and that users benefited from having more timely insight into the recognition of credit losses for securities. In addition, they mentioned that having a different impairment model for debt securities is justified because available-for-sale debt securities are managed differently than other financial assets are managed. Users also expressed a mixed reaction to the approach for available-for-sale debt securities. Users were less concerned about when impairment is recorded in the income statement because the primary measurement of available-for-sale debt securities is fair value.

Based on the FASB's received responses to feedback on the December 2012 Exposure Draft, the FASB considered a CECL fair value floor model for available-for-sale debt securities for which the expected credit losses would be measured under the CECL model with certain modifications. Under a CECL fair value floor model, an entity would not recognize expected credit losses if the financial asset's fair value equals or exceeds its amortized cost basis. Furthermore, if the financial asset's fair value is less than its amortized cost basis, an entity would recognize expected credit losses in net income determined under the CECL model but the allowance for credit losses would be limited to the difference between the financial asset's fair value and its amortized cost basis (BC78).

The FASB continued to receive extensive feedback and it additionally sought out additional feedback through outreach calls and roundtables with various stakeholders. In the end, based on consideration of all the feedback received, the FASB recognized that the available-for-sale credit loss model within the final ASU is similar to the CECL model because they both require lifetime losses to be reflected in earnings; however, the same credit loss model cannot apply because there are different measurement attributes (BC81). Refer to Exhibit 14 below which provides an overview of the final conclusions made by the FASB with respect to the changes to the impairment model for available-for-sale debt securities.

Exhibit 14: Development of Available-for-Sale Debt Security Model (BC82 thru 83)

The Board decided to make targeted improvements to the impairment guidance for available-for-sale debt securities. Specifically, an allowance approach should be used for measuring credit losses when there is not an intent or more-likely-than-not requirement to sell, which will allow an entity to record reversals of credit losses in current-period net income. The measurement of credit losses will be similar to current GAAP; however, the measurement of credit losses will be reported as an allowance rather than a write-down of the amortized cost basis. Additionally, the Board decided to prohibit an entity from avoiding the recording of credit losses by considering the length of time that the fair value of an available-for-sale debt security has been less than its amortized cost basis. Finally, in determining whether a credit loss exists, an entity no longer should consider the historical and implied volatility and recoveries or additional declines in the fair value after the balance sheet date of an available-for-sale debt security.

In subsequent redeliberations, the Board reconsidered adding a fair value floor to the amended model. The Board decided that consistent with the objectives of an available-for-sale security, an entity could look to limit its credit loss exposure by selling a security if the total fair value loss was less than the credit loss measured for the security. That outcome could occur if a portion of the fair value attributable to non-credit-related factors offset the portion of fair value attributable to credit factors. Given the importance of fair value in the measurement of available-for-sale securities, the Board decided to incorporate a fair value floor in the amended model.

Scope

The scope of the new amendments outlined within subtopic 30 are applicable to all debt securities that are classified as available-for-sale securities including loans that meet this definition.

Subsequent Measurement

Simply put, an investment is considered to be impaired if the fair value of the investment is less than the amortized cost basis. The important point to note here is that an entity is required to determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. If an entity has determined that the impairment results from a credit loss, then the entity should record the impairment through an allowance for credit losses. With respect to the allowance, it should be limited by the amount that the fair value is less than the amortized cost basis. If an impairment has not been recorded through an allowance, then the impairment should be recorded through other comprehensive income, net of applicable taxes (ASC 326-30-35-2). Refer to Exhibit 15 which provides additional insight from the FASB with respect to the subsequent measurement of available-for-sale debt securities.

Exhibit 15: Impairment of Available-for-sale Debt Securities (BC34)

The Board acknowledged that available-for-sale debt securities are recorded at fair value with changes in fair value included in other comprehensive income because under the measurement approach in Accounting Standards Update 2016-01, an entity represents that it may realize the total value of the securities either through collection or through sales of the securities. For these assets, a credit loss model is required in order to recognize in earnings any changes in fair value due to credit-related factors because those losses are expected to be realized regardless of whether the entity will realize value through collection or through sale. However, the Board decided that an allowance for credit losses on available-for-sale debt securities should be limited by the amount that fair value is less than amortized cost because an entity can sell its investment at fair value to avoid realization of credit losses.

In assessing whether a credit loss exists, an entity should compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security (ASC 326-30-35-6). If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses should be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis.

The impairment loss noted above should be recorded at each reporting date. The key point to note is that with the fact an allowance is used to record impairment losses, changes in the allowance account can go both ways. In other words, the allowance can be increased to reflect additional credit losses. Alternatively, the allowance can also be reduced to reflect reductions in credit losses. However, at the risk of stating the obvious, the allowance account can only be reversed up to zero (that is the asset's value cannot be written up above its original value before the first allowance recorded). Specifically, the FASB notes in ASC 326-30-35-12 that an entity should not reverse a previously recorded allowance for credit losses to an amount below zero.

With respect to the unit of account, impairment should be assessed at the individual security level (ASC 326-30-35-4). To that end, ASC 326 defines individual security level as the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities.

Factors to Consider

In the previous section, we have identified the overall principles with respect to how and when a credit loss and related allowance is recorded with an available-for-sale debt security. In this section, we focus more on the specific factors that an entity should assess to determine if an actual credit loss exists.

The actual factors an entity should assess are prescribed within the implementation guidance of subtopic 30. While the listing and related considerations may seem fairly comprehensive below, it should be noted that the listing is not meant to be all inclusive. To summarize, there are numerous factors that should be considered when determining whether a credit loss exists. For starters, this includes the following (ASC 326-30-55-1):

- The extent to which the fair value is less than the amortized cost basis
- Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors. Examples of those changes include any of the following:
  - Changes in technology
  - The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security
  - Changes in the quality of the credit enhancement.
- The payment structure of the debt security (for example, non-traditional loan terms as described in paragraphs 825-10-55-1 through 55-2) and the likelihood of the issuer being able to make payments that increase in the future
- Failure of the issuer of the security to make scheduled interest or principal payments
- Any changes to the rating of the security by a rating agency.

Specific to developing the estimate of cash flows expected to be collected, an entity should also consider certain information with respect to the collectibility of the security. This includes information about past events, current conditions, as well as reasonable and supportable forecasts. This information should include all of the following (ASC 326-30-55-2):

- The remaining payment terms of the security
- Prepayment speeds
- The financial condition of the issuer(s)
- Expected defaults
- The value of any underlying collateral.

In addition to the above factors, an entity should also consider the following to the extent they influence the estimate of cash flows of a security (ASC 326-30-55-3):

- Industry analyst reports and forecasts
- Credit ratings
- Other market data that are relevant to the collectibility of the security

Finally, an entity should also consider how other credit enhancements affect the expected performance of the security, including the following (ASC 326-30-55-4):

- Consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract)
- The willingness of the guarantor to pay
- Whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security.

Furthermore, it's important to note that the remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by nontraditional loans). As a result, an entity should consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including balloon payments). Finally, an entity also should consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, an entity should assess the effect of that decline on its ability to collect the balloon payment (ASC 326-30-55-4).

Future Cash Flow Considerations

Simply put, the estimates of expected future cash flows should be the entity's best estimate based on past events, current conditions, and on reasonable and supportable forecasts. Furthermore, available evidence should be considered in developing the estimate of expected future cash flows with weight given to the information used in the assessment being commensurate with the extent to which the evidence can be verified objectively (ASC 326-30-35-8). Examples of this available information includes the following (ASC 326-30-35-9):

- Existing environmental factors such as
    - Industry
    - Geographical
    - Economic
    - Political

Another important point to note is that if an entity estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.

Finally, the ASC 326 offers flexibility to entities when utilizing a rate for discounting future cash flows. For example, some debt securities contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the LIBOR, or the U.S. Treasury bill weekly average (ASC 326-30-35-11). In these situations when there is variability in the interest rate, an entity may conclude that the security's effective interest rate used to discount expected cash flows may be calculated based on the changing factor or may be fixed at the rate in effect at the date an entity determines that the security has a credit loss (ASC 326-30-35-11). The important takeaway with respect to this choice point is that the entity should consistently apply its conclusion on the effective interest rate to be used for all securities whose contractual interest rate varies based on changes in an independent factor. In other words, an entity cannot apply a different discount percentage among different securities whose contractual rate interest rate varies based on subsequent changes in an independent factor. As with many other accounting principles, this needs to be consistently applied.

Future Sales of the Security

Another set of key requirements to be familiar with relates to potential future sales of a debt security. For example, if an entity intends to sell the debt security (that is, it has decided to sell the security), or more likely than not will be required to sell the security before recovery of its amortized cost basis, any allowance for credit losses should be written off and the amortized cost basis should be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings (ASC 326-30-35-10). However, if an entity does not intend to sell the debt security, the entity should consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs) (ASC 326-30-35-10).

Based on the above paragraph, we noted that if an entity intends to sell (or more likely than not will be required to sell), the security should be written down to the security's fair value at the reporting date. The important point here is that once a security has been written down to its fair value, the new amortized cost basis should not be adjusted for subsequent recoveries in fair value (ASC 326-30-35-14). That is, if the security that has been recently written down based on an entity's intent to sell that security, and the fair value of the security appreciates after that write-down, the new amortized cost basis should not be adjusted upwards.

However, for those debt securities for which impairments were reported in earnings as a write-off because of an intent to sell or a more-likely-than-not requirement to sell, the difference between the new amortized cost basis and the cash flows expected to be collected should be accreted in accordance with existing applicable guidance as interest income (ASC 326-30-35-15). Refer to Exhibit 16 below for additional insight from the FASB with respect to interest income recognition.

Exhibit 16: Interest Income Recognition (BC98 thru 99)

The existing interest income recognition method for loans (other than purchased financial assets with credit deterioration) is based on the initial investment without deducting the allowance for credit losses, which may allow certain entities to continue to recognize interest income on principal that is not expected to be collected. Regulatory instructions for certain financial institutions currently mitigate this concern by requiring that interest accrual cease when collection of principal, interest, or both becomes doubtful (so-called nonaccrual practices that are permissible under GAAP).

In the May 2010 proposed Update, the Board proposed that interest income should always be calculated on the basis of the amortized cost less any allowance for credit impairments of the financial asset. This proposed change was strongly opposed by many stakeholders, including preparers, some auditors, regulators, and many investors. Stakeholders noted that the existing approach to recognizing interest income and credit losses separately provides users with relevant information about the credit risk of the underlying assets. Interest income is greater for riskier assets, and seeing an increase in interest income that is not reflected in comparable peers gives users insight into the financial institution's current credit lending practices. Users consistently asserted that interest income should not be further diluted for changes in cash flows related to credit losses. Therefore, in its redeliberations, the Board decided not to amend the guidance on interest income recognition in GAAP. The Board decided as a result of feedback received that existing nonaccrual practices may continue and decided to exclude from the amendments in this Update the nonaccrual guidance that was proposed as part of the December 2012 Exposure Draft. Respondents to the nonaccrual guidance proposed in the December 2012 Exposure Draft expressed concern that the guidance could add complexity for certain financial assets that currently are not placed on nonaccrual, such as credit cards. Additionally, there was concern about possible application inconsistencies with the proposed nonaccrual guidance proposed in the December 2012 Exposure Draft and regulatory guidance.

Comparison of the Models

Up to this point in the course, we have addressed the two separate impairment models. One model, the CECL model, relates to held to maturity debt securities whereas the other model relates specifically to available-for-sale debt securities. Included within Ernst & Young's Technical Line "A Closer Look at the New Credit Impairment Standard" from October 12, 2016 (Link) is a summary table that compares the two models. This table is presented below.

Topic	AFS debt security impairment model*	HTM current expected credit loss model
Unit of measurement	Individual AFS debt security	Collective (pool) when similar risk characteristics exist; otherwise, individual
Allowance recognition threshold	When a decline in fair value below the amortized cost basis has resulted from a credit loss	None
Measurement of credit losses	Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost	Expected credit loss that reflects the risk of loss even if that risk is remote
Acceptable methods for measuring credit losses	DCF	Various methods are appropriate, including DCF, loss rate, PD and others that faithfully estimate collectibility by applying the principles in ASC 326-20
*When the entity has decided to sell the debt security or it's more likely than not the entity will be required to sell the security before recovery of the security's amortized cost basis, the security's amortized cost basis should be written down to fair value through earnings at the reporting date.		

As you'll note from the table above, there are distinct differences between the two models with respect to the unit of measurement, the allowance recognition threshold, the measurement of credit losses, as well as the acceptable methods for measuring credit losses. For example, for available-for-sale debt securities, discounted cash flows (DCF) is used as the primary method whereas for held to maturity securities, the use of various methods are appropriate including, but not limited to, DCF.

The overall message being communicated from the table above is that depending on how an entity classifies a debt security, be it available-for-sale or held to maturity, different amounts for credit losses of the same security can be recorded.

Review Questions

12. Which of the following financial instruments is included within the scope of ASC 326-30?
    a. Financing receivables.
    b. Reinsurance recoverables.
    c. Receivables that relate to repurchase agreements.
    d. Available-for-sale debt securities.

13. Which of the following statements is correct with respect to the held to maturity current expected credit loss model?
    a. There is no allowance recognition threshold.
    b. The unit of measurement is the individual available-for-sale debt security.
    c. The only acceptable method for measuring credit losses is the discounted cash flow method.
    d. The measurement of credit losses is the expected credit loss that reflects the loss unless it is considered remote.

Financial Statement Disclosures

Similar to the previous section on the financial statement disclosures for assets measured at amortized costs, the financial statement disclosure requirements with respect to available-for-sale debt securities are outlined within subtopic 50 within ASC 326-30.

The required disclosures with respect to credit losses of available-for-sale debt securities are prescribed to accomplish three specific objectives. This includes providing information that enables users of an entity's financial statements to understand each of the following (ASC 326-30-50-2):

- The credit risk inherent in available-for-sale debt securities
- Management's estimate of expected credit losses
- Changes in the estimate of expected credit losses that have taken place during the period.

The disclosure requirements outlined within ASC 326-30-50 are broken out between major categories, as is the case with other ASC topics. This includes the following categories:

- Available-for-sale debt securities in unrealized loss positions without an allowance for credit losses
- Allowance for credit losses
- Purchased financial assets with credit deterioration

Similar to the previous financial statement disclosure section, in cases where certain financial instruments are aggregated for disclosure purposes, there is an inherent risk that excessive detail may obscure important financial information useful to users of the financial statements. Accordingly, an entity must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses (ASC 326-30-50-3).

Available-for-Sale Debt Securities in Unrealized Loss Positions without an Allowance for Credit Losses

For starters, there are specific disclosure requirements for those available-for-sale debt securities that are in unrealized loss positions but that do not have an allowance for credit losses. For these types of securities, including certain beneficial interests in securitized financial assets, an entity is required to disclose all of the following in its interim and annual financial statements (ASC 326-30-50-4):

- As of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment—each major security type that the entity discloses in accordance with this Subtopic—in tabular form:
  - The aggregate related fair value of investments with unrealized losses
  - The aggregate amount of unrealized losses (that is, the amount by which amortized cost basis exceeds fair value).
- As of the date of the most recent statement of financial position, additional information (in narrative form) that provides sufficient information to allow a financial statement user to understand the quantitative disclosures and the information that the entity considered (both positive and negative) in reaching the conclusion that an allowance for credit losses is unnecessary. The disclosures required may be aggregated by investment categories, but individually significant unrealized losses generally should not be aggregated. This disclosure could include all of the following:
  - The nature of the investment(s)
  - The cause(s) of the impairment(s)
  - The number of investment positions that are in an unrealized loss position
  - The severity of the impairment(s)
  - Other evidence considered by the investor in reaching its conclusion that an allowance for credit losses is not necessary, including, for example, any of the following:
    - Performance indicators of the underlying assets in the security, including any of the

following:
    - Default rates
    - Delinquency rates
    - Percentage of nonperforming assets.
- Debt-to-collateral-value ratios
- Third-party guarantees
- Current levels of subordination
- Vintage
- Geographic concentration
- Industry analyst reports
- Credit ratings
- Volatility of the security's fair value
- Interest rate changes since purchase
- Any other information that the investor considers relevant.

It's important to note that for those disclosures noted above requiring presentation in tabular form, these should be disaggregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer (ASC 326-30-50-5). Included within the implementation guidance is an example of the application of this tabular form presentation for purposes of meeting the respective disclosure requirements. Refer to this example illustrated below.

Example 2 (ASC 326-30-55-8 thru 9)

This example illustrates the guidance in Section 326-30-50 with a table followed by illustrative narrative disclosures. The table shows the gross unrealized losses and fair value of Entity B's investments with unrealized losses that are not deemed to have credit losses (in millions), aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 20X3. This Example illustrates the application of paragraphs 326-30-50-4 through 50-6 and, in doing so, describes Entity B's rationale for not reporting all or a portion of unrealized losses presented in the table as credit losses. In the application of paragraph 326-30-50-4(b), Entity B should provide meaningful disclosure about individually significant unrealized losses. To facilitate the narrative disclosures and for simplicity, this example presents only the quantitative information as of the date of the latest statement of financial position. However, in accordance with paragraphs 326-30-50-4 through 50-6, that information is required as of each date for which a statement of financial position is presented.

	Less Than 12 Months		12 Months or Greater		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	$ 172	$ 2	$ 58	$ 1	$ 230	$ 3
Federal agency mortgage-backed securities	367	5	18	1	385	6
Corporate bonds	150	7	-	-	150	7
Total	$ 689	$ 14	$ 76	$ 2	$ 765	$ 16

Included within Exhibit 17 below is an example of the narrative disclosure that would accompany the quantitative disclosure above.

Exhibit 17: Narrative Disclosure Example (ASC 326-30-55-9)

U.S. Treasury obligations. The unrealized losses on Entity B's investments in U.S. Treasury obligations and direct obligations of U.S. government agencies were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Entity B does not intend to sell the investments and it is not more likely than not that Entity B will be required to sell the investments before recovery of their amortized cost bases. Federal agency mortgage-backed securities. The unrealized losses on Entity B's investment in federal agency mortgage-backed securities were caused by interest rate increases. Entity B purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of Entity B's investments. Entity B does not intend to sell the investments and it is not more likely than not that Entity B will be required to sell the investments before recovery of their amortized cost bases. Corporate bonds. Entity B's unrealized loss on investments in corporate bonds relates to a $150 investment in Entity C's Series C Debentures. Entity C is a manufacturer. The unrealized loss was primarily caused by a recent decrease in profitability and near-term profit forecasts by industry analysts resulting from intense competitive pricing pressure in the manufacturing industry and a recent sector downgrade by several industry analysts. The contractual terms of those investments do not permit Entity C to settle the security at a price less than the amortized cost basis of the investment. While Entity C's credit rating has decreased from A to BBB (Standard& Poor's), Entity B currently does not expect Entity C to settle the debentures at a price less than the amortized cost basis of the investment (that is, Entity B expects to recover the entire amortized cost basis of the security). Entity B does not intend to sell the investment and it is not more likely than not that Entity B will be required to sell the investment before recovery of its amortized cost basis.

Allowance for Credit Losses

The second disclosure area relates to the allowance for credit losses on available-for-sale debt securities. Specifically, for interim and annual periods in which an allowance for credit losses of an available-for-sale debt security is recorded, an entity is required to disclose by major security type, the methodology and significant inputs used to measure the amount related to credit loss, including its accounting policy for recognizing write-offs of uncollectible available-for-sale debt securities. Examples of significant inputs include, but are not limited to, all of the following (ASC 326-30-50-7):

- Performance indicators of the underlying assets in the security, including all of the following:
  - Default rates
  - Delinquency rates
  - Percentage of nonperforming assets
- Debt-to-collateral-value ratios
- Third-party guarantees
- Current levels of subordination
- Vintage
- Geographic concentration
- Industry analyst reports and forecasts
- Credit ratings
- Other market data that are relevant to the collectibility of the security.

In addition to the above disclosures, entities are also required to present a rollforward of the allowance for credit losses for each interim and annual period for each major security type. At minimum, this rollforward is required to include the following (ASC 326-30-50-9):

- The beginning balance of the allowance for credit losses on available-for-sale debt securities held by the entity at the beginning of the period
- Additions to the allowance for credit losses on securities for which credit losses were not previously recorded
- Additions to the allowance for credit losses arising from purchases of available-for-sale debt securities accounted for as purchased financial assets with credit deterioration (including beneficial interests that meet the criteria in paragraph 325-40-30-1A)
- Reductions for securities sold during the period (realized)
- Reductions in the allowance for credit losses because the entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis
- If the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, additional increases or decreases to the allowance for credit losses on securities that had an allowance recorded in a previous period
- Write-offs charged against the allowance
- Recoveries of amounts previously written off
- The ending balance of the allowance for credit losses related to debt securities held by the entity at the end of the period.

Purchased Financial Assets with Credit Deterioration

The final disclosure area relates to specific disclosures with respect to purchased financial assets with credit deterioration. To the extent an entity acquired purchased financial assets with credit deterioration during the current reporting period, an entity is required to provide a reconciliation of the difference between the purchase price of the assets and the par value of the available-for-sale debt securities including the following information (ASC 326-30-50-10):

- The purchase price
- The allowance for credit losses at the acquisition date based on the acquirer's assessment
- The discount (or premium) attributable to other factors
- The par value.

Transition

Up to this point in the course, we've focused primarily in presenting the new recognition and measurement amendments as a result of ASU No. 2016-13. At this point in the course though, it's critical that we spend some time addressing the respective transition requirements for entities. As you can easily note, this is not one of those ASUs that will be a simple adoption for most entities. In other words, it certainly does not fit within the bucket of the FASB's routine simplification initiatives that can generally be easily adopted by entities without significant effort. This ASU, instead, encompasses significant changes to current GAAP that requires entities to evaluate many aspects of their current accounting policies with respect to credit losses.

As we previously noted, for public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments in this ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. By contrast, for all other public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Still, for all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this ASU are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

The FASB noted in BC126 that initially, it was determined the effective dates to be one year earlier than the respective dates mentioned above. However, the final issuance of the ASU occurred later than the FASB expected because additional outreach was performed. As a result, in consideration of the Private Company Decision-Making Framework and the FASB's reconsideration of the effective dates to the effective dates

mentioned above, the FASB decided that all entities may adopt the amendments in the ASU as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. It's also important to note that earlier adoption is not permitted as a result of this ASU.

Simply put, these amendments will take entities both time and effort to appropriately evaluate and implement. Refer to Exhibit 18 which provides additional insight from the FASB on the efforts required and their goal at minimizing the costs of implementation as well as complexity.

Exhibit 18: FASB's Views on Transition (BC8)

The Board recognizes that the amendments in this Update may require significant effort for many entities to gather the necessary data for estimating expected credit losses. The Board also recognizes that the guidance will require additional effort to review, audit, and examine financial statements. During the course of developing the amendments, the Board sought to minimize the cost of implementing the credit loss guidance and its complexity by developing an approach that:

- Permits an entity to utilize its current internal credit-risk management approaches and systems as a framework for applying the new measurement objective
- Does not include multiple measurement objectives that would have required different measures of credit losses depending on whether credit deterioration for financial assets has occurred for assets measured on an amortized cost basis
- Does not prescribe specific estimation methods to be used in any specific circumstance but, rather, allows an entity to apply judgment to develop estimation methods that are appropriate, practical, and consistent with the principles of the guidance
- Does not change the guidance for writing off uncollectible assets
- Does not change interest income reporting for originated loans on the basis of feedback received that preparers manage and users seek separate reporting of credit risk and interest income separately
- Requires an entity to consider forward-looking information rather than limiting consideration to current and past events, at the date of the statement of financial position
- Allows an entity to revert to historical loss information, with a straight line or immediate reversion both being acceptable methods if the expected contractual term of financial assets goes beyond periods for which reasonable and supportable forecasts can be obtained
- Makes targeted improvements to the impairment of available-for-sale debt securities, which was supported by both users and preparers
- Provides transition relief for a prospective transition approach for assets for which the guidance in previous GAAP (Subtopic 310-30) had been applied and for assets for which an other-than-temporary impairment had been recognized before the effective date.

In addition to the information provided in Exhibit 18 above, the FASB also understands that some stakeholders are of the view that a requirement to record the full estimate of expected losses may inhibit lending, particularly to less creditworthy borrowers or during an economically stressed environment (BC9). However, the FASB notes that the amendments in this ASU do not change the economics of lending. Said another way, the same loss ultimately will be recorded, regardless of the accounting requirements. The critical aspect that is changing is the accounting threshold for the recognition of credit losses, which affects only the timing of when to record credit losses, not the ultimate amount realized on the financial assets. On account of these changes, the FASB notes that the guidance on credit losses should provide information that is useful in making business and economic decisions, and that guidance on credit losses should provide information that faithfully reports the economics of a transaction, regardless of any perceived positive or negative impact of reporting that information in the financial statements (that is, "neutrality") has on business and policy decisions (BC9).

Similar to ASU No. 2014-09, *Revenue from Contracts with Customers*, which included sweeping changes to the accounting principles with respect to revenue recognition and drove the creation of a Revenue Recognition Transition Resource Group (TRG), so too is the case for the ASU that is the subject of this course. As a result, a TRG was put in place at the FASB with respect to implementation issues of the new credit loss amendments. The purpose of this TRG is to do the following:

- To solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance
- To inform the FASB about those implementation issues, which will help the Board determine what, if any, action will be needed to address those issues
- To provide a forum for stakeholders to learn about the new guidance from others involved with implementation

Refer to Exhibit 19 which provides additional insight into the role of the TRG as the implementation date of this new ASU gets closer.

Exhibit 19: FASB's Views on Transition (BC8)

The Board believes that the TRG will be in a position to monitor implementation efforts and provide support as needed. The Board has considered the role of the TRG when assessing costs and benefits. The Board also observes that the shortcomings of current GAAP create a need for users to derive their own estimates of expected credit losses. Therefore, the amendments in this Update will reduce costs for users. The Board acknowledges that some of those costs will shift to preparers but notes that the costs to the system as a whole should be reduced because management is in a position to make a more informed estimate based on information used in assessing collectibility and underwriting decisions.

Transition Guidance

The FASB noted in the release of ASU No. 2016-13 that there are several transition requirements as it relates to components. Overall, an entity is required to apply the amendments in the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. This is commonly referred to as a modified-retrospective approach. Additionally, entities are required to apply a prospective transition approach for debt securities for which an other-than-temporary impairment had been recognized before the effective date. The FASB notes that the effect of a prospective transition approach is to maintain the same amortized cost basis before and after the effective date of the ASU. The FASB noted that this approach simplified the subsequent accounting for preparers and was favored by users because the yields on the securities continue to be comparable from one reporting period to the next.

It's important to note that amounts previously recognized in accumulated other comprehensive income as of the date of adoption that relate to improvements in cash flows expected to be collected should continue to be accreted into income over the remaining life of the asset. Additionally, recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption should be recorded in earnings when received. Refer to Exhibit 20 below which provides additional insight from the FASB with respect to transition considerations.

Exhibit 20: FASB's Views on Transition (BC8)

The Board decided that the amendments in this Update should be applied on a modified-retrospective transition approach that would require a cumulative-effect adjustment to the opening retained earnings in the statement of financial position as of the date of adoption. The Board rejected other methods, including methods that would have required full retrospective transition. The Board acknowledges that retrospective transition methods generally provide the most useful information. However, the Board determined them to be impracticable to apply in prior periods because the use of hindsight would be necessary in making estimates of expected credit losses. Stakeholders generally agreed with a modified-retrospective transition approach.

Stakeholders requested additional transition guidance for certain debt securities and those financial assets that would meet the criteria of purchased financial assets with credit deterioration. For example, questions were raised about whether an allowance would be recorded for a debt security that had an OTTI before the effective date, which may result in a reversal of a previous write-down that was in accordance with previous GAAP. In addition, if an allowance was recorded, preparers would have to use hindsight to determine the write-down amount, if applicable. In response to stakeholders' feedback, the Board provided transition relief to debt securities that had OTTIs in accordance with previous GAAP and for purchased financial assets that were within the scope of Subtopic 310-30, including those that applied Subtopic 310-30 by analogy.

Transition Disclosures

Included within ASC 326-10-65 is the specific transition requirements, several of which have been previously noted in the preceding paragraphs. Included within this section are the specific disclosures that an entity is required to make when they adopt the requirements of the ASU. This includes disclosing the following (ASC 326-10-65-1):

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

Recent Developments

In January 2017, the FASB released ASU No. 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments – Equity Method and Joint Ventures (Topic 323).* This ASU included specific amendments to SEC paragraphs pursuant to SEC Staff Announcements from the September 22, 2016 and November 17, 2016 Emerging Issues Task Force (EITF).

As noted in the name of the ASU above, this ASU made amendments to ASC Topic 250 and included additional requirements for entities with respect to the disclosures of certain ASUs. This included the following ASUs:

- ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*
- ASU No. 2016-02, *Leases (Topic 842)*
- ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*

As you'll note, the ASU that is the subject of this course is included in the additional disclosure requirements. Refer to Exhibit 21 below which provides an overview of the additional requirements prescribed within ASC 250-10-S99-6.

Exhibit 21: Additional Disclosures (ASC 250-10-S99-6)

SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.

Comparison to IFRS 9

Similar to other significant recent accounting updates, the FASB and the IASB) initially set out on a joint project to improve the impairment models for financial instruments. While the intentions were good, and converged guidance was the ultimate goal, this was not the end result. Given the differing stakeholder input on the FASB and IASB version of the models, convergence was simply not achievable.

The IASB published the final version of IFRS 9, a replacement of IAS 39, in July 2014 with the new requirements effective for annual periods beginning on or after January 1, 2018. However, unlike the FASB's version, IFRS 9 is available for early adoption.

Refer to Exhibit 22 for an overview of the FASB's view on this failure in convergence.

Exhibit 22: Convergence Results (BC128)

The FASB understands the desire for a converged model. However, in response to differing feedback received on the joint Supplementary Document, the FASB decided to continue to develop the CECL model, which was exposed in the December 2012 Exposure Draft. The FASB and IASB received different feedback on their respective proposed credit loss models. The IASB stakeholders strongly preferred an impairment model that utilizes a dual measurement approach, while U.S. stakeholders strongly preferred the CECL model proposed by the FASB.

In line with the statements from the FASB included in Exhibit 22, the IASB also noted that it worked closely with the FASB throughout the developed of IFRS 9. The IASB noted however that although every effort was made to come to a converged solution, ultimately these efforts were unsuccessful.

The FASB identified three primary reasons why convergence was unachievable. These include the following (BC129):

- Before the issuance of IFRS 9 and the amendments in this Update, the practices for accounting for credit losses were different between GAAP and IFRS preparers. The FASB and the IASB concluded that the preexisting differences influenced stakeholders' perceptions of the two models.
- The interaction between the role of prudential regulators and loss allowances determined for financial

reporting purposes is historically stronger in the United States.

- Many users of financial statements prepared in accordance with GAAP place greater weight on the loss allowances on the balance sheet.

While we will not engage in a comprehensive discussion of the similarities and differences of the FASB and IASB requirements with respect to credit losses on financial instruments, we will touch on a few of the key points between the impairment model prescribed by the FASB (the CECL model) and the model prescribed by the IASB through IFRS 9. These are summarized in the final sections of this course.

Scope of the Standards

For U.S. GAAP, the scope applies to financial assets measured at amortized cost, including debt instruments, held-to-maturity debt securities and trade receivables, net investments in leases recognized by a lessor under ASC 842, contract assets under ASC 606, and off-balance-sheet credit exposures that are not accounted for as insurance. As we've previously noted, the new standards are not applicable to instruments in the scope of ASC 815.

From the IFRS 9 perspective, the new IFRS standard applies to debt instruments recorded at amortized cost or at fair value through other comprehensive income such as loans, debt securities and trade receivables, lease receivables under IFRS 16, contract assets under IFRS 15, and loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss.

Measurement Objectives

For U.S. GAAP, there is one measurement objective. Simply put, it is to reflect an allowance for credit losses that, when deducted from the amortized cost basis of the financial asset, reflects the net amount expected to be collected.

From the IFRS 9 perspective, there are two measurement objectives instead of just one. The first objective relates to the fact that the amount of the allowance depends on the extent of credit deterioration since the initial recognition of the asset. The second objective relates to the fact that for all other assets, the allowance reflects 12 months of expected credit losses.

Recognition of Credit Losses

This is one area where the standards between U.S. GAAP and IFRS are fairly aligned. From a U.S. GAAP perspective, an allowance is established through net income for expected credit losses with changes in the allowance recognized immediately in net income. From an IFRS 9 perspective, movements between the two measurement objectives are also recognized immediately in net income.

Estimating Expected Credit Losses

For U.S. GAAP, the ASU does not require a specific approach to determine the allowance. Additionally, there is no explicit requirement to consider the time value of money. Additionally, if a discounted cash flow (i.e., future principal and interest cash flows) approach is used, then the discount rate is the financial asset's original effective interest rate. Alternatively, from an IFRS 9 perspective, a discounted cash flow approach is required and expected credit losses must be discounted using a rate that approximates the effective interest rate of the asset.

Write-Offs

This is another area where the standards between U.S. GAAP and IFRS are also aligned granted they use slightly different vernacular. From a U.S. GAAP perspective, financial assets are written off when they are deemed uncollectible. From an IFRS 9 perspective, financial assets are written off when the entity has no reasonable expectation of recovery.

A more comprehensive overview of the similarities and differences between the two standards, summarized from the FASB's BCs, is included in Exhibit 23 below.

Exhibit 23: U.S. GAAP vs. IFRS (BC131)

The following are notable similarities and differences between the CECL model and IFRS 9:

- Both the CECL model and IFRS 9 are considered to be expected credit loss models. The CECL model requires that the full amount of expected credit losses be recorded for all financial assets measured at amortized cost, whereas IFRS 9 requires that an allowance for credit losses equal to the 12-month expected credit losses as defined in IFRS 9 be recognized, until there is a significant increase in credit risk when lifetime expected credit losses are recognized.
- Under IFRS 9, the full amount of expected credit losses is measured for financial assets that have experienced a significant increase in credit risk since initial recognition. For these assets, there may be similar measurements of expected credit losses under IFRS 9 and CECL because, under both, an entity will measure credit losses over the expected life, subject to key differences highlighted below.
- The amendments in this Update have different requirements based on the measurement attribute. Specifically, different considerations and indicators for impairment exist for available-for-sale debt securities. IFRS 9 requires one credit loss approach for all financial assets (described as fair value through other comprehensive income assets under IFRS 9), regardless of the measurement attribute.
- The FASB acknowledges the time value of money is implicitly present in credit loss methodologies using amortized cost information, whereas IFRS 9 requires an explicit consideration of the time value of money.
- The CECL model requires collective evaluation of credit losses when similar risk characteristics exist. IFRS 9 states that the measurement of expected credit losses shall reflect a probability-weighted amount but particular measurement techniques are not prescribed. Therefore, IFRS 9 allows collective evaluation of credit losses based on shared risk characteristics; however, unlike the CECL model, the probability weighted outcomes must be considered.
- GAAP treats a concession provided to a troubled borrower to be a continuation of the original lending agreement. Differences exist for modifications of financial assets and the concept of a troubled debt restructuring does not exist in IFRS 9.
- Differences exist for purchased financial assets. IFRS 9 also includes requirements for originated credit impaired financial assets as well as purchased credit impaired financial assets. GAAP does not contain provisions for originated impaired financial assets, and there are differences in the scope and measurement of expected credit losses for purchased financial assets.
- GAAP continues to permit the application of nonaccrual practices, whereas IFRS 9 continues to preclude the use of nonaccrual practices. IFRS 9 requires a net-interest approach to be applied to the "Stage 3" assets, which represent individual assets that are credit impaired, whereas a gross interest approach is used otherwise.
- The discount rate utilized when a discounted cash flow approach is used under the CECL model is required to be the effective interest rate. IFRS 9 provides that an entity also is permitted to use an approximation of the effective discount rate when discounting expected credit losses.
- The CECL model requires expected credit losses for unfunded commitments to reflect the full contractual period over which an entity is exposed to credit risk via a present obligation to extend credit. The CECL model does not require an allowance for expected credit losses beyond the contractual term or beyond the point in which a loan commitment may be unconditionally cancelled by the issuer. In contrast, for a financial asset that contains both a loan and an undrawn commitment component, IFRS 9 states that an entity should measure expected credit losses over the period that an entity is exposed to credit risk and expected credit losses are not mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

- The CECL model requires the amortized cost basis of financing receivables and net investment in leases to be disclosed by credit quality indicator, disaggregated by year of origination. This information is intended to help users understand the credit quality trends within the portfolio from period to period. IFRS 9 requires an entity to disclose a reconciliation of the financial assets relating to the allowance for credit losses from the opening balance to the closing balance and requires explanations of how significant changes in the gross carrying amounts of financial assets during the period contributed to the changes in the allowance for credit losses.

Review Questions

14. Which of the following identifies one of the categories of financial statement disclosures for available-for-sale debt securities?
    a. Available-for-sale debt securities in unrealized loss positions without an allowance for credit losses.
    b. Past-due status.
    c. Nonaccrual status.
    d. Collateral-dependent financial assets.

15. Which of the following statements is correct with respect to IFRS 9?
    a. It includes two measurement objectives.
    b. It does not require the use of the discounted cash flow method.
    c. It acknowledges the time value of money is implicitly present in credit loss methodologies
    d. Permits the application of nonaccrual practices.

Solutions to Review Questions

1. Which of the following ASUs released in 2016 will change how entities document and account for credit impairment on their respective financial instruments?
    a. ASU No. 2016-02.
    Incorrect. ASU No 2016-02 was released in February 2016 and was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.
    b. ASU No. 2016-05.
    Incorrect. ASU No 2016-05 was released in March 2016 and was issued because GAAP is not explicitly clear about the effect on an existing hedging relationship, if any, of a change in the counterparty to a derivative instrument that has been designated as a hedging instrument.
    c. ASU No. 2016-09.
    Incorrect. ASU No 2016-09 was released in March 2016 and included improvements to employee share-based payment accounting.
    d. ASU No. 2016-13.
    Correct. ASU No 2016-13 was released in June 2016 and was released to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date.

2. The amendments within ASU No. 2016-13 included amendments for each of the following financial instruments, except?
    a. Assets measured at amortized cost.
    Incorrect. The amendments within ASU No. 2016-13 include amendments with respect to assets measured at amortized costs. Specifically, the amendments in this ASU require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected.
    b. Fair value hedges.
    Incorrect. The amendments within ASU No. 2016-13 do not include amendments related to fair value hedges. The accounting for these items is included in ASC 815.
    c. Available-for-sale debt securities.
    Incorrect. The amendments within ASU No. 2016-13 include amendments with respect to available-for-sale debt securities. Specifically, the amendments require that credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses.
    d. Purchased financial instruments with credit deterioration.
    Incorrect. The amendments within ASU No. 2016-13 include amendments with respect to purchased financial instruments with credit deterioration. Specifically, the FASB concluded that the allowance for purchased assets with more than-insignificant credit deterioration since origination should be added to the purchase price upon recognition of those assets (commonly referred to as the gross-up approach).

3. Which of the following financial instruments are within the scope of ASC 326-20?
    a. Financial assets measured at amortized costs.
    Correct. Financial assets measured at amortized costs are within the scope of ASC 326-20. Also included in the scope is off balance-sheet credit exposures not accounted for as insurance.
    b. Available-for-sale debt securities.
    Incorrect. Available-for-sale debt securities is not included in the scope of ASC 326-20. Instead, these are within the scope of ASC 326-30.
    c. Loans made to participants by defined contribution employee benefit plans.
    Incorrect. Loans made to participants by defined contribution employee benefit plans are not

included in the scope of ASC 326-20. An additional item not included in the scope of ASC 326-20 include promises to give (pledges receivable) of a not-for-profit entity.

d. Policy loan receivables of an insurance entity.
Incorrect. Policy loan receivables of an insurance entity are not included in the scope of ASC 326-20. Additional items not included in the scope of ASC 326-20 include loans and receivables between entities under common control.

4. The FASB identified each of the following as being accomplished by the amendments in ASU No. 2016-13, except?
   a. Earlier measurement of credit losses.
   Incorrect. The FASB noted that earlier measurement of credit losses will be accomplished as a result of the ASU. Additionally, the FASB also noted that the ASU will improve a user's ability to understand purchased financial assets with credit deterioration.
   b. Greater transparency about the extent of credit losses on financial assets.
   Incorrect. The FASB noted that greater transparency about the extent of credit losses on financial assets will be accomplished as a result of the ASU. Additionally, the FASB also noted that the ASU will improve a user's ability to understand the realizability of assets held at each reporting period.
   c. Improvement in user's ability to understand changes in expected credit losses.
   Incorrect. The FASB noted that the ASU will result in an improvement in user's ability to understand changes in expected credit losses. Additionally, the FASB also noted that the ASU will provide greater transparency to the user in assessing the credit quality indicators of a financial asset portfolio and changes in composition of the financial asset portfolio over time.
   d. Increase the significance of quantitative disclosures with respect to credit losses.
   Correct. This was not one of the factors noted by the FASB as being accomplished by the ASU. It's important to note that the financial statement disclosures required by this ASU retains many of the existing disclosures prescribed by ASU No. 2010-20.

5. If an entity estimates expected credit losses using a discounted cash flow method, the entity should discount expected cash flows using which of the following?
   a. Weighted average cost of capital.
   Incorrect. If an entity estimates expected credit losses using a discounted cash flow method, the entity should not discount expected cash flows using the weighted average cost of capital. This is the rate that a company is expected to pay on average to all its security holders to finance its assets.
   b. Effective interest rate.
   Correct. If an entity estimates expected credit losses using a discounted cash flow method, the entity should discount expected cash flows using the effective interest rate. Furthermore, when a discounted cash flow method is applied, the allowance for credit losses should reflect the difference between the amortized cost basis and the present value of the expected cash flows.
   c. LIBOR rate.
   Incorrect. If an entity estimates expected credit losses using a discounted cash flow method, the entity should not discount expected cash flows using the LIBOR rate. This is a benchmark rate that some of the world's leading banks charge each other for short-term loans.
   d. Cost of equity.
   Incorrect. If an entity estimates expected credit losses using a discounted cash flow method, the entity should not discount expected cash flows using the cost of equity. The cost of equity is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors (i.e., shareholders) to compensate for the risk they undertake by investing their capital

6. An entity is required to add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for which of the following financial instruments?
   a. Purchased financial assets with credit deterioration.

Correct. The FASB noted that recording the amortized cost as the sum of the allowance and the purchase price enhances comparability and prevents the accretion of the credit discount into interest income.

b. Available-for-sale debt securities.
Incorrect. An entity is not required to add the allowance for credit losses at the date of acquisition to the purchase price of available-for-sale debt securities to determine the initial amortized cost basis. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses should be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis.

c. Cash flow hedges.
Incorrect. Cash flow hedges are not within the scope of the amendments prescribed by ASU No. 2016-13. Instead, the accounting for these types of instruments is prescribed by ASC 815.

d. Off-balance-sheet commitments.
Incorrect. Estimates of expected credit losses for off-balance-sheet credit exposures should be presented as a liability.

7. Based on the amendments of ASU No. 2016-13, the FASB ultimately concluded that which of the following models should be used for those assets that are measured at amortized cost?

a. CECL model.
Correct. The FASB ultimately concluded that the use of a current expected credit loss, or CECL, model should be used for those assets that are measured at amortized cost. It's important to note that the FASB considered, but ultimately rejected, various alternatives to the CECL model when considering the feedback from stakeholders that primarily advocated for the gross-up model and models that were an abbreviated version of the CECL model.

b. Discounted cash flow model.
Incorrect. The FASB did not conclude that a discounted cash flow model be used. Instead, the FASB noted that an allowance for credit losses may be determined using various methods.

c. Probable loss model.
Incorrect. The FASB did not conclude that a probable loss model be used. Users criticized previous GAAP because the thresholds required to recognize credit losses delayed the recognition until the credit losses were probable, even if an entity may have had an expectation of a future loss

d. Incurred loss model.
Incorrect. The incurred loss model represents current GAAP. The amendments replace the incurred loss impairment methodology with an updated methodology that reflects expected credit losses and requires entities to consider a broader range of reasonable and supportable information with respect to credit loss estimates.

8. Which of the preceding illustrative examples presented discussed the practical expedient for financial assets with collateral maintenance provisions?

a. Example 5.
Incorrect. Example 5 provides an illustrative example of estimating credit losses for trade receivables using an aging schedule.

b. Example 7.
Correct. Example 7 provides an example of the practical expedient for financial assets with collateral maintenance provisions. The example related to Bank H entering into a reverse repurchase agreement with Entity I that is in need of short-term financing.

c. Example 9.
Incorrect. Example 9 provides an illustrative example of recognizing write-offs and recoveries.

d. Example 11.
Incorrect. Example 11 provides an illustrative example of identifying purchased financial assets with credit deterioration.

9. An entity is permitted to estimate, as a practical expedient, credit losses as the difference between a collateral's fair value and the amortized cost basis of which of the following financial assets?
    a. Purchased financial assets with credit deterioration.
       Incorrect. Entities are not allowed a practical expedient with respect to measuring credit losses for purchased financial assets with credit deterioration.
    b. Available-for-sale debt securities.
       Incorrect. Entities are not allowed a practical expedient with respect to measuring credit losses for available-for-sale debt securities.
    c. Certain collateral-dependent financial assets.
       Correct. For collateral-dependent financial assets, an entity is permitted to estimate credit losses on certain collateral-dependent financial assets as the difference between the collateral's fair value and the amortized cost basis of the financial asset. However, entities are only allowed to use this practical expedient if repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date.
    d. Held-to-maturity securities.
       Incorrect. Entities are not allowed a practical expedient with respect to measuring credit losses for held-to-maturity securities.

10. The financial statement disclosures for assets measured at amortized cost retain many of the existing disclosures prescribed by which of the following ASUs?
    a. ASU No. 2010-20.
       Correct. The financial statement disclosures required by ASU No. 2016-13 retain many of the existing disclosures of ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, particularly those about an entity's credit risk exposures and its evaluation of the appropriateness of the allowance for credit losses.
    b. ASU No. 2011-07.
       Incorrect. The amendments within ASU No. 2011-07 relate to health care entities and the presentation and disclosure of patient services revenue, provision for bad debts, and the allowance for doubtful accounts for certain health care entities.
    c. ASU No. 2012-07.
       Incorrect. The amendments within ASU No. 2011-07 relate to accounting for fair value information that arises after the measurement date and its inclusion in the impairment analysis of unamortized film costs.
    d. ASU No. 2014-09.
       Incorrect. The amendments within ASU No. 2014-09 relate to revenue from contracts with customers and other assets and deferred costs.

11. Entities are required to disclosure which of the following through the use of a rollforward schedule?
    a. Purchase price.
       Incorrect. Purchase price is not required to be disclosed within the rollforward schedule. Instead, an example of a required component in the rollforward schedule is the beginning balance in the allowance for credit losses.
    b. Write-offs charged against the allowance.
       Correct. Write-offs charged against the allowance is required to be disclosed within the rollforward schedule. Additionally, recoveries of amounts previously written off should also be disclosed, if applicable.
    c. Past-due status.
       Incorrect. Past-due status is not required to be disclosed within the rollforward schedule. Instead, an example of a required component in the rollforward schedule is the ending balance in the

allowance for credit losses.

d. Par value of purchased financial assets.
Incorrect. Par value of purchased financial assets is not required to be disclosed within the rollforward schedule. Instead, an example of a required component in the rollforward schedule is the current-period provision for expected credit losses.

12. Which of the following financial instruments is included within the scope of ASC 326-30?
    a. Financing receivables.
    Incorrect. Financing receivables are not within the scope of ASC 326-30. Instead, these instruments are within the scope of ASC 326-20.
    b. Reinsurance recoverables.
    Incorrect. Reinsurance recoverables are not within the scope of ASC 326-30. Instead, these instruments are within the scope of ASC 326-20.
    c. Receivables that relate to repurchase agreements.
    Incorrect. Receivables that relate to repurchase agreements are not within the scope of ASC 326-30. Instead, these instruments are within the scope of ASC 326-20.
    d. Available-for-sale debt securities.
    Correct. The scope of the new amendments outlined within subtopic 30 are applicable to all debt securities that are classified as available-for-sale securities including loans that meet this definition. An available-for-sale security is a type of investment that is not classified as either a trading security or as held-to-maturity security.

13. Which of the following statements is correct with respect to the held to maturity current expected credit loss model?
    a. There is no allowance recognition threshold.
    Correct. There is no allowance recognition threshold with respect to the held to maturity CECL model. For the available-for-sale debt security model, there is an allowance threshold. This is the case when a decline in fair value below the amortized cost basis has resulted from a credit loss.
    b. The unit of measurement is the individual available-for-sale debt security.
    Incorrect. The unit of measurement with respect to the held to maturity CECL model is the collective (pool) when similar risk characteristics exists.
    c. The only acceptable method for measuring credit losses is the discounted cash flow method.
    Incorrect. There are various methods, including the discounted cash flow method that are acceptable. An example of an acceptable model is the loss-rate model and others that faithfully estimate collectibility by applying the principles in ASC 326-20.
    d. The measurement of credit losses is the expected credit loss that reflects the loss unless it is considered remote.
    Incorrect. The measurement of credit losses is the expected credit loss that reflects the risk of loss even if that risk is remote.

14. Which of the following identifies one of the categories of financial statement disclosures for available-for-sale debt securities?
    a. Available-for-sale debt securities in unrealized loss positions without an allowance for credit losses.
    Correct. This is one of the categories of financial statement disclosures for available-for-sale debt securities. For certain of these disclosures requiring presentation in tabular form, these should be disaggregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer
    b. Past-due status.
    Incorrect. Disclosures with respect to past-due status relate to assets measured at amortized costs. Specifically, an entity is required to provide an aging analysis of the amortized cost basis for financial assets that are past due as of the reporting date, disaggregated by class of financing

receivable and major security type.

c. Nonaccrual status.
Incorrect. Disclosures with respect to nonaccrual status relate to assets measured at amortized costs. Entities are required to disclose nonaccrual policies, including the policies for discontinuing accrual of interest, recording payments received on nonaccrual assets (including the cost recovery method, cash basis method, or some combination of those methods), and resuming accrual of interest, if applicable.

d. Collateral-dependent financial assets.
Incorrect. Disclosures with respect to collateral-dependent financial assets relate to assets measured at amortized costs. For a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty, an entity should the type of collateral and a qualitative description of the extent to which collateral secures its collateral-dependent financial assets.

15. Which of the following statements is correct with respect to IFRS 9?

a. It includes two measurement objectives.
Correct. The requirements prescribed by IFRS 9 have two measurement objectives whereas the U.S. GAAP version only has one measurement objective.

b. It does not require the use of the discounted cash flow method.
Incorrect. IFRS 9 requires the use of the discounted cash flow method whereas the U.S. GAAP version does not require a specific approach to determining the credit loss allowance.

c. It acknowledges the time value of money is implicitly present in credit loss methodologies.
Incorrect. The FASB acknowledges the time value of money is implicitly present in credit loss methodologies using amortized cost information, whereas IFRS 9 requires an explicit consideration of the time value of money.

d. Permits the application of nonaccrual practices.
Incorrect. U.S. GAAP continues to permit the application of nonaccrual practices, whereas IFRS 9 continues to preclude the use of nonaccrual practices.

Final Examination Questions

1. The requirements prescribed by ASU No. 2016-13 are effective for public business entities for annual periods beginning after what date?
    a. December 15, 2017.
    b. December 15, 2018.
    c. December 15, 2019.
    d. December 15, 2020.

2. The requirements prescribed by ASU No. 2016-13 are primarily outlined within which of the following ASC Topics?
    a. ASC 250.
    b. ASC 326.
    c. ASC 842.
    d. ASC 942.

3. In what year did the FASB issue a second exposure draft that more closely aligned with the single measurement objective?
    a. 2011.
    b. 2012.
    c. 2013.
    d. 2014.

4. The amendments within ASU No. 2016-13 require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at which of the following?
    a. Net amount expected to be collected.
    b. Net book value.
    c. Fair value.
    d. Fair value less costs to sell.

5. Prior to the amendments within ASU No. 2016-13, credit losses on available-for-sale debt securities are required to be measured and presented as which of the following?
    a. Write-downs.
    b. Valuation allowances.
    c. Contra-assets.
    d. Other comprehensive income.

6. Which of the following financial instruments are not included in the scope of ASC 326-20?
    a. Financial assets measured at amortized cost basis.
    b. Net investments in leases.
    c. Off-balance sheet credit exposures.
    d. Policy loan receivables of an insurance entity.

7. When estimating credit losses for assets measured at amortized cost, an entity should consider each of the following factors, except?
    a. The borrower's financial condition.
    b. The remaining time to maturity.
    c. The quality of the entity's credit review system.
    d. The planned use of deferred tax assets.

8. The FASB provided for two practical expedients as a result of ASU No. 2016-13 for which of the following

types of financial instruments?

   a. Financial assets secured by collateral.
   b. Financial assets measured at fair value through net income.
   c. Available-for-sale securities.
   d. Loans made to participants by defined contribution employee benefit plans.

9. Which of the following is a required disclosures as it relates to credit quality information?
   a. Management's method for developing its allowance for credit losses.
   b. The information that management used in developing its current estimate of expected credit losses.
   c. The amortized cost basis by credit quality indicator (public business entities only).
   d. The amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period.

10. Entities are required to provide an aging analysis of the amortized cost basis for financial assets that are which of the following?
    a. Past-due.
    b. Impaired.
    c. Uncollectible.
    d. Written-off.

11. If an entity intends to sell a debt security, any allowance for credit losses should be
    a. Written off and the amortized cost basis should be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings.
    b. Recorded as a contra-asset and evaluated each reporting period.
    c. Written off and the amortized cost basis should be written down to the debt security's net book value at the reporting date with any incremental impairment reported in other comprehensive income.
    d. Recorded as a contra-asset and accreted to interest income over the life of the financial instrument.

12. Which of the following statements is correct with respect to the available-for-sale debt security impairment model?
    a. There is no allowance recognition threshold.
    b. The unit of measurement is the individual available-for-sale debt security.
    c. There are several acceptable methods for measuring credit losses.
    d. The measurement of credit losses is the expected credit loss that reflects the loss even if that risk is remote.

13. Which of the following disclosures with respect to credit losses on available-for-sale debt securities is required to be presented in tabular form?
    a. Nonaccrual status.
    b. Available-for-sale debt securities that are in unrealized loss positions.
    c. Purchased financial assets with credit deterioration.
    d. Collateral-dependent financial assets.

14. Entities are required to apply the amendments in ASU No. 2016-13 through a cumulative-effect adjustment to which of the following?
    a. Retained earnings.
    b. Net income.
    c. Other comprehensive income.
    d. Other assets.

15. For all other entities that are not public business entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after what date?
    a. December 15, 2019.
    b. December 15, 2020.
    c. December 15, 2021.
    d. December 15, 2022.

16. The amendments prescribed by ASU No. 2016 are required to be adopted using which of the following types of transition approaches?
    a. Prospective.
    b. Retrospective.
    c. Modified retrospective.
    d. Modified prospective.

17. Which of the following ASUs released in 2017 requires entities to consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that ASU No. 2016-13 (as well as other significant ASUs) will have on their financial statements?
    a. ASU No. 2017-01.
    b. ASU No. 2017-02.
    c. ASU No. 2017-03.
    d. ASU No. 2017-04.

18. Which of the following IFRS was published by the IASB in July 2014 with the new requirements effective for annual periods beginning on or after January 1, 2018?
    a. IFRS 9.
    b. IFRS 10.
    c. IFRS 13.
    d. IFRS 15.

19. Which of the following methods for estimating credit losses is required by IFRS 9?
    a. Discounted cash flow method.
    b. Loss-rate method.
    c. Roll-rate method.
    d. Probability-of-default method.

20. The discount rate utilized when a discounted cash flow approach is used under the CECL model is required to be the effective interest rate whereas IFRS 9 provides that an entity also is permitted to use which of the following?
    a. Weighted average cost of capital.
    b. An approximation of the effective discount rate.
    c. Cost of equity.
    d. LIBOR rate.

Glossary

Amortized Cost Basis

The amount at which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange, and fair value hedge accounting adjustments.

Available-for-Sale Securities

Investments not classified as either trading securities or as held-to-maturity securities.

Credit Quality Indicator

A statistic about the credit quality of financing receivables.

Debt Security

Any security representing a creditor relationship with an entity.

Effective Interest Rate

The rate of return implicit in the loan, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to either receive cash or another financial instrument from a second entity or exchange other financial instruments on potentially favorable terms with the second entity.

Financing Receivable

A financing arrangement that has both of the following characteristics: a) it represents a contractual right to receive money either on demand or on fixed or determinable dates and b) it is recognized as an asset in the entity's statement of financial position.

Portfolio Segment

The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses.

Purchased Financial Assets with Credit Deterioration

Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.

Reinsurance Recoverable

All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits.

Troubled Debt Restructuring

A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

Index of Key Terms

Assets measured at amortized cost, 4, 5, 51
ASU No. 2016-13, 1, 3, 5, 26, 43, 45, 46, 51, 53, 54, 57, 58, 59
Available-for-sale debt securities, 4, 5, 13, 32, 39, 40, 50, 51, 53, 54, 55, 58
CECL model, 6, 33, 34, 38, 47, 48, 49, 50, 53, 55, 59
collateral-dependent financial assets, 14, 15, 32, 54, 56
credit quality information, 28, 58
Discounted cash flow, 7, 59
FASB, 1, 2, 3, 4, 6, 7, 8, 9, 11, 12, 13, 14, 26, 27, 28, 33, 34, 35, 37, 43, 44, 45, 46, 47, 48, 49, 51, 53, 56, 57
IASB, 2, 3, 47, 48, 59
IFRS 9, 1, 47, 48, 49, 50, 56, 59
Interest Income, 38
past-due, 30, 55
pool, 9, 11, 13, 14, 16, 18, 55
practical expedient, 14, 15, 57
purchased financial assets with credit deterioration, 3, 13, 14, 22, 23, 24, 30, 32, 38, 43, 46, 54
required disclosures, 26, 40, 58
scope, 2, 5, 6, 22, 34, 39, 43, 46, 48, 49, 51, 52, 53, 55, 57, 59
transition requirements, 1, 43, 45, 46