Credit impairment

Handbook

US GAAP

January 2023

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Contents

No one-size-fits-all solution

In June 2016, the FASB issued ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, the culmination of a project that began in the wake of the global financial crisis. This standard has marked a significant change – requiring the immediate recognition of estimated credit losses expected to occur over the remaining life of many financial assets.

The accounting change has been particularly impactful to institutions with significant lending activities or investments in debt securities. But amid all the change, the standard is also flexible, allowing companies to formulate their own approaches and to leverage many existing practices.

Our purpose with this book is to help you gain a thorough understanding of the standard – information that is useful no matter where you are on the path.

We intend to continue the dialogue – updating our guidance to provide our insights on issues that arise.

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About this publication

The purpose of this Handbook is to assist you in understanding the standard on credit impairment issued in June 2016.

Accounting literature

Unless otherwise stated, references to the standard and/or Topic 326 comprise all of the following Accounting Standards Updates:

— No. 2016-13, Measurement of Credit Losses on Financial Instruments

— No. 2018-10, Codification Improvements to Topic 842, Leases (consequential amendments)

— No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses

— No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

— No. 2019-05, Financial Instruments—Credit Losses: Targeted Transition Relief

— No. 2019-10, Financial Instruments—Credit Losses, Derivatives and Hedging, and Leases: Effective Dates

— No. 2019-11, Codification Improvements to Topic 326, Financial Instruments—Credit Losses

— No. 2020-02, Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842)—Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842) (SEC Update)

— No. 2020-03, Codification Improvements to Financial Instruments

— No. 2022-01, Derivatives and Hedging (Topic 815): Fair Value Hedging — Porfolio Layer Method

— No. 2022-02, Financial Instruments—Credit Losses: Troubled Debt Restructurings and Vintage Disclosures

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification and overviews of the relevant requirements.

Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include examples to explain key concepts, and we explain the changes from legacy US GAAP.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples.

- 326-20-30-1 is paragraph 30-1 of ASC Subtopic 326-20.
- ASU 2016-13.BC68 is paragraph 68 of the basis for conclusions to ASU 2016-13.
- TRG 6-17.1 is agenda paper No. 1 from the meeting of the FASB's Transition Resource Group for Credit Losses (TRG) held in June 2017.
- Agency FAQ is the joint statement issued by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC), which includes frequently asked questions about ASU 2016-13.
- 2018 AICPA Conf is the 2018 AICPA Conference on Current SEC and PCAOB Developments.
- Reg S-K 10(f)(1) is Item 10(f)(1) of SEC Regulation S-K.

Future developments

As more people turn their attention to the application of the new credit impairment standard, more questions are arising and the interpretations of the principles in the standard continue to evolve. This means that some positions may change, and positions on new issues will emerge, as we get closer to implementation.

January 2023 edition

This version of our Handbook includes guidance about ASU 2022-02 and new interpretations based on our experience with companies implementing Topic 326. Guidance for adopting ASU 2022-02 is included separately from the guidance for adopting ASU 2016-13. An entity that adopts ASU 2016-13 in fiscal years beginning after December 15, 2022 must adopt ASU 2022-02 at the same time.

Compared to the January 2022 edition, new sections, Questions and Examples are identified with ** and items that have been significantly updated or revised are identified with #. Items moved from another chapter without significant change are marked with ●. A summary is included in the Index of changes.

Pending content

This edition of our Handbook incorporates amendments to Topic 326 and Topic 310 in ASU 2022-01 and ASU 2022-02 that are not yet effective for all entities. The Codification excerpts containing these amendments are labeled as Pending Content. If the amendments have a significant effect on the accounting discussed in this Handbook, we have explained that effect.

Abbreviations

We use the following abbreviations in this Handbook.

AFS	Available-for-sale
EIR	Effective interest rate
DIEP	AICPA's Depository Institutions Expert Panel
HTM	Held-to-maturity
LIBOR	London Interbank Offered Rate
OTTI	Other-than-temporary impairment
PBE	Public business entity
PCD	Purchased financial assets with credit deterioration
PCI	Purchased credit impaired loans accounted for under ASC 310-30
SRC	Smaller reporting company
TDR	Troubled debt restructuring
TRG	FASB's Transition Resource Group for Credit Losses

1. Executive summary

Earlier recognition of credit losses

Topic 326 is intended to improve financial reporting by requiring earlier recognition of credit losses on loans, held-to-maturity (HTM) securities and certain other financial assets.

Topic 326 replaces the current incurred loss impairment model that recognizes losses when a probable threshold is met with a requirement to recognize lifetime expected credit losses immediately when a financial asset is originated or purchased.

Effective in 2020

SEC filers that are not eligible to be SRCs apply Topic 326 for interim and annual periods in fiscal years beginning after December 15, 2019.

All other entities apply Topic 326 for interim and annual periods in fiscal years beginning after December 15, 2022.

Early adoption is permitted as of the beginning of a fiscal year for fiscal years beginning after December 31, 2018.

This will affect your business

Entities that will be most affected by Topic 326 are banks and other financial institutions.

However, this is not just a standard for banks. All entities that engage in lending activities and invest in debt securities that are classified as available-for-sale (AFS) or HTM will be affected. Additionally, entities with trade receivables, reinsurance recoverables, and loans to equity method investees also will be affected by Topic 326.

Topic 326 is expected to require management to make new judgments and calculations when measuring expected credit losses. This may require changes in policies, processes and internal controls.

IT systems also may need to be upgraded or modified to capture additional data to support the accounting and disclosure requirements.

What's in the scope?

More than just financial assets measured at amortized cost

Topic 326 applies to all entities. It is divided into two substantive subtopics – Subtopic 326-20 and Subtopic 326-30 – each of which contains a different credit loss model.

Subtopic 326-20 applies to:	Subtopic 326-30 applies to:
Financial assets measured at amortized cost	AFS debt securities
Net investments in leases	
Off-balance sheet credit exposures not accounted for as insurance	

The FASB decided that the measurement attribute for AFS debt securities necessitates a separate credit loss model. Moreover, financial assets measured at fair value through net income are excluded from the scope of both Subtopics.

New credit loss model under Subtopic 326-20

The new credit loss model under Subtopic 326-20 is called the 'expected credit loss' model because it requires estimating and recognizing credit losses for the lifetime of assets within its scope.

Flexibility to select the method

Subtopic 326-20 does not prescribe all aspects of the expected credit loss estimate, including the specific method to be used. However, it describes how an entity should estimate expected credit losses based on the type of method used.

Method	Allowance calculation
Discounted cash flow method	The allowance for credit losses reflects the difference between: — the amortized cost basis; and — the present value of the principal and interest cash flows expected to be collected.
Other methods	The allowance for credit losses reflects the entity's expected credit losses of the amortized cost basis.

Pooling is required

Subtopic 326-20 requires that an entity estimate expected credit losses of financial assets with similar risk characteristics on a collective (pool) basis.

A financial asset is measured individually only if it does not share similar risk characteristics with other financial assets.

Both credit and non-credit related characteristics are relevant in determining whether certain assets share similar risk characteristics.

Contractual term is critical

Subtopic 326-20 requires an entity to estimate expected credit losses over a financial asset's contractual term, adjusted for prepayments. Therefore, the determination of the contractual term will generally significantly affect the size of the allowance for credit losses. In general, the longer the contractual term, the larger the allowance for credit losses.

Certain features of a financial asset can make determining its contractual term more complex, including:

- options to extend the contractual term;
- call options; and
- expected prepayments.

There are also some specific considerations for estimating the life of credit card receivables and determining the contractual term for reasonably expected troubled debt restructurings (TDRs) and net investments in leases.

Historical losses are the starting point

The estimate of expected credit losses is based on relevant information about past events, current economic conditions, and reasonable and supportable forecasts of future economic conditions that affect the collectibility of the reported amounts. Historical loss experience is generally the starting point for estimating expected credit losses.

Adjustments are made to historical loss experience to reflect differences in:

- **asset-specific risk characteristics** – e.g. underwriting standards, portfolio mix or asset terms; and
- **economic conditions** – both current conditions and reasonable and supportable forecasts of future conditions. If an entity is not able to make or obtain reasonable and supportable forecasts of future economic conditions for the entire life of the financial asset, it is required to estimate expected credit losses for the remaining life using an approach that reverts to historical credit loss information.

Recoveries are considered

Subtopic 326-20 requires an entity to write off financial assets that it deems uncollectible. When estimating lifetime expected credit losses, an entity considers expected recoveries of amounts previously written off and expected to be written off. In limited circumstances, this may result in the allowance for credit losses being negative.

Not everything needs an allowance for credit losses

Generally, Subtopic 326-20 requires that an allowance for credit losses be estimated and recognized for financial assets measured at amortized cost within its scope. However, it contains an exception for financial assets with a zero loss expectation.

If there is an expectation that a financial asset will have a zero loss, then an entity is not required to estimate or recognize an allowance for credit losses.

Credit enhancements have a role to play

In developing its estimate of credit losses under Topic 326, an entity considers how credit enhancements that are not freestanding contracts mitigate expected credit losses.

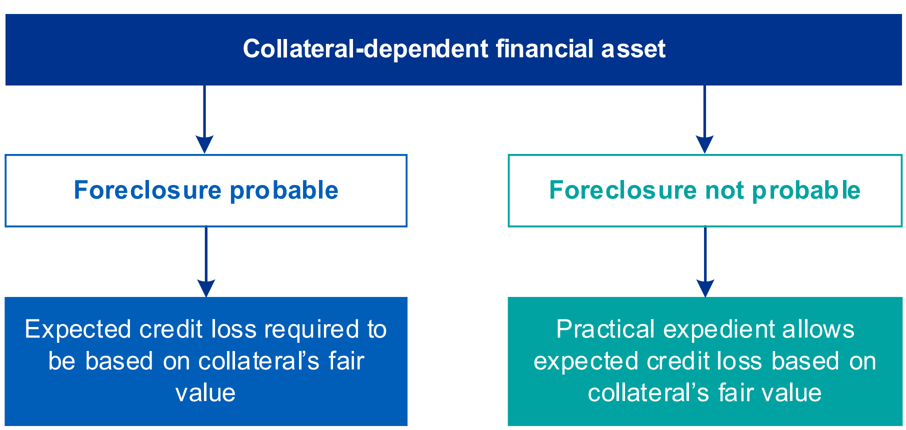
In contrast, an entity recognizes and measures credit enhancements that are freestanding contracts (e.g. credit default swaps) separately from the underlying financial instrument that is subject to Topic 326.

Determining whether a credit enhancement contract is freestanding or is embedded in another financial instrument requires judgment and consideration of all facts and circumstances. We generally expect that practice under legacy US GAAP will continue under Topic 326.

Collateral-dependent assets treated differently

The principles for estimating expected credit losses of collateral-dependent assets differ from the general measurement principles under the expected credit loss model.

A financial asset is collateral-dependent when the debtor is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. Subtopic 326-20 includes specific guidance regarding the estimation of expected credit losses for collateral-dependent financial assets.



Troubled debt restructurings

Before adoption of ASU 2022-02

Topic 326 does not affect how a TDR is defined. However, it does affect the timing of TDR identification and potentially how the allowance for credit losses is determined for a TDR.

If TDRs are included in an entity's historical loss experience, then their estimated effect is included in the initial and subsequent measurement of the allowance for credit losses. TDRs involving principal forgiveness are generally included in an entity's historical loss experience.

If TDRs are not included in an entity's historical loss experience, then their estimated effect is included in the allowance for credit losses only after the entity has a reasonable expectation that a specific financial asset will be modified as a TDR. TDRs involving extensions, more than insignificant delays in payments or interest rate concessions are generally not included in an entity's historical loss experience.

Under legacy US GAAP, credit losses for a TDR are generally estimated using a discounted cash flow method or based on the fair value of the underlying collateral. In contrast, Subtopic 326-20 permits an entity to estimate expected credit losses using different methods; however, a discounted cash flow (or reconcilable) method is required when it is the only method that can capture the effects of the TDR.

After adoption of ASU 2022-02**

ASU 2022-02 eliminates separate recognition and measurement guidance for TDRs, as well as the related guidance in Subtopic 326-20 for measuring credit losses on TDRs.

The guidance for measuring credit losses on TDRs in Subtopic 326-20 continues to apply when an entity adopted ASU 2022-02 using the prospective transition approach. In this situation, certain guidance in Subtopic 326-20 about TDRs applies to loans that:

— were modified in TDRs before adoption; and
— have not been subsequently modified after adoption.

Credit deteriorated assets

Subtopic 326-20 replaces the concept of purchased credit impaired loans (PCI assets) with the concept of purchased financial assets with credit deterioration (PCD assets). An entity records a PCD asset at the purchase price plus the allowance for credit losses expected at the time of acquisition.

Under this method, there is no credit loss expense affecting net income on acquisition. Changes in estimates of expected credit losses after acquisition are recognized as credit loss expense (or reversal of credit loss expense) in subsequent periods as they arise.

There is also specific guidance for PCD beneficial interests and for PCD AFS debt securities.

It's not just assets on the balance sheet

The expected credit loss model under Subtopic 326-20 applies to off-balance sheet credit exposures such as unfunded loan commitments and standby letters of credit.

A liability for expected credit losses for off-balance sheet credit exposures is recognized if both of the following conditions are met:

- the entity has a present contractual obligation to extend the credit; and
- the obligation is not unconditionally cancellable by the entity.

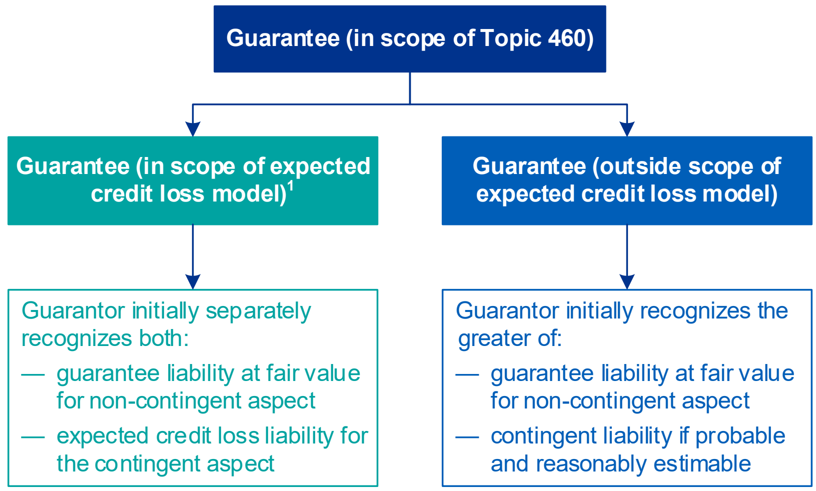
Loan commitments may have a funded and an unfunded portion.

Portion	Accounting
Funded portion	— Expected credit losses are estimated under the same guidance used for estimating expected credit losses for other financial assets in the scope of Subtopic 326-20. — The expected credit losses for funded portions are reported in an allowance for credit losses.
Unfunded portion of loan commitments that are not unconditionally cancellable by the lender	— Expected credit losses are estimated over the contractual term of the loan that will be originated. Subtopic 326-20 requires the estimate of expected credit losses to consider both: – the likelihood that funding will occur; and – an estimate of expected credit losses on commitments expected to be funded. — The expected credit losses for unfunded portions are reported as a liability for off-balance sheet credit losses.
Unfunded portion of loan commitments that are unconditionally cancellable by the lender	An estimate of expected credit losses is not established.

Guarantees can have expected credit losses

Guarantees in the scope of Topic 460 that create off-balance sheet credit exposure for the guarantor are also in the scope of Subtopic 326-20.

The contingent aspect of these guarantees is accounted for separately from the guarantee liability (non-contingent aspect) accounted for under Topic 460. Subtopic 326-20's expected credit loss model is applied to the contingent aspect.



Note:

1. Guarantees that create off-balance sheet credit exposure are within scope of Subtopic 326-20.

Transactions with equity method investees

Topic 326 and Subtopic 323-10 interact when an entity (investor) holding an equity method investment provides additional financial support through financial assets subject to Topic 326 – e.g. a loan to the investee or an investment in debt securities issued by the investee.

Revised credit loss model under Subtopic 326-30

Allowance for credit losses for AFS debt securities

Although Subtopic 326-30 replaces the legacy US GAAP other-than-temporary impairment (OTTI) model with a credit loss model, it retains the OTTI model's fundamental nature – that entities recognize credit losses only once securities become impaired.

Subtopic 326-30 also retains some aspects of the OTTI model, including the requirement to assess AFS debt securities at the individual security level. However, it differs from the OTTI model in the following respects.

New concepts under Subtopic 326-30
— Credit loss recognized through an allowance account, thereby permitting reversals of previously recognized credit losses through net income in the period they occur. — Credit loss limited to difference between security's amortized cost basis and fair value ('fair-value floor'). — Evaluation of whether credit loss exists does not consider: 1. Length of time fair value has been less than amortized cost. 2. Changes in fair value after reporting date. 3. Historical or implied volatility of fair value. — Evaluation of whether a purchased AFS debt security should be considered PCD.

Effects beyond Topic 326

Beneficial interests

Amendments made to Subtopic 325-40 by ASU 2016-13 affect how to account for credit losses on beneficial interests, including how changes in credit losses affect accretable yield.

The appropriate accounting treatment for beneficial interests in the scope of Subtopic 325-40 depends on whether they are classified as HTM or AFS and whether they are PCD beneficial interests.

The credit loss guidance on PCD financial assets applies to a beneficial interest that meets the definition of PCD or that has a significant difference between contractual and expected cash flows when acquired.

The following table summarizes the four different accounting models applicable to beneficial interests that are in the scope of Subtopic 325-40.

Beneficial interests classification	Accounting for PCD assets is applied	Accounting for PCD assets is not applied
Held-to-maturity	Initial estimate of expected credit losses is recognized as an allowance through a gross-up that increases the amortized cost basis of the asset with no effect on net income at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If a favorable change in expected cash flows	No allowance at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If a favorable change in expected cash flows is not fully recognized through a decrease to the allowance (including a negative allowance), the accretable yield

Beneficial interests classification	Accounting for PCD assets is applied	Accounting for PCD assets is <u>not</u> applied
	is not fully recognized through a decrease to the allowance (including a negative allowance), the accretable yield is adjusted on a prospective basis.	is adjusted on a prospective basis.
Available-for-sale	Initial estimate of expected credit losses is recognized as an allowance through a gross-up that increases the amortized cost basis of the asset with no effect on net income at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If the allowance has been reduced to zero (due to favorable changes) or met the fair value floor (due to adverse changes), the accretable yield is adjusted on a prospective basis.	No allowance is recognized at initial recognition. If a decline in fair value below amortized cost results from credit losses, an allowance is recognized through net income. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If the allowance has been reduced to zero (due to favorable changes) or has met the fair value floor (due to adverse changes), the accretable yield is adjusted on a prospective basis.

Subsequent events

Amendments made to Subtopic 855-10 by ASU 2016-13 require that changes in estimates of credit losses arising after the reporting date be considered Type II (disclosure-only) subsequent events. However, in a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff provided its view that information received after the reporting date that is asset-specific information about factual conditions that existed at the reporting date should be reflected in the financial statements.

Additionally, the SEC staff provided its view about information received after the reporting date that relates to forecasting assumptions. The staff indicated that whether the information should be reflected in the financial statements depends on whether it indicates there was a weakness or deficiency in the entity's estimation process.

— If there was a weakness or deficiency, the information should be reflected in the financial statements.

— If there was not a weakness or deficiency, the approach depends on when the information was received.

  – If the information was received *before* the estimation process was complete, the entity may choose whether or not to reflect the information in the financial statements.

– If the information was received *after* the estimation process was complete, the entity should not reflect the information in the financial statements.

Income taxes

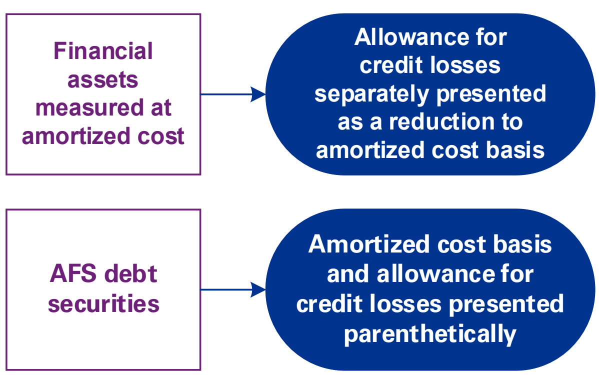
Topic 326 does not contain tax accounting guidance and ASU 2016-13 made no amendments to Topic 740. Nevertheless, the adoption of Topic 326 will likely affect the calculation of an entity's deferred tax assets.

We expect that the following aspects of Topic 326 will have the most significant effect on an entity's accounting for deferred taxes compared to legacy US GAAP.

- The recognition and measurement guidance in Topic 326 will generally increase the allowance for credit losses and therefore the related deferred tax asset will also increase.
- It is not yet clear whether an allowance for credit losses established for an AFS debt security will result in a deferred tax asset. However, if it will, any subsequent reversals of credit losses recognized under Subtopic 326-30 for the AFS debt security when the expected cash flows or fair value floor increase will result in a need to adjust the related deferred tax asset.
- For PCD assets, the amount of any net book-tax basis difference on the acquisition date will likely be the same under Topic 326 as it would have been under legacy US GAAP. Subsequent to the acquisition date, there will be book-tax differences due to differences in the timing and amount of income recognized for book and tax purposes and the timing of tax deductions related to changes to the allowance for credit losses.

New presentation and expanded disclosures

Financial assets measured at amortized cost and AFS securities are presented differently under Topic 326.



Topic 326 requires disclosure of both qualitative and quantitative information about an entity's financial assets and the allowance for credit losses. Some of the disclosure requirements are new and others were retained from legacy US GAAP. The retained disclosure requirements mostly relate to an entity's credit risk exposures and evaluation of the appropriateness of the allowance for credit losses. However, the financial assets to which the retained disclosures apply may be different under Topic 326 than under legacy US GAAP.

Transition approach

Adoption of ASU 2016-13 (and related amendments other than amendments in ASU 2022-02)

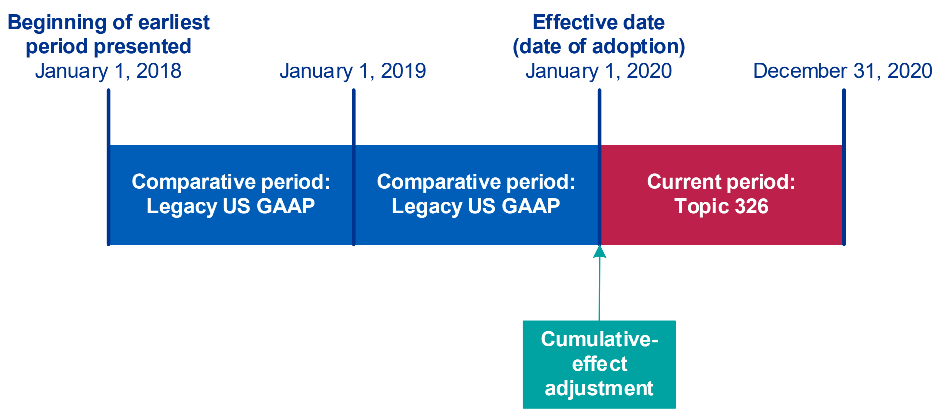
An entity records a cumulative effect adjustment in retained earnings in the balance sheet as of the beginning of the year of adoption of Topic 326.

Additional transition guidance is applicable for the following:

— assets previously accounted for as PCI assets under Subtopic 310-30, including where an entity had applied that guidance by analogy; and

— debt securities for which OTTI had been recognized before adoption of Topic 326.

If a calendar year-end PBE that is an SEC filer adopts Topic 326 in accordance with the mandatory effective date, then the following are the relevant dates.



Adoption of ASU 2022-02**

An entity generally applies ASU 2022-02 prospectively after the first day of the fiscal year of adoption.

However, related to the elimination of recognition and measurement of TDRs, an entity can elect to apply the ASU on a modified retrospective basis to recognize any change in the allowance for credit losses that had been recognized for receivables previously modified (or reasonably expected to be modified) in a TDR.

2. Scope of Subtopic 326-20

Detailed contents

2.1 How the standard works

The expected credit loss guidance in Topic 326 applies to all entities. It is divided into two substantive subtopics – Subtopic 326-20 and Subtopic 326-30 – each of which contains a different credit loss model.

This chapter discusses the types of financial assets in the scope of Subtopic 326-20.

	Does Subtopic 326-20 apply?
Financial assets measured at amortized cost	✓
Net investment in leases	✓
Off-balance sheet credit exposures not accounted for as insurance	✓
AFS debt securities	Subtopic 326-30 applies[1]
Financial assets measured at fair value through net earnings	✗

Note:

1. The FASB decided that the measurement attribute for AFS debt securities necessitated a separate credit loss model. Subtopic 326-30 is discussed in chapter 19.

2.2 Instruments in scope

2.2.10 Overview

Excerpt from ASC 326-20

> Instruments

15-2 The guidance in this Subtopic applies to the following items:

a. Financial assets measured at amortized cost basis, including the following:
   1. **Financing receivables**
   2. Held-to-maturity **debt securities**
   3. 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
   4. Subparagraph superseded by Accounting Standards Update No 2019-04.
   5. Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860
b. Net investments in leases recognized by a lessor in accordance with Topic 842 on leases
c. Off-balance-sheet credit exposures not accounted for as insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815 on derivatives and hedging
d. **Reinsurance recoverables** that result from insurance transactions within the scope of Topic 944 on insurance.

20 Glossary

Financing Receivable – A financing arrangement that has both of the following characteristics:

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

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

Excerpt from ASC 310-10

>>> Meaning of *Financing Receivable*

55-13 This implementation guidance addresses the meaning of the term financing receivable.

55-14 All of the following are examples of **financing receivables**:

a. Loans
b. Trade accounts receivable
c. Notes receivable
d. Credit cards
e. Receivables relating to a lessor's right(s) to payment(s) from a **leveraged lease** that should be recognized as an asset in accordance with paragraphs 842-10-65-1(z)…
f. **Lease receivables** arising from **sales-type leases** or **direct financing leases**.

55-15 None of the following meet the definition of financing receivables:

a. **Debt securities** within the scope of Topic 320 (see the guidance beginning in paragraph 320-10-15-5)
b. Unconditional promises to give (for example, contributions receivable) that should be recognized as an asset in accordance with paragraphs 958-605-25-7 through 25-15
c. Both of the following instruments, which are within the scope of Subtopic 5-25-7 through 25-15 325-40:
    1. A transferor's interests in securitization transactions that are accounted for as sales under Topic 860
    2. Purchased beneficial interests in securitized financial assets.

For related guidance, see paragraph 325-40-15.

The guidance on expected credit losses in Subtopic 326-20 applies to many assets measured at amortized cost. As discussed in section 2.3, certain instruments are excluded from the scope of Subtopic 326-20. [326-20-15-2]

Question 2.2.10

Are cash equivalents in the scope of Subtopic 326-20?

Interpretive response: It depends. Cash equivalents are short-term highly liquid investments that are:

— readily convertible to known amounts of cash; and
— so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. [305-10 Glossary]

Cash equivalents may include US Treasury bills, commercial paper, money market funds, certificates of deposit, balances with the Federal Reserve Banks and the Federal Home Loan Banks and federal funds sold.

Cash equivalents that are financial assets measured at amortized cost (e.g. US Treasury bills) are in the scope of Subtopic 326-20. Nevertheless, if there is an expectation that a financial asset will have a zero loss (i.e. a 'zero loss expectation'), an entity is not required to estimate expected credit losses for these instruments. For a discussion of how to determine whether the zero loss expectation exception applies to a financial asset, see chapter 8.

Question 2.2.20

Is preferred stock in the scope of Topic 326?

Interpretive response: It depends. The legal form of an instrument does not always determine whether a security should be accounted for as an equity security (in the scope of Topic 321) or a debt security (in the scope of Topic 326).

Preferred stock that meets the definition of a debt security is in the scope of Subtopic 326-20 (if classified as HTM) and Subtopic 326-30 (if classified as AFS).

The definition of a debt security includes preferred stock that, by its terms, either: [320-10 Glossary]

— must be redeemed by the issuing entity; or
— is redeemable at the option of the holder.

Additionally, the definition of equity securities specifically excludes preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor. [320-10 Glossary]

We believe that for a preferred share that is redeemable at the option of the investor to be classified as a debt security (in the scope of Topic 326), the investor must have the unilateral ability to redeem its investment. Additionally, the investor's determination of whether an investment in preferred stock meets the definition of a debt or equity security will not necessarily align with the issuer's balance sheet classification. For example, there may be instances where the investor concludes that its investment in a preferred share meets the definition of a debt security, while the issuer classifies the preferred share as equity (e.g. temporary equity) in its financial statements.

The following chart illustrates different preferred stock redemption options, the associated classification, and whether we believe it is in the scope of Topic 326.

Preferred share redemption option	Classification
Redemption option is currently exercisable by the investor	Debt security (in scope of Topic 326)
Redemption option is time-based – i.e. it will become exercisable by the investor following the passage of time	Debt security (in scope of Topic 326)
Redemption option will become exercisable by the investor on the occurrence of a contingent event outside the investor's control	Equity security (outside scope of Topic 326)

Question 2.2.30

Are perpetual preferred securities in the scope of Subtopic 326-20?

Interpretive response: No. As discussed in Question 2.2.20, preferred stock that neither requires redemption by the issuer nor is redeemable at the option of the holder is an equity security and is therefore outside of the scope of Subtopic 326-20.

Perpetual preferred securities are often issued in equity form but possess significant debt-like characteristics, such as periodic dividends and issuer call features. Therefore, their credit ratings are similar to debt securities and they are priced similarly to callable bonds.

Before the issuance of ASU 2016-13, the SEC staff had issued guidance relating to the assessment of OTTI of equity securities – such as high-quality perpetual preferred stock – that are similar to debt instruments. The SEC staff indicated that because of the challenges with assessing OTTI for perpetual preferred stock, it would not object to applying an impairment model (including an anticipated recovery period) similar to the model applicable to debt securities if there has been no evidence of deterioration in the credit of the issuer. However, the perpetual preferred stock would otherwise continue to be treated as an equity security by the holder.

Because perpetual preferred securities are equity securities, the guidance in Topic 321 – created by ASU 2016-01 (Recognition and Measurement of Financial Assets and Financial Liabilities) – applies. These securities are measured at fair value through net income unless they do not have a readily determinable fair value and the measurement alternative described in paragraph 321-10-35-2 is elected. If the measurement alternative is elected, these securities are subject to the specific impairment guidance in Subtopic 321-10. See KPMG Handbook, Investments. [321-10-35-1 – 35-4]

Question 2.2.40

Are held-for-sale loans in the scope of Subtopic 326-20?

Interpretive response: No. Held-for-sale loans are not in the scope of Subtopic 326-20 because they are reported at the *lower of* amortized cost or fair value, rather than *at* amortized cost. A valuation allowance is recorded for the amount by which the amortized cost basis of a held-for-sale loan exceeds its fair value. [948-310-35-2]

See section 3.2.20 for considerations when a loan is transferred into or out of the held-for-sale category, including the effect on the related valuation allowance or allowance for credit losses, as applicable.

Question 2.2.50

Are investments in bank-owned or corporate-owned life insurance policies in the scope of Subtopic 326-20?

Interpretive response: No. Investments in bank-owned life insurance (BOLI) or corporate-owned life insurance (COLI) policies are not in the scope of Subtopic 326-20 because they are not measured at amortized cost.

Investments in BOLI and COLI are subject to the guidance in Subtopic 325-30 (investments in insurance contracts). Subtopic 325-30 requires these investments to be measured at the amount that could be realized under the life insurance contract. That amount includes consideration of amounts included in the contractual terms of the policy, such as cash surrender value, deferred acquisition costs, tax, and claims stabilization reserves. [325-30-30-1, 35-1, 55-1]

This measurement does not represent amortized cost and these investments are not otherwise included in the scope of Subtopic 326-20.

Question 2.2.60

Are tax receivables from taxing authorities in the scope of Subtopic 326-20?

Excerpt from ASC 326-20

20 Glossary

Financial Asset – Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

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

Interpretive response: Generally, no. To be a financial asset, a receivable must result from a contractual right. In contrast, a tax receivable from a taxing authority (e.g. a refund resulting from overpayment of income taxes) generally is not the result of a contract. Rather, it is the result of a taxing authority's legal right to impose a tax on the taxpayer. Because tax receivables that do not arise from a contract are not financial assets and are not otherwise included, they are not in the scope of Subtopic 326-20.

In contrast, when a tax receivable from a taxing authority is incorporated into a contract that meets the definition of a financial asset, that financial asset is subject to Subtopic 326-20. Examples include tax receivables that have been contractually reduced to a fixed payment schedule through: [860-10-55-10 – 55-11]

— contractual settlement agreements; or
— judgments from litigation that are enforceable by a government or a court of law.

Question 2.2.70

Is an off-balance-sheet credit exposure in the scope of Subtopic 326-20 if it relates to a financial asset that is not?

Interpretive response: Yes, we believe such a credit exposure is generally in the scope of Subtopic 326-20 unless it is explicitly excluded (see section 2.3.10).

Subtopic 326-20 specifically includes in its scope "credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815." The off-balance sheet exposures described in this scope inclusion are not limited to exposures relating to financial assets in the scope of Subtopic 326-20. [326-20-15-2(c)]

Example 2.2.10

Guarantees of operating lease payments to the lessor

ABC Corp. is the lessee in a lease of retail space classified as an operating lease. ABC sells its retail operations to XYZ Corp. and assigns the operating lease to XYZ – i.e. it substitutes XYZ for itself in the lease agreement.

Lessor permits that assignment such that ABC is relieved of the primary obligation under the original lease. However, ABC remains secondarily liable for making the lease payments to Lessor in the event of XYZ's non-performance – i.e. ABC guarantees XYZ's payment of amounts payable to Lessor under the lease agreement. This guarantee results in ABC having off-balance sheet credit exposure. ABC concludes that the guarantee is not in the scope of Topic 815.

Although Lessor's operating lease receivables are outside the scope of Subtopic 326-20 (see section 2.3.10), ABC's guarantee of those amounts is not explicitly excluded from the scope of Subtopic 326-20. Therefore, because it is not in the scope of Topic 815, ABC's guarantee of Lessor's operating lease payments from XYZ is in the scope of Subtopic 326-20.

Question 2.2.80

Are supplier advances in the scope of Subtopic 326-20?

Background: Some entities are required under their supply arrangements to advance amounts to suppliers as prepayment of expected future deliveries of goods or services (referred to as 'supplier advances'). These prepayments may be provided for a variety of reasons, including to protect the supplier against nonpayment or to cover the supplier's out-of-pocket costs for supplying the service or product. Under the terms of the arrangement, the supplier is not required to refund the advance unless it fails to deliver the agreed upon goods or services. The entity that makes the advance recognizes an asset when the payment is made.

Interpretive response: No. The asset recognized by the entity relates to its right to receive goods or services from the supplier. It does not represent a financial asset because it does not convey to the entity a right to receive cash or another financial instrument, or to exchange other financial instruments. Because a supplier advance is not a financial asset and is not otherwise included in the scope of Subtopic 326-20, it is outside the scope of that Subtopic. [326-20 Glossary]

Question 2.2.90

Are repurchase arrangements related to transferred loans in the scope of Subtopic 326-20?

Background: Bank (the transferor) originates residential mortgage loans for sale or securitization in secondary market transactions. Those transfers are accounted for as sales under Topic 860. In connection with the transfers, Bank has certain contingent arrangements to repurchase the loans from the transferees. The repurchase price is an amount greater than the fair value of the loans.

Interpretive response: We believe a repurchase arrangement is in the scope of Subtopic 326-20 if all of the following conditions are met.

— If the repurchase arrangement arose from a previous transfer, the transfer was accounted for as a sale under Topic 860.
— The contingent event triggering the repurchase arrangement is credit-related. [326-20-15-2(c)]
— The obligation to repurchase is outside the transferor's control. We believe this condition must be met because an entity does not estimate a liability for off-balance sheet credit exposures when the entity can unconditionally cancel the obligation (see section 13.3.10).
— The repurchase arrangement is not accounted for as a derivative instrument in the scope of Topic 815.

The following table summarizes examples of common repurchase arrangements and whether each is in the scope of Subtopic 326-20. The examples assume that the related transfer is appropriately accounted for as a sale under Topic 860.

Description	In scope of Subtopic 326-20?
Standard representations and warranties[1]	
Bank makes representations and warranties to the transferees about the sold loans. Those representations and warranties specifically relate to: — the underwriting standards that were followed in originating the loans; and — the accuracy and completeness of the loan documents.	No. We believe the contingent event triggering repurchase arrangements related to standard representations and warranties is an operational / legal risk and not credit related. [326-20-55-81– 55-82] The transferee can require Bank to repurchase a loan under this arrangement regardless of whether a credit-related

Description	In scope of Subtopic 326-20?
When the transferee determines that a standard representation or warranty has been breached, it can require Bank to repurchase the loan.	event (e.g. a default or other deterioration in credit quality since origination) has occurred.
Default call option (held by transferor)	
Bank has an option to repurchase a loan if the borrower defaults.	No. Although this arrangement is triggered by a credit-related event, we believe it is not in the scope of Subtopic 326-20 because the arrangement to repurchase the defaulted loan is at Bank's sole discretion.
Default put option (held by transferee)	
Bank provides the transferee with an option to require Bank to repurchase a loan if the borrower defaults.	Yes. This arrangement is triggered by a credit-related event (i.e. borrower default) and is unilaterally exercisable by the transferee (i.e. not in Bank's control). As a result, we believe the arrangement is in the scope of Subtopic 326-20. Further, such an arrangement represents a financial guarantee under Topic 460 (see chapter 14). For an illustration of the accounting for a default put option, see Example 14.4.10.

Note:

1. Standard representations and warranties are those that assert that the financial asset being transferred is what it is purported to be at the transfer date. [860-10 Glossary]

Question 2.2.100

Are indemnification assets arising from business combinations in the scope of Subtopic 326-20?

Excerpt from ASC 805-20

25-27 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

35-4 At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

Background: Topic 805 requires a valuation allowance for uncollectible amounts to be created for an indemnification asset arising from a business combination but does not specify what guidance should be applied to measure the allowance. [805-20-25-27]

Interpretive response: It depends. We believe indemnification assets are in the scope of Subtopic 326-20 only when the indemnified item is a financial asset measured at amortized cost.

This is because Subtopic 326-20 applies to financial assets measured at amortized cost. Indemnification assets are measured on the same basis as the indemnified item. Therefore, they are not measured based on amortized cost unless the indemnified item is a financial asset measured at amortized cost.

For further discussion of the accounting for indemnification assets in business combinations, see paragraphs 7.168 – 7.173a of KPMG Handbook, Business combinations.

Question 2.2.110

Are guarantees between entities under common control that relate to a third-party credit exposure in the scope of Subtopic 326-20?

Interpretive response: Yes. Subtopic 326-20 does not specifically address guarantees between entities under common control. However, we believe such guarantees are in the scope of Subtopic 326-20 if they relate to third-party credit exposure.

Financial guarantees that are off-balance sheet credit exposures are in the scope of Subtopic 326-20 if they are not accounted for as insurance contracts or derivatives. Conversely, loans and receivables between entities under common control are not in scope. However, this scope exception relates to credit exposure to another entity in a common control group. A guarantee between common control entities that relates to a third-party credit exposure is significantly different. Therefore, we believe Subtopic 326-20 applies to common control guarantees that relate to a third-party credit exposure. [326-10-15-3, 326-20-15-2(c)]

Example 2.2.20

Accounting for guarantees between entities under common control that relates to third-party credit exposure

Subsidiary A and Subsidiary B are wholly owned consolidated subsidiaries of Parent, which makes them entities under common control. Parent issues consolidated financial statements and Subsidiary A and Subsidiary B issue stand-alone financial statements.

Subsidiary A makes a loan to an unrelated third-party entity. Subsidiary B (guarantor) guarantees this loan such that if the third-party borrower fails to repay, Subsidiary B will reimburse Subsidiary A. The guarantee is not accounted for as a derivative.

Subsidiary B estimates credit losses for the guarantee for purposes of its stand-alone financial statements because the guarantee is an off-balance sheet credit exposure in the scope of Subtopic 326-20.

2.3 Explicit scope exclusions

2.3.10 Overview

Excerpt from ASC 326-20

> Instruments

15-3 The guidance in this Subtopic does not apply to the following items:

a. Financial assets measured at **fair value** through net income
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
e. Promises to give (pledges receivable) of a not-for-profit entity
f. Loans and receivables between entities under common control.
g. Receivables arising from operating leases accounted for in accordance with Topic 842.

The following are observations about the explicit scope exclusions from Subtopic 326-20. [326-20-15-3]

Scope exclusions	Observations
Financial assets measured at fair value through net income	The exclusion of financial assets measured at fair value through net income is consistent with legacy US GAAP.
AFS debt securities	AFS debt securities are accounted for under Subtopic 326-30 rather than Subtopic 326-20.

Scope exclusions	Observations
	Subtopic 326-30 contains targeted changes to the legacy impairment guidance for AFS debt securities (see chapter 19).
Loans made to participants by defined contribution employee benefit plans	Subtopic 962-310 provides industry-specific guidance for these loans.
Policy loan receivables of an insurance entity	Topic 944 provides industry-specific guidance for insurance entities.
Pledge receivables of a not-for-profit entity	Subtopics 958-310 and 958-605 provide industry-specific not-for-profit entity guidance for contributions of cash and other assets received, including promises to give.
Loans and receivables between entities under common control	The FASB decided to exclude loans and receivables between entities under common control from the scope of Subtopic 326-20. This was in response to concerns raised by the Private Company Council that some related party loans may be viewed as capital contributions rather than loans to be repaid. [ASU 2016-13.BC31] Loans and receivables between related parties – other than those in common control situations – are in the scope of Subtopic 326-20.
Receivables arising from operating leases	The FASB decided to exclude receivables arising from operating leases from the scope of Subtopic 326-20. This is because Topic 842 has measurement guidance for operating lease receivables, including when collectibility is not probable. [ASU 2018-19.BC13]

In addition to the specific scope exclusions, servicing rights are also not in the scope of Subtopic 326-20 because they are nonfinancial assets or liabilities. Servicing rights are subsequently measured at fair value or under the amortization method. Under the amortization method, impairment on servicing assets is recognized through a valuation account at an amount by which the carrying amount for a stratum exceeds its fair value. [860-50-35]

Question 2.3.10

Is there a difference in the timing and amount of credit losses when a debt security is classified as HTM rather than AFS?

Interpretive response: Under Topic 326, there may be significant differences in the timing and amount of credit losses recognized for debt securities classified as HTM (Subtopic 326-20 applies) versus AFS (Subtopic 326-30 applies).

Credit losses for a security classified as HTM will generally be recognized earlier than if the security is classified as AFS. This is because lifetime expected credit losses are recognized for HTM securities upon purchase, while credit losses for

AFS debt securities are recognized only once they have occurred. [326-20-30, 326-30-35]

Question 2.3.20

When does the scope exclusion for loans and receivables between entities under common control apply?

Interpretive response: The term 'common control' is not defined in the Master Glossary and it is applied in multiple contexts throughout the Codification. In finalizing its 2015 amendments to the consolidation analysis in Topic 810 (consolidation), the FASB noted that its intent was for the term in the context of Topic 810 "to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent." We believe this guidance applies under Subtopic 326-20. [ASU 2015-02.BC69]

Additionally, although a consensus was not reached on EITF Issue No. 02-5 regarding business combinations, we believe that an entity should also consider the discussion related to that EITF Issue.

In particular, the SEC staff indicated in EITF 02-5 that common control also exists among separate entities in the following circumstances:

— Immediate family members collectively hold a controlling financial interest in each entity, and there is no evidence that those family members will exercise their decision-making rights in any way other than in concert.

— A group of shareholders holds a controlling financial interest in each entity, and contemporaneous written evidence of an agreement to exercise their decision-making rights in concert exists.

Question 2.3.30

Are assets that arise from recognizing lease income on a straight-line basis in the scope of Subtopic 326-20?

Background: In an operating lease, the lessor recognizes lease income on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset. If the lease payments escalate over the lease term, the lessor recognizes an accrued rent asset in the periods that lease income exceeds the contractual rent payment. The asset is eliminated in later periods when the opposite is true. [842-30-25-11]

Interpretive response: No. We believe assets that arise from recognizing lease income on a straight-line (or other systematic and rational) basis are not financial assets. As a result, they are excluded from the scope of Subtopic 326-20.

2.4 Interaction with other recently issued standards

2.4.10 Overview

Topic	Interaction with credit loss standard (ASU 2016-13)
Revenue from contracts with customers (Topic 606)	The scope of Subtopic 326-20 specifically includes receivables that result from revenue transactions in the scope of Topic 606. Topic 606 initially stated that an entity assesses a contract asset for impairment under Topic 310 on receivables. ASU 2016-13 amended Topic 606 to require an entity to estimate credit losses for both receivables and contract assets under Subtopic 326-20. [326-20-15-2(a)(3), 606-10-45-3 – 45-4] — *Receivables* are unconditional rights to consideration. A right is unconditional if only the passage of time is required before payment becomes due. — *Contract assets* are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time. Subtopic 326-20 cannot be early adopted by calendar year-end entities before January 1, 2019, and the new revenue standard becomes effective for PBEs before that date. Therefore, many entities will not initially apply the provisions of Subtopic 326-20 when the new revenue standard is first applied. [606-10-65, 326-10-65] For further discussion of the impairment of trade receivables, see chapter 18. For further discussion of the new revenue standard, see KPMG Handbook, Revenue recognition.
Leases (Topic 842)	Net investments in leases recognized by the lessor under Topic 842 are in the scope of Subtopic 326-20. Receivables arising from operating leases are excluded from the scope of Subtopic 326-20. See section 2.3.10, including Question 2.3.30. An entity can early adopt the new leases standard at any time after its issuance. An entity could adopt both the new leases standard and Subtopic 326-20 in the same reporting period. For example, a PBE with a calendar year-end could early adopt Subtopic 326-20 in 2019 to coincide with the required adoption of the leases standard. [326-20-15-2(b), 842-10-65, 326-10-65] For further discussion of the impairment of net investments in leases, see chapter 16. For further discussion of the new leases standard, see KPMG Handbook, Leases.

Topic	Interaction with credit loss standard (ASU 2016-13)
Recognition and measurement of financial assets and financial liabilities (Topic 321)	Equity securities are in the scope of Topic 321 and not Topic 326. Topic 321 requires equity securities that have readily determinable fair values to be measured at fair value through net income. Entities have the option to measure equity securities without readily determinable fair values at either fair value through net income, or at cost adjusted for changes in observable prices minus impairment. Topic 321 provides impairment guidance for these investments. [321-10-35-1 – 35-4] For further discussion of the accounting for equity instruments, see KPMG Handbook, Investments.

3. Recognition of expected credit losses, writeoffs and recoveries

Detailed contents

Item significantly updated in this edition: #

Example

Comparison to legacy US GAAP

3.1 How the standard works

Subtopic 326-20 requires lifetime expected credit losses of a financial asset to be recognized when the asset is purchased or originated.

The following are the significant differences in the recognition principles of this expected credit loss model and the impairment model in legacy US GAAP.

Legacy US GAAP	Subtopic 326-20
Loans	
Incurred losses – probability threshold. [310-10-35-4]	Lifetime losses – no recognition threshold.
HTM debt securities	
Other-than-temporary impairment. [320-10-35-34]	Lifetime losses – no recognition threshold.
Credit losses reduce amortized cost basis. [320-10-35-34]	Credit losses recognized using an allowance approach.
Prospectively adjust accretable yield if expectations of cash flows improve significantly subsequent to impairment recognition. [320-10-35-35]	Recognize subsequent changes in expected credit losses (favorable and unfavorable) immediately in net income by adjusting the allowance.

Subtopic 326-20 requires an entity to write off financial assets that it deems uncollectible. When estimating lifetime expected credit losses, an entity considers expected recoveries of amounts previously written off and expected to be written off. In limited circumstances, this may result in the allowance for credit losses being negative.

3.2 Recognition of allowance for credit losses

3.2.10 Overview

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

30-1 The allowance for credit losses is a valuation account that is deducted from the **amortized cost basis** of the **financial asset(s)** to present the net amount expected to be collected on the financial asset. Expected recoveries of amounts previously written off and expected to be written off shall be included in the valuation account and shall not exceed the aggregate of amounts previously written off and expected to be written off by an entity. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

> Reporting Changes in Expected Credit Losses

35-1 At each reporting date, an entity shall record an allowance for credit losses on **financial assets** (including **purchased financial assets with credit deterioration**) within the scope of this Subtopic. An entity shall compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded. An entity shall 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). The method applied to initially measure expected credit losses for the assets included in paragraph 326-20-30-14 generally would be applied consistently over time and shall faithfully estimate expected credit losses for financial asset(s).

On initial recognition and at each reporting date, an entity recognizes an allowance for remaining lifetime expected credit losses. The allowance is deducted from the amortized cost basis of a financial asset or a group of financial assets so that the balance sheet reflects the net amount an entity expects to collect. Subsequent changes (favorable and unfavorable) in expected credit losses are recognized immediately in net income as a credit loss expense or a reversal of credit loss expense. See chapter 23 for presentation guidance. [326-20-30-1, 35-1]

Question 3.2.10

Is there a recognition threshold for credit impairment under Subtopic 326-20?

Interpretive response: No. Recognition of credit impairment is no longer based on a recognition threshold such as the probability threshold in legacy US GAAP, under which an impairment loss for a loan is not recognized until the loss is probable of being incurred. Removing this threshold results in earlier recognition of expected credit losses because all losses expected over an asset's life are recorded before they are probable of occurring – even if the likelihood of a loss is remote. [310-10-35-4, 450-20-25-2(a)]

Because of the lack of a recognition threshold, an allowance for credit losses – and the related credit loss expense recognized in net income – is generally recognized at the first reporting date following the purchase or origination of a financial asset. This has the practical effect of recognizing a Day 1 loss in net income when an entity originates a financial asset or purchases a non-credit deteriorated financial asset that is in the scope of Subtopic 326-20. Purchased financial assets with credit deterioration (PCD) are accounted for differently, as discussed in chapter 12. [ASU 2016-13.BC48]

Comparison to legacy US GAAP

Effect of adoption of Subtopic 326-20 on allowance for credit losses and related earnings measures

Under legacy US GAAP, many entities have processes for estimating the allowance for loan losses under the incurred loss model that result in some allowance being established in the period that the loan is originated or purchased.

Because Topic 326 replaces the incurred loss model with a requirement to recognize lifetime expected credit losses, the allowance for credit losses is generally expected to increase on adoption of Subtopic 326-20. However, other factors may offset (fully or partially) that increase – e.g. Subtopic 326-20 requires an entity to consider expected recoveries of amounts previously written off. The amount of the change in the allowance will depend on many factors, including the remaining contractual term of the portfolio and the forecasted future economic conditions – e.g. position in the credit cycle.

Because an entity will immediately recognize lifetime expected credit losses when it originates or purchases financial assets, changes in the volume of loan originations or purchases of non-credit deteriorated loans and HTM debt securities will likely affect the comparisons of an entity's earnings measures between periods and/or with other entities.

We expect the amount of expected credit losses immediately recognized through net income may be significantly greater for longer duration loan portfolios. Further, the immediate recognition of expected credit losses for HTM debt securities will be a change for all entities. As a result, preparers, analysts and other stakeholders may want to understand the effect on key earnings measures of originating loans or acquiring loans and debt securities in a particular period.

Question 3.2.20

What regulatory capital effect will Topic 326 have on financial institutions?

Interpretive response: Regulated entities such as banks and insurance entities may need to consider the effect that Topic 326 may have on regulatory capital requirements. The Agencies' FAQs on Topic 326 note that upon initial adoption, the earlier recognition of credit losses will likely increase allowance levels and lower the retained earnings component of equity, thereby lowering common equity tier 1 capital of banks and thrifts for regulatory capital purposes. However, for credit unions, although Topic 326 will affect retained earnings and will likely lower regulatory net worth it will not affect the measurement of risk-based capital under the National Credit Union Administration's rules that become effective in 2019. [Agency FAQs #18]

In December 2018, the federal bank regulatory agencies approved a final rule that modifies their regulatory capital rules and provides institutions the option to phase in over three years any Day 1 regulatory capital effects of Topic 326. [Agency FAQs #18]

Question 3.2.25

How does a transferor account for the allowance for credit losses associated with a transfer of financial assets accounted for as a sale?

Background: In a transfer of financial assets accounted for as a sale, a transferor: [860-20-40-1A - 40-1B]

- derecognizes the financial asset;
- recognizes assets obtained and liabilities incurred (net proceeds) in the sale at fair value; and
- recognizes any gain or loss in earnings, calculated as the difference between the net proceeds received and the carrying amounts of the financial assets derecognized.

Chapter 7 of KPMG Handbook, Transfers and servicing of financial assets, includes guidance on the accounting for transfers of financial assets that qualify as a sale.

Interpretive response: A loan classified as held-for-investment is reclassified to held-for-sale when an entity decides to sell a loan. Therefore, when an entity decides to sell a financial asset in a transfer accounted for as a sale, it first applies the guidance on transfers from held-for-investment to held-for-sale. Therefore, an entity:

- reverses in earnings any allowance for credit losses previously recorded on the loan;
- reclassifies and transfers the loan into the held-for-sale classification at its amortized cost basis; and
- determines whether a valuation allowance is necessary by following the guidance in Subtopic 310-10 or 948-310, as applicable.

Therefore, the allowance for credit losses does not impact the gain or loss on sale amount recognized in earnings. [310-10-35-48A, 948-310-35-2A]

Example 3.2.05

Sale of a group of entire financial assets

ABC Corp. holds a group of trade receivables that are classified as held-for-investment. ABC decides to sell trade receivables with an unpaid principal balance of $100,000. Accordingly, it reclassifies the trade receivables to held-for-sale. Based on its policy, ABC determines that the receivables were not uncollectible and did not have significant credit deterioration.

ABC transfers the receivables to an unconsolidated securitization entity for $98,000 in cash and a beneficial interest in the securitization trust. ABC continues to service the transferred receivables.

The $100,000 of receivables have unamortized deferred origination costs (net) of $5,000 resulting in a carrying amount of $105,000. The allowance for credit losses is $1,500.

ABC determines that the fair values of the beneficial interest and servicing asset are $10,000 and $2,000, respectively.

ABC determines that the transfer meets the criteria to be accounted for as a sale. It calculates the gain on the sale of the receivables as follows.

Fair value of assets obtained in the sale (and calculation of net proceeds)	
Cash	$98,000
Beneficial interest	$10,000
Servicing asset	$2,000
Fair value of assets obtained (net proceeds)	**$110,000**

Calculation of the gain (loss) on sale	
Fair value of assets obtained in the sale (net proceeds)	$110,000
Less: Carrying amount of transferred receivables	($105,000)
Gain on sale of receivables	**$5,000**

ABC records the following journal entry to account for the transfer from held-for-investment to held-for-sale.

	Debit	*Credit*
Allowance for credit losses	1,500	
Credit loss expense		1,500
To reverse existing allowance for credit losses on held-for-investment receivables.		

	Debit	Credit
Receivables – held-for-sale	100,000	
Deferred origination costs (net) – held-for-sale	5,000	
Receivables – held-for-investment		100,000
Deferred origination costs (net) – held-for-investment		5,000
To record transfer of receivables from held-for-investment to held-for-sale.		

ABC records the following journal entry to account for the transfer of these receivables to an unconsolidated securitization entity.

	Debit	Credit
Cash	98,000	
Beneficial interest	10,000	
Servicing asset	2,000	
Receivables – held-for-sale		100,000
Deferred origination costs (net) – held for sale		5,000
Gain on sale		5,000
To derecognize carrying amount of assets sold, recognize fair value of assets obtained and recognize gain on sale.		

3.2.20 Considerations for loans transferred between categories#

Excerpt from ASC 326-20

> Loans Subsequently Identified for Sale

35-7 Once a decision has been made to sell **loans** not currently classified as held for sale, those loans shall be transferred into the held-for-sale classification. See paragraph 310-10-35-48A for guidance on transfers of nonmortgage loans between classifications and see Topic 948 for guidance on transfers of mortgage loans between classifications. The application of the writeoff guidance in paragraph 326-20-35-8 may result in a portion of the amortized cost basis being written off before the loan has been transferred to the held-for-sale classification.

Excerpt from ASC 310-10

>> Transfers of Nonmortgage Loans between Classifications

35-48A For a nonmortgage loan that is transferred into the held-for-sale classification from the nonmortgage loan not-held-for-sale classification, an entity shall reverse in earnings any allowance for credit losses previously recorded on the nonmortgage loan not held for sale at the transfer date. An entity shall then reclassify and transfer the nonmortgage loan into the held-for-sale classification at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses). An entity shall then determine if a valuation allowance is necessary by following the guidance in Subtopic 310-10.

35-48B For a nonmortgage loan that is transferred into the not-held-for-sale classification from the nonmortgage loans held-for-sale classification, an entity shall reverse in earnings any valuation allowance previously recorded on the nonmortgage loan held for sale at the transfer date. An entity shall then reclassify and transfer the nonmortgage loan into the not-held-for-sale classification at its amortized cost basis (which is reduced by any previous writeoffs but excludes any valuation allowance). An entity shall then determine if an allowance for credit losses is necessary by following the guidance in Subtopic 326-20.

> Nonmortgage Loans or Trade Receivables

45-2 Nonmortgage loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables held for sale shall be a separate balance sheet category. Major categories of nonmortgage loans or trade receivables shall be presented separately either in the balance sheet or in the notes to financial statements. An entity shall present the amounts reversed or established for the valuation allowance and the allowance for credit losses, as applicable, related to the transfer of nonmortgage loans (see paragraphs 310-10-35-48A through 35-48B) on a gross basis in the income statement. An entity may present those amounts on the income statement or in the notes to financial statements.

Excerpt from ASC 948-10

> Loans Held for Sale

35-2A For a mortgage loan that is transferred into the held-for-sale classification from the held-for-long-term-investment classification, an entity shall reverse in earnings any allowance for credit losses previously recorded on the mortgage loan held-for-long-term-investment at the transfer date. An entity shall then reclassify and transfer the mortgage loan into the held-for-sale classification at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses). An entity shall then determine if a valuation allowance is necessary by following the applicable guidance in this Subtopic.

> Loans Held as Long-Term Investments

35-5A For a mortgage loan that is transferred into the held-for-long-term-investment classification from the mortgage loans held-for-sale classification, an entity shall reverse in earnings any valuation allowance previously recorded on the mortgage loan held for sale at the transfer date. An entity shall then reclassify and transfer the mortgage loan into the held-for-long-term-investment classification at its amortized cost basis (which is reduced by any previous writeoffs but excludes any valuation allowance). An entity shall then determine if an allowance for credit losses is necessary by following the guidance in Subtopic 326-20.

General

45-2 An entity shall present the amounts reversed or established for the valuation allowance and the allowance for credit losses, as applicable, related to the transfer of a mortgage loan between classifications (see paragraphs 948-310-35-2A and 948-310-35-5A) on a gross basis in the income statement. An entity may present those amounts on the income statement or in the notes to financial statements.

Specific considerations apply when loans are transferred between the held-for-investment and held-for-sale categories (or when debt securities are transferred between the HTM and AFS categories). This chapter discusses transfers of loans between categories. For transfers of debt securities between categories, see section 4.4 of KPMG Handbook, Investments.

Loans

Transfer from held-for-investment to held-for-sale	Transfer from held-for-sale to held-for-investment
— Reverse in earnings any allowance for credit losses previously recorded on the loan. — Reclassify and transfer the loan into the held-for-sale classification at its amortized cost basis.[1] — Determine whether a valuation allowance is necessary by following the guidance in Subtopic 310-10 or 948-310, as applicable. [310-10-35-48A, 948-310-35-2A]	— Reverse in earnings any valuation allowance previously recorded on the loan. — Reclassify and transfer the loan into the held-for-investment classification at its amortized cost basis.[1] — Determine whether an allowance for credit losses is necessary by following the guidance in Subtopic 326-20. [310-10-35-48B, 948-310-35-5A]

Note:

1. The amortized cost basis that is transferred is reduced by any previous writeoffs, but excludes any valuation allowance or allowance for credit losses, as applicable.

Question 3.2.30#

Are the effects of a transfer between categories reported on a gross or net basis?

Interpretive response: An entity presents the amounts reversed or established for a valuation allowance or allowance for credit losses, as applicable, on a gross basis in the income statement or in the notes to the financial statements. [310-10-45-2, 948-310-45-2]

Question 3.2.40

Does an entity recognize a writeoff when a loan is transferred from held-for-investment to held-for-sale?

Interpretive response: It depends. We believe the accounting for the loan and associated allowance depends on the credit quality of the loan when an entity changes its intent.

When an entity changes its intent, it reclassifies and transfers a loan into the held-for-sale category at the loan's amortized cost basis, which is reduced by any previous writeoffs, but excludes any allowance for credit losses. Therefore, an entity applies its writeoff policy before transferring a loan to held-for-sale. The portion of the allowance that does not relate to the amount written off is reversed in earnings upon transfer. [310-10-35-48A, 948-310-35-2(a)]

As noted in Question 4.2.35, if an entity expects to sell a loan with significant credit deterioration, it incorporates its estimate of future losses from the expected sale when estimating expected credit losses. Therefore, the allowance for credit losses reflects the full amount of the expected loss on sale.

When the specific loan is identified and ultimately transferred to the held-for-sale category, we believe the portion of the loan's carrying amount that exceeds its fair value should be deemed uncollectible. Therefore, it should be written off against the associated allowance for credit losses at the time of transfer.

In contrast, when a loan does not have significant credit deterioration – and therefore the allowance does not include an estimate of the expected loss on sale – we believe a writeoff generally should not be recognized when the loan is transferred. An exception arises when the writeoff relates to an aspect of the entity's writeoff policy that is unrelated to the intent to sell the loan, such as the number of days that the loan has been delinquent.

Example 3.2.20

Transferring a financial asset from held-for-investment to held-for-sale

ABC Corp. changes its intent and decides to transfer a loan from held-for-investment to held-for-sale on January 1, Year 2. Before changing its intent on January 1, Year 2, ABC had the intent and ability to hold the loan for the foreseeable future.

On December 31, Year 1 (immediately before this transfer), the loan has:

— an amortized cost basis of $100
— a previously recorded allowance for credit losses of $2
— a fair value of $95.

Scenario 1: Loan does not have significant credit deterioration based on ABC's policy

Because the loan does not have significant credit deterioration based on ABC's accounting policy, ABC records the following journal entries upon transfer.

	Debit	Credit
Allowance for credit losses	2	
Provision for credit losses		2
To reverse existing allowance for credit losses on held-for-investment loan.		
Loans held-for-sale	100	
Loans held-for-investment		100
To record transfer of the loan from held-for-investment to held-for-sale.		
Loss on loans held-for-sale	5	
Valuation allowance (loans held for sale)[1]		5
To establish valuation allowance under Subtopic 310-10.		

Note:
1. The valuation allowance is the difference between the amortized cost basis ($100) and fair value ($95).

Scenario 2: Loan is considered to have significant credit deterioration based on ABC's policy

Because the loan has significant credit deterioration based on ABC's accounting policy, ABC records the following journal entry when it changes its intent.

	Debit	Credit
Provision for credit losses	3	
Allowance for credit losses[1]		3
To record increase in allowance for credit losses to reflect full amount of expected loss on sale.		

Note:

1. The valuation allowance is the difference between the amortized cost basis ($100) and fair value ($95).

ABC records the following journal entries upon transfer.

	Debit	*Credit*
Allowance for credit losses	5	
Loans held for investment		5
To record writeoff of portion of carrying amount of loan that exceeds fair value (uncollectible portion) and associated allowance.		
Loans held for sale	95	
Loans held for investment		95
To record transfer of loan from held-for-investment to held-for-sale.		

3.3 Recognition of writeoffs and recoveries

3.3.10 Overview

Excerpt from ASC 326-20

> Writeoffs of Financial Assets

35-8 Writeoffs of financial assets, which may be full or partial writeoffs, shall be deducted from the allowance. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible.

For financial assets measured at amortized cost, an entity is required to: [326-20-30-1, 35-8]

— deduct (or add) the allowance for credit losses from (to) the amortized cost of financial assets to present the net amount expected to be collected on the financial assets; and

— recognize writeoffs (full or partial) of financial assets in the period in which they are deemed uncollectible.

The allowance for credit losses is required to include expected recoveries of amounts previously written off and expected to be written off. Considering recoveries of previously charged-off financial assets in the estimate of expected credit losses may, in limited circumstances, result in the allowance for credit losses being negative (i.e. a debit balance). The negative allowance for credit losses may not exceed amounts previously written off (or expected to be written off). [326-20-30-1]

Additional guidance applies to the following.

— Collateral dependent financial assets, including that a negative allowance for credit losses may result when the practical expedient is applied. See section 10.2 for further discussion.

— PCD assets, including that when a method other than a discounted cash flow method is used to estimate credit losses, expected recoveries do not include any amounts that result in an acceleration of the non-credit discount. See section 12.4.20 for further discussion.

The writeoff of an asset is generally recognized as a reduction from the allowance for credit losses. However, the FASB has provided additional flexibility for writeoffs of accrued interest receivable on financial assets carried at amortized cost. See further discussion in Questions 4.2.50 and 19.6.30. [326-20-35-8 – 35-8A, 326-30-35-13A]

Comparison to legacy US GAAP
Consideration of expected recoveries in allowance

The following summarizes differences in how expected recoveries of written off amounts are considered in the expected credit loss model versus the loan impairment model in legacy US GAAP.

Legacy US GAAP	Subtopic 326-20
Expected recoveries of amounts expected to be written off	
No specific measurement is prescribed. In our experience, financial institutions generally *include* these expected recoveries when estimating the allowance for loan losses.	Included when estimating the allowance for expected credit losses.
Expected recoveries of amounts previously written off	
No specific measurement is prescribed; there is diversity in practice. In our experience, the majority of financial institutions *exclude* these recoveries when estimating the allowance for loan losses and instead recognize them when received.	Included when estimating the allowance for expected credit losses.

Question 3.3.10
Does an entity include contractual interest in its estimate of expected recoveries?

Interpretive response: No, not unless it was accrued prior to the asset being written off.

A negative allowance for credit losses is limited to amounts previously written off and expected to be written off. Contractual interest that has not been accrued has not been written off. As a result, it is not included in an entity's estimate of expected recoveries. [326-20-30-1]

Example 3.3.10
Effect of expected recoveries on allowance for credit losses

Bank is measuring its allowance for credit losses at the end of Year 2 for a portfolio of financial assets measured at amortized cost. Its portfolio includes the following:

— loans for which no amounts have been written off;
— a loan for which a partial writeoff has been recognized; and
— loans that have been fully written off.

Loans with no amounts written off

Bank estimates that it will write off 4% of these loans, excluding the effects of expected recoveries of amounts expected to be written off. Bank's expected recovery rate related to amounts expected to be written off is 20%.

Bank estimates expected credit losses on these loans as follows.

Amortized cost of loan portfolio not written off	$100 million
Expected gross loss rate	4%
Expected credit losses, excluding expected recoveries[1]	$4 million
Expected recovery rate	(20%)
Expected recoveries [of amounts expected to be written off][2]	($800 thousand)
Expected credit losses, net[3]	$3.2 million

Notes:
1. Amortized cost of loan portfolio not written off × Expected gross loss rate.
2. Expected credit losses, excluding expected recoveries × Expected recovery rate.
3. Expected credit losses, excluding expected recoveries + Expected recoveries.

Loan partially written off

During Year 2, Bank writes off $3.75 million of a loan that had an amortized cost of $5 million – i.e. the loan had a remaining amortized cost of $1.25 million at the end of Year 2. At the end of Year 2, Bank expects to collect $1.5 million related to the loan.

Bank estimates expected credit losses on this loan as follows.

Amount Bank expects to collect	$ 1.5 million
Amortized cost at end of Year 2	$ 1.25 million
Expected credit losses (recoveries), net[1]	$(0.25) million)

Note:
1. The negative allowance is $0.25 million, which is less than the limit of the amount previously written off ($3.75 million).

Loans fully written off

Bank fully wrote off $3 million of loans in each of Year 1 and Year 2. Bank's expected recovery rate related to amounts fully written off is 20%.

For simplicity, this example assumes that Bank:

— does not expect to recover any amounts on loans written off before Year 1; and
— has not yet received any recoveries of amounts written off in either Year 1 or Year 2.

Bank estimates expected recoveries on these loans as follows.

Amortized cost of loans fully written off[1]	$ 6	million
Expected recovery rate		20%
Expected recoveries[2]	$ (1.2)	million

Notes:
1. $3 million written off in each of Year 1 and Year 2.
2. Amortized cost of loans written off × Expected recovery rate; the negative allowance is $1.2 million, which is less than the limit of the amount previously written off ($6 million).

Allowance for credit losses

Bank's allowance for credit losses is summarized as follows.

Loans with no amounts written off – Expected credit losses (including expected recoveries of amounts expected to be written off)	$ 3.2	million
Loans partially written off – Expected recoveries of amounts previously written off	(0.25)	million
Loans fully written off – Expected recoveries of amounts previously written off	(1.2)	million
Total	**$ 1.75**	million

Excerpt from ASC 326-20

>> Example 9: Recognizing Writeoffs and Recoveries

55-51 This Example illustrates how an entity may implement the guidance in paragraphs 326-20-35-8 through 35-9 relating to writeoffs and recoveries of expected credit losses on financial assets.

55-52 Bank K currently evaluates its loan to Entity L on an individual basis because Entity L is 90 days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio. At the end of December 31, 20X3, the amortized cost basis for Entity L's loan is $500,000 with an allowance for credit losses of $375,000. During the first quarter of 20X4, Entity L issues a press release stating that it is filing for bankruptcy. Bank K determines that the $500,000 loan made to Entity L is uncollectible. Bank K considers all available information that is relevant and reasonably available, without undue cost or effort, and determines that the information does not support an expectation of a future recovery in accordance with paragraph 326-20-30-7. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance in accordance with paragraph 326-20-35-8, as follows.

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

During March 20X6, Bank K receives a partial payment of $50,000 from Entity L for the loan previously written off. Upon receipt of the payment, Bank K recognizes the recovery in accordance with paragraph 326-20-35-8, as follows:

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

55-53 For its March 31, 20X6 financial statements, Bank K estimates expected credit losses on its financial assets and determines that the current estimate is consistent with the estimate at the end of the previous reporting period. During the period, Bank K does not record any change to its allowance for credit losses account other than the recovery of the loan to Entity L. To adjust its allowance for credit losses to reflect the current estimate, Bank K reports the following on March 31, 20X6:

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

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

4. Methods to estimate expected credit losses

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

4.1 How the standard works

Subtopic 326-20 does not prescribe all aspects of the expected credit loss estimate, including the specific method to be used. However, it describes how an entity should estimate expected credit losses based on the type of method used.

Method	Allowance calculation
Discounted cash flow method	The allowance for credit losses reflects the difference between: — the amortized cost basis; and — the present value of the principal and interest cash flows expected to be collected.
Other methods	The allowance for credit losses reflects the entity's expected credit losses of the amortized cost basis.

Subtopic 326-20 provides additional guidance on estimating expected credit losses for certain financial instruments, including but not limited to, purchased financial assets with credit deterioration (chapter 12), off-balance sheet credit exposures (see chapter 13), collateral-dependent financial assets (see chapter 10) and net investments in leases (see chapter 16).

The following are the significant differences in the measurement principles of this expected credit loss model and those of the impairment model in legacy US GAAP.

Legacy US GAAP	Subtopic 326-20
Generally considers past loss experience and current conditions. [310-10-35-4]	Considers past loss experience, current conditions, and reasonable and supportable forecasts of future conditions.
Incurred credit losses on loans considers a loss-emergence period. [310-10-35]	Considers lifetime expected losses.
Generally measures HTM debt securities and non-collateral-dependent impaired loans on an individual asset basis using a discounted cash flow method. [310-10-35-21, 35-22, 320-10-35-18 – 35-33D]	Does not prescribe a specific method. Requires collective assessment for financial assets with similar risk characteristics.

4.2 Estimating expected credit losses

4.2.10 Overview

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

30-3 The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

>> Developing an Estimate of Expected Credit Losses

55-6 Estimating expected credit losses is highly judgmental and generally will require an entity to make specific judgments. Those judgments may include any of the following:

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

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

Subtopic 326-20 does not prescribe a specific method for estimating expected credit losses. Rather, given the subjective nature of the estimate, the FASB decided that an entity should use judgment to develop an approach that faithfully reflects expected credit losses for financial assets and can be applied consistently over time.

Examples of methods that may be used to estimate expected credit losses include: [326-20-30-3, 55-6, 55-7]

— discounted cash flow method;
— probability of default and loss given default methods;
— loss-rate and roll-rate methods; and
— methods that use an aging schedule.

The amortized cost is the amount for which a receivable or investment is originated or acquired, adjusted for accrued interest, accretion or amortization of premiums, discounts, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments. Although the amortized cost includes accrued interest, an entity that writes off accrued interest receivable in a timely manner is permitted to elect not to measure an allowance for credit losses on accrued interest (see section 4.2.20). [326-20 Glossary, 326-20-30-5]

Question 4.2.10

Does Subtopic 326-20 provide specific guidance on how to estimate expected credit losses?

Interpretive response: Subtopic 326-20 requires an entity to recognize lifetime expected credit losses but does not prescribe certain aspects of the expected credit loss estimate, including:

— the specific method to be used, including whether to apply a discounted cash flow method;
— how to determine the reasonable and supportable forecast period;
— how to revert to historical losses beyond the reasonable and supportable forecast period;
— how to determine historical losses; and
— how to determine forecasted future credit losses.

Therefore, Subtopic 326-20 allows various approaches. See chapter 7 regarding historical losses and forecasts. [326-20-55-6]

Different approaches may lead to diversity in practice and ranges of acceptable estimates of expected credit losses for similar assets. However, by not dictating the method to use, the FASB has accepted that different outcomes may result in less comparability. It based its decision on the fact that the credit risks inherent in an entity's financial assets and how the entity manages those risks are unique to the entity. Therefore, the FASB believes each entity should have flexibility to best report its expectations. [ASU 2016-13.BC50]

In explaining its reasoning, the FASB noted that given the subjective nature of the estimate, one method's consideration of time value may have a more direct effect on the estimate of expected credit losses than other methods. Furthermore, some entities may be able to forecast over the contractual term of an asset, while other entities may only be able to forecast over a shorter period. The FASB noted there are several factors that may influence the approach an entity uses to estimate expected credit losses, including:

— the complexity of its portfolio;
— the entity's size;
— access to information; and
— how the entity manages the portfolio.

Due to these and other factors, the FASB concluded that different outcomes for expected credit losses are acceptable. [ASU 2016-13.BC50]

Question 4.2.20

May an entity leverage its existing allowance method to comply with Subtopic 326-20?

Interpretive response: Yes. Subtopic 326-20 does not prescribe a specific method to estimate expected credit losses and provides examples of methods that may be used. The FASB expects that entities can leverage their current systems and methods for recording the allowance for credit losses.

However, the inputs used need to change to appropriately estimate expected lifetime credit losses. For example, the inputs to a loss-rate method need to reflect expected credit losses over the contractual term, rather than the annual loss rates commonly used under the existing incurred loss model. In addition, entities need to consider how to adjust historical loss experience not only for current conditions but also for reasonable and supportable forecasts (see chapter 7).

Question 4.2.25**

Are expected losses associated with risks other than credit risk included in the estimate of expected credit losses?

Interpretive response: No, except for the allowance associated with a net investment in a lease. Certain financial assets or off-balance sheet arrangements in the scope of Topic 326 may expose an entity to potential losses from both credit risk and other types of risks (such as fraud, contractual disputes or foreign currency risks). However, only expected losses attributable to credit risk are included in the estimate of expected credit losses under Topic 326. Potential losses related to other risks may have to be recognized under other guidance (including Topic 450). [326-20-55-82]

In some circumstances, a potential loss may have aspects of credit risk and one or more other risks. In these cases, determining whether a risk of loss is primarily related to credit or non-credit requires judgment. For examples of instruments where the risk of loss is outside the scope of Topic 326, see the discussion of foreign currency risk in AFS debt securities (Question 19.3.05) and of dispute risk that affects the collectability of a reinsurance contract (section 17.3.10).

Exception for certain non-credit risk in a net investment in a lease

When determining the loss allowance for a net investment in a lease an entity considers expected gains and losses associated with the unguaranteed residual value even though those expected gains and losses do not relate to credit risk. See section 16.2.

Question 4.2.30

Are anticipated costs associated with loss mitigation and/or potential future declines in collateral values included in the estimate of expected credit losses?

Background: An entity may anticipate that it will incur a variety of incremental costs relating to its efforts to mitigate credit losses. For example, the entity may anticipate costs associated with:

- collection efforts;
- the foreclosure process (e.g. legal fees);
- owning and operating the asset (e.g. taxes and insurance).

The entity may also anticipate credit losses arising from changes in the fair value of the collateral – either before or after foreclosure.

Interpretive response: The following table summarizes whether anticipated costs and changes in collateral values are included in (or excluded from) an entity's estimate of expected credit losses.

Incurred (or expected to be incurred) before foreclosure	Incurred (or expected to be incurred) after foreclosure
Costs (other than estimated costs to sell)	
Excluded from the estimate of expected credit losses. These represent period costs. They are not included in the allowance for credit losses and are not recognized as an expense before they are incurred. If the borrower is required under the loan terms to reimburse the lender for the costs incurred, the lender records a loan receivable for amounts due from the borrower – e.g. through adding the amount to the loan's principal balance. The entity estimates expected credit losses related to that receivable after it has been recognized. If the borrower is not required to reimburse the lender for the cost, the lender recognizes an expense when the cost has been incurred.	**Excluded** from the estimate of expected credit losses. Anticipated costs on the foreclosed assets (i.e. costs expected to be incurred after foreclosure) are excluded from the allowance for expected credit losses. This is because they are associated with the period that the entity has recognized a foreclosed asset, rather than the period that it holds the loan.

Incurred (or expected to be incurred) before foreclosure	Incurred (or expected to be incurred) after foreclosure
Potential future changes in collateral value	
— Guidance on collateral-dependent loans is *not* applied: – **Included** in the estimate of expected credit losses. – The entity considers potential changes in collateral values that could occur between the reporting date and the date of foreclosure. [326-20-30-10] — Guidance for collateral-dependent loans *is* applied: – **Excluded** from the estimate of expected credit losses. – Potential future changes in collateral values are excluded from the estimate of expected credit losses because the entity uses the fair value of collateral at the reporting date (see section 10.2).	**Excluded** from the estimate of expected credit losses. Changes in value of the foreclosed assets are associated with the period that the entity owns the foreclosed asset, rather than the period that it holds the loan.

Question 4.2.35

How are expected sales of loans considered when estimating expected credit losses?

Interpretive response: It depends. If an entity expects to sell loans with significant credit deterioration, we believe it should incorporate its estimate of future losses from the expected sale when estimating expected credit losses even if the loans to be sold have not yet been specifically identified. This would be the case regardless of whether the planned sale was a one-time, nonrecurring sale or part of a routine pattern of selling loans. For example, if an entity expects to sell loans once they are considered defaulted, it estimates future losses from those sales of defaulted loans when estimating the allowance for credit losses even though it may not yet know which specific loans will default.

Effectively, the expected loss on sale in that scenario is a credit loss that is included in the allowance for credit losses. Therefore, the estimate of expected credit losses reflects the full amount of the expected loss on the sale of the loan – i.e. the difference between the carrying amount and the estimated sales price.

In contrast, when an entity expects to sell loans that do not have significant credit deterioration since origination, we believe any expected losses are not considered to be credit losses and are therefore not included in the allowance for credit losses.

Determining whether a loan has experienced significant credit deterioration requires a judgment for which an entity develops an accounting policy that it applies consistently.

4.2.20 Accrued interest receivable

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

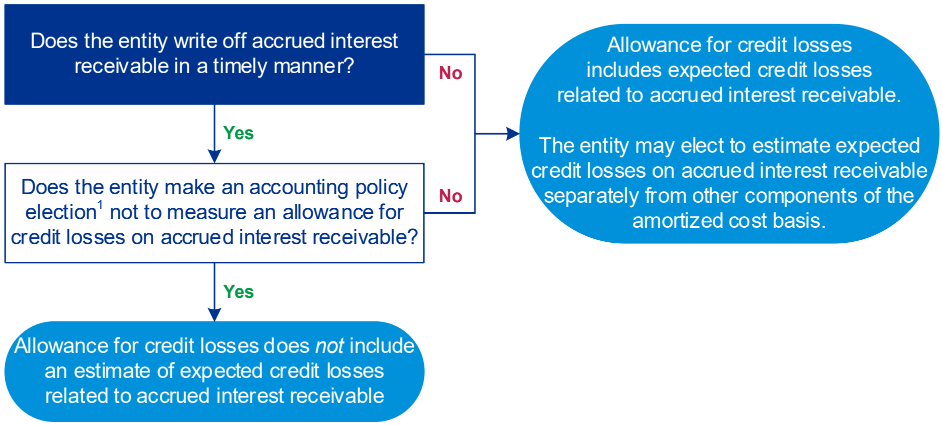
30-5A An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an allowance for credit losses for accrued interest receivables if the entity writes off the uncollectible accrued interest receivable balance in a timely manner. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-35-8A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

> Writeoffs of Financial Assets

35-8A An entity may make an accounting policy election, at the class of financing receivable or the major security-type level, to write off accrued interest receivables by reversing interest income or recognizing credit loss expense or a combination of both. This accounting policy election should be considered separately from the accounting policy election in paragraph 326-20-30-5A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

As indicated in section 4.2.10, a financial asset's amortized cost includes the related accrued interest receivable. The FASB provided relief from estimating credit losses on accrued interest receivable balances that an entity writes off in a timely manner. This relief was provided after stakeholders raised concerns, including about the operational burden and cost of tracking accrued interest at the individual loan level, and about some stakeholders' current nonaccrual practice of reversing accrued interest receivable through interest income.

The following decision tree summarizes whether an entity should measure an allowance for credit losses on accrued interest receivable balances. [326-20-30-5 – 30-5A]



1. The accounting policy election is made at the class of financing receivable or major security-type level.

In addition to permitting an entity to not measure an allowance for credit losses for accrued interest receivable in certain circumstances, the FASB provided relief related to how an entity may write off accrued interest receivable (see Question 4.2.50) and relief from certain presentation and disclosure requirements (see Question 23.2.05 and section 24.3.100, respectively).

Question 4.2.40

What time period for writing off accrued interest receivable is considered 'timely'?

Interpretive response: The FASB decided not to provide a specific time period that is considered timely. Instead, an entity is required to apply judgment based on its specific facts and circumstances. [ASU 2019-04.BC20]

For example, an entity may have a policy to write off accrued interest receivable when a loan becomes 90 days delinquent. We believe this would generally be considered a timely writeoff policy.

Question 4.2.50

Must an entity write off accrued interest receivable as a deduction from the allowance for credit losses?

Interpretive response: No. In response to stakeholder concerns about changing the current nonaccrual practice of reversing accrued interest receivable through interest income, the FASB provided relief from the requirement to deduct writeoffs of accrued interest receivable from the allowance for credit losses. Under that relief, an entity may make an accounting policy election to write off accrued interest receivable in any of the following ways; this election is made separately for each class of financing receivable or major security type: [326-20-35-8A]

— reversing interest income;
— recognizing credit loss expense; or

— a combination of both.

An entity's accounting policy election for writing off accrued interest receivable is made separately from its accounting policy election about whether its allowance for credit losses includes expected credit losses of accrued interest receivable.

The following table summarizes how expected credit losses of accrued interest receivable may be reflected in an entity's financial statements; combinations of these outcomes may also result.

	Accrued interest receivable is written off through:	
	Reversing interest income	**Recognizing credit loss expense**
Allowance for credit losses includes expected credit losses of accrued interest receivable	— Credit loss expense, and a related allowance, are initially recognized for expected credit losses of accrued interest receivable. — When accrued interest receivable is subsequently deemed uncollectible, interest income is reversed. In addition, related amounts in the allowance for credit losses are reversed, resulting in a decrease to credit loss expense.	— Credit loss expense is recognized for expected credit losses of accrued interest receivable. — Accrued interest receivable is deducted from the allowance for credit losses when it is deemed uncollectible.
Allowance for credit losses *does not* include expected credit losses of accrued interest receivable	Interest income is reversed when accrued interest receivable is deemed uncollectible.	Credit loss expense is recognized when accrued interest receivable is deemed uncollectible.

4.3 Methods other than discounted cash flow methods

4.3.10 Overview

Excerpt from ASC 326-20

30-5 If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following:

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

Pending Content:

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

30-5 If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following:

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

If a method other than a discounted cash flow method is used, an entity may develop the estimate of expected credit losses by measuring components of the amortized cost basis separately (see Example 4.3.20) or on a combined basis (see Example 4.3.10). [326-20-30-4 – 30-5]

Question 4.3.10

May an entity estimate lifetime expected credit losses by multiplying an annual loss rate used under the incurred loss model by the remaining contractual term of the financial asset?

Interpretive response: Generally, no. Historical loss experience generally serves as a starting point for estimating expected credit losses under Subtopic 326-20. However, the historical experience needs to be adjusted to reflect management's expectations of current conditions, and reasonable and supportable forecasts.

Additionally, because losses do not generally occur evenly over time, an entity's estimate based on an annual loss rate multiplied by the remaining contractual term may result in either understating or overstating lifetime expected credit losses. Instead, the entity should generally use cumulative lifetime historical loss data as a starting point. Judgment is required in selecting the historical data as well as the historical period over which the data will be collected (see chapter 7).

Question 4.3.20

Can an entity discount cash flows when applying a method other than a discounted cash flow method?

Interpretive response: It depends. The FASB and TRG observed that although Subtopic 326-20 distinguishes between a discounted cash flow method and other methods, it does not explicitly prohibit the use of discounting when other methods are used. [FASB 11-18, TRG 11-18.14]

We believe the guidance below should be followed when an entity incorporates discounting in its measurement methodology.

Consideration	Guidance
Cash flows to be discounted	In general, we believe the entity should discount *all* cash flows. [FASB 11-18, TRG 11-18.14] As an exception, when estimating expected credit losses for TDR's, we believe that it would generally be appropriate to use a method other than a discounted cash flow method to estimate the expected credit losses that are not directly related to the TDR concession(s) while using a discounted cash flow method to estimate the effects of TDR concession(s). For further discussion, see Questions 11.3.40 and 11.3.42.
EIR for discounting cash flows	We believe an entity should apply Subtopic 326-20's guidance for calculating the EIR (see section 4.4).

Consideration	Guidance
Date to which cash flows are discounted	The FASB and TRG indicated that an entity is not permitted to discount cash flows or inputs to a date other than the reporting date. [FASB 11-18, TRG 11-18.14] Certain entities are required to discount cash flows to a date other than the reporting date when making estimates for regulatory purposes. For example, under certain provisions of the Basel III capital framework, cash flows that are projected to occur after a loan has defaulted are discounted to the default date, rather than to the reporting date (if earlier). Such an approach cannot be applied when estimating expected credit losses.

For discussion of whether an entity may estimate expected credit losses by discounting expected losses, see Question 4.4.25.

Question 4.3.30

Does an entity reserve for future interest when applying a method other than a discounted cash flow method to estimate expected credit losses?

Interpretive response: No. An entity does not reserve for future interest – i.e. interest that has not yet been accrued – when applying a method other than a discounted cash flow method. The FASB and TRG discussed this issue at meetings in August and June 2018, respectively. They agreed that the allowance reflects an entity's expected credit losses of the amortized cost basis at the balance sheet date, and future interest amounts are not part of the amortized cost basis until accrued. [326-20-30-5, TRG 2018-06.8, TRG 2018-06.13]

This approach includes situations in which accrued interest is added to the outstanding principal balance. For example, student loans sometimes have deferment periods during which the borrower does not make payments and accrued interest is added to the outstanding principal balance. In these situations, if an entity uses a method that applies probability of default and loss given default rates to the expected unpaid principal balance at the time of default (i.e. expected exposure at default), the expected unpaid principal balance should not include interest that is expected to be added to the principal balance after the balance sheet date.

Similarly, we do not believe an entity includes contractual interest in its estimate of expected recoveries, unless it was accrued prior to the asset being written off (see Question 3.3.10).

Question 4.3.40
What effect do unamortized premiums and discounts have on the estimate of expected credit losses?

Interpretive response: In estimating expected credit losses of the amortized cost basis for an asset (or group of assets) using a method other than a discounted cash flow method, the estimate needs to reflect: [326-20-30-5]

— the expected loss of principal;
— the effect of unamortized premiums and discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments; and
— accrued interest receivable, if applicable (see section 4.2.20).

When an entity uses historical credit loss data to estimate how premiums or discounts will affect future credit losses, we believe it will generally consider what effect (if any) its reasonable and supportable forecasts of future conditions might have on that estimate. For example, expected changes in prepayments as a result of forecasted changes in market interest rates from those observed in the historical period might result in a change in the amount of premium or discount amortization that is recognized before a credit loss. This may affect the amount of unamortized premium or discount reflected in the writeoff amount.

Subtopic 326-20 permits entities to develop the credit loss estimate by considering the components of the amortized cost basis using either:

— a combined approach – i.e. the principal amount together with accrued interest, if applicable, and/or all premiums and discounts; or
— a separate approach.

The FASB decided to permit entities to consider the components of the amortized cost on a separate basis to better help them leverage historical loss information that may frequently be based on unpaid principal balances. [ASU 2016-13.BC59]

We expect that entities will generally choose to analyze the amortized cost basis in a manner (combined or separate) that is consistent with how the historical loss information used in preparing the allowance for credit losses was determined.

If an entity elects to use a combined approach that applies a loss rate based on historical writeoffs of amortized cost, we believe the loss rate could be based on, and then applied to, either the unpaid principal balance or the original amortized cost basis.

Example 4.3.10
Applying the combined approach

Development of historical loss rates and estimation of expected credit losses

ABC Corp. estimates its allowance for credit losses using a loss-rate method. ABC originates a portfolio of non-prepayable loans that have similar risk characteristics with an original amortized cost basis of $20,400,000 (principal of $20,000,000 and net deferred costs of $400,000).

ABC has a policy to write off accrued interest receivable in a timely manner and has elected not to measure an allowance for expected credit losses on accrued interest receivable. ABC gathered historical loss data for a portfolio of similar assets that it originated in the past and that had a contractual term that was consistent with the contractual term of the portfolio that it just originated. Further, the loans observed in developing the historical loss rate were originated with net deferred costs of similar magnitude in relation to the principal amount as the current portfolio.

The following data are relevant for ABC's historical loan portfolio at the date of its origination.

Unpaid principal balance of the loan portfolio [a]	$ 100,000,000
Loan origination transaction costs pertaining to the loan portfolio [b]	2,000,000
Amortized cost [c = a + b]	**$ 102,000,000**

Out of the total portfolio, 10% of the loans defaulted. The following is ABC's historical loss experience on the defaulted loans.

Unpaid principal balance of the defaulted loans – 10% of $100,000,000 [a]	$ 10,000,000
Unamortized costs pertaining to the defaulted loans at the time of writeoff [b]	80,000
Amortized cost at the time of writeoff [c = a + b]	**10,080,000**
Cash received as final settlement of the loans [d]	9,000,000
Writeoff of amortized cost basis [e = c – d]	**$ 1,080,000**

ABC elects to develop its estimate of expected credit losses by considering the components of the amortized cost on a combined basis, and determines that its historical writeoffs of the amortized cost basis were $1,080,000.

In estimating its expected credit losses, ABC could use an approach that is consistent with how it developed the historical loss rate – i.e. based on either the unpaid principal balance or amortized cost.

Scenario 1: Historical loss rate based on amortized cost

ABC determines its historical loss rate based on amortized cost: $1,080,000 / $102,000,000 = 1.059% (rounded).

Next, ABC considers its current asset-specific risk characteristics, the current economic conditions, and reasonable and supportable forecasts of future economic conditions. ABC determines that no adjustment to the historical loss rate is necessary because it expects that credit losses will be consistent with the historical period in terms of both timing and amount.

Because the historical loss rate is based on amortized cost, the rate is applied to the amortized cost basis of the loan portfolio. Therefore, ABC calculates its allowance for credit losses related to this portfolio as $20,400,000 × 1.059% = $216,000.

Scenario 2: Historical loss rate based on unpaid principal balance

ABC determines its historical loss rate based on unpaid principal balance: $1,080,000 / $100,000,000 = 1.08%.

Next, ABC considers its current asset-specific risk characteristics, the current economic conditions, and reasonable and supportable forecasts of future economic conditions. ABC determines that no adjustment to the historical loss rate is necessary because it expects that credit losses will be consistent with the historical period in terms of both timing and amount.

Because the historical loss rate is based on unpaid principal balance, the rate is applied to the unpaid principal balance of the loan portfolio. Therefore, ABC calculates its allowance for credit losses related to this portfolio as $20,000,000 × 1.08% = $216,000.

Question 4.3.50

Must an entity accumulate new data if it measures the components of the amortized cost separately?

Interpretive response: It depends. If an entity develops the expected credit loss estimate by considering the components of amortized cost separately, it needs to consider the effect that the following items have on the expected credit loss estimate:

- accrued interest receivable, if applicable (see section 4.2.20); and
- unamortized premiums and discounts (including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments).

For example, the entity needs to consider what amount of unaccreted net deferred fees will remain when a credit loss occurs.

This will represent a new data requirement for entities that have not historically tracked such data.

Example 4.3.20

Applying the separate approach

ABC Corp. estimates its allowance for credit losses using a probability of default/loss given default (PD/LGD) method. It has a policy to write off accrued interest receivable in a timely manner and has elected not to measure an allowance for expected credit losses on accrued interest receivable.

ABC originates a portfolio of non-prepayable loans with an original amortized cost basis of $980,000 (principal of $1,000,000 and net deferred fees of $20,000). It estimates that 3% of these loans will default during their lifetimes, and that the loss given default will be 40% of the original principal amount.

ABC analyzes its historical loss experience and determines that credit losses have, on average, occurred when 60% of the original net deferred fees remain unaccreted. Due to current conditions and its reasonable and supportable forecasts of future conditions, ABC adjusts the amount of unaccreted net deferred fees by 10% – from 60% of the original amount to 70% – to account for differences in the expected timing of credit losses compared to the timing observed in the historical period.

ABC elects to develop its estimate of expected credit losses by considering the components of the amortized cost basis on a separate basis.

ABC calculates its allowance for credit losses related to this portfolio as follows.

Principal amount	$1,000,000
Principal amount of loans multiplied by PD [$1,000,000 × 3% PD]	30,000
Expected loss on principal amount [$30,000 × 40% LGD]	12,000
Less: Unaccreted deferred fees included in expected credit loss of amortized cost basis[1]	(420)
Allowance for credit losses	**$ 11,580**

Note:

1. ABC estimates the unaccreted deferred fees at the time credit losses are expected to occur as follows.

Total net deferred fees at origination	$ 20,000
Less: Amount expected to be accreted at the time credit losses are expected to occur [$20,000 × 30%]	(6,000)
Unaccreted amount expected at the time credit losses are expected to occur [$20,000 × 70%]	14,000
Unaccreted amount included in expected credit loss of amortized cost basis [$14,000 × 3% PD]	**$ (420)**

Comparison to legacy US GAAP
Treatment of loans acquired at a discount

Under legacy US GAAP, the carrying amount for acquired pools of loans that are not accounted for under Subtopic 310-30 – loans and receivables acquired with credit deterioration – generally reflects the collective contractual amount of the loans less any allowance for loan losses. When loans have been acquired at a discount, practice has often been to not recognize any associated allowance for loan losses until the estimated allowance exceeds the unaccreted discount. [310-10-35-24, 210-10-45-3]

In contrast, Subtopic 326-20 precludes an entity from using the discount to offset its expectation of credit losses. Instead, as illustrated in Examples 4.3.10 and 4.3.20, the entity estimates the effect that the discount will have on the expected credit losses of the amortized cost basis. Consistent with legacy US GAAP, the discount is accreted to interest income. Before adoption of Subtopic 326-20, an entity may be recognizing an allowance for loan losses only to the extent that the incurred losses exceed the unaccreted discount. In that case, the addition to the allowance for credit losses at the date it adopts

Subtopic 326-20 will generally be more significant than if it has not been considering the discount in that manner.

Excerpt from ASC 326-20

>> Example 1: Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation)

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

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

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

55-21 In accordance with paragraph 326-20-55-4, Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates a 10-basis-point increase in credit losses incremental to the 1.5 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 in accordance with paragraphs 326-20-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

55-22 The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 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.

4.4 Discounted cash flow method

4.4.10 Overview

Subtopic 326-20 permits, but does not require, an entity to use a discounted cash flow method to determine the allowance for credit losses. An estimate of expected credit losses that discounts projected future principal and interest cash flows is a discounted cash flow method. If an entity uses a discounted cash flow method, it discounts the expected cash flows at the financial asset's EIR. See sections 4.4.20 – 4.4.40 for guidance about calculating the EIR. [326-20-30-3 – 30-4]

Question 4.4.10

When a discounted cash flow method is used, at what date should cash flows from expected recoveries be included?

Background: An entity may have a policy to fully or partially write off a loan when it defaults – e.g. when the loan is 180 days past due. The entity may expect to subsequently recover a portion of the written-off amount.

Interpretive response: When a discounted cash flow method is used, we believe that forecasted cash inflows from expected recoveries should be included on the date on which they are expected to be received – as opposed to the date the loan is projected to be written off. For discussion of the timing of recoveries from foreclosed assets, see Question 4.2.20.

In a discounted cash flow method, the estimate of expected credit losses is the present value of expected future principal and interest cash flows. As a result, cash flows are included on the date they are projected to occur. This is the case even if a loan has been (or will be) written off before that date.

For example, if a recovery is expected to occur when the loan is 270 days past due, the cash inflow should be included when the loan is forecast to be

270 days past due. This is the case even if the entity expects to write off the loan before the projected recovery date.

Question 4.4.20

When a discounted cash flow method is used, at what date are amounts from expected foreclosed assets included?

Interpretive response: When a discounted cash flow method is used and an entity expects to recover amounts through foreclosure, we believe an entity should impute a cash flow for the fair value (less estimated costs to sell) on the expected date of foreclosure – not on the forecasted date of sale of the foreclosed property.

When an entity forecloses on a long-lived asset, the asset is initially recognized at fair value less estimated costs to sell. As discussed in Question 4.2.30, expenses and losses (other than costs to sell) that the entity anticipates incurring subsequent to the foreclosure are associated with the period that the entity owns the asset – rather than the period that it holds the loan – and are not included when estimating the allowance for credit losses before foreclosure. [310-20-40-2 – 20-3]

As a result, a cash inflow should be:

— imputed for the fair value (less estimated costs to sell) of expected foreclosed assets; and
— included in the discounted cash flow approach on the expected date that the loan will be effectively exchanged for the foreclosed property.

Question 4.4.25

Can an entity estimate expected credit losses by discounting expected losses?

Interpretive response: Yes, provided it results in an allowance for credit losses that is consistent with the allowance that would result by comparing the amortized cost basis to the discounted expected cash flows. This is because the present value of contractual cash flows expected to be collected plus the present value of contractual cash flows *not* expected to be collected (that is, expected credit losses) is equivalent to the present value of all contractual cash flows – i.e. the amortized cost basis. Further, the allowance for credit losses represents the difference between amortized cost basis and the present value of expected cash flows.

These relationships are depicted in the following diagram.

PV of contractual cash flows = Amortized cost basis = PV of expected cash flows + PV of expected credit losses

Amortized cost basis − PV of expected cash flows = PV of expected credit losses = Allowance for credit losses

An entity using this approach should be careful to ensure that its methodology results in an allowance for credit losses consistent with the allowance that would have been calculated if the entity had compared the amortized cost basis to the discounted expected cash flows.

For example, to achieve this objective, an entity should:

— discount losses from the date that the cash shortfall is expected, not the date that a charge-off is expected to be recognized; and

— ensure expected recoveries are discounted based on the expected timing of the cash inflows.

An additional complexity of this approach is considering whether the effects of expected prepayments and accruals of interest are consistent with the effects that would have been calculated if the entity had compared the amortized cost basis to the discounted expected cash flows.

Example 4.4.05
Discounting expected losses

This example illustrates measuring the allowance for credit losses by discounting expected losses instead of comparing the amortized cost basis to the discounted expected cash flows.

Bank originates a non-prepayable loan to Borrower with the following attributes.

Principal amount:	$1,000,000
Discount (deferred fees, net):	$ 18,714
Contractual interest rate:	10%
EIR (based on contractual cash flows):	10.5%
Contractual term:	5 years
Payment terms:	Interest only with balloon at maturity

Bank calculates the allowance for credit losses by discounting expected credit losses. At origination, Bank estimates the cash flows it expects to collect (and to *not* collect) as follows.

Year	Contractual cash flows		Total contractual cash flows	Expected cash flows	Expected credit losses[1]
	Principal	Interest			
1	$ 0	$100,000	$ 100,000	$ 95,000	$ 5,000
2	0	100,000	100,000	97,000	3,000
3	0	100,000	100,000	95,000	5,000
4	0	100,000	100,000	100,000	0
5	1,000,000	100,000	1,100,000	1,020,000	80,000
6	0	0	0	0	0
7	0	0	0	0	0
8[2]	0	0	0	50,000	(50,000)
9[2]	0	0	0	2,000	(2,000)
Present value at EIR				$ 945,347	$ 35,939
Amortized cost[3]				$ 981,286	
Allowance for credit losses				$ 35,939	$ 35,939

Notes:
1. Total contractual cash flows – Expected cash flows.
2. Expected cash flows in years after contractual maturity result from expected recoveries in those years.
3. Amortized cost at origination is the sum of the principal amount less the discount resulting from deferred fees, net ($1,000,000 – $18,714).

As demonstrated in the table, Bank would calculate the same allowance for expected credit losses by either of the following:

— discounting expected credit losses; or
— comparing the amortized cost basis to the discounted expected cash flows.

4.4.20 Calculating the EIR

Excerpt from ASC 326-20

20 Glossary

Effective Interest Rate – The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

> Developing an Estimate of Expected Credit Losses

30-4 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 shall discount expected cash flows at the financial asset's

effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

Pending Content:

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

30-4 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 shall discount expected cash flows at the financial asset's **effective interest rate**. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. <u>See paragraph 815-25-35-10 for guidance on the treatment of a basis adjustment related to an existing portfolio layer method hedge.</u> If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-20-30-4A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

30-4A As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments. However, if the asset is restructured in a troubled debt restructuring, the effective interest rate used to discount the expected cash flows shall not be adjusted because of subsequent changes in expected timing of cash flows.

Pending Content:

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

30-4A As an accounting policy election for each class of financing receivable or major security type, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments. ~~However, if the asset is restructured in a troubled debt restructuring, the effective interest rate used to discount expected cash flows shall not be adjusted because of subsequent changes in expected timing of cash flows.~~

> Estimating Principal Prepayments

35-26 Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the entity anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the entity shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income.

>> Effect of a Fair Value Hedge on the Discount Rate When Using a Discounted Cash Flow Method

55-9 Section 815-25-35 implicitly affects the measurement of credit losses under this Topic by requiring the present value of expected future cash flows to be discounted by the new **effective interest rate** based on the adjusted **amortized cost basis** in a hedged **loan**. When the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective interest rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Section 815-25-35 shall be considered to be an adjustment of the loan's amortized cost basis. Paragraph 815-25-35-11 explains that the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value.

Pending Content:

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

55-9 Section 815-25-35 implicitly affects the measurement of credit losses under this Topic by requiring the present value of expected future cash flows to be discounted by the new **effective interest rate** based on the adjusted **amortized cost basis** in a hedged **loan**. When the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective interest rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Section 815-25-35 shall be considered to be an adjustment of the loan's amortized cost basis. Paragraph 815-25-35-11 explains that the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Paragraph 815-25-35-11 also explains that an entity should not adjust the amortized cost basis or the discount rate of the individual assets or individual beneficial interest included in the closed portfolio for a basis adjustment that is maintained on the closed portfolio basis in accordance with paragraph 815-25-35-1(c).

Excerpt from ASC 835-30

20 Glossary

Interest Method – The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.

An EIR is used to either:

- discount projected future principal and interest cash flows when estimating expected credit losses using a discounted cash flow method under Topic 326; or
- recognize interest income on financial assets under Topic 310.

ASU 2016-13, which introduced Topic 326 to the Codification, did not make substantive changes to the guidance in Subtopic 310-20 regarding the recognition of interest income or the accretion/amortization of nonrefundable fees and other costs. As a result, the EIR under Topic 326 may not be the same as the rate used to recognize interest income under Topic 310.

The following table compares how the EIR for recognizing interest income compares to the EIR used to discount expected cash flows for determining the allowance.

<table>
<tr><th>Instrument</th><th>EIR used to recognize interest income</th><th>EIR used to discount expected cash flows for determining the allowance for credit losses</th></tr>
<tr><td>Prepayable fixed rate financial assets</td><td>General requirement
EIR is based on contractual terms. [310-20-35-26]
Exception
For large numbers of similar loans for which prepayments are probable and the timing and amounts can be reasonably estimated, EIR is based on: [310-20-35-26]
— contractual cash flows; or
— prepayment-adjusted EIR. If there is a difference between anticipated and actual prepayments, a new EIR is calculated. The net investment in the asset is adjusted to the amount that would have existed had the new EIR been applied since acquisition of the asset.</td><td>Policy election (for each class of financing receivable or major security type) to calculate the EIR based on: [326-20-30-4A, 326-30-35-11, 35-7A]
— contractual cash flows; or
— prepayment-adjusted EIR, considering the timing (and changes in timing) of expected cash flows resulting from expected prepayments. If there is a difference between anticipated and actual prepayments, the adjustment to EIR is prospective.</td></tr>
<tr><td>Non-prepayable fixed rate financial assets</td><td>EIR is based on contractual terms. [310-20-35-26]</td><td>EIR is based on contractual terms.</td></tr>
<tr><td>Variable rate financial assets</td><td>EIR is calculated based on: [310-20-35-18(c), 35-20]
— the factor as it changes over the life of the asset; or
— fixed at the rate in effect at inception of the asset.</td><td>Loans and HTM debt securities
EIR is calculated based on the independent factor as it changes over the life of the financial asset. [326-20-30-4]
AFS debt securities
EIR is calculated based on: [326-30-35-11]
— the factor as it changes over the life of the AFS debt security; or
— fixed at the rate in effect at the time of the most recent credit loss.
A consistent method should be applied for all securities that have a contractual interest rate that varies based on changes in an independent factor. [326-30-35-11]</td></tr>
</table>

Instrument	EIR used to recognize interest income	EIR used to discount expected cash flows for determining the allowance for credit losses
		All financial assets Projections of changes in the factor are not required when estimating expected future cash flows for determining the allowance for credit losses. However, if such projections are made, the same projections are used in calculating the EIR used for discounting those expected future cash flows. Further, in this situation, the EIR is also adjusted for expected prepayments. [326-20-30-4, 326-30-35-11]

The focus of the discussion in the remainder of this section is the EIR used in a discounted cash flow method when determining the allowance for credit losses under Subtopic 326-20.

The EIR is the rate of return implicit in the financial asset. It is the financial asset's stated contractual rate adjusted for any purchase or origination date net deferred fees or costs, premiums or discounts. [326-20 Glossary]

Question 4.4.30#

How is the EIR calculated under Subtopic 326-20?

Interpretive response: The EIR is the rate of return implicit in a financial asset. Generally it is the interest rate that equates the present value of an asset's cash flows with the asset's amortized cost basis on the acquisition or origination date.

Calculating this rate requires adjusting the asset's contractual interest rate for net deferred fees or costs, and premiums or discounts existing at the origination or acquisition of the financial asset. When a loan is modified, the EIR is calculated based on the receivable's modified (not original) contractual terms (see Question 4.4.40). [326-20 Glossary]

However, the EIR for a financial asset restructured in a TDR is based on the original contractual rate and not the rate specified in the restructuring agreement in the following situations. [326-20-30-4, 310-40-35-12]

- An entity has not yet adopted ASU 2022-02.
- An entity adopted ASU 2022-02 using the prospective transition approach. In this situation, the EIR is based on the original contractual rate when measuring expected credit losses for loans that:
  - were modified in TDRs before adoption; and

– have not been subsequently modified after adoption.

See section 25.5 for guidance about ASU 2022-02's effective dates and transition.

Additional guidance applies when the EIR is adjusted for prepayment assumptions (see section 4.4.30) and for variable rate assets (see section 4.4.40).

Question 4.4.40#

Is the EIR recalculated when a financial asset's amortized cost basis changes?

Interpretive response: Yes. Subtopic 310-20 addresses transactions for which the rate used for recognizing interest income should be adjusted throughout the life of a financial asset due to changes in its amortized cost basis. We believe when those transactions occur, an entity should also adjust the EIR used to determine the allowance for credit losses.

Those transactions include the following: [310-20-35-10, 35-34]

- transactions in which additional fees are collected;
- costs are incurred or prepayment penalties are charged in conjunction with a loan modification; and
- fees are received by the lender unrelated to the origination of the loan.

Before adopting ASU 2022-02, an entity (1) applies the fees received in connection with a loan modification that is a TDR as a reduction of the recorded investment in the loan and (2) expenses all related costs – including direct loan origination costs. See section 25.5 for guidance about ASU 2022-02's effective dates and transition. [310-20-35-12]

These transactions result in an adjustment to the EIR on a prospective basis for the purpose of interest income recognition. [310-20-35-10, 35-34]

Further, when the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the EIR is adjusted to equate the present value of the loan's future cash flows with the adjusted amortized cost basis. [326-20-55-9]

Example 4.4.10

Discounted cash flow method – changes in EIR due to additional costs

This example illustrates the effect of the EIR on the determination of the allowance for credit losses when additional costs are incurred. To isolate this effect, the example assumes that no credit losses are expected. Actual scenarios would generally include a credit loss assumption.

Bank makes a loan to Borrower with the following attributes.

Unpaid principal balance (UPB):	$ 1,000,000
Premium:	$ 24,500
Contractual payment amount:	$ 129,505
Contractual interest rate:	5.00%
EIR (based on contractual cash flows):	4.50%
Contractual term:	10 years
Payment terms:	Annual payments

The loan is prepayable without penalty; however, Bank does not expect that Borrower will prepay the loan.

The loan has the following contractual amortization schedule.

Year	Beginning principal balance	Scheduled payment		Ending principal balance	Ending premium balance	Ending amortized cost
		Principal	Interest			
				$1,000,000	$24,500	$1,024,500
1	$1,000,000	$ 79,505	$50,000	920,495	20,650	941,145
2	920,495	83,480	46,025	837,015	17,020	854,035
3	837,015	87,654	41,851	749,361	13,641	763,002
4	749,361	92,037	37,468	657,324	10,543	667,867
5	657,324	96,639	32,866	560,685	7,762	568,447
6	560,685	101,470	28,035	459,215	5,334	464,549
7	459,215	106,544	22,961	352,671	3,299	355,970
8	352,671	111,871	17,634	240,800	1,701	242,501
9	240,800	117,465	12,040	123,335	585	123,920
10	123,335	123,335	6,170	0	0	0

Bank has determined that the loan to Borrower does not share similar risk characteristics with other loans; therefore, it has decided to estimate expected credit losses on this loan separately.

Bank uses discounted cash flows to estimate expected credit losses. At the end of Year 5, Bank modifies the loan to remove certain collateral requirements and incurs additional costs of $20,000 related to the modification. The modification is not a TDR and does not result in more than minor modifications to the loan; therefore, it is accounted for as a continuation of the original loan. After including the additional costs as an increase to the premium on the loan, the amortized cost basis of the loan is $588,447 at the end of Year 5.

Year	Ending principal balance	Ending original premium balance	Additional costs	Ending amortized cost
5	$560,685	$7,762	$20,000	$588,447
6	459,215	5,334	13,671	478,220
7	352,671	3,299	8,411	364,381
8	240,800	1,701	4,313	246,814
9	123,335	585	1,474	125,394
10	0	0	0	0

At the end of Year 5, Bank calculates an updated EIR of 3.28% – i.e. the rate that equates the present value of the expected cash flows to the new amortized cost basis (exclusive of accrued interest) of $588,447.

Bank's expected cash flows are shown in the table.

Year	Expected cash flow
6	$129,505
7	129,505
8	129,505
9	129,505
10	129,505

If Bank incorrectly did not adjust the EIR as required and instead discounted the expected cash flows at the original EIR based on the contractual cash flows (over the contractual term) of 4.50%, the present value of the expected cash flows would have been $568,447 at the end of Year 5.

The use of the incorrect EIR would have an effect on the estimate of expected credit losses, despite the assumption of no expected credit losses. When the present value is compared to the amortized cost basis of $588,447, the resulting estimated expected credit loss at the end of Year 5 would be $20,000 – i.e. the amount of the additional costs incurred.

However, because Bank correctly used the updated EIR of 3.28% to discount the expected cash flows, the present value of the expected cash flows is $588,447. When compared to the amortized cost basis of $588,447, the resulting estimated expected credit loss at Year 5 is $0, which is consistent with the simplifying assumption of no expected credit losses.

4.4.30 Calculating the EIR – Prepayment considerations

Question 4.4.50
How is the prepayment-adjusted EIR determined?

Interpretive response: The prepayment-adjusted EIR is the rate that equates the present value of the expected cash flows including prepayment expectations to the amortized cost basis, exclusive of accrued interest. Those expected cash flows should be based on contractual cash flows and only adjusted for prepayment expectations.

If differences arise between the expected prepayments and actual prepayments received, an entity recalculates the EIR to reflect actual payments to date and anticipated future payments. Similarly, if an entity changes its future expectations regarding prepayments, the EIR should be updated for those changes in expectations. [TRG 06-17.1, TRG 06-17.6]

As discussed in Question 6.2.50, an entity is permitted (but not required) to consider the guidance in paragraphs 310-20-35-9 to 35-12 when determining whether a refinancing constitutes a prepayment when estimating expected credit losses. We believe this includes estimating prepayments when using a prepayment-adjusted EIR. [TRG 2018-06.12, TRG 2018-06.13]

Question 4.4.60
Why would an entity elect to use a prepayment-adjusted EIR to discount cash flows?

Interpretive response: An accounting issue arises when an entity:

— considers prepayment expectations in estimating future principal and interest cash flows when applying a discounted cash flow method (regardless of the types of loans involved), which is required by Subtopic 326-20; but [326-20-30-6]

— discounts the prepayment-adjusted expected cash flows at an EIR that is not adjusted for prepayments – i.e. an EIR based on contractual cash flows (see Question 4.3.30). [310-20-35-26]

This approach would result in differences between the amortized cost of the financial asset and the present value of the expected cash flows. These differences would always increase the allowance for credit losses for financial assets held at a premium and offset the allowance for those held at a discount; see Example 4.4.20 for an illustration of the effect. These differences do not represent expected credit losses, but rather would be solely because of the inconsistency of including prepayment expectations in the projected cash flows but excluding prepayment expectations when determining the EIR. This inconsistency is not expected to arise when methods other than discounted cash flows are used to estimate the allowance for credit losses.

To resolve this issue, an entity is permitted to make an accounting policy election (for each class of financing receivable or major security type) to incorporate prepayment assumptions to determine an EIR used to discount expected cash flows when estimating credit losses under Subtopic 326-20 – unless the asset is restructured in a TDR. [326-20-30-4A]

If an entity does not make this election, it determines the EIR using the contractual cash flows without considering prepayment assumptions. [TRG 06-17.1, TRG 06-17.6]

Question 4.4.70#

When cash flows are discounted for TDRs, is the EIR updated for changes in prepayment expectations after the TDR?

Background: As discussed in Question 4.4.30, the EIR for a financial asset restructured in a TDR is based on the original contractual rate and not the rate specified in the restructuring agreement in the following situations.

- An entity has not yet adopted ASU 2022-02.
- An entity adopted ASU 2022-02 using the prospective transition approach. In this situation, the EIR is based on the original contractual rate when measuring expected credit losses for loans that:
  - were modified in TDRs before adoption; and
  - have not been subsequently modified after adoption.

This Question applies in those situations. See section 25.5 for guidance about ASU 2022-02's effective dates and transition.

Interpretive response: No. When estimating expected credit losses using discounted cash flows for TDRs, an entity can either: [310-40-35-12, TRG 06-17.1, TRG 06-17.6]

- use the prepayment-adjusted EIR in effect immediately before the TDR; or
- use the original EIR.

After a modification resulting in a TDR, the EIR should not be updated for future changes in prepayment expectations. [310-40-35-12, TRG 06-17.1, TRG 06-17.6]

The FASB has issued amendments to provide transition relief to entities that elect to use a prepayment-adjusted EIR in a discounted cash flow approach to estimate credit losses on financial assets modified in a TDR before the adoption date. For discussion of the specific relief, see section 25.3.50.

Example 4.4.20

Effect of using a prepayment-adjusted EIR

This example illustrates the effect of the EIR on the determination of the allowance for credit losses. To isolate this effect of prepayments, the example assumes that no credit losses are expected. Actual scenarios would generally include a credit loss assumption.

Bank makes a loan to Borrower with the following attributes.

Unpaid principal balance (UPB):	$1,000,000
Premium:	$24,500
Contractual payment amount:	$ 129,505
Contractual interest rate:	5.00%
EIR based on contractual cash flows:	4.50%
Contractual term:	10 years
Payment terms:	Annual payments

The loan is prepayable without penalty. The loan has the following contractual amortization schedule.

Year	Beginning principal balance	Scheduled payment		Ending principal balance	Ending premium balance	Ending amortized cost
		Principal	Interest			
				$1,000,000	$24,500	$1,024,500
1	$1,000,000	$ 79,505	$50,000	920,495	20,650	941,145
2	920,495	83,480	46,025	837,015	17,020	854,035
3	837,015	87,654	41,851	749,361	13,641	763,002
4	749,361	92,037	37,468	657,324	10,543	667,867
5	657,324	96,639	32,866	560,685	7,762	568,447
6	560,685	101,470	28,035	459,215	5,334	464,549
7	459,215	106,544	22,961	352,671	3,299	355,970
8	352,671	111,871	17,634	240,800	1,701	242,501
9	240,800	117,465	12,040	123,335	585	123,920
10	123,335	123,335	6,170	0	0	0

Bank has determined that the loan to Borrower does not share similar risk characteristics with other loans; therefore, it estimates expected credit losses on this loan separately. [326-20-30-2]

Bank uses discounted cash flows to estimate expected credit losses. For simplicity, assume that Bank expects to collect the amortized cost basis of the loan with full prepayment at the end of Year 5.

Bank's expected cash flows are as follows.

Year	Expected cash flow
1	$129,505
2	129,505
3	129,505
4	129,505
5[1]	690,190

Note:
1. $657,324 (unpaid principal balance at the beginning of Year 5) + $32,866 (interest accrued during Year 5).

Scenario 1: Discount at EIR based on contractual cash flows over the contractual term (i.e. EIR is not adjusted for expected prepayments)

Using discounted cash flows to estimate credit losses, Bank discounts the expected cash flows (which consider full prepayment in Year 5) at 4.50%, the EIR based on contractual cash flows with the following results.

Year	Amortized cost basis	Present value of cash flows	Allowance for credit losses
Origination	$1,024,500	$1,018,275	$6,225
1	941,145	934,639	6,506
2	854,035	847,236	6,799
3	763,002	755,896	7,106
4	667,867	660,442	7,425
5	0	0	0

Despite the fact that this example uses a simplifying assumption of zero credit losses (solely to isolate the effect of the EIR), an allowance for credit losses still arises solely due to the inconsistency in the consideration of prepayment expectations between estimated future cash flows (which incorporate prepayment expectations) and the EIR based on contractual cash flows (which does not incorporate prepayment expectations). The remaining allowance of $7,425 would be reversed when the loan prepays in Year 5.

Scenario 2: Discount at the prepayment-adjusted EIR

Using its expectation of cash flows, Bank calculates a prepayment-adjusted EIR of 4.34% (rounded) – i.e. the rate that equates the present value of the expected cash flows including prepayment expectations to the initial amortized cost basis (exclusive of accrued interest) of $1,024,500.

The following is the amortization table based on the prepayment-adjusted cash flows.

Year	Beginning principal balance	Expected payment		Ending principal balance	Ending premium balance	Ending amortized cost
		Principal	Interest			
				$1,000,000	$24,500	$1,024,500
1	$1,000,000	$ 79,505	$50,000	920,495	18,950	939,445
2	920,495	83,480	46,025	837,015	13,685	850,700
3	837,015	87,654	41,851	749,361	8,743	758,104
4	749,361	92,037	37,468	657,324	4,167	661,491
5	657,324	657,324	32,866	0	0	0

Using discounted cash flows to estimate credit losses, Bank discounts the expected cash flows (which consider full prepayment in Year 5 at 4.34%) using the EIR based on the contractual cash flows (over the contractual term) adjusted for prepayment expectations with the following results.

Year	Amortized cost basis	Present value of cash flows	Allowance for credit losses
Origination	$1,024,500	$1,024,500	0
1	939,445	939,445	0
2	850,700	850,700	0
3	758,104	758,104	0
4	661,491	661,491	0
5	0	0	0

The result is consistent with the assumption that no credit losses were expected at any point during this loan's life.

4.4.40 Calculating the EIR – Variable rate loan considerations

Question 4.4.80

How is the EIR calculated under Subtopic 326-20 for a variable rate loan?

Interpretive response: Subtopic 326-20 provides the two alternatives outlined below.

EIR is based on independent factor as it changes over life of loan

Subtopic 326-20 indicates that if the financial asset's stated interest rate is based on an index or rate that varies based on subsequent changes in an independent factor (e.g. the prime rate or LIBOR), the EIR may be calculated based on the factor as it changes over the life of the loan. [326-20-30-4, 310-20-35-18(c)]

This means that an entity uses the current market rate at the reporting date and does not project changes in the independent factor when determining the EIR. Therefore, an entity assumes that the factor does not change over the remaining life of the asset. [326-20-30-4, 310-20-35-18(c)]

Financial assets with initial fixed interest rates that become adjustable in the future based on subsequent changes in an independent factor are included in this guidance. Therefore, an entity should forecast contractual cash flows using the:

- initial fixed interest rate over the fixed period; and
- current rate for the independent factor, without projecting changes in the independent factor, over the variable period.

EIR is based on projections of independent factor

Alternatively, an entity may adjust the EIR based on projections of the independent factor. When an entity elects this alternative, it is also required to: [326-20-30-4]

— use the same projections for purposes of estimating expected future cash flows that it used when determining the EIR; and
— adjust the EIR to consider the effect of expected prepayments.

Example 4.4.30

EIR used to calculate the allowance for credit losses – variable rate loan

Bank makes a loan to Borrower with the following attributes.

Unpaid principal balance (UPB) (initial):	$100,000
Stated interest rate:	Prime on Jan. 1 + 100 bps
Contractual term:	10 years
Payment terms:	Annual payments

The loan is prepayable without penalty. Prime is 7.25% in Year 1, 8.25% in Year 2, 7.25% in Year 3 and 3.25% in Year 4.

For purposes of estimating expected credit losses, Bank makes the following elections related to determining the EIR used to discount expected cash flows when estimating credit losses.

— Bank does not elect to project changes in the prime rate for purposes of estimating cash flows or determining the EIR. Instead, Bank keeps the rate unchanged in future periods.
— Bank elects to incorporate prepayment assumptions.

The contractual amortization schedule follows. Years 1-4 are actual rates and Years 5-10 represent the prime rate in effect at the end of Year 4 without projecting further change in the prime rate.

Year	Beginning principal balance	Contractual payment[1]	Scheduled payment		Ending principal balance
			Principal	Interest	
1	$100,000	$15,071	$ 6,821	$8,250	$93,179
2	93,179	15,700	7,081	8,619	86,098
3	86,098	15,125	8,022	7,103	78,076
4	78,076	13,129	9,811	3,318	68,265
5	68,265	13,129	10,228	2,901	58,037
6	58,037	13,129	10,662	2,467	47,375
7	47,375	13,129	11,116	2,013	36,259
8	36,259	13,129	11,588	1,541	24,671
9	24,671	13,129	12,080	1,049	12,591

Year	Beginning principal balance	Contractual payment[1]	Scheduled payment		Ending principal balance
			Principal	Interest	
10	12,591	13,129	12,591	538	0

Note:

1. The contractual payment amount varies each period as the variable spot interest rate changes.

At the end of Year 4, Bank expects full prepayment at the end of Year 7. Bank calculates the prepayment-adjusted EIR as the rate that equates the present value of the contractual cash flows, adjusted for prepayment expectations, to the amortized cost basis (exclusive of accrued interest).

Amortized cost basis Year 4:	$68,265
Expected payment Year 5:	13,129
Expected payment Year 6:	13,129
Expected payment Year 7:[1]	49,388

Note:

1. $47,375 (amortized cost at the beginning of Year 7) + $2,013 (interest accrued during Year 7).

At the end of Year 4, the rate that equates the present value of the expected cash flows, including prepayment assumptions, to the amortized cost basis (exclusive of accrued interest) is 4.25% (prime rate of 3.25% at the end of Year 4 +100 bps).

5. Collective assessment

Detailed contents

5.1 How the standard works

An entity estimates expected credit losses of financial assets with similar risk characteristics on a collective (pool) basis.

A financial asset is measured individually only if it does not share similar risk characteristics with other financial assets.

Both credit and non-credit related characteristics are relevant in determining whether certain assets share similar risk characteristics.

5.2 Identifying pools

5.2.10 Overview

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

30-2 An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

> Developing an Estimate of Expected Credit Losses

55-5 In evaluating **financial assets** on a collective (pool) basis, an entity should aggregate financial assets on the basis of similar risk characteristics, which may include any one or a combination of the following (the following list is not intended to be all inclusive):

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

>> Disclosure—Application of the Term Credit Quality Indicator

55-15 This implementation guidance addresses application of the term ***credit quality indicator***. Examples of credit quality indicators include all of the following:

a. Consumer credit risk scores
b. Credit-rating-agency ratings
c. An entity's internal credit risk grades
d. Debt-to-value ratios
e. Collateral
f. Collection experience
g. Other internal metrics.

20 Glossary

Credit quality indicator – A statistic about the credit quality of a financial asset.

Expected credit losses for financial assets are estimated on a collective – i.e. pool – basis. Financial assets with similar risk characteristics are pooled. Subtopic 326-20 contains several risk characteristics that may be relevant in identifying pools of financial assets. [326-20-30-2, 55-5]

Question 5.2.10

Must an entity pool assets based on similar risk characteristics?

Interpretive response: Yes. An entity estimates expected credit losses of financial assets with similar risk characteristics collectively. [326-20-30-2]

Subtopic 326-20 provides a list of characteristics that an entity may consider in aggregating financial assets into pools. This list includes both credit and non-credit related characteristics. Although Subtopic 326-20 does not specifically require an entity to consider a financial asset's primary credit quality indicator(s) when aggregating financial assets, we would generally expect an entity to factor in some credit related characteristics. [326-20-55-5, 55-15]

The FASB proposed requiring the estimate of expected credit losses to consider multiple outcomes. However, based on feedback received during deliberations, the FASB decided to require an entity to estimate losses on a collective basis instead of requiring the estimate to consider multiple outcomes. This is because constituents were concerned "that the multiple-outcome approach could be interpreted as requiring complex modeling techniques." This decision was anchored in the FASB's understanding that although there is no requirement to do so under legacy US GAAP, collective approaches are often used in practice. [ASU 2016-13.BC68, BC66]

In requiring a pool-based estimate, the FASB reasoned that while an entity may expect to collect all the contractual cash flows on an individual asset, "it ordinarily would expect some level of losses in a group of assets with similar risk characteristics. Therefore, an estimate of expected credit losses should reflect a collective assessment if similar risk characteristics exist." [ASU 2016-13.BC69]

From an operational perspective, we believe there may be circumstances in which an entity would be permitted to estimate expected credit losses on an individual basis, despite sharing similar risk characteristics with other financial assets. An entity would need to support (either qualitatively or quantitatively) that the estimation method applied would generally be expected to achieve results similar to a collective estimate. [ASU 2016-13.BC70]

Question 5.2.20

Must an entity revise pools of financial assets if risk characteristics change?

Interpretive response: Yes. An entity evaluates whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in the pool. A financial asset is moved to another pool or evaluated individually if it does not continue to share similar risk characteristics with other financial assets in the pool. [326-20-35-2]

Having factored in some credit characteristics when pooling financial assets (see Question 5.2.10), we would expect an entity to revise the composition of the financial assets in a pool if there are changes in credit risk or other risks such that the assets are no longer considered to share similar risk characteristics.

If an asset no longer shares similar risk characteristics with other financial assets in the pool and does not share similar risk characteristics with another pool, it is evaluated on an individual basis and should not be included in the collective evaluation. [326-20-30-2]

For example, if an asset is removed from a pool for which a loss-rate method is used to estimate expected credit losses, the entity should evaluate the loss rate for the pool to ensure that the losses are not being double counted – i.e. factored into the losses at both the pool level and individual level.

Question 5.2.30

Are an entity's segmentation practices under the incurred loss model permitted under Subtopic 326-20?

Interpretive response: It depends. An entity's current segmentation practices under the incurred loss model may not, in all cases, be consistent with Subtopic 326-20's requirement to pool financial assets with similar risk characteristics.

We believe the legacy US GAAP segmentation may continue to be applied in some circumstances, but only after an entity has:

- evaluated the similarity of risk characteristics (one of which we believe would be credit related) of loans within the current portfolio segments; and
- determined that its method to estimate expected credit losses will consider the effect of including loans within each segment that have different remaining durations.

Question 5.2.40

Is the collective assessment guidance applied to off-balance sheet credit exposures?

Interpretive response: Yes. We believe the collective assessment guidance should be applied by analogy to off-balance sheet credit exposures even though they do not represent financial assets. This is because the guidance for off-balance sheet credit exposures refers to estimating expected losses based on the guidance in Subtopic 326-20. [326-20-30-2, 30-11]

Under legacy US GAAP, collective approaches are often used in practice to measure off-balance sheet credit exposure but there is no requirement to do so.

5.3 Changes to pools

5.3.10 Overview

Excerpt from ASC 326-20

> Reporting Changes in Expected Credit Losses

35-2 An entity shall evaluate whether a financial asset in a pool continues to exhibit similar risk characteristics with other financial assets in the pool. For example, there may be changes in credit risk, borrower circumstances, recognition of writeoffs, or cash collections that have been fully applied to principal on the basis of nonaccrual practices that may require a reevaluation to determine if the asset has migrated to have similar risk characteristics with assets in another pool, or if the credit loss measurement of the asset should be performed individually because the asset no longer has similar risk characteristics.

Pools used to collectively estimate expected credit losses are not static. If an asset in a pool no longer exhibits the same risk characteristics as the other assets in a pool, it should be removed from the pool. It can either be measured for expected credit losses individually or placed in another pool, if appropriate. Subtopic 326-20 gives several examples of changes that may lead to removing an asset from a pool. [326-20-35-2]

Excerpt from ASC 326-20

>> Example 4: Estimating Expected Credit Losses Using both a Collective Method and an Individual Asset Method

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

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

55-34 One loan program from Bank D provides unsecured commercial loans of up to $75,000 to small businesses and entrepreneurs. Given the relative homogeneity of the borrowers (in terms of credit risk) and loans (in terms of type, amount, and underwriting standards) in the program, Bank D manages this loan program on a collective basis. However, Bank D concludes that the loss estimates for loans with credit deterioration is based on borrower-specific facts and circumstances because the repayment of those loans depends on facts and circumstances unique to each borrower. Therefore, Bank D estimates expected credit losses on an individual basis for loans that no longer exhibit similar risk characteristics because of credit deterioration. A loss-rate method for estimating expected credit losses on a pooled basis is applied for the loans in the portfolio segment that continue to exhibit similar risk characteristics.

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

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

6. Contractual term

Detailed contents

New item added in this edition: **

6.1 How the standard works

Subtopic 326-20 requires an entity to estimate expected credit losses over a financial asset's contractual term. The contractual term is adjusted for prepayments.

Because expected credit losses are estimated over the contractual term, the determination of the contractual term will generally significantly affect the size of the allowance for credit losses. In general, the longer the contractual term, the larger the allowance for credit losses.

This chapter discusses the effect of the following on a financial asset's contractual term:

- options to extend the contractual term;
- call options; and
- expected prepayments.

It also addresses some specific considerations for estimating the life of credit card receivables and determining the contractual term for net investments in leases and (before adoption of ASU 2022-02) TDRs that are reasonably expected.

6.2 Determining the contractual term

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

30-6 An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless either of the following applies:

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

Pending Content:

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

> Developing an Estimate of Expected Credit Losses

30-6 An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless ~~either of~~ the following applies:

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

6.2.10 Intention to renew

An entity estimates expected credit losses over the contractual term. The contractual term does not include expected future renewals or extensions, unless (before adopting ASU 2022-02) the entity has a reasonable expectation of a future TDR. This is the case even if the entity has established a past practice of renewing similar financial assets.

Example 6.2.10
Loan with no lender contractual obligation to renew

Bank provides a one-year, $50,000 bridge loan to Borrower.

Bank has no contractual obligation to extend the bridge loan or to provide a new loan to Borrower at the end of the bridge loan term. However, Bank has a past practice for similar loans of subsequently providing a three-year term loan for the same amount (i.e. $50,000) once the bridge loan matures. Borrower would then use the proceeds from the term loan to pay off the bridge loan.

Although Bank has established a past practice of renewing similar loans, it is not contractually obligated to extend the bridge loan or to provide a new term loan. Therefore, Bank uses the one-year contractual term of the bridge loan to measure expected credit losses.

Additionally, Bank does not recognize a separate liability for any potential off-balance sheet credit exposure because the ability to renew the loan is within its control – i.e. there is no contractual obligation placed on Bank.

6.2.20 Options to extend the contractual term

Either the borrower or lender may have an option to extend the maturity date of a loan. The lender needs to evaluate the effect of these options on the contractual term over which expected credit losses should be estimated.

If the lender has the unconditional option to extend the contractual term, the lender should not consider the potential extension when determining the contractual term. If the borrower has the contractual option to extend the contractual term, the lender should evaluate whether the potential extension affects the contractual term, unless the lender accounts for the option as a derivative. [326-20-30-6]

Example 6.2.20
Effect of extensions on the contractual term

At the beginning of Year 1, Bank provides a three-year loan to Borrower (the maturity date is the end of Year 3). The loan does not contain any extension or renewal options that are not unconditionally cancellable by Bank. Based on historical experience, Bank does not expect Borrower to prepay the loan.

During Year 3, Borrower requests an extension of the original maturity date and the Bank agrees in principle to grant the extension. However, Bank does not enter into an agreement to contractually extend the term until Year 4. Borrower is not in financial difficulty, and therefore the extension is not a TDR (see chapter 11).

Bank determines the contractual term over which expected credit losses should be estimated. For the Year 3 reporting period, Bank does not consider the potential extension because Borrower does not have the contractual option to extend the loan and Bank has not yet granted the extension by contractually extending the loan's term. Rather, the estimate of expected credit losses is based on the original contractual term of the loan (i.e. three years) because in this example the extension is not a TDR.

The contractual term is not adjusted as a result of Borrower's request for an extension and Bank agreeing to grant the extension. However, once the extension has been entered into contractually, Bank includes the effect of the extended contractual term when estimating expected credit losses.

Question 6.2.10

What is the effect on the contractual term of a borrower's option to extend the maturity date of a funded loan?

Interpretive response: A loan may include contractual features that allow the maturity date to be extended at the borrower's option.

Borrower option outside lender's control

The borrower's contractual option to extend the maturity date could be unilateral (i.e. unconditional), or it could be conditional upon the occurrence of events outside the lender's control. In either scenario, the lender does not have the ability to avoid extending the maturity date of the loan.

In these scenarios, the option affects the loan's contractual term and resulting estimate of expected credit losses, unless the option is accounted for as a derivative. The lender should measure the allowance for credit losses by considering the option's expected effects and the likelihood that the borrower will exercise the option. [326-20-30-6]

Borrower option within lender's control

If the borrower's ability to exercise the term-extension option is within the lender's control, the lender should not adjust the contractual term of the funded loan or record an off-balance sheet credit exposure because there is no contractual obligation placed on the lender. An example of this type of situation is when a new underwriting is required in connection with the borrower's request for a term-extension. [326-20-30-6]

Example 6.2.30

Loan with borrower conditional option to extend

Bank provides a $1,000 one-year loan to Borrower. The loan may be extended for an additional year at Borrower's option if Borrower's external credit rating does not decline, which is a condition outside Bank's control. Bank does not account for the extension option as a derivative.

Bank estimates the probability of default is 2% per year and the loss given default is 65% of the original principal amount. Bank also estimates that there is a 50% likelihood that Borrower will exercise its option – meaning Borrower's credit rating will not decline and Borrower will elect to extend the term of the loan for an additional year.

For the $1,000 loan, Bank calculates its allowance for credit losses as $1,000 × 2% × 65% = $13, representing expected credit losses over the one-year contractual term of the funded loan.

Because Borrower has an option to extend the loan for an additional year, Bank has additional credit exposure for the period covered by the potential extension. Bank calculates its allowance for credit losses as $1,000 × 2% × 65% × 50% = $6.50.

Question 6.2.20

What is the effect on the contractual term of a lender's option to extend the maturity date of a funded loan?

Interpretive response: A loan may include features that allow the maturity date to be extended at the lender's option.

If the term of the loan may be extended at the lender's option, the contractual term should not include the potential extension(s), even if the lender has a past practice of extending the term. However, once the extension has been entered into contractually, the lender includes the effect of the extended contractual term when estimating expected credit losses. The term is not extended until it is contractually entered into. Additionally, no off-balance sheet credit exposure exists, because there is no contractual obligation placed on the lender.

Question 6.2.25

Is it appropriate for an entity to assume that all (or no) extension or renewal options will be exercised?

Interpretive response: It depends. In general, we do not believe it is appropriate for an entity to assume that either all (or no) extension or renewal options will be exercised if that assumption does not reflect the entity's historical experience. An exception arises if the entity can demonstrate that the current facts and circumstances have changed from its historical experience in a manner that supports the assumption.

In our experience, many entities do not currently track extension or renewal options and how often these options have been exercised. To prepare for implementation, we believe an entity will need to consider whether and how its estimate of the allowance for credit losses incorporates the credit risk related to these options.

Some entities may need to change their existing processes and related controls to:

- identify whether contracts contain contractual extension or renewal options that are not unconditionally cancellable by the entity – i.e. are not in the lender's control;
- capture information necessary to estimate the likelihood that the renewal or extension option will be exercised, including the likelihood that the contingent events will occur; and
- measure the effect of the potential extension period on the estimate of expected credit losses.

6.2.30 Call options

Question 6.2.30
What is the effect on the contractual term of a call option held by the lender?

Interpretive response: When a financial asset is callable by the lender, we believe the lender should estimate credit losses only for the minimum period that it is contractually exposed to credit losses. This is the period between the reporting date and the date that repayment would become due if the call option were exercised at the earliest possible date. That is, an entity should measure the allowance for credit losses by estimating the expected credit losses that would occur if the entity were to call the loan at the earliest possible date.

For example, if the reporting date is December 31, Year 1 and the lender has an option that is exercisable immediately with repayment due in 12 months, the period over which credit losses should be estimated is 12 months. Alternatively, if the option is not exercisable for six months (July 1, Year 2) with repayment due in 12 months from the date of exercise, the period over which credit losses should be estimated is 18 months.

A financial instrument that is callable by the lender at any time is economically equivalent to a loan that is due in the near-term (i.e. in one day) for which the lender has a series of one-day extension options. Therefore, we believe the approach to determining the allowance for credit losses should be similar.

In the past, an entity may not have called all financial assets on their earliest call dates. As a result, the entity may have had a longer period of credit exposure to those financial assets than would be considered under Subtopic 326-20. Therefore, the entity's historical loss experience may not reflect the losses that would have occurred (or not occurred) if the entity had called those assets at their earliest call dates. In this situation, an entity should consider whether its historical loss experience should be adjusted to reflect its estimate of what expected credit losses would have been if the option had been exercised at the earliest call date.

Example 6.2.40
Callable loan

Bank provides a $1,000,000 loan to Borrower. Bank may call the loan at any time, and Borrower is given one day to repay the loan in full. However, in practice, Bank only cancels the facility when it becomes aware of a significant deterioration in the credit quality of a borrower.

Bank estimates the allowance for credit losses over the minimum period that it is exposed to credit losses. In this case, Bank assumes it would immediately exercise its option, and that Borrower would then have one day to repay the loan.

Bank estimates that if the loan were called immediately there would be a 0.5% chance that Borrower would not be able to pay the outstanding balance the following day. Bank also estimates that the loss given default would be 30% of the original principal amount. For the $1,000,000 loan, Bank calculates its allowance for credit losses as $1,000,000 × 0.5% × 30% = $1,500.

6.2.40 Expected prepayments

The contractual term of a loan must be adjusted for expected prepayments. [326-20-30-6]

Question 6.2.40
May the weighted-average remaining life be used as the contractual term for a portfolio of loans?

Interpretive response: It depends. When estimating prepayments for a portfolio of loans, we believe there are several challenges that should be addressed before using the weighted-average remaining life as a simplifying assumption for the remaining duration of a portfolio of financial assets. For example, this assumption may be challenging to sustain when loan losses are expected to occur at significantly different times or at different rates over the contractual term of the loans rather than on a ratable basis, as illustrated in Example 6.2.50.

When loss rates are expected to be reasonably consistent over the contractual term of a financial asset, an entity may have a greater ability to use the weighted-average life as a simplifying assumption. In other circumstances, we believe practices may develop whereby simplifying assumptions such as weighted-average remaining lives will be used in quantitative models, and then qualitative adjustments will be made to the allowance for credit losses to compensate for the effect of the simplifying assumptions. However, the benefit from simplifying the quantitative model may be offset by the complexity of developing and supporting the amount of the qualitative adjustments.

The FASB staff issued a Q&A document that addresses issues related to the weighted-average remaining maturity method for estimating the allowance for credit losses. The FASB staff indicated that the weighted-average remaining

maturity method is one of many methods that could be used to estimate an allowance for credit losses for less complex financial asset pools, and that an entity needs to consider whether qualitative adjustments should be made.
[FASB Staff Q&A]

Example 6.2.50
Weighted-average remaining life

ABC Corp. has a portfolio of three newly originated five-year loans that are each prepayable. Loan #1 is expected to be prepaid in Year 1, Loan #2 is expected to be prepaid in Year 3 and Loan #3 is not expected to be prepaid. Because the amortized cost of each loan is $2,000,000, the weighted-average life of the portfolio is three years after considering prepayments. ABC expects different loss rates throughout the five-year contractual term.

This example is intended to illustrate the potential effect of using the weighted-average remaining life as a simplifying assumption when estimating credit losses. Specifically, it illustrates how the allowance for credit losses differs when ABC uses different loss rates for each loan in the portfolio based on each loan's expected prepayment date, and when it bases its loss rate on a simplifying assumption that all loans in the portfolio will prepay on the same date – i.e. assuming that the remaining term for all loans equals the weighted-average maturity date for the overall portfolio.

Calculation of expected credit losses using contractual term and loss rates determined for each loan

Loan	Amortized cost	Prepayment expected after __ years	Cumulative loss rate	Expected credit losses
1	$2,000,000	1	2.50%	$ 50,000
2	2,000,000	3	4.50%	90,000
3	2,000,000	5	5.00%	100,000
Total	**$6,000,000**		**4.00%**[1]	**$240,000**

Note:
1. This is the weighted-average loss rate for the portfolio, calculated as $240,000 / $6,000,000.

Calculation of expected credit losses using the weighted-average life as the remaining term for all loans in the portfolio

Loan	Amortized cost	Prepayment expected after __ years	Cumulative loss rate	Expected credit losses
Pool	$6,000,000	3	4.50%[1]	$270,000

Note:
1. The weighted-average remaining life of the loan portfolio is three years. Because this approach assumes that all loans will prepay in three years, the loss rate for loans with an expected prepayment date of three years (4.50%) is applied to the entire portfolio.

Comparison of estimated expected credit losses

Calculated based on:	Expected credit losses
Using the contractual term and loss rates determined for each loan	$240,000
Using weighted-average life as the remaining term for all loans in the portfolio	270,000
Difference	**$ 30,000**

Because different loss rates are expected throughout the contractual term of the portfolio, if the weighted-average life is used for the remaining duration of the entire portfolio, qualitative adjustments need to be made to the allowance to compensate for the effect of the simplifying assumption. As mentioned in Question 6.2.40, the benefit obtained by the entity from simplifying the quantitative model may be offset by the complexity of developing and supporting the qualitative adjustments.

Question 6.2.50

Must a lender use the loan modification guidance to determine whether a refinancing should be considered a prepayment?

Background: Paragraphs 310-20-35-9 to 35-12 provide guidance that a lender uses to determine whether a refinancing results in recognition of a new loan or a continuation of the existing loan (i.e. a loan modification).

Before adoption of ASU 2022-02, paragraphs 310-20-35-9 to 35-12 do not apply to loan modifications that are TDRs.

Interpretive response: No. The TRG and FASB discussed this issue at meetings in June and August 2018, respectively. They agreed that an entity is permitted (but not required) to consider the guidance in paragraphs 310-20-35-9 to 35-12 when determining what constitutes a prepayment for purposes of estimating expected credit losses. [TRG 2018-06.12, TRG 2018-06.13]

The FASB decided that an entity should use judgment to develop an approach that faithfully reflects expected credit losses for financial assets and can be applied consistently over time. This includes applying judgment when identifying the appropriate methods and inputs (including prepayments) to be used. However, this judgment may differ for different loan types. [TRG 2018-06.12, TRG 2018-06.13]

For example, an entity may have a refinancing that results in recognizing a new loan under the guidance in paragraphs 310-20-35-9 to 35-12. An entity is permitted to only consider such a refinancing as a prepayment for purposes of estimating the contractual term under Subtopic 326-20. [TRG 2018-06.12, TRG 2018-06.13]

Because Subtopic 326-20 requires prepayments to be considered in estimating a financial asset's contractual term, an entity needs to develop processes and controls to estimate prepayments. This encompasses estimating refinancing activity based on the entity's approach for determining whether refinancings are considered prepayments.

Question 6.2.60

Are reasonable and supportable forecasts of future economic conditions considered in developing a prepayment assumption?

Interpretive response: Yes. In developing its prepayment assumption, we believe an entity should not rely solely on historical experience but should also consider its reasonable and supportable forecast of economic conditions. For example, forecasted changes in interest rates or other economic conditions may impact expected prepayments. The estimate of prepayments will affect the life of the financial asset and therefore the amount of losses an entity includes in its estimate of expected credit losses.

This approach is consistent with how an entity considers reasonable and supportable forecasts of future economic conditions in developing other aspects of the allowance for expected credit losses, including the probability of default and the loss given default assumptions. [326-20-30-9]

See section 7.3.10 for additional information on reasonable and supportable forecasts.

Question 6.2.70

Can an entity assume that prepayments will occur at a constant rate over the remaining contractual term?

Interpretive response: It depends. Estimating the contractual term of a portfolio of prepayable financial assets requires an entity to estimate both the magnitude of prepayments and the timing of those prepayments.

In some circumstances, an entity may conclude that a constant prepayment rate represents its best estimate of the timing of prepayments. In that case, we believe the use of a constant prepayment rate is appropriate.

In other circumstances, an entity may conclude that a constant prepayment rate does not represent its best estimate of the timing of prepayments. In such cases, we believe an entity should either:

— incorporate a non-constant prepayment assumption that reflects its best estimate of the timing of prepayments; or

— use a constant prepayment rate as a simplifying assumption in the quantitative model, along with qualitative adjustments made to the allowance for credit losses to compensate for the effect of the simplifying assumption. However, the benefit of simplifying the quantitative model may be offset by the complexity of developing and supporting the amount of the corresponding qualitative adjustments.

For example, an entity owns a portfolio of residential mortgage loans. It evaluates the expected timing of prepayments using its own experience and available external information; as a result, it determines that its best estimate is not a constant prepayment rate but rather that prepayment rates will be lower in the earlier portion of the contractual term and higher in the later portion of the contractual term. In this example, the entity should either:

— incorporate an assumption in the quantitative model that prepayment rates will be lower in the earlier portion of the contractual term and higher in the later portion of the contractual term; or

— follow a two-step approach by:

  – using a simplifying assumption that prepayments will occur evenly over the remaining contractual term in the quantitative model; and
  – developing a qualitative adjustment to adjust the quantitative model for the estimated effect of using the simplifying assumption.

6.3 TDRs that are reasonably expected (before adoption of ASU 2022-02)

6.3.10 Overview

Certain TDRs include a more than insignificant delay in payments (i.e. term extension). When there is a reasonable expectation that an individual financial asset will have a TDR, an entity considers any expected extensions, renewals and modifications when determining the period over which to estimate expected credit losses. The FASB decided to extend the contractual term for TDRs that are reasonably expected based on its view that a financial asset that is modified by a TDR should be treated as a continuation of the original financial asset. Therefore, once a TDR that will extend the contractual term is reasonably expected the probability of default should be assessed over the extended contractual term. [326-20-30-6, ASU 2016-13.BC100]

We believe that the extension of the contractual term for a TDR that is reasonably expected should not be analogized to in other circumstances. For example, an entity would not analogize to this guidance if it planned to extend, modify or renew a non-TDR that had experienced credit deterioration.

See section 11.2.40 for additional information on timing of TDR identification.

Effect of ASU 2022-02**

This section 6.3 does not address the amendments in ASU 2022-02, Financial Instruments—Credit Losses: Troubled Debt Restructurings and Vintage Disclosures, which was issued by the FASB in March 2022. The ASU affects this section because ASU 2022-02 eliminates separate recognition and measurement guidance for TDRs, as well as the related guidance in Subtopic 326-20 for measuring credit losses on TDRs. After ASU 2022-02 is adopted, a loan modification is not evaluated to determine whether it is a TDR. An entity also does not evaluate whether a TDR is reasonably expected when determining the contractual term of a loan.

See section 25.5 for guidance about ASU 2022-02's effective dates and transition.

6.4 Estimating the life of credit card receivables

6.4.10 Overview

For most credit card relationships, Subtopic 326-20 requires an entity to estimate the allowance for credit losses for only the balance existing at the reporting date. An allowance for credit losses is generally not recognized for the amounts that are expected to be drawn in the future because they are typically unconditionally cancellable by the entity. This adds complexity to the estimate of the remaining life of a credit card receivable because an entity needs to determine whether expected future principal payments will relate to the reporting date balance or balances arising after the reporting date (i.e. future drawdowns).

The TRG discussed how to allocate expected future payments between the reporting date balance and balances expected to arise after the reporting date. Specifically, the TRG clarified that an entity is permitted but not required to apply expected principal payments to the credit card receivable balances existing at the reporting date until the balance is exhausted. Alternatively, an entity could choose other methods that allocate expected principal payments between the balance existing at the reporting date and future balances. The TRG noted that different approaches will result in different estimates of expected credit losses. [326-20-30-6, TRG 06-17.5, TRG 06-17.6]

Some TRG members raised questions about how future principal payment amounts should be determined when an entity elects to allocate those payments to the credit card receivables balance existing at the reporting date until the balance is exhausted. In an October 2017 FASB meeting, the Board discussed how to determine estimated expected future payments.

Consistent with the flexibility provided in other aspects of measuring expected credit losses, the Board decided that a specific approach would not be required. Instead, an entity may:

- include all payments expected to be collected from the borrower;
- include a portion of the payments expected to be collected from the borrower; or
- apply a different approach.

The Board noted that the approach selected should be consistent with the objectives of the standard.

7. Historical loss experience, forecasts and reversion

Detailed contents

7.1 How the standard works

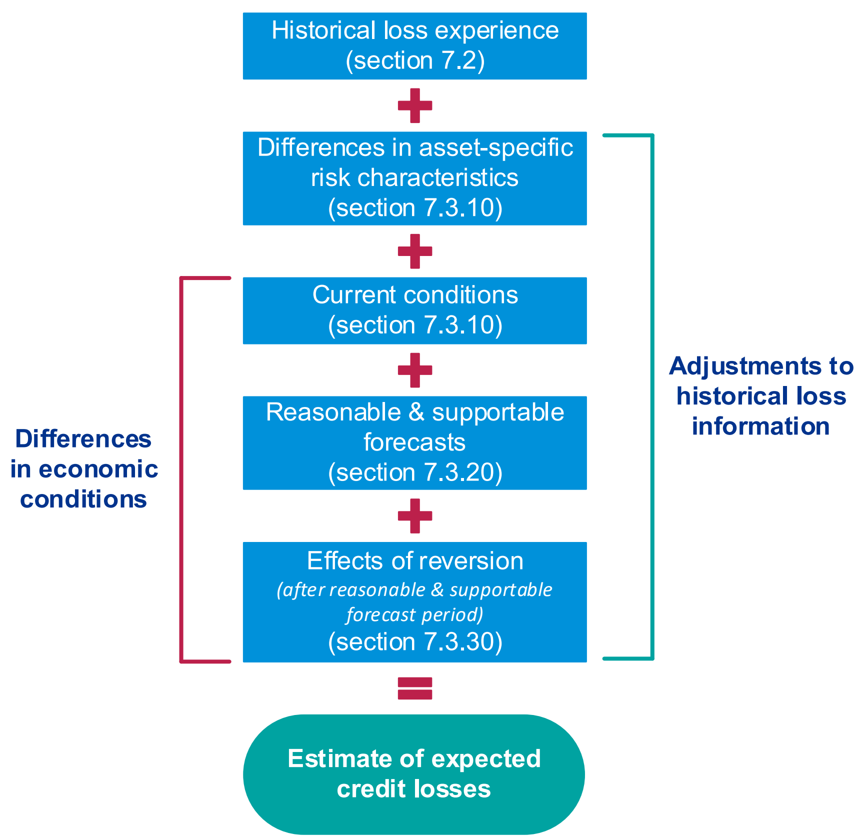
The estimate of expected credit losses is based on relevant information about past events, current economic conditions, and reasonable and supportable forecasts of future economic conditions that affect the collectibility of the reported amounts. Historical loss experience is generally the starting point for estimating expected credit losses.

Adjustments are made to historical loss experience to reflect:

— differences in asset-specific risk characteristics – e.g. underwriting standards, portfolio mix or asset terms.

— differences in economic conditions – both current conditions and reasonable and supportable forecasts of future economic conditions. If an entity is not able to make or obtain reasonable and supportable forecasts of future economic conditions for the entire life of the financial asset, it is required to estimate expected credit losses for the remaining life using an approach that reverts to historical credit loss information.

The following diagram summarizes the concepts discussed in this chapter.



7.2 Historical loss experience

7.2.10 Overview

Excerpt from ASC 326-20

> Historical Loss Experience

30-7 When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

30-8 Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

>> Information Considered When Estimating Expected Credit Losses

55-2 In determining its estimate of expected credit losses, an entity should evaluate information related to the borrower's creditworthiness, changes in its lending strategies and underwriting practices, and the current and forecasted direction of the economic and business environment. This Subtopic does not specify a particular methodology to be applied by an entity for determining historical credit loss experience. That methodology may vary depending on the size of the entity, the range of the entity's activities, the nature of the entity's **financial assets**, and other factors.

55-3 Historical loss information generally provides a basis for an entity's assessment of expected credit losses. An entity may use historical periods that represent management's expectations for future credit losses. An entity also may elect to use other historical loss periods, adjusted for current conditions, and other reasonable and supportable forecasts. When determining historical loss information in estimating expected credit losses, the information about historical credit loss data, after adjustments for current conditions and reasonable and supportable forecasts, should be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed.

An entity bases its estimate of expected credit losses on relevant information about past events, current conditions, and reasonable and supportable forecasts that affect the collectibility of the financial asset. [326-20-30-7]

Historical loss experience generally serves as the starting point for this estimate. An entity uses its judgment in selecting: [326-20-30-8]

— source(s) of historical information (see section 7.2.20); and
— historical period(s) to use for obtaining historical loss experience (see section 7.2.30).

Historical loss information should be separately determined for each of the asset pools for which expected credit losses are being estimated. Moreover, the level at which historical loss information is developed should be consistent with the level of pooling elected by the entity. [326-20-55-3]

7.2.20 Source(s) of historical information

An entity may use internal and/or external historical loss information when estimating expected credit losses. However, the FASB indicated that an entity should not default to using only the most observable external data if its internal data is sufficient. Additionally, while an entity should not ignore relevant data when considering historical loss information, it is not required to search for information that is not reasonably available without undue cost and effort. [ASU 2016-13.BC51]

Question 7.2.10
Under what circumstances may an entity use external data?

Interpretive response: In selecting source(s) of historical information, we believe an entity should begin by determining whether internal data is available that is relevant and reliable. We believe an entity may elect to use external data when limitations exist on the availability of internal data or when external data has been determined to be more relevant and/or reliable. However, an entity should place more emphasis on its internal data if that data is (or subsequently becomes) more relevant and reliable than the external data.

There may be circumstances where relevant and reliable internal data is not reasonably available for historical periods without undue cost or effort. If an entity decides it would not be beneficial to undertake efforts to gather internal historical data – e.g. because certain data is not available or is not accessible from its information systems – we believe it should begin to capture and maintain this information for use in future periods. Until an entity has developed sufficient internal data, relevant and reliable external information may be used. [Agency FAQ #26]

7.2.30 Selecting historical period(s)

Excerpt from ASC 326-20

>> Developing an Estimate of Expected Credit Losses

55-6 Estimating expected credit losses is highly judgmental and generally will require an entity to make specific judgments. Those judgments may include any of the following:

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

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

Subtopic 326-20 does not provide prescriptive guidance about what historical period should be used for obtaining historical loss experience – e.g. a full credit cycle, recent experience or a historical period that is representative of the expected conditions in the future. Instead, it indicates that the estimate of expected credit losses generally requires an entity to make specific judgments, including the approach used to determine the historical period. Different approaches may lead to diversity in practice. [326-20-55-3, 55-6 – 55-7]

Once an entity has selected a historical period, it needs to adjust the historical loss information for current conditions and reasonable and supportable forecasts – as well as for asset-specific risk characteristics.

Therefore, all of the following items are inputs into the estimate of expected credit losses:

- the unadjusted historical loss information;
- adjustments for asset-specific risk characteristics;
- adjustments for current conditions;
- adjustments for reasonable and supportable forecasts; and
- reversion to historical loss information for periods during which reasonable and supportable forecasts are not available.

Section 7.3 explains how and when to make these adjustments and when to revert to historical loss information.

The historical period selected may be a more significant input to the estimate of expected credit losses when an entity cannot make or obtain reasonable and supportable forecasts over the entire contractual term of the financial asset. This is because the historical credit loss experience from the selected historical period serves as the basis for estimating expected credit losses for periods beyond the reasonable and supportable forecast period, and therefore has a greater effect on the estimate in those circumstances. [326-20-30-9]

Regardless of the period used, an entity should evaluate whether the selected period, in combination with other assumptions and adjustments, results in the best estimate of expected credit losses.

See also Question 7.3.30 regarding supporting documentation for the selection of the historical period(s) as compared to supporting documentation for the reasonable and supportable forecasts.

Question 7.2.20

Must an entity select a historical period that represents its expectation for future periods?

Interpretive response: When obtaining historical loss information, Subtopic 326-20 permits (but does not require) an entity to use historical periods that represent management's expectation of future credit losses. [326-20-55-3]

This allows an entity to use, as a starting point, the period that it believes is most consistent with its forward-looking expectations – taking into account both (1) expected future economic conditions, and (2) similarities and differences regarding the risk characteristics of the financial assets themselves.

An entity may find it beneficial to use the period that it believes is most consistent with its forward-looking expectations because it may reduce the number and/or magnitude of required adjustments that need to be made.

However, it may be difficult to determine which periods to use when there are conflicting factors. For example, factors such as attributes of the financial asset will likely be most similar in recent periods. But management's expectations about future economic conditions may be most similar to a period further in the past. Accordingly, an entity will need to exercise judgment in selecting the historical period.

Question 7.2.30

May an entity base its selection of a historical loss period on an economic outlook that extends further than its reasonable and supportable forecast period?

Interpretive response: Yes. Subtopic 326-20 specifically permits an entity to use historical periods that represent management's expectations for future credit losses. In making this selection, we believe that an entity could use an economic outlook that extends further than its reasonable and supportable forecast period.

For example, an entity may be able to demonstrate an understanding of the current point in the economic cycle and develop its best estimate of expected credit losses using historical loss experience that reflects an improving or deteriorating point in an economic cycle based on that understanding. However, despite its ability to select a historical loss period that represents its expected future conditions, it may be unable to develop reasonable and supportable forecasts for certain inputs beyond a certain period. In those future periods for which it is unable to develop reasonable and supportable forecasts, the entity reverts to the historical loss experience and does not make further adjustments to that experience based on its expectations for future economic conditions.

However, if an entity reverts to a historical loss period that represents its expectations of future economic conditions, both the specific period chosen by the entity and the economic outlook used in the determination should be supported by documentation and analysis. We believe the nature and extent of documentation supporting the selection of the period used to determine the historical loss experience – which is the information to which the estimate of expected credit losses reverts – will be different than the documentation needed for reasonable and supportable forecasts.

7.3 Adjusting historical loss information

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

30-9 An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

>> Information Considered When Estimating Expected Credit Losses

55-4 Because historical experience may not fully reflect an entity's expectations about the future, management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information. In making this determination, management should consider characteristics of the financial assets that are relevant in the circumstances. To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility. Examples of factors an entity may consider include any of the following, depending on the nature of the asset (not all of these may be relevant to every situation, and other factors not on the list may be relevant):

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

3. Changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments.

7.3.10 Overview

Historical loss information generally provides a starting point for the estimate of expected credit losses. An entity considers whether adjustments are needed for differences between the historical period chosen by the entity and its forward-looking estimates.

As noted in section 7.2, Subtopic 326-20 does not indicate the historical period that should be selected and instead requires an entity to use judgment in making its selection. Once an entity selects a historical period, it should consider the need for any adjustments to the period's historical loss information.

Subtopic 326-20 describes three types of adjustments to historical credit losses. [326-20-30-8 – 30-9, 55-4]

Type of adjustment	Description
For current asset-specific risk characteristics	Adjustments intended to capture differences between the assets existing at the reporting date and the assets included in the historical credit loss experience. For example, an entity may need to adjust the historical loss experience for differences in underwriting standards, changes in the portfolio mix or changes in the contractual terms of the assets. [326-20-30-8, 55-4]
For current conditions	Adjustments for external economic factors at the reporting date that did not exist over the period from which historical experience was used.
For reasonable and supportable forecasts	Adjustments for external economic factors that are expected to be different in future periods and are not already reflected in the historical loss experience. For periods beyond the reasonable and supportable forecast period, an entity reverts to historical loss information using a reversion method. See sections 7.3.20 and 7.3.30.

Question 7.3.10

What types of adjustments are required or precluded during and after the reasonable and supportable forecast period?

Interpretive response: We believe that whether adjustments for differences in asset-specific risk characteristics and economic conditions are required to be made – or are precluded from being made – depends on the nature of the differences and whether an entity is able to make or obtain reasonable and supportable forecasts of economic conditions. [326-20-30-8 – 30-9]

Nature of differences as compared to historical loss information	Periods that an entity can reasonably and supportably forecast economic conditions	Periods that an entity *cannot* reasonably and supportably forecast economic conditions
Differences in asset-specific risk characteristics (e.g. underwriting or loan terms)	Adjustment required (see Question 7.3.12)	Adjustment required (see Question 7.3.12)
Differences in economic conditions, both current conditions and expectations for future conditions	Adjustment required	Adjustment prohibited (other than the effects of reversion)

If an entity asserts that it is unable to make or obtain a reasonable and supportable forecast of future economic conditions beyond a certain point in time, there is no basis to determine what economic adjustments should be made in those periods. Therefore, for periods beyond the reasonable and supportable forecasts, an entity uses the historical credit loss information – adjusted for asset-specific risk characteristics and the effect of the reversion method (see section 7.3.30) – without further adjustments for future economic conditions.

When an entity determines the adjustments to historical loss experience for asset-specific risk characteristics, it needs to avoid inadvertently reflecting differences in economic conditions in that adjustment. This is to avoid inadvertently: [326-20-30-8 – 30-9]

— double-counting the effect of differences in economic conditions during the reasonable and supportable forecast period. The entity ensures those differences are not reflected in an adjustment for differences in economic conditions during the reasonable and supportable forecast period and also in an adjustment for asset-specific risk characteristics; and/or

— making adjustments for economic conditions for periods beyond the reasonable and supportable forecast period (prohibited other than the effects of reversion).

Adjustments for differences in asset-specific risk characteristics and economic conditions may be made in an entity's quantitative model or reflected through a qualitative adjustment (see Question 7.3.75).

Example 7.3.02

Adjustments for asset-specific risk characteristics – change in lending management

Bank is estimating expected credit losses for similar loans that each have a remaining contractual term of three years and Bank's reasonable and supportable forecast period is two years.

Bank recently hired a new Chief Credit Officer, who is tasked with aggressively growing the loan portfolio, and is making changes in lending management to further that objective. Bank has determined that this change in lending management resulted in less stringent underwriting standards, which Bank expects to affect credit losses over the entire contractual term of loans originated since the CCO was hired.

Bank makes an adjustment for the remaining three-year contractual term for those loans originated since the new CCO was hired, even though that extends beyond the two-year reasonable and supportable forecast period.

Question 7.3.12

Is an adjustment for differences in asset-specific risk characteristics made for the remaining contractual term for all assets held?

Interpretive response: Not necessarily. An adjustment for differences in asset-specific risk characteristics should be made for the specific timeframe to which the identified incremental risk applies. Further, those adjustments should be made only to assets affected by the difference, which may be less than all assets for which expected credit losses are measured.

Question 7.3.15

Must an entity consider multiple economic scenarios when developing its economic forecast?

Interpretive response: No. Subtopic 326-20 does not provide specific guidance on how to consider economic factors, including: [ASU2016-13.BC67–BC68]

— whether a single most likely or multiple forward-looking economic scenarios should be used; or
— how to incorporate multiple forward-looking economic scenarios.

Therefore, an entity may use either a single most likely or multiple forward-looking economic scenarios when developing its economic forecast that will be used for adjusting historical loss information. An entity should use the method that, in combination with other assumptions and adjustments, results in the entity's best estimate of expected credit losses.

A multiple forward-looking economic scenarios approach generally involves identifying specific economic scenarios, the credit losses expected in each scenario, and the likelihood of each scenario occurring. When an entity uses this approach, we believe the allowance for credit losses should reflect the possibility that credit losses may be worse or may be better than the losses estimated under the most likely scenario. An entity reflects these possibilities through at least one scenario that is more favorable and at least one that is less favorable than the most likely scenario. See also Question 7.3.16, which explains that an entity may include the effect of multiple economic scenarios through a qualitative adjustment.

Further, we believe an entity generally should disclose whether it uses a single most likely or multiple forward-looking economic scenarios as part of the disclosures about its methodology for estimating the allowance for credit losses. See disclosure requirements in chapter 24. [326-20-50-10 – 50-11]

Example 7.3.05

Multiple scenarios vs single most likely scenario for economic forecasts

Bank determines it should adjust its historical loss information for changes in unemployment rates to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from those in the selected historical period.

The following table reflects management's expectations about future unemployment rates and credit losses that it expects for each scenario.

Scenario	Forecasted unemployment rate	Expected credit losses	Likelihood of scenario
1 Favorable	4%	$ 30	20%
2 Most likely	5%	70	50%
3 Recession	8%	170	30%

Single most likely approach

Under this approach, expected credit losses are $70, which reflects the expected credit losses associated with the scenario that is most likely – i.e. Scenario 2, which is 50% likely.

Bank also considers whether $70 reflects its best estimate of expected credit losses.

Multiple scenario approach

Under this approach, expected credit losses are $92, determined as follows.

Scenario	Forecasted unemployment rate	Expected credit losses	Likelihood of scenario	Probability-weighted expected credit losses[1]
1 Favorable	4%	$ 30	20%	$ 6
2 Most likely	5%	70	50%	35
3 Recession	8%	170	30%	51
Total				**$ 92**

Note:

1. Expected credit losses × likelihood of scenario.

Question 7.3.16

May an entity include the effect of multiple economic scenarios through a qualitative adjustment?

Interpretive response: Yes. Subtopic 326-20 does not specify how an entity should incorporate its consideration of multiple economic scenarios into its estimate of expected credit losses. As a result, we believe an entity may use a qualitative adjustment to include the effect of multiple scenarios in its estimate of expected credit losses.

For example, assume an entity uses a quantitative model for determining the effect of differences in forecasted economic conditions as compared to historical loss information. The entity may determine those effects by including in the quantitative model:

— multiple economic scenarios; or
— the most likely economic scenario and separately adjusting the model's output for the effect of scenarios not included in the model – i.e. a 'qualitative adjustment' (see Question 7.3.75).

As discussed in Question 7.3.15, we believe that when an entity uses multiple forward-looking economic scenarios, the allowance for credit losses should include at least one scenario that is more favorable and at least one that is less favorable than its most likely scenario. This is the case even if an entity reflects scenarios other than the most likely scenario through a qualitative adjustment.

If an entity makes a qualitative adjustment to incorporate the effects of economic scenarios not included in the quantitative model, it needs to ensure those effects relate solely to the reasonable and supportable forecast period. As discussed in Question 7.3.10, an entity does not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable forecast period. This is the case regardless of whether the effect of multiple economic scenarios is included in the entity's quantitative model or through a separate qualitative adjustment. [326-20-30-9]

7.3.20 Determining the reasonable and supportable forecast period

Estimating expected credit losses under Subtopic 326-20 requires an entity to consider the effect of forecasted future economic conditions.

The reasonable and supportable forecast period relates to the entity's ability to forecast external economic conditions over a financial asset's entire contractual term. However, as the length of time increases, there will be circumstances in which relevant, detailed inputs will not be available to support those forecasts. Whether an entity is able to forecast over a financial asset's entire contractual term is influenced by the source(s) of information used to develop the forecast and, more specifically, the period covered by that information.

Subtopic 326-20 does not provide guidance on determining whether a forecast is reasonable and supportable. We believe there are no bright lines in making this determination and significant judgment may be required. Instead, the length of the period is a judgmental determination based on the:

- level to which the entity can support its forecast of economic conditions further into the future; and
- specific point at which it can no longer make a reasonable forecast.

Developing a reasonable and supportable forecast

The following represents one way to develop a reasonable and supportable forecast.

Steps	Comments
Determine appropriate source(s) for an economic forecast	Examples of sources include: — publicly available external consensus forecasts; — internal experts; and — external experts.
Determine the period that the source(s) provide(s) a sufficient basis on which an estimate can be made	If using publicly available external consensus forecasts: the period that is reasonable and supportable may depend on the periods for which consensus forecasts are available. If using an internal or external expert: the period that is reasonable and supportable may be a matter of the expert's professional judgment.

Question 7.3.20

May an entity assert that it cannot develop any economic forecasts and rely solely on historical losses?

Interpretive response: No. As a result of having different sources of information and/or different judgments about information, the length of the reasonable and supportable forecast period about future economic conditions may differ between entities. While some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, we do not believe it is acceptable for an entity to assert that it cannot develop any economic forecasts and rely solely on historical losses for an asset's entire contractual term.

Question 7.3.25

Is the reasonable and supportable forecast period determined based on an entity's ability to make or obtain forecasts of future economic conditions?

Interpretive response: Yes. We believe that the reasonable and supportable forecast period specifically relates to the entity's ability to forecast economic conditions. This is consistent with the Board's discussion in the basis for conclusions that reversion to historical credit losses is a relevant metric when "an entity is unable to precisely estimate future economic conditions for those periods." [ASU 2016-13.BC53, 326-20-30-9]

Once an entity has developed its reasonable and supportable forecast of economic conditions for purposes of estimating expected credit losses, it is required to adjust its historical loss information to reflect the extent to which management expects credit losses to differ during the reasonable and supportable forecast period as a result of forecasted conditions being different from the historical period. We do not believe it would be appropriate for an entity that has the ability to make or obtain reasonable and supportable forecasts of economic conditions to assert that it cannot reasonably estimate the effect of those conditions on expected credit losses.

For example, an entity makes or obtains a reasonable and supportable forecast of economic conditions for a five-year period. The entity should not assert that it cannot reasonably estimate the effect of that forecast on expected credit losses for all or a portion of that five-year period – i.e. it would not be appropriate to apply reversion for all or a portion of the five-year period. This is because applying a reversion approach for the remaining period would inherently reflect economic conditions different from the entity's reasonable and supportable forecast – which would be inconsistent with the notion of a best estimate of credit losses.

Subtopic 326-20 does not provide specific guidance for determining the extent of adjustments to make to historical loss information. Selecting the appropriate method to determine those adjustments requires management to exercise significant judgment. [326-20-30-9]

For additional discussion of methods that may be used to determine the adjustment, see KPMG observation (g) in section A.3.30 of the Illustrative example.

Question 7.3.30

May the length of the reasonable and supportable forecast period differ for different economic assumptions?

Interpretive response: Yes. The length of the reasonable and supportable forecast period may differ when different economic assumptions are relevant for different types of financial assets. For example, unemployment rates may be a key assumption for some assets, while a home price index may be a key assumption for other assets. An entity could conclude that those inputs have different reasonable and supportable forecast periods.

Similarly, when an entity incorporates an economic forecast into its estimate of expected credit losses, we believe it should consider whether that forecast is relevant to an asset or portfolio of assets for which an estimate is being prepared. For example, if an entity is using publicly available external consensus forecasts of economic conditions for the entire United States, it should consider whether that forecast is relevant to a portfolio of loans made to borrowers in a specific region. The entity may need to adjust the forecast based on the economic outlook for that region, or obtain forecasts that are more relevant to the specific region. In addition, forecasts for similar economic assumptions may not be available for all relevant geographies for the same period(s). As a result, the length of the reasonable and supportable forecast period may differ between geographies.

However, we believe an entity is expected to consider whether the assumptions are consistent with one another, especially when different sources are used for different assumptions.

Question 7.3.40

Is a statistical confidence level required to support the length of the reasonable and supportable forecast period?

Interpretive response: No. Subtopic 326-20 does not require an entity to develop a statistical confidence level to support the length of its reasonable and supportable forecast period.

However, if the length of the reasonable and supportable forecast period is shorter than the period for which relevant economic data is available, we believe an entity should provide support for its assertion that the longer-term forecast is not reasonable. One acceptable method is to use a measure of historical accuracy of previous forecasts.

Question 7.3.50

Is 'backtesting' the historical accuracy of the forecasting process required to substantiate whether a current period forecast is reasonable and supportable?

Interpretive response: No. We believe Subtopic 326-20 does not require an entity to backtest the historical accuracy of its forecasting process to substantiate whether its current forecast is reasonable and supportable. However, an entity may elect to use backtesting as a historical measure of its ability to forecast information when assessing the length of the reasonable and supportable period.

Question 7.3.60

Must an entity reevaluate the reasonable and supportable forecast period?

Interpretive response: Yes. We believe an entity is required to reevaluate the length of a reasonable and supportable forecast period at each reporting date because the length could change. For example, different or additional sources of supporting information may be considered or the period covered by the supporting information may have changed. Processes and related controls should be developed to support this ongoing evaluation.

Question 7.3.70

Should there be consistency between economic forecasts used for estimating expected credit losses and other purposes?

Interpretive response: It depends. An entity may use economic forecasts for a variety of purposes – e.g. budgeting, forecasting or capital planning; or valuation and/or impairment testing of loan servicing rights, deferred tax assets or goodwill.

We generally expect that an entity will consider the relevant economic forecasts used for other purposes (e.g. other accounting estimates) when evaluating whether the forecast for estimating the allowance for credit losses is reasonable and supportable. However, there may be instances where forecasts are not consistent. For example, a treasury function may use forecasts in its capital planning that are based on negatively biased or stressed scenarios. When forecasts are not consistent, an entity should consider documenting the reason(s) for the inconsistency.

While the economic forecasts used for estimating the allowance for credit losses generally are expected to be consistent with other economic forecasts used within the entity, the forecasted periods may differ. For example, an entity may forecast economic conditions for a defined period for use in regulatory stress testing, but conclude that for estimating expected credit losses it can make or obtain reasonable and supportable forecasts of economic conditions for a longer period.

Example 7.3.10

Adjusting for differences in asset-specific risk characteristics and economic conditions

Bank is developing its estimate of expected credit losses for a portfolio of five-year commercial loans that share similar risk characteristics for the period ending December 31 of Year 0. All of the loans were newly originated at the end of Year 0.

To determine the appropriate historical loss information, Bank has selected the period that most closely reflects its future expectations, considering both the risk characteristics of the loans and the economic conditions. On that basis, it identifies lifetime loss experience for a portfolio of five-year commercial loans originated in Year -8 that matured in Year -3.

Assumptions

The loans originated in Year -8 had annual loss rates of 0.10% and lifetime loss rates of 0.50%.

The economic conditions from Year -8 to Year -3 were worse than current conditions and Bank's forecasts of future conditions. Bank estimates that the differences in economic conditions will, in isolation, cause loan losses to decrease by 0.06% per annum.

The loans originated in Year -8 were similar to the loans for which Bank is estimating expected credit losses, with the exception of specific differences in underwriting. Bank estimates that the differences in underwriting will, in isolation, cause loan losses to increase by 0.05% per annum. This estimate assumes economic conditions consistent with Year -8 through Year -3.

Bank determines that its forecasts are reasonable and supportable only through Year +2. Bank has determined that it is appropriate to revert to historical loss experience on a straight-line basis following the reasonable and supportable forecast period.

Calculation

As noted in Question 7.3.10, during the reasonable and supportable forecast period, adjustments to historical loss experience are made for differences in asset-specific risk characteristics (0.05% for differences in underwriting) and current and future economic conditions (-0.06%). After the reasonable and supportable forecast period, adjustments are made only for differences in asset-specific risk characteristics assuming economic conditions consistent with the historical period (0.05%).

The effects of reversion after Year +2 are ignored for illustration purposes (see section 7.3.30).

		Adjustment for differences in:		
Year	**Unadjusted historical loss rates**	**Asset-specific risk charact. (i.e. underwrite.)**	**Economic conditions**	**Annual loss rate**
+1	0.10%	0.05%	-0.06%	0.09%
+2	0.10%	0.05%	-0.06%	0.09%
+3	0.10%	0.05%		0.15%
+4	0.10%	0.05%		0.15%
+5	0.10%	0.05%		0.15%
Cumulative lifetime loss rate				**0.63%**

Question 7.3.75

Does an entity include 'qualitative' adjustment(s) in its estimate of expected credit losses?

Interpretive response: It depends. If the output of an entity's quantitative model does not reflect the entity's best estimate of expected credit losses in accordance with Subtopic 326-20, the entity should include qualitative adjustment(s).

Quantitative model output + **Qualitative adjustments** = **Best estimate of expected credit losses** *(Historical loss experience + Adjustments to historical loss information[1])*

Note:

1. Adjustments to historical loss information are made for:

   — differences in asset-specific risk characteristics (see section 7.3.10)

   — current economic conditions (see section 7.3.10)

   — reasonable and supportable forecasts of economic conditions (see section 7.3.20)

   — effects of reversion after the reasonable and supportable forecast period (see section 7.3.30)

Subtopic 326-20 does not provide specific guidance on the method that must be used to estimate credit losses or the extent of adjustments to historical loss information necessary to reflect differences in forecasted economic conditions or asset-specific risk characteristics. Therefore, selecting the appropriate methods requires management to exercise significant judgment. We believe an entity should adjust the output of its quantitative model to the extent needed for its allowance for credit losses to reflect its best estimate of expected credit losses in accordance with Subtopic 326-20. [326-20-30-9, 55-4, 55-6 – 55-7]

The following are examples.

— An entity that considers multiple economic scenarios for the reasonable and supportable forecast period may either:

  – incorporate all scenarios into its quantitative model; or

  – incorporate only the most likely scenario into that model and separately use a qualitative adjustment to adjust the model's output to reflect the effect of scenarios not included in the model for the reasonable and supportable forecast period (see Question 7.3.16).

— An entity may use a quantitative model that estimates expected credit losses considering forecasted economic conditions during the reasonable and supportable forecast period, the estimated contractual term of its financial assets, and the volume and severity of past due and adversely classified financial assets. The entity may separately adjust the model's output to reflect the effects of other factors not captured in the model – e.g. changes in the quality of its credit review system or of the experience, ability and depth of management, lending staff and other relevant staff.

When an entity makes a qualitative adjustment to its quantitative model's output, it should be careful to avoid capturing in that adjustment the effects of factors already contemplated in the quantitative model – i.e. to avoid double counting. For example, an entity making a qualitative adjustment to reflect differences in asset-specific risk characteristics should avoid inadvertently also including the effects of economic conditions that are captured in the quantitative model in that adjustment.

Further, an entity should be careful to avoid capturing the effects of factors for which recognizing estimated credit losses are not permitted by Subtopic 326-20 – e.g. expected credit losses related to unfunded loan commitments that are unconditionally cancellable (see Example 13.3.05) or the effects of economic conditions beyond the reasonable and supportable forecast period.

Example 7.3.15
Qualitative adjustment to reflect changes in underwriting standards

Bank is estimating expected credit losses for a portfolio of similar loans. The underwriting standards when the portfolio was originated were more stringent than those used during the historical period from which historical loss information is being used to estimate losses.

Bank's quantitative model includes adjustments for forecasted economic conditions during the reasonable and supportable forecast period, but does not include adjustments for changes in underwriting standards. Therefore, Bank uses a qualitative adjustment to reflect the decreased expected credit losses associated with the improved underwriting standards.

To determine the extent of the qualitative adjustment, Bank uses a statistical analysis that estimates the effect changes in underwriting standards have had on credit losses based on Bank's historical experience.

In performing its statistical analysis, Bank isolates the effect of changes in underwriting standards. That is, Bank adapts its historical loss information to exclude the effects of other conditions or factors – such as different economic conditions – that also affected credit losses during those periods.

Example 7.3.16
Qualitative adjustment to reflect changes in collateral value

Bank is estimating expected credit losses for a portfolio of similar residential mortgage loans. Management has identified changes in collateral values and unemployment rates as conditions that may cause expected credit losses to differ from those experienced in the historical period.

Bank's quantitative model includes adjustments to credit losses for unemployment during the reasonable and supportable forecast period. Bank uses a qualitative adjustment to reflect differences in credit losses compared to historical experience as a result of estimated changes in collateral values.

When determining the extent of the qualitative adjustment for changes in collateral value, Bank uses a statistical analysis that estimates the effect changes in collateral value have had on credit losses based on Bank's historical experience. In performing its statistical analysis, Bank isolates the effect of changes in collateral value on credit losses that are unrelated to changes in unemployment. That is, Bank adapts its historical loss information to exclude the effects of unemployment on credit losses during those periods.

By adapting its historical loss information in this way, Bank avoids capturing the effect changes in unemployment are expected to have on credit losses during the reasonable and supportable period. This is captured in Bank's quantitative model and should not be double counted in a qualitative adjustment.

Question 7.3.77

Can a reversion-like approach be used to develop a forecast of future economic conditions during the reasonable and supportable forecast period?

Background: If an entity is not able to make or obtain reasonable and supportable forecasts of future economic conditions for the entire life of a financial asset, it is required to estimate expected credit losses for the remaining life using an approach that reverts to historical credit loss information. [326-20-30-9]

Some forecasts of future economic conditions, especially those that project over a longer term, are developed using a reversion-like approach. For example, an economist might project that unemployment rates will gradually return to projected long-term average unemployment rates over a given timeframe.

Using a reversion approach *beyond* the reasonable and supportable forecast period is specifically permitted in Subtopic 326-20. In contrast, Subtopic 326-20 does not specifically address using a reversion-like approach *during* the reasonable and supportable forecast period.

Interpretive response: Yes. We believe a reversion-like approach can be used to develop a forecast of future economic conditions during the reasonable and supportable forecast period – i.e. to *develop* the reasonable and supportable forecast as long as it represents an entity's best estimate of future economic conditions.

We believe there are similarities and differences between a reversion approach applied after the reasonable and supportable forecast period and a reversion-like approach used to develop a reasonable and supportable forecast.

Some judgments that will need to be applied in both instances include:

- the period over which economic conditions will revert;
- what conditions will be reverted to; and
- whether the reversion will occur evenly over time, or in another pattern.

However, during the reasonable and supportable forecast period, an entity is not required to apply a reversion-like approach to develop its forecast. If it uses a reversion-like approach within the development of its forecast, it is not required to revert to historical loss experience or use a specific method of reversion – i.e. straight-line basis, immediate or another rational and systematic basis) to develop its forecast. Instead, an entity could revert to a projection, as opposed to reverting to historical loss experience. It could also revert using a method that is not systematic and rational. This additional flexibility requires a higher level of judgment and additional support to demonstrate why the assumptions used are consistent with the entity's best estimate of future economic conditions. For those reasons, we expect these judgments will generally be made by personnel with the requisite knowledge, skills and experience to develop economic forecasts.

Beyond the reasonable and supportable forecast period, an entity is required to revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis. An entity should use the reversion method that, in combination with other assumptions and adjustments, results in its best estimate of expected credit losses. [326-20-30-9]

7.3.30 Reversion to historical loss information

As explained in section 7.3.20, as the length of a financial asset's contractual term increases, there will be circumstances in which relevant, detailed inputs will not be available to support forecasts over the entire remaining contractual term. Rather than reducing the allowance for credit losses to zero for those future periods, the FASB decided that an entity should base its estimate for the remaining period on a reversion to historical losses. [ASU 2016-13.BC52–BC53]

The guidance on reverting to historical credit losses should not be applied to periods that can be reasonably forecasted. In other words, while significant judgment may be necessary to determine whether a reasonable and supportable forecast can be made beyond a certain point, the guidance on reverting to historical losses should not be viewed as an election. Instead, it is a requirement that is applied only after the entity has made the determination that these forecasts cannot be made or obtained.

Reverting at input-level vs estimate-level

Subtopic 326-20 permits an entity to revert to historical loss information at either the input level or based on the entire estimate. As discussed in Question 7.3.40, different economic assumptions may have reasonable and supportable forecast periods of differing lengths.

If an entity chooses to revert at the input level, it identifies each significant input made in preparing the estimate and determines the period that the input can be forecasted in a reasonable and supportable manner. An entity then reverts to historical loss information that is specific to any input that cannot be forecasted for the asset's entire remaining contractual term. [326-20-30-9]

Example 7.3.20
Reversion at input level

ABC Corp. determines that each significant input into its expected credit loss estimate can be reasonably and supportably forecasted for the entire life of the financial asset with one exception: unemployment rates can be forecasted for only four years.

ABC chooses to apply reversion at the input level, so it estimates the asset's expected credit losses using:

- unemployment rates forecasted for four years, and then reverts to historical loss information for the remainder of the lifetime of the financial asset; and
- other inputs estimated for the entire lifetime of the financial asset.

Question 7.3.80

How is the reasonable and supportable forecast period determined when reversion is based on the entire estimate?

Interpretive response: If an entity reverts based on the entire estimate, rather than at the input level, we believe that the reasonable and supportable forecast period generally is limited to the shortest period of the significant economic inputs that can be forecasted.

Example 7.3.30

Reversion based on the entire estimate

This example is based on the facts in Example 7.3.20, except that ABC Corp. chooses to revert based on the entire estimate.

As a result, ABC estimates the asset's expected credit losses using adjustments for unemployment and other inputs forecasted for four years, which is the shortest period for which any of the significant economic inputs could be forecasted. It then reverts to historical loss information for the remainder of the lifetime of the financial asset.

Methods for reverting

Subtopic 326-20 does not prescribe how an entity should revert to historical loss information. Instead, the FASB indicated that an entity could revert immediately, on a straight-line basis, or using another rational and systematic basis. [326-20-30-9]

As further explained in Question 7.3.90, the reversion method selected by an entity is an assumption in its overall estimate of expected credit losses. As a result, when an entity is unable to develop reasonable and supportable forecasts for the full contractual term of its financial assets, it should apply a reversion method that, in combination with other assumptions and adjustments, results in an allowance that represents management's best estimate of expected credit losses.

We believe that it may be appropriate for an entity to apply different reversion methods for different asset types, portfolio segments, etc. Regardless of the method applied, an entity estimates the specific point at which a reasonable and supportable forecast can no longer be made. It is required to provide a discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period in its financial statement disclosures (see chapter 24).

Question 7.3.90
Is the reversion method a practical expedient?

Interpretive response: No. The FASB did not create a separate practical expedient. Further, selection of the method is not an accounting policy election. As a result, an entity should use the reversion method that results in its best estimate of expected credit losses and should reevaluate the method each reporting period.

We believe that once an entity can no longer make or obtain a reasonable and supportable forecast of economic conditions, Subtopic 326-20 requires it to prepare a best estimate of expected credit losses that does not include an adjustment to historical loss experience for these forecasts. However, the assumptions made in applying the reversion method should (in combination) be consistent with an entity's best estimate of expected credit losses. These assumptions include:

— the period used to determine the historical credit loss experience that an entity will revert to; and
— the method used to revert to the historical credit loss experience.

We believe the forecasted economic conditions immediately preceding the period covered by the reversion method will be a significant consideration in making these assumptions. For example, assume the forecasted economic conditions in this preceding period are expected to be significantly better or worse than average. An entity should consider that fact when determining both the period it uses to determine the historical credit loss experience (which is the experience to which it will revert) and the method it uses to revert.

If the selected historical loss period is a long-term average that includes a range of economic conditions, it may not be appropriate to revert immediately to those losses if the forecasted economic conditions at the end of the reasonable and supportable forecast period are different from the long-term average. However, in making this determination the entity would need to use judgment and consider its specific facts and circumstances, including the sensitivity of its expected credit losses to changes in economic conditions.

The SEC staff provides guidance for public companies in SEC Staff Accounting Bulletin No. 119 (which updated portions of SEC Staff Accounting Bulletin No. 102 to align with Topic 326). This guidance also was issued by federal banking agencies through the Federal Financial Institutions Examination Council's, *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*. The guidance states, "A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its allowance for loan losses." [310-10-S99-4, Policy Statement]

We believe this guidance applies to the entire estimate of the allowance for credit losses, including the assumptions discussed above that are made in applying the reversion method.

Question 7.3.100

May an entity revert to historical loss experience over a period shorter than the remaining contractual term of the financial assets?

Interpretive response: Yes. We believe an entity can revert to historical loss experience over a period shorter than the remaining contractual term of the financial assets.

As discussed in Question 7.3.90, the estimate of the allowance for credit losses, including the selection of assumptions related to reversion, should be representative of an entity's best estimate of credit losses. We believe that in addition to selecting the reversion method, an entity should also choose the time period that results in its best estimate of expected credit losses. That time period, which could be shorter than the remaining contractual term of financial assets, should be reevaluated each reporting period.

For example, if a pool of financial assets has a contractual term of 10 years, and the entity is able to make or obtain a reasonable and supportable forecast for 3 years, it must choose a period over which it will revert from its reasonable and supportable forecast at the end of Year 3 to its historical loss experience. In some cases, it may be appropriate to revert over the entire remaining term, while in other cases a shorter reversion period may be appropriate. In making this judgment, an entity may consider the forecasted direction of economic conditions and historical patterns that economic conditions have taken in the past.

Example 7.3.40

Applying immediate and straight-line reversion

ABC Corp. is developing its estimate of expected credit losses for a portfolio of four-year, non-prepayable loans that were originated in the current year.

This Example illustrates applying certain reversion methods and is not intended to imply that other methods are not appropriate. As discussed in Question 7.3.90, the reversion method that is appropriate in a given period is that which results in an entity's best estimate of expected credit losses. This determination is reevaluated each reporting period.

Assumptions

The historical information shows that the annual loss rates that make up the cumulative lifetime loss rate are broken down as follows.

Year	Loss rate
1	3.0%
2	2.0%
3	1.0%
4	1.0%
Cumulative lifetime loss rate	**7.0%**

ABC has determined that no adjustments are needed for asset-specific risk characteristics. ABC has also determined that it can develop a reasonable and supportable forecast for economic conditions for one year. To this end, ABC believes unemployment is the primary condition that may cause expected credit losses to differ from those in the historical period; the unemployment rate in the historical period was 4% and is expected to be 5% in one year. Based on this expectation, ABC determines that an adjustment of 0.8% for economic conditions is appropriate during the reasonable and supportable forecast period.

Scenario 1: Immediate reversion method

If ABC applies the immediate reversion method, the cumulative loss rate is 7.8%.

Year	Unadjusted historical loss rates	Adjustment for differences in		Annual loss rate
		Asset-specific risk charact. (i.e. underwrite.)	Economic conditions	
1	3.0%	0%	0.8%	3.8%
2	2.0%	0%		2.0%
3	1.0%	0%		1.0%
4	1.0%	0%		1.0%
Expected cumulative lifetime loss rate				**7.8%**

Scenario 2: Straight-line reversion method (adjustment is reverted)

If ABC applies the straight-line reversion method, the 0.8% economic adjustment may be amortized over the remaining period and result in a cumulative loss rate of 9.0%.

Year	Unadjusted historical loss rates	Adjustment for differences in			Annual loss rate
		Asset-specific risk charact. (i.e. underwrite.)	Economic conditions	Straight-line reversion	
1	3.0%	0%	0.8%		3.8%
2	2.0%	0%		0.6%	2.6%
3	1.0%	0%		0.4%	1.4%
4	1.0%	0%		0.2%	1.2%
Expected cumulative lifetime loss rate					**9.0%**

Scenario 3: Straight-line reversion method (input is reverted)

Rather than amortizing the *adjustment* to its historical loss rates (as in Scenario 2), ABC applies the straight-line reversion method in a manner that reverts the *forecasted economic conditions* on a straight-line basis. This means that the 1% difference between the 5% unemployment rate at the end of the reasonable and supportable forecast period and the 4% unemployment rate in the historical period is reduced on a straight-line basis.

		Adjustment for differences in unemployment rate		
Year	**Unadjusted historical unemployment rate**	**During Reasonable and supportable forecast period**	**Straight-line reversion**	**Adjusted unemployment rate**
1	4.0%	1.0%		5.00%
2	4.0%		0.75%	4.75%
3	4.0%		0.50%	4.50%
4	4.0%		0.25%	4.25%

Under this approach, ABC determines the extent of the adjustment to historical loss rates that is needed in each year of the reversion period based on the adjusted unemployment rate presumed for that period – e.g. ABC determines the adjustment to historical information needed for Year 2 as if unemployment were forecasted to be 4.75% in that year. Because changes in economic conditions may not have a linear effect on expected credit losses, this approach may result in adjustments in Years 2–4 different from when the adjustment itself is reverted on a straight-line basis (i.e. the adjustments in Years 2–4 may be different than those determined in Scenario 2).

		Adjustment for differences in			
Year	**Unadjusted historical loss rates**	**Asset-specific risk charact. (i.e. underwrite.)**	**Adjusted unemployment rate (including straight-line reversion)**	**Assumed adjustment**	**Annual loss rate[1]**
1	3.0%	0%	5.00%	0.8%	3.8%
2	2.0%	0%	4.75%	0.7%	2.7%
3	1.0%	0%	4.50%	0.5%	1.5%
4	1.0%	0%	4.25%	0.2%	1.2%
Expected cumulative lifetime loss rate					**9.2%**

Note:

1. Unadjusted historical loss rate + Asset-specific risk characteristics + Adjustment.

Question 7.3.110

Can a reversion method effectively incorporate economic forecasts?

Interpretive response: No. A reversion method cannot incorporate economic forecasts beyond the reasonable and supportable forecast period. This is because incorporating economic forecasts into an entity's reversion method would have the practical effect of adjusting historical loss experience for those forecasts. Subtopic 326-20 precludes such adjustments beyond the reasonable and supportable forecast period. [326-20-30-9]

For example, assume Bank has determined its reasonable and supportable forecast period to be two years. There are economic forecasts available for three additional years, but Bank does not consider these forecasts to be 'reasonable and supportable'. The historical period Bank uses for its historical loss information reflects long-term average economic conditions. Bank should not use a reversion method that incorporates any economic forecast, such as using a reversion method that:

- assigns weights to forecasted economic conditions for periods beyond the reasonable and supportable forecast period and long-term average economic conditions; and
- gradually increases the weighting applied to the long-term average economic conditions until the forecast is entirely based on the long-term average economic conditions.

Such an approach would have the practical effect of adjusting the historical loss experience for the economic forecast beyond the reasonable and supportable forecast period.

Instead, an entity reverts to historical loss information immediately, on a straight-line basis, or using a rational and systematic basis for reverting. A reversion method that has a rational and systematic basis is a method for rationally and systematically removing (over time) the difference between the economic conditions that the entity forecasts will exist at the end of the reasonable and supportable period and the economic conditions underlying the historical loss information – e.g. using a supportable formula or mathematical curve. [326-20-30-9]

Although forecasts of economic conditions beyond the reasonable and supportable period should not be incorporated into an entity's reversion method, they may influence an entity's judgment when selecting *other* assumptions made in applying reversion – e.g. whether to revert immediately or over time and the length of the reversion period (see Questions 7.3.90 and 7.3.100).

Further, an entity can use a reversion-like approach to develop its forecast *within* the reasonable and supportable forecast period, as discussed in Question 7.3.77.

7.4 FASB examples

The examples in this section reproduced from Subtopic 326-20 illustrate how to apply historical loss experience with appropriate adjustments in the context of the following three methods for estimating expected credit losses:

- loss-rate approach (individual evaluation);
- vintage-year approach; and
- aging schedule approach.

Excerpt from ASC 326-20

>> Example 2: Estimating Expected Credit Losses Using a Loss-Rate Approach (Individual Evaluation)

55-23 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.

55-24 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.

55-25 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.

55-26 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 in accordance with paragraphs 326-20-30-8 through 30-9.

55-27 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 would be $6,000.

Excerpt from ASC 326-20

>> Example 3: Estimating Expected Credit Losses on a Vintage-Year Basis

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

55-29 Bank C is a lending institution that provides financing to consumers purchasing new or used farm equipment throughout the local area. Bank C originates approximately the same amount of loans each year. The four-year amortizing loans it originates are secured by collateral that provides a relatively consistent range of loan-to-collateral-value ratios at origination. If a borrower becomes 90 days past due, Bank C repossesses the underlying farm equipment collateral for sale at auction.

55-30 Bank C tracks those loans on the basis of the calendar year of origination. The following pattern of credit loss information has been developed (represented by the nonshaded cells in the 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 Origination	Loss Experience in Years Following Origination					
	Year 1	Year 2	Year 3	Year 4	Total	Expected
20X1	$ 50	$ 120	$ 140	$ 30	$ 340	–
20X2	$ 40	$ 120	$ 140	$ 40	$ 340	–
20X3	$ 40	$ 110	$ 150	$ 30	$ 330	–
20X4	$ 60	$ 110	$ 150	$ 40	$ 360	–
20X5	$ 50	$ 130	$ 170	$ 50	$ 400	–
20X6	$ 70	$ 150	$ 180	$ 60	$ 460	$ 60

20X7	$ 80	$ 140	**$ 190**	**$ 70**	$ 480	**$ 260**
20X8	$ 70	**$ 150**	**$ 200**	**$ 80**	$ 500	**$ 430**
20X9	**$ 70**	**$ 160**	**$ 200**	**$ 80**	$ 510	**$ 510**

55-31 In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, Bank C considers its historical loss information. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans. It notes that historical loss experience has worsened since 20X3 and that loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5 despite the fact that the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5. In considering current conditions and reasonable and supportable forecasts, Bank C notes that there is an oversupply of used farm equipment in the resale market that is expected to continue, thereby putting downward pressure on the resulting collateral value of equipment. It also notes that severe weather in recent years has increased the cost of crop insurance and that this trend is expected to continue. On the basis of those factors, Bank C determines adjustments to historical loss information for current conditions and reasonable and supportable forecasts. The remaining expected losses (represented by the shaded cells in the table in paragraph 326-20-55-30 in each respective year) reflect those adjustments, and Bank C arrives at expected losses of $60, $260, $430, and $510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively. Therefore, the allowance for credit losses for the reporting period date would be $1,260.

Excerpt from ASC 326-20

>> Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule

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

55-38 Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 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:

a. 0.3 percent for receivables that are current
b. 8 percent for receivables that are 1–30 days past due
c. 26 percent for receivables that are 31–60 days past due
d. 58 percent for receivables that are 61–90 days past due
e. 82 percent for receivables that are more than 90 days past due.

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

55-40 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**

8. No allowance for credit losses

Detailed contents

8.1 How the standard works

Subtopic 326-20 creates both:

- a general requirement that an allowance for credit losses be recognized for financial assets measured at amortized cost; and
- an exception for financial assets with a zero loss expectation.

If there is an expectation that a financial asset will have a zero loss, then an entity is not required to estimate or recognize an allowance for credit losses. This chapter explains how to determine if the 'zero loss expectation' exception applies to a financial asset.

8.2 Zero loss expectation exception

8.2.10 Overview

Excerpt from ASC 326-20

> Developing an Estimate of Expected Credit Losses

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.

Subtopic 326-20 requires an entity's allowance for credit losses to reflect the risk of loss, even when that risk is remote. This is required whether the entity is estimating the allowance for a group of assets or an individual asset. Therefore, even if it is remote that an entity will incur a loss on a financial asset carried at amortized cost, it is required to estimate and recognize an allowance for credit losses. [326-20-30-10]

An exception to this requirement applies when a financial asset has a zero loss expectation. This zero loss expectation exception applies when historical credit loss experience adjusted for current conditions and reasonable and supportable forecasts provides an expectation that non-payment of the amortized cost basis is zero. If the exception applies, the entity is not required to estimate and recognize an allowance for credit losses. [326-20-30-10]

Financial assets secured by collateral

An entity is not permitted to assume a zero loss expectation for a financial asset that is secured by collateral simply because the current value of the collateral exceeds the amortized cost basis of the asset. Rather, it is required to consider potential future changes in collateral value and historical loss experience for financial assets that were secured by similar collateral. However, there are special considerations when a collateral maintenance provision exists (see section 10.3) or the financial asset is collateral dependent (see section 10.2). [326-20-30-10]

Question 8.2.10
What financial assets are eligible for the zero loss expectation exception?

Interpretive response: The FASB decided not to identify specific financial assets that are eligible for the zero loss expectation exception. Determining whether the exception can be applied to a specific financial asset requires judgment. [ASU 2016-13.BC63]

To determine whether there is a zero loss expectation, we believe an entity needs to establish that it expects non-payment of an asset's amortized cost to be zero even if the borrower defaults. Therefore, the zero loss expectation exception can apply even if default could occur or has occurred as long as non-payment of the amortized cost basis is expected to be zero.

There are at least two types of financial assets for which an entity might determine that the zero loss expectation exception applies.

— **Securities issued or guaranteed by a government entity.** Certain of these securities might be eligible for the exception if the entity concludes that a loss would not be expected should the government entity default; see Example 8 from Subtopic 326-20 in section 8.3.

— **Financial assets secured by collateral provided by the borrower.** An entity might conclude that the exception can be applied to assets that are secured by collateral provided by the borrower, if the entity has concluded that a loss would not be expected on the occurrence of a default by the borrower. In that scenario, the entity's evaluation considers factors such as the potential future values of the collateral and the entity's historical loss experience when defaults have occurred in the past for similar assets.

Generally, an entity does not anticipate an expectation of zero losses for corporate bonds. Although an entity may have no history (or expectation) of loss for a particular corporate borrower, corporate bond default studies generally demonstrate that there is a risk of loss, even for highly rated bonds. Because Subtopic 326-20 requires an entity's allowance for credit losses to reflect the risk of loss – even when that risk is remote – we expect it generally will not be acceptable for an entity to establish a zero loss expectation for a highly rated (e.g. AAA) corporate bond it classifies as HTM.

Question 8.2.20
What information does an entity consider when evaluating historical loss experience?

Interpretive response: When an entity is evaluating historical loss experience and defaults have occurred in the past for similar assets, we believe it should consider all reasonably available information (both internal and external). The entity should not limit its consideration to loss experience in narrow, defined periods. We believe that a historical default in which the amortized cost basis was not fully repaid establishes a presumption that an allowance for credit losses of greater than zero is required.

Example 8.2.10
Investment grade security

ABC Corp. invests in a $1,000 HTM debt security issued by Borrower that has an investment-grade credit rating. ABC estimates that:

— the probability of Borrower defaulting on the security is 0.5%; and
— the loss expected if Borrower were to default is $400.

In this example, the zero loss expectation exception does not apply because the loss that is expected in the event of a default by Borrower ($400) is greater than zero. Therefore, ABC is required to estimate and recognize an allowance for credit losses for the security.

However, the allowance may be a relatively insignificant amount. For example, when considering the probability of default, ABC might conclude that the allowance for credit losses is $2 ($400 × 0.5%).

Example 8.2.20
Collateralized loan

ABC Corp. originates a $1,000 loan that is secured by collateral comprising $2,000 of highly liquid, relatively risk-free securities. ABC estimates that:

— the probability of Borrower defaulting on the loan is 2%; and
— the non-payment of the amortized cost basis that would be expected if Borrower were to default is zero. This is because of the nature of the collateral provided and the fact that its value exceeds, and is expected to continue to exceed, the loan's amortized cost basis.

In reaching its conclusion that non-payment of the amortized cost basis would be zero, ABC considers not only the adequacy of the current value of the collateral but also reasonable and supportable forecasts, including potential changes in fair value of the collateral in the future. In addition, ABC has experienced defaults on similarly collateralized loans in the past and, because of the collateral provided, has not experienced a credit loss related to those loans.

In this example, the zero loss expectation exception applies because if Borrower were to default, non-payment of the amortized cost basis is estimated to be zero. Therefore, ABC is not required to estimate or recognize an allowance for credit losses on the loan.

Example 8.2.30
Residential mortgage loan

ABC Corp. originates a $10 million portfolio of residential mortgage loans. Each of the loans in the portfolio is collateralized by a first lien on the borrower's primary residence. The estimated value of the collateral is such that the loan-to-value ratio is 80% for each of the mortgage loans.

ABC estimates the following:

— the likelihood of default for each mortgage loan is 1%; and
— non-payment of the amortized cost basis that would be expected if a borrower were to default is 15% of the amortized cost basis.

ABC estimates the loss given default of 15% based on historical loss experience when defaults have occurred for similar residential mortgage loans. This estimate reflects adjustments for current conditions and reasonable and supportable forecasts that consider potential future values for the collateral.

In this example, the zero loss expectation exception does not apply because if borrowers were to default, non-payment of the amortized cost basis is estimated to be greater than zero (15% of the amortized cost basis). Therefore, ABC recognizes an allowance for credit losses on the portfolio of residential mortgages.

8.3 Agency-backed securities and sovereign debt

Excerpt from ASC 326-20

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

55-48 This Example illustrates one way, but not the only way, an entity may estimate expected credit losses when the expectation of nonpayment is zero. This example is not intended to be only applicable to U.S. Treasury securities.

55-49 Entity J invests in U.S. Treasury securities with the intent to hold them to collect contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.

55-50 Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J's management still believes that there is a possibility of default, even if that risk is remote. However, Entity J considers the guidance in paragraph 326-20-30-10 and concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity's currency is routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its U.S. Treasury securities at the end of the reporting period. The qualitative factors considered by Entity J in this Example are not an all-inclusive list of conditions that must be met in order to apply the guidance in paragraph 326-20-30-10.

8.3.10 Overview

Example 8 in Section 326-20-55 illustrates how an entity might develop a zero loss expectation for US Treasury securities classified as HTM. However, it indicates that the zero loss exception is not limited to these securities. We expect that many entities will reach a conclusion that securities carrying guarantees provided by Ginnie Mae (GNMA) (as an agency of the US government), and Fannie Mae and Freddie Mac (as government-sponsored enterprises, collectively, GSEs) should be evaluated in a manner similar to US Treasury securities. In evaluating whether a zero loss exception is appropriate for these securities, an entity should consider the nature and extent of the guarantee provided by the agency or GSE. We believe factors specific to these enterprises should be considered, as outlined in sections 8.3.20 and 8.3.30. [326-20-55-48 – 55-50]

8.3.20 Ginnie Mae guarantees

GNMA guarantees investors the full and timely payment of principal and interest on certain mortgage backed securities (MBS) backed by federally insured or guaranteed loans, mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). MBS guaranteed by GNMA carry an explicit US government guarantee and typically have a term of 30 years.

The following qualitative factors are consistent with an expectation of zero credit losses.

— Full and timely payment of principal and interest on the MBS is explicitly guaranteed by GNMA as an agency of the US government.

— The ultimate guarantor (US government) can print its own currency.

— GNMA is essential in providing liquidity and stability to the US housing finance market. Therefore, it is unlikely that the US government would not perform on its guarantee obligation in the event that GNMA were to default on its guarantee – i.e. if default occurs, non-payment of the amortized cost basis is expected to be zero as a result of the US government guarantee.

However, there are certain other qualitative factors that could give rise to a possibility of credit losses on GNMA MBS. These factors should also be considered in the evaluation.

— Market participants do not price the GNMA MBS as risk-free.

- GNMA is a government agency and relies on funding from government appropriations.
- There may be heightened government budgetary concerns from time to time.

8.3.30 Financial assets that are fully guaranteed by Fannie Mae or Freddie Mac

Fannie Mae and Freddie Mac (collectively, GSEs) provide liquidity to the secondary mortgage market by purchasing conventional conforming mortgage loans and issuing guaranteed MBS. The GSEs guarantee the timely payment of principal and interest to investors of certain MBS. Since September 2008, the GSEs have been under government conservatorship, operating under the direction of the Federal Housing Finance Agency (FHFA).

The following qualitative factors are consistent with an expectation of zero credit losses on GSE MBS.

- Principal and interest payments on the MBS are guaranteed by the GSEs.
- As part of entering into the 2008 conservatorship, the GSEs entered into a Purchase Agreement (through the FHFA) with the US government. Under the terms of the Purchase Agreement, the GSEs can draw funds (subject to a cap). Therefore, the MBS carry an 'explicit guarantee' from the US government up to this cap.
- The ultimate guarantor (US government) can print its own currency.
- The GSEs are essential in providing liquidity and stability to the US housing finance market. Therefore, it is unlikely that the US government would not perform in the event the GSEs were to default on their guarantees – i.e. if default occurs, non-payment of the amortized cost basis is expected to be zero due to the US government guarantee.

However, there are certain other qualitative factors that could give rise to a possibility of credit losses on GSE MBS. These factors should also be considered in the evaluation.

- Market participants do not price the MBS as risk-free.
- The explicit government guarantee is subject to a cap.
- There may be heightened government budgetary concerns from time to time.

8.3.40 Non-US sovereign debt

An entity needs to evaluate whether sovereign debt obligations from other jurisdictions have a zero loss expectation. Judgment is required when evaluating whether these debt obligations qualify for the zero loss expectation exception.

An entity may evaluate whether the sovereign debt obligation is similar to the US Treasuries described in Example 8 in Subtopic 326-20 by weighing several relevant factors. Specifically, an entity may consider whether the debt of a sovereign entity has the following.

- Debt:
  - a high credit rating by rating agencies;
  - a long history where non-payment of the amortized cost basis is zero;
  - explicit full guarantee by a sovereign entity;
  - interest rate is widely recognized as a 'risk-free rate'.
- Sovereign entity:
  - an ability to print its own currency;
  - low political uncertainty;
  - lack of significant budgetary concerns;
  - low credit default swap spreads;
  - currency is routinely held by central banks, used in international commerce, and commonly viewed as a reserve currency.

9. Credit enhancements

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

9.1 How the standard works

In developing its estimate of expected credit losses under Topic 326, an entity considers how credit enhancements that are not freestanding contracts mitigate expected credit losses.

An entity recognizes and measures credit enhancements that are freestanding contracts (e.g. credit default swaps) separately from the underlying financial instrument that is subject to Topic 326.

Determining whether a credit enhancement contract is freestanding or is embedded in another financial instrument requires judgment and consideration of all facts and circumstances. We generally expect that practice under legacy US GAAP will continue under Topic 326.

9.2 Determining whether a credit enhancement is freestanding

9.2.10 Overview

Excerpt from ASC 326-20

> Credit Enhancements

30-12 The estimate of expected credit losses shall reflect how credit enhancements (other than those that are **freestanding contracts**) mitigate expected credit losses on **financial assets**, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

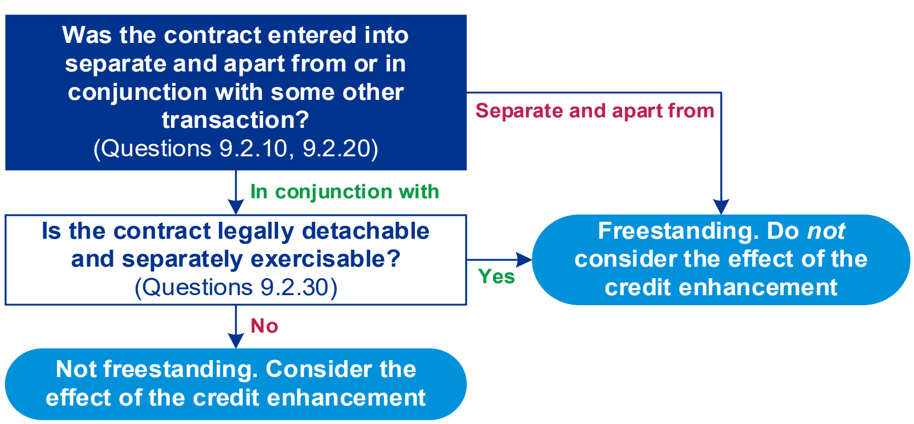
20 Glossary

Freestanding contract – A freestanding contract is entered into either:

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

Separate, freestanding contracts that serve to mitigate credit losses – e.g. purchased credit default swaps or certain types of insurance – should not be considered for the purposes of estimating expected credit losses. [326-20-30-12]

The following decision tree, which is based on the definition of a freestanding contract, provides one acceptable method for performing the analysis to determine whether the credit enhancement is freestanding. [326-20 Glossary]



Question 9.2.10

When is a credit enhancement entered into separate and apart from other transactions?

Interpretive response: For a credit enhancement contract to be considered as entered into separate and apart from an entity's other financial instruments transactions, it needs to be contractually distinct.

In addition, we believe that when two or more contractually distinct instruments are entered into, the evaluation may differ based on whether the instruments were entered into with the same or different counterparties.

Counterparties	Analysis
Separate, unrelated counterparties	Except in rare circumstances, we believe each instrument should be considered freestanding under this criterion, even if they are issued contemporaneously or within a very short time period.
Same counterparty (or related party group)	We believe two conditions should be met to conclude that one or more of the instruments has been entered into separate and apart from any of the entity's other financial instruments transactions: — the instruments are contractually distinct – i.e. each instrument is documented separately; and — there is a reasonable period between the issuance of the various financial instruments being evaluated.

Question 9.2.20#

When is a credit enhancement entered into in conjunction with a financial asset?

Interpretive response: Except in rare circumstances, we believe for a credit enhancement to be considered as entered into in conjunction with a financial asset, it should be entered into as part of the same contract as the financial asset and with the same counterparty. Said differently, it should not be contractually distinct.

A credit enhancement can either be entered into separate and apart from or in conjunction with other transactions. Therefore, if the credit enhancement is not entered into separate and apart from a transaction, it is likely entered into in conjunction with a transaction. See Question 9.2.10 for more information regarding the analysis of separate and apart.

Question 9.2.30#
When is a credit enhancement legally detachable and separately exercisable?

Interpretive response: Legally detachable and separately exercisable generally means the credit enhancement and the financial asset can be separated such that the two components may be held by different parties.

In general, we believe it is not necessary for the financial instrument being evaluated to be transferable to third parties for it to be considered legally detachable and separately exercisable. However, if the underlying financial asset is transferable and the credit enhancement must be transferred with the underlying financial asset, that is generally an indication that the credit enhancement is not legally detachable and separately exercisable.

We believe one important factor to consider when evaluating whether a credit enhancement is legally detachable and separately exercisable is whether it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised.

For example, consider a credit enhancement that a lender obtains in the form of a co-signor for a consumer loan. If the primary borrower defaults on the loan, the lender can seek repayment from the co-signor. After the lender has recovered the loan balance from the co-signor, the lender no longer retains a claim against the primary borrower for the amounts paid by the co-signor. In this case, the credit enhancement is not freestanding.

Example 9.2.10#
Credit insurance

Lenders may manage exposure to credit risk in their portfolios by acquiring supplemental insurance coverage. Typically the insurance company compensates the lender for losses in the event of default by the borrower. For example, in the case of mortgage insurance, the insurance company compensates the lender for losses sustained when the mortgage is foreclosed and the property is sold.

Two common examples of insurance coverage are analyzed in the following table. It is assumed that the insurance contracts are not treated as derivatives because the holder is compensated only if, as a result of an identifiable insurable event, the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. [815-10-15-52 – 15-54]

Description	Scenario 1	Scenario 2
Nature of coverage	Lender requires Borrower to take insurance coverage for specific loans – e.g. when the loan-to-value ratio exceeds a	Lender acquires mortgage insurance covering a portfolio of loans. The insurance policy provides coverage only for losses incurred by Lender, and therefore does not cover a

Description	Scenario 1	Scenario 2
	specified level (say 80%). A separate contract is entered into between Insurer and Borrower, with Lender named as the beneficiary. The individual coverage is often referred to as private mortgage insurance (PMI).	subsequent purchaser if the loans are subsequently sold.
Premiums	Typically paid by Borrower.	Typically paid by Lender.
Is the insurance contract (i.e. the credit enhancement) entered into separate and apart from, or in conjunction with the mortgage loan?	The terms of the mortgage state that when Lender requires mortgage insurance as a condition of making the loan, Borrower is required to maintain the insurance unless written approval is obtained from Lender. The PMI is therefore incorporated into the mortgage agreement between Lender and Borrower and, as a result, the PMI is not contractually distinct. Instead, it was obtained in conjunction with the mortgage loan.	Lender enters into contractually distinct instruments with separate, unrelated counterparties – i.e. the loans with the Borrowers and the insurance contract with Insurer. Therefore, the insurance contract was entered into separate and apart from the loans and is considered a freestanding contract.
Is the contract legally detachable and separately exercisable?	No, the insurance contract is neither legally detachable from the loan nor separately exercisable. If the loan is sold, the insurance contract transfers with the loan and the new owner of the loan will be the beneficiary. Additionally, if Borrower defaults and the PMI payment is triggered, Lender has no remaining claim against the loan to Borrower.	N/A When an instrument is entered into separate and apart from other transactions, it is considered freestanding and this evaluation is not required.
Is the insurance contract freestanding?	No, the insurance contract is not freestanding.	Yes, the insurance contract is freestanding.

Description	Scenario 1	Scenario 2
Consideration of credit enhancement (insurance) in estimating expected credit losses	Should be considered in estimating expected credit losses because the credit enhancement is not a freestanding contract. Insurer's financial condition, willingness and ability to pay claims should be considered in the estimate.	Should not be considered in estimating expected credit losses because the credit enhancement is a freestanding contract.

Example 9.2.20#
Insurance-wrapped debt security

XYZ Corp. purchases an ABC City municipal bond and classifies the bond as HTM.

The municipal bond prospectus states that scheduled payments of principal and interest are guaranteed by Insurer under an insurance policy to be issued concurrently with the municipal bond. In the event that ABC does not make a principal or interest payment on its scheduled date, Insurer will make the payments to the bondholder (XYZ). ABC will pay the premium(s) on the insurance policy to Insurer.

If XYZ sells the municipal bond to another entity, the purchaser becomes the beneficiary of the insurance.

The financial guaranty insurance is a credit enhancement. The following chart illustrates how XYZ analyzes whether to consider this credit enhancement in estimating expected credit losses on the municipal bond.

Description	Municipal bond with an insurance wrapper
Is the financial guaranty insurance contract (i.e. the credit enhancement) entered into separate and apart from, or in conjunction with the municipal bond?	The terms of the municipal bond contract (the prospectus) include the provision that the municipal bond is insured and that the bondholder is the beneficiary of the insurance. Therefore, the financial guaranty insurance is not contractually distinct and was obtained in conjunction with the municipal bond.
Is the contract legally detachable or separately exercisable?	No, the insurance contract is neither legally detachable from the municipal bond nor separately exercisable. If the municipal bond is sold, the insurance contract transfers with the municipal bond and the new owner of the bond will be the beneficiary. Additionally, if ABC defaults, Insurer will make the scheduled principal and interest payments to XYZ, and XYZ will no longer have a claim against ABC for those payments.
Is the insurance contract freestanding?	No, the insurance contract is not freestanding.

Description	Municipal bond with an insurance wrapper
Consideration of credit enhancement (insurance) in estimating expected credit losses	The insurance contract should be considered in estimating expected credit losses because the credit enhancement is not a freestanding contract. Insurer's financial condition, willingness and ability to pay claims, should be considered in the estimate.

9.3 Freestanding credit enhancements

Many entities enter into freestanding credit enhancement contracts, such as freestanding purchased credit insurance contracts, to mitigate credit losses on financial assets in the scope of Topic 326.

Question 9.3.10

How does an insured entity account for a freestanding purchased credit insurance contract used to mitigate credit losses?

Background: Freestanding purchased credit insurance contracts can take several forms and contain a variety of terms. The terms in the contract influence the accounting method used.

US GAAP does not explicitly address how the insured entity (the holder) accounts for a freestanding purchased credit insurance contract that meets the following criteria:

— is legally enforceable;
— the insured entity is expected to make all contractually required premium payments;
— is expected to be in force when a loss event occurs (i.e. default);
— the insured event has not occurred for any of the financial assets covered by the policy;
— is not accounted for as a derivative under Topic 815; and
— provides for substantive risk transfer (see Question 9.3.20).

Interpretive response: In a March 2020 FASB meeting, the Board acknowledged that there are multiple views when accounting for a freestanding purchased credit insurance contract used to mitigate credit losses when the criteria above are met. Three of the approaches that we consider acceptable are the mirror image accounting method, the probable incurred loss and recovery method, and the insurance contract claim method. Other accounting policies may also be acceptable. We believe the chosen policy should be applied consistently.

These three approaches address how to account for the insurance receivable related to expected claims, the premiums paid (or to be paid in the future), and the credit losses and related provision.

Mirror image accounting method

Under a mirror image approach, the insured entity measures the insurance receivable based on the amount of expected credit losses recognized under Topic 326. We have identified two separate methods for recording the insurance premiums.

Mirror image method 1

Under this method, the insured entity records an insurance receivable at contract inception and measures the receivable at the same amount as the expected credit losses that are recognized under Topic 326 with a corresponding amount recognized in earnings. In subsequent periods, the insurance receivable is adjusted to match the related portion of the expected credit losses that are recognized under Topic 326 with a corresponding amount recognized in earnings. The amounts recognized as an insurance receivable factor in any deductible – i.e. the insurance receivable is net of any deductible.

Under this method, the full amount of insurance premiums paid (or payable) is deferred at the contract's inception and amortized into expense over the insured period.

Mirror image method 2

Similar to method 1:

- an entity records an insurance receivable at contract inception and measures the receivable at the same amount as the related portion of the expected credit losses that are recognized under Topic 326, net of any deductible; and
- premium expense is recognized over the insured period.

However, in contrast to method 1, only the excess of insurance premiums paid (or payable) over the amount of the insurance receivable initially recognized is deferred and amortized into expense.

Similar to method 1, in subsequent periods the insurance receivable is adjusted to match the related portion of the expected credit losses that are recognized under Topic 326 with a corresponding amount recognized in earnings.

Probable incurred loss and recovery method

Under this method, an insurance receivable, and the related earnings, are recognized only when:

- an incurred loss that is insured under the contract is probable of occurring; and
- the recovery of the insurance receivable is probable.

Under this method, the full amount of insurance premiums paid (or payable) are deferred at inception of the contract and amortized into expense over the insured period.

Insurance contract claim method

Under this method, an insurance receivable, and the related earnings, are recognized only when:

- a loss event occurs (i.e. a default);
- a claim is submitted or the insured party has the ability under the contractual terms of the contract to submit a claim; and

— the recovery of the insurance receivable is probable.

Under this method, the full amount of insurance premiums paid (or payable) are deferred at inception of the contract and amortized into expense over the insured period.

Example 9.3.10

Accounting for a freestanding purchased credit insurance contract

Bank originates a $100,000,000 portfolio of loans and estimates the allowance for credit losses on the portfolio as $1,000,000 under Topic 326. Concurrently, Bank enters into a freestanding purchased credit insurance contract with Insurer.

Under the contract, Bank pays $2,100,000 of premiums to Insurer at inception. In exchange, Insurer insures 100% of Bank's credit losses on the portfolio of loans throughout the contractual term of the loans.

Bank concludes that Insurer's expected profit margin is consistent with a profit margin that would be demanded by an insurer assuming substantive insurance risk related to this portfolio. Bank also considers the other factors in Question 9.3.20, and concludes that the contract involves substantive risk transfer.

At origination of the loans and inception of the freestanding purchased credit insurance contract, an incurred loss on the loans and recovery of the insurance receivable is not considered probable and no claims are eligible to be submitted under the contract. Bank determines the contract is legally enforceable, is expected to be in force when a loan in the portfolio defaults and is not accounted for as a derivative under Topic 815. Bank is expected to make all contractually required premium payments.

The journal entries below illustrate:

— the origination of the loans;
— the application of four possible accounting policies for the freestanding purchased credit insurance contract at origination of the loans and inception of the contract; and
— the related entries to the allowance for credit losses.

Mirror image method 1

Bank makes the following journal entries at origination of the loans and inception of the freestanding purchased credit insurance contract.

	Debit	*Credit*
Loans	100,000,000	
Cash		100,000,000
To record origination of loans.		
Credit loss expense	1,000,000	
Allowance for credit losses		1,000,000

	Debit	Credit
To record estimate of expected credit losses on portfolio of loans at origination.		
Insurance receivable[1]	1,000,000	
Gain on recovery of insured credit losses		1,000,000
To record insurance receivable from freestanding purchased credit insurance contract.		
Credit loss expense[1]	1,000	
Allowance for credit losses		1,000
To record estimate of credit losses on insurance receivable at inception.		
Deferred premium expense[2]	2,100,000	
Cash		2,100,000
To record premiums paid for freestanding purchased credit insurance contract.		

Notes:

1. Neither the insurance recovery asset nor the related amounts recorded in earnings are presented net against the allowance for credit losses or credit loss expense.
2. The premiums paid at inception are deferred and amortized over the insured period.

Mirror image method 2

Bank makes the following journal entries at origination of the loans and inception of the freestanding purchased credit insurance contract.

	Debit	Credit
Loans	100,000,000	
Cash		100,000,000
To record origination of loans.		
Credit loss expense	1,000,000	
Allowance for credit losses		1,000,000
To record estimate of expected credit losses on portfolio of loans at origination.		
Insurance receivable[1]	1,000,000	
Deferred premium expense[2]	1,100,000	
Cash		2,100,000
To record insurance receivable and deferred premiums from freestanding purchased credit insurance contract.		
Credit loss expense[1]	1,000	
Allowance for credit losses		1,000
To record estimate of credit losses on insurance receivable at inception.		

Notes:

1. Neither the insurance receivable nor the related amounts recorded in earnings are presented net against the allowance for credit losses or credit loss expense.
2. Deferred premium expense is calculated as the excess of insurance premiums paid ($2,100,000) over the amount of the insurance receivable ($1,000,000). The premiums deferred are amortized over the insured period.

Probable incurred loss and recovery method

Bank makes the following journal entries at origination of the loans and inception of the freestanding purchased credit insurance contract.

	Debit	*Credit*
Loans	100,000,000	
Cash		100,000,000
To record origination of loans.		
Credit loss expense	1,000,000	
Allowance for credit losses		1,000,000
To record estimate of expected credit losses on portfolio of loans.		
Deferred premium expense[1,2]	2,100,000	
Cash		2,100,000
To record deferred premiums from freestanding purchased credit insurance contract.		

Notes:

1. At inception, an incurred loss is not probable, and therefore an insurance receivable is not recognized. The insurance receivable will be recognized when an incurred loss and recovery of the receivable are both probable.
2. The premiums paid at inception are deferred and amortized over the insured period.

Insurance contract claim method

Bank makes the following journal entries at origination of the loans and inception of the freestanding purchased credit insurance contract.

	Debit	*Credit*
Loans	100,000,000	
Cash		100,000,000
To record origination of loans.		
Credit loss expense	1,000,000	
Allowance for credit losses		1,000,000
To record estimate of expected credit losses on portfolio of loans.		
Deferred premium expense[1,2]	2,100,000	
Cash		2,100,000

To record deferred premiums from freestanding purchased credit insurance contract.	

Notes:

1. At inception, there are no claims that are eligible to be submitted under the contract. Therefore, the conditions for recognizing an insurance receivable have not been met. The insurance receivable will be recognized when there is an eligible claim under the terms of the insurance contract.
2. The premiums paid at inception are deferred and amortized over the life of the insurance contract.

Question 9.3.15**

Does the guidance for freestanding purchased credit insurance contracts apply to a financial guarantee embedded in a hybrid financial instrument?

Background: A financial guarantee is a contract that contingently requires a guarantor to make payments due to a failure of another party to satisfy its required payment obligations. See chapter 14 for more information on guarantees.

Interpretive response: No. A financial guarantee contract embedded in a hybrid financial instrument is not a freestanding credit enhancement when it is not bifurcated from the host contract under Topic 815. Since the credit enhancement is not freestanding, the guidance for freestanding purchased credit insurance contracts in Question 9.3.10 does not apply.

The guidance for freestanding purchased contracts also does not apply when the financial guarantee contract embedded in a hybrid financial instrument is bifurcated from the host contract and accounted for as a derivative. Financial guarantees accounted for as derivatives do not meet the criteria to apply the guidance in Question 9.3.10. [815-15-25-1]

Question 9.3.20

How does an insured entity determine whether a freestanding purchased credit insurance contract provides substantive risk transfer?

Interpretive response: In determining whether a purchased freestanding credit insurance contract provides substantive risk transfer, we believe the following should be among the factors considered:

— whether the amount and timing of the insurer's payments to the insured entity depend on, and vary directly with, the amount and timing of claims settled under the contract;

— the probability and magnitude of potential variation in the amount and timing of claims payments made by the insurer; and

— whether, at inception of the contract, the excess of (1) the present value of expected amounts payable to the insurer over (2) the present value of expected amounts receivable from the insurer, are indicative of a financing-like return to the insurer – as opposed to a return that would be paid to an insurer that is assuming substantive insurance risk.

The assessment of whether a freestanding purchased credit insurance contract provides substantive risk transfer involves significant judgment. Entities should carefully consider all terms and features of the contract (including relevant side agreements), especially those that limit insurance risk of the insurer or delay the timely payment of claims to the insured entity.

Example 9.3.20
Substantive risk transfer does not take place

Bank originates a portfolio of non-prepayable loans with an original amortized cost basis of $100,000,000. At inception, Bank estimates the allowance for credit losses on the portfolio is $1,000,000.

On the same date, Bank enters into a freestanding purchased credit insurance contract with Insurer. Under the contract, Insurer will insure the first $250,000 of credit losses incurred by Bank in exchange for premiums with a net present value of $275,000.

At the time the contract is executed, the likelihood that Bank will incur less than $250,000 of credit losses over the contractual term of the insurance contract is remote. Further, the excess of the net present value of expected premiums ($275,000) over expected claims ($250,000) is consistent with a financing-like return over the contract period for Insurer and would not be consistent with the return typically demanded by an insurer that is assuming substantive insurance risk.

In this scenario, Bank considers the following.

— The loss cap of $250,000 limits the variability in the timing and amount of claims payments made by Insurer under the contract. There is also a remote probability of significant variation in the amount and timing of claims payments because the $250,000 losses are considered highly likely over the contractual term.

— Insurer is protected from a loss under the contract because the net present value of premiums ($275,000) exceeds the maximum amount of insured losses ($250,000).

— The contract is expected to provide a financing-like return to Insurer, as opposed to a return consistent with the transfer of substantive insurance risk.

After considering the factors described above, Bank concludes that the contract does not provide substantive risk transfer.

Question 9.3.30

How is a freestanding purchased credit insurance contract outside the scope of Topic 815 accounted for if it does not provide substantive risk transfer?

Interpretive response: When a freestanding purchased credit insurance contract outside the scope of Topic 815 does not provide substantive risk transfer, we believe the entity should apply the deposit method described in Subtopic 340-30.

10. Practical expedients

Detailed contents

Item significantly updated in this edition: #
Item moved from another chapter without significant change: ●

Examples

Comparison to legacy US GAAP

10.3 Collateral maintenance provisions

Questions

Example

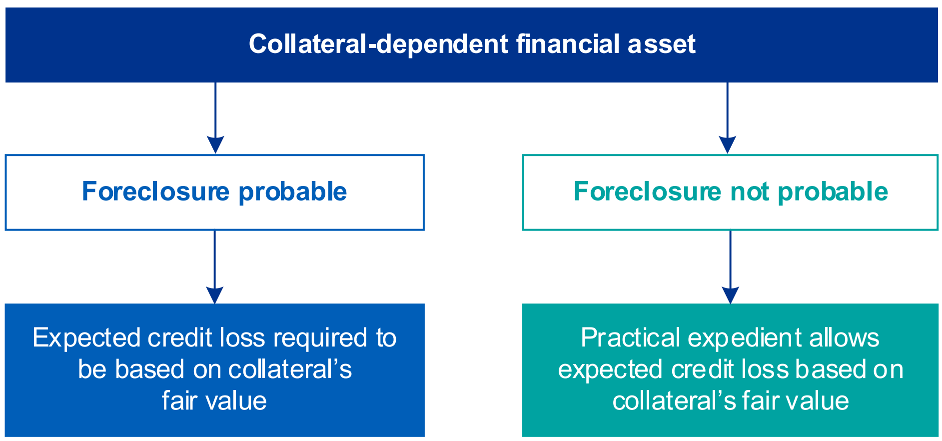
10.1 How the standard works

Subtopic 326-20 provides two practical expedients – for collateral-dependent assets and assets with collateral maintenance provisions.

Collateral-dependent financial assets

The principles for estimating expected credit losses of collateral-dependent assets differ from the general measurement principles under the expected credit loss model.

A financial asset is collateral-dependent when the debtor is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. Subtopic 326-20 includes specific guidance on estimating expected credit losses for collateral-dependent financial assets.



For guidance on how to estimate expected credit losses when a financial asset is not collateral-dependent, see chapters 4 to 8.

Collateral maintenance provisions

Certain arrangements require the borrower to continually adjust the amount of collateral securing the financial asset as a result of changes in the fair value of the collateral. These arrangements are 'collateral maintenance provisions'.

For these types of arrangements, when the borrower is expected to replenish the collateral as required by the terms of the agreement, Subtopic 326-20 permits (but does not require) the use of a practical expedient. Under this practical expedient, an entity estimates expected credit losses for any difference between the financial asset's amortized cost basis and the fair value of the collateral securing the financial asset. This means that if the amortized cost basis is greater, the entity estimates expected credit losses for the portion of the amortized cost that is greater than the fair value of the collateral.

10.2 Collateral-dependent financial assets

Excerpt from ASC 326-20

>> Collateral-Dependent Financial Assets

35-4 Regardless of the initial measurement method, an entity shall measure expected credit losses based on the **fair value** of the collateral at the reporting date when the entity determines that foreclosure is probable. The entity shall adjust the fair value of the collateral for the estimated costs to sell if it intends to sell rather than operate the collateral. When an entity determines that foreclosure is probable, the entity shall remeasure the **financial asset** at the fair value of the collateral at the reporting date (less costs to sell, if applicable) so that the reporting of a credit loss is not delayed until actual foreclosure. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses. An allowance for credit losses that is added to the **amortized cost basis** of the financial asset(s) shall not exceed amounts previously written off.

35-5 An entity may use, as a practical expedient, the fair value of the collateral at the reporting date when recording the net carrying amount of the asset and determining the allowance for credit losses for a financial asset for which the 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 (collateral-dependent financial asset). If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell. However, the entity shall not incorporate in the net carrying amount of the financial asset the estimated costs to sell the collateral if repayment or satisfaction of the financial asset depends only on the operation, rather than on the sale, of the collateral. When the fair value (less costs to sell, if applicable) of the collateral at the reporting date exceeds the **amortized cost basis** of the financial asset, an entity shall adjust the allowance for credit losses to present the net amount expected to be collected on the financial asset equal to the fair value (less cost to sell, if applicable) of the collateral as long as the allowance that is added to the amortized cost basis of the financial asset(s) does not exceed amounts previously written off. If the fair value of the collateral is less than the amortized cost basis of the financial asset for which the practical expedient has been elected, an entity shall recognize an allowance for credit losses on the collateral-dependent financial asset, which is measured as the difference between the fair value of the collateral, less costs to sell (if applicable), at the reporting date and the amortized cost basis of the financial asset. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses.

Excerpt from ASC 326-20

>> Example 6: Estimating Expected Credit Losses—Practical Expedient for Collateral-Dependent Financial Assets

55-41 This Example illustrates one way an entity may implement the guidance in paragraph 326-20-35-5 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.

55-42 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.

55-43 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.

55-44 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 provided in paragraph 326-20-35-5 and uses the apartment building's fair value, less costs to sell, when developing its estimate of expected credit losses.

10.2.10 Overview

A financial asset is collateral-dependent when the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. [326-20-35-4]

The collateral-dependent practical expedient is applied when:

— **Foreclosure is probable.** An entity uses the collateral's fair value at the reporting date to estimate the financial asset's expected credit losses.

— **The financial asset is collateral-dependent but foreclosure is not probable.** An entity can elect to apply the practical expedient to use the collateral's fair value at the reporting date to estimate the asset's expected credit losses.

If the financial asset was previously written off (either partially or fully) and the collateral's fair value at the reporting date is greater than the amortized cost, an entity adjusts the allowance to present the net amount expected to be collected. However, the allowance that is added to the amortized cost may not exceed amounts previously written off. [326-20-35-4 – 35-5]

If the entity chooses not to elect the practical expedient or the practical expedient does not apply, it uses the general measurement principles in Subtopic 326-20 to estimate the allowance for credit losses. [326-20-35-4 – 35-5]

Calculation of allowance for credit losses

There is no difference in the calculation of expected credit losses when use of the practical expedient is mandatory versus elective. How expected credit losses are calculated in both instances depends on whether repayment of the financial asset is expected to be from the sale or the operation of the collateral. The following decision tree summarizes how an allowance for credit losses is calculated based on the expected source of repayment.

What does repayment of the collateral-dependent financial asset depend on?

Sale of collateral	Operation of collateral
Allowance calculated as:	
Amortized cost basis – Fair value of collateral – Effect of credit enhancements that are not freestanding + Estimated costs to sell	Amortized cost basis – Fair value of collateral – Effect of credit enhancements that are not freestanding

Either calculation may result in a zero, positive, or negative amount. Any negative allowance may not exceed the amount of previous writeoffs.

Comparison to legacy US GAAP
Collateral-dependent measurement approach

ASU 2016-13 expanded both the definition of collateral-dependent as well as the situations in which the value of the collateral can be used to estimate expected credit losses, as demonstrated in the following table.

	Legacy US GAAP	Subtopic 326-20
Scope	Limited to loans. [310-10-35-22]	Applicable to all financial assets.
Applicability	Required when foreclosure is probable. [310-10-35-32] Permitted as a practical expedient only when a loan is impaired. [310-10-35-22]	Required when foreclosure is probable. Permitted as a practical expedient when: — repayment is expected to be provided substantially by the sale

	Legacy US GAAP	Subtopic 326-20
		or operation of the collateral; and — the borrower is experiencing financial difficulty.
Definition of collateral-dependent financial asset	A loan for which repayment is expected to be provided *solely* by the underlying collateral. [310-10 Glossary]	A financial asset for which repayment is expected to be provided *substantially* through the operation or sale of the collateral when the borrower is experiencing financial difficulty.
Requirement to consider borrower's financial condition	Borrower's financial condition is not explicitly considered. However, it is likely that it is considered implicitly because an impaired loan would generally be expected to involve a borrower experiencing financial difficulty. [310-10-35-22]	Borrower's financial condition is explicitly considered when foreclosure is not probable.

10.2.20 Scope

The collateral-dependent practical expedient must be applied when foreclosure is probable. Further, it may be elected when foreclosure is not probable but:

- repayment is expected to be provided substantially through the operation or sale of the collateral; and
- the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date. [326-20-35-4 – 35-5]

Question 10.2.45

If foreclosure is not probable, can the practical expedient be applied regardless of which party will operate the collateral?

Interpretive response: Yes. When repayment or satisfaction of the financial asset depends on the operation (rather than on the sale) of the collateral, we believe the practical expedient can be applied regardless of which party (lender, borrower or third party) will operate the property. [326-20-35-5]

Question 10.2.50#

How does an entity determine if the debtor is experiencing financial difficulty?

Excerpt from ASC 310-10

Pending Content:

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

>> Determining Whether a Debtor Is Experiencing Financial Difficulty

50-45 In evaluating whether the debtor is experiencing financial difficulties for the purpose of the disclosure requirements in paragraphs 310-10-50-42 through 50-44 , a creditor shall consider the following indicators:

a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.
b. The debtor has declared or is in the process of declaring bankruptcy.
c. There is substantial doubt as to whether the debtor will continue to be a going concern.
d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

Interpretive response: Subtopic 310-10 provides indicators for determining whether a borrower is experiencing financial difficulty when evaluating whether incremental disclosures are required about a loan modification. Before adopting ASU 2022-02, an entity uses these indicators to determine if a borrower is experiencing financial difficulty when evaluating whether a loan modification is a TDR (see section 11.2.20). We believe those indicators may be applied by analogy when considering whether the practical expedient for collateral-dependent financial assets can be elected. [310-10-50-45]

Example 10.2.05●

Evaluating whether the debtor is experiencing financial difficulties

Developer is a private company builder of apartment buildings and strip malls. To finance the construction of one of its apartment complexes, on April 1, Year 1 it obtains a 15-year loan for $20 million at 7.5% interest from Bank. Interest reserves are established to provide interest-only payments during the two-year construction period.

As of January 1, Year 3, construction has not been completed and three months of interest reserves remain. There are commitments to lease 75% of the building's space, but based on current projections rental receipts will not be sufficient to service the loan unless the building is leased up to at least 90%.

Developer's financial statements for the last two years show approximately break-even net income and operating cash flows. Current financial statements indicate that Developer has minimal other resources available to support this debt. Because the project has not been completed, Developer cannot obtain take-out or permanent financing.

Bank concludes that Developer is experiencing financial difficulties for the following reasons:

— Developer is not expected to have sufficient cash flows to service the debt in accordance with the original contractual terms;
— Developer cannot obtain take-out financing from another lender; and
— Developer's repayment capacity is uncertain and it has weak financial support.

Question 10.2.60

Once an entity has elected the practical expedient when foreclosure is not probable, must it reassess the expedient's applicability in subsequent periods?

Interpretive response: Yes. If foreclosure is not probable, we believe for an entity to continue to apply the practical expedient, the borrower should continue to be experiencing financial difficulty and the entity should continue to expect repayment to be provided substantially through the collateral's sale or operation. If one or both of these conditions no longer exist and foreclosure is not probable, another acceptable method should be used to estimate expected credit losses. [326-20-35-4 – 35-5]

An entity will need to use judgment and develop processes and controls to determine at what point a borrower that was previously experiencing financial difficulty has overcome that financial difficulty.

10.2.30 Measurement

If on the reporting date an entity (1) determines that foreclosure of a collateral-dependent financial asset is probable or (2) elects the practical expedient, it estimates the asset's expected credit losses based on the fair value of the collateral at the reporting date and records any resulting credit losses at that time. This requirement prevents the entity from delaying recognition of the credit losses until foreclosure occurs. [326-20-35-4]

— **Fair value of collateral is less than amortized cost.** If the fair value of the underlying collateral at the reporting date – adjusted for estimated costs to sell, if applicable – is less than the amortized cost of the financial asset, the resulting difference is the allowance for credit losses. The fair value of the underlying collateral is not reduced by estimated costs to sell when repayment is expected to come from operation rather than sale of the collateral. [326-20-35-4]

— **Fair value of collateral is greater than amortized cost.** If the financial asset has previously had a full or partial write off and the fair value of the underlying collateral at the reporting date – adjusted for estimated costs to sell, if applicable – is greater than the amortized cost, the allowance for credit losses is adjusted to present the net amount expected to be collected. However, the allowance for credit losses that is added to the amortized cost may not exceed amounts previously written off. [326-20-35-4 – 35-5]

Further, an entity considers credit enhancements that are not freestanding when estimating expected credit losses. Chapter 9 discusses credit enhancements in greater detail.

Example 10.2.10

Application of the practical expedient when the debtor operates the property

Bank loans ABC Corp. $20 million on January 1, Year 1. The loan is secured by commercial real estate that has a fair value at origination of $25 million. The primary source of repayment of the loan is rent collected from the property's tenants.

In April, Year 4, ABC informs Bank that it has lost the anchor tenant and current rent projections do not support the loan payments. ABC has made no payments for two months and Bank has adversely classified the loan.

Bank obtains an updated appraisal as of June 30, Year 4, indicating that the real estate's fair value is now $15 million, compared with the remaining amortized cost of the loan of $19 million.

Bank does not intend to foreclose on the property. It believes that cash flows will be maximized by allowing ABC to continue to operate the commercial real estate and attempt to secure a new anchor tenant.

At June 30, Year 4, Bank determines that repayment of the loan is expected to be substantially through ABC's operation of the collateral and that ABC is experiencing financial difficulty. Therefore, Bank elects the practical expedient to measure the loan's expected credit losses.

Bank estimates that the allowance for credit losses is $4 million at June 30, Year 4: loan's remaining amortized cost of $19 million less fair value of the collateral of $15 million (which does not consider costs to sell).

Question 10.2.65

What types of costs are considered in estimated selling costs?

Interpretive response: We believe costs to sell represent incremental direct costs to transact a sale. Incremental direct costs are costs that result directly from, and are essential to, a sale transaction and that would not have been incurred if the entity had not sold the asset.

An entity needs to evaluate whether costs such as broker commissions, legal and transfer fees, and closing costs to transfer legal title are expected to be incurred solely because the asset was sold. Further, expenses that an entity anticipates paying on behalf of the borrower that are associated with owning and operating the asset (e.g. taxes and insurance) are not considered costs to sell.

Question 10.2.70

Is the practical expedient applied at the individual financial asset level?

Interpretive response: Yes. We believe an entity should apply the practical expedient at the individual financial asset level.

Applying the practical expedient at the portfolio level could inappropriately allow expected credit losses from financial assets for which the fair value of the collateral is less than the amortized cost to be offset by gains from those financial assets for which the fair value of the collateral is greater than the amortized cost. [326-20-35-5]

Question 10.2.80

Are credit enhancements considered when estimating expected credit losses using the practical expedient?

Interpretive response: Yes, when applying the practical expedient an entity also considers credit enhancements that are not freestanding when estimating expected credit losses for collateral-dependent financial assets. [326-20-35-5]

Chapter 9 discusses credit enhancements in greater detail.

Question 10.2.85

How does an entity account for a subsequent increase in the fair value of the collateral?

Interpretive response: A subsequent increase in the fair value of the underlying collateral – adjusted for estimated costs to sell, if applicable – above the financial asset's amortized cost is first reflected as a reduction in the allowance for credit losses, if any. The allowance for credit losses may be negative (i.e. a debit balance) if the financial asset had previously had a full or partial write off. However, the negative allowance is limited to the amount of previous writeoffs. [326-20-35-4 – 35-5]

Example 10.2.20

Increase in fair value of collateral after a previous writeoff

Bank loans ABC Corp. $10 million on January 1, Year 1. The loan is secured by commercial real estate that has a fair value at origination of $11 million.

In Year 2, Bank determines that the loan is collateral-dependent and applies the practical expedient when measuring the related allowance for credit losses. Therefore, the loan's allowance for credit losses is based on the collateral's fair value. Bank obtains an updated appraisal as of the end of Year 2 indicating that the fair value of the collateral securing the loan is $8 million. For simplicity, assume that amortized cost is $10 million at the end of Year 2 and there are no costs to sell.

Bank estimates that the allowance for credit losses is $2 million at the end of Year 2, which is the difference between the fair value of the collateral ($8 million) and the loan's amortized cost ($10 million). Further, Bank determines that $2 million of the remaining $10 million is uncollectible and writes off the $2 million allowance and related loan balance.

Bank continues to monitor the fair value of the collateral and obtains an updated appraisal as of the end of Year 3, which indicates that the fair value of the collateral is $12 million. Bank recognizes an adjustment to the allowance for credit losses related to the subsequent increase in the fair value of the collateral. Although the excess of fair value of the collateral over amortized cost is $4 million, the negative allowance that is recognized is only $2 million because it is limited to the amount previously written off.

Question 10.2.90

When a loan is considered collateral-dependent, must an entity use the fair value of collateral to estimate expected credit losses for bank regulatory reporting purposes?

Interpretive response: Yes. For bank regulatory reporting purposes, consistent with existing guidance, an entity is required to estimate expected credit losses based on the fair value of the collateral for loans held-for-investment that individually meet the definition of collateral-dependent financial assets regardless of whether foreclosure is probable. This requirement is specific to loans held-for-investment and does not extend to other financial assets in the scope of Subtopic 326-20 (such as HTM debt securities). [Agency FAQs #37]

If foreclosure on held-for-investment loans is not probable, differences could result between bank regulatory and US GAAP reporting if the entity does not elect Subtopic 326-20's practical expedient for US GAAP reporting purposes. These differences will result because when an entity does not elect the practical expedient under Subtopic 326-20, it applies that Subtopic's general guidance on estimating credit losses. However, the Bank regulatory guidance may effectively prohibit the use of this general guidance in Subtopic 326-20 in these circumstances. [326-20-35-4 – 35-5, Agency FAQs #37]

This scenario was raised by the SEC staff in a speech at the 2017 AICPA Conference on Current SEC and PCAOB Developments. A registrant sought the staff's view on whether it could apply the general guidance on determining expected credit losses for US GAAP financial reporting, as opposed to the practical expedient, for collateral-dependent financial assets when foreclosure is not deemed probable. The staff indicated they would not object to a registrant's decision to apply the general expected credit loss approach. [2017 AICPA Conf]

Question 10.2.95

Do expected credit losses include amounts anticipated to be collected from a borrower after foreclosure or repossession when the lender applies the collateral dependent practical expedient?

Background: A loan may provide the lender with the contractual right to continue to pursue payments from the borrower after foreclosure or repossession. In some cases, the entity's past experience and future expectation is that it will continue to pursue collection from the borrower and receive payments after foreclosure or repossession.

For certain of these loans, the allowance will be estimated using the collateral dependent practical expedient – e.g. when foreclosure or repossession of the collateral-dependent loan is probable.

Interpretive response: No. However, an entity should consider anticipated collections from a borrower after foreclosure or repossession for a loan for which the collateral dependent practical expedient was applied before foreclosure or repossession of the collateral occurred.

The following table summarizes when anticipated collections from a borrower in these circumstances should be considered in estimating expected credit losses.

Allowance is estimated prior to foreclosure or repossession	Allowance is estimated subsequent to foreclosure or repossession
Do not consider. Because the practical expedient is applied, the allowance is the difference between the fair value (adjusted for estimated cost to sell) and the amortized cost with no additional adjustments. Further, the anticipated collections are not considered a credit enhancement as contemplated in paragraph 326-20-30-12. [326-20-35-4]	Consider. Because the loan is no longer collateral-dependent after foreclosure or repossession, the practical expedient cannot be applied. We believe that if an entity retains the contractual right to continue to pursue collection and receive payments from the borrower after foreclosure or repossession, and those amounts have been written off, the anticipated collections are considered as

	anticipated recoveries in estimating the allowance for credit losses. However, estimated recoveries are limited to amounts previously written off (see section 3.3.10). [326-20-30-1]

Example 10.2.30
Estimating the allowance before repossession

Bank makes a direct auto loan to Borrower for $80,000 on January 1, Year 1. The loan is secured by a vehicle that has a fair value at origination of $100,000.

In Year 2, Bank determines that the loan is collateral-dependent. Bank applies the practical expedient when measuring the related allowance for credit losses because repossession is probable.

When Bank repossesses the vehicle, it retains the right to continue to pursue payments from Borrower. That right comes from the original loan agreement, which continues to exist and continues to be enforceable. Bank's past experience demonstrates that it will collect amounts after repossession.

In Year 2, Bank's estimates are as follows.

Amortized cost:	$70,000
Fair value of collateral:	$50,000
Anticipated collections from Borrower after repossession:	$10,000
Estimated costs to sell:	$1,000

Bank estimates the allowance for credit losses at $21,000 at the end of Year 2, which is the difference between the fair value of the collateral ($50,000) adjusted for estimated costs to sell ($1,000) and the loan's amortized cost ($70,000).

Bank does not consider anticipated collections in the calculation because the practical expedient is applied.

Example 10.2.35
Estimating the allowance after repossession

This example uses the facts in Example 10.2.30 except that the following events occur at the end of Year 2.

- Immediately before repossession, Bank writes off the allowance for credit losses and the related loan balance.
- Bank repossesses the vehicle associated with the loan. The collateral is classified as a repossessed asset and measured at the lower of cost or fair value less costs to sell.
- After repossession, Bank sells the vehicle and is left with a shortfall.

After repossession, Bank retains the right to continue to pursue payments from Borrower and expects to collect $10,000 based on its past experience adjusted for specific facts and circumstances. As a result, Bank recognizes a negative allowance of $10,000, which represents the expected recovery.

Question 10.2.100

Can an entity use liquidation value to estimate expected credit losses for a collateral-dependent financial asset, if different from fair value?

Background: In the context of this question, liquidation value refers to the amount the seller expects to collect from the sale of the asset. In many cases, the liquidation value and the fair value will be the same, but not in all cases.

Interpretive response: No. An entity determines the value of the underlying collateral of a collateral-dependent financial asset using a fair value measurement (Topic 820). The Board deliberated whether the collateral-dependent practical expedient should be based on liquidation value instead of fair value, but it decided to retain the fair value measurement concept because fair value is well understood and applied in current practice. Therefore, when the liquidation value and the fair value of the underlying collateral are different, the entity must use the fair value. [326-20 Glossary, ASU 2016-13.BC65]

We believe that if an entity observes a pattern of significant differences between the appraised value for a foreclosed property and the amount ultimately realized on its sale (the liquidation value), an entity should perform a retrospective review and investigate the reason(s) for the difference – e.g. the appraiser did not contemplate that the property was a foreclosed property. The results of that review can be used to determine whether the entity should incorporate changes to its fair value estimation process, including considering the potential need to adjust the appraised values used to measure the allowance for credit losses for other collateral-dependent financial assets (i.e. that have not yet been foreclosed upon).

However, an adjustment to appraised value will not always be appropriate. For example, the appraisal value would not be adjusted if the difference is solely because the appraisal assumed a marketing period or practices that are customary for the type of asset being sold while the actual sale occurred in a marketing period that was shorter or less robust. This is because a fair value measurement is based on an orderly transaction, and orderly transactions involve the use of a marketing period or practices that are customary for the type of asset being sold. [820-10-35-54(I)(a)]

10.3 Collateral maintenance provisions

Excerpt from ASC 326-20

> Financial Assets Secured by Collateral Maintenance Provisions

35-6 For certain **financial assets**, the borrower may be contractually required to continually adjust the amount of the collateral securing the financial assets as a result of **fair value** changes in the collateral. In those situations, if an entity reasonably expects the borrower to continue to replenish the collateral to meet the requirements of the contract, an entity may use, as a practical expedient, a method that compares the **amortized cost basis** with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity reasonably expects the borrower to continue to replenish the collateral as necessary to meet the requirements of the contract. If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset and the entity reasonably expects the borrower to continue to replenish the collateral as necessary to meet the requirements of the contract, the entity shall estimate expected credit losses for the unsecured amount of the amortized cost basis. The allowance for credit losses on the financial asset is limited to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

>> Example 7: Estimating Expected Credit Losses – Practical Expedient for Financial Assets with Collateral Maintenance Provisions

55-45 This Example illustrates one way an entity may implement the guidance in paragraph 326-20-35-6 for estimating expected credit losses on financial assets with collateral maintenance provisions.

55-46 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.

55-47 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 in accordance with paragraph 326-20-35-6 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 in paragraph 326-20-35-6 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.

Certain arrangements require the borrower to continually adjust the amount of collateral securing the financial asset as a result of changes in the fair value of the collateral. Subtopic 326-20 refers to these arrangements as collateral maintenance provisions.

For these types of arrangements, when the borrower is expected to replenish the collateral as required by the terms of the agreement, Subtopic 326-20 permits (but does not require) the use of a practical expedient to estimate expected credit losses. Under this practical expedient, an entity estimates expected credit losses for any difference between the financial asset's amortized cost basis and the fair value securing the financial asset. This means that if the amortized cost basis is greater, the entity estimates expected credit losses for the unsecured portion of the amortized cost. [326-20-35-6]

Question 10.3.10

To apply the practical expedient, does an entity need to assess whether the borrower will replenish the collateral?

Interpretive response: Yes. To apply the practical expedient, an entity needs to assess whether the borrower will replenish the collateral.

The entity only needs to assess whether it has a *reasonable expectation* that the borrower will be able to replenish collateral, if necessary. The Board clarified in the basis for conclusions that the entity would not need to either: [ASU 2019-11.BC23]

— assess whether it is probable that the borrower will replenish collateral, if necessary; or
— consider remote scenarios where the borrower may not be able to replenish the collateral.

Question 10.3.15

What should an entity consider when evaluating whether a borrower is required to continually adjust the amount of collateral?

Interpretive response: We believe an entity should consider the following two factors when evaluating whether a borrower is required to continually adjust the amount of collateral securing the financial asset:

— how frequently the collateral is required to be replenished; and
— the liquidity of the collateral.

Although this is a judgment-based determination that depends on facts and circumstances, we believe the term 'continually' implies a frequency that would generally align with daily or weekly adjustments to the amount of collateral securing the financial asset.

We further believe that the liquidity of the collateral should be considered. We believe that illiquidity of the collateral may indicate that the borrower is either not required to continually replenish, or may not be able to replenish, the collateral securing the financial asset.

Question 10.3.20

How does an entity apply the practical expedient when the fair value of the collateral is equal to or greater than the amortized cost basis?

Interpretive response: If the fair value of the collateral at the reporting date is equal to or greater than the amortized cost of the financial asset, an entity does not recognize an allowance for credit losses. Further, we believe the entity does not need to consider the possibility of the collateral declining in value after the reporting date. [326-20-35-6]

Question 10.3.30

How does an entity apply the practical expedient when the fair value of the collateral is less than the amortized cost basis?

Interpretive response: If the fair value of the collateral at the reporting date is less than the amortized cost of the financial asset, an entity should evaluate the financial asset as two separate components.

For the portion of the financial asset that is collateralized, the entity does not recognize an allowance for credit losses.

For the portion of the financial asset that is uncollateralized, the entity should use the general guidance on estimating expected credit losses (see chapter 4). The maximum amount of expected credit losses is capped at the amount that is uncollateralized (that is, it is limited to the difference between the fair value of the collateral at the reporting date and the amortized cost).

Example 10.3.10

Repurchase agreement

ABC Corp. transfers securities that have a fair value of $1,000 to XYZ Corp. as collateral in exchange for $1,000 in cash. ABC agrees to repurchase the securities from XYZ in 90 days.

The transaction is accounted for by ABC as a secured borrowing (repurchase agreement), and not a sale of a security. Similarly, XYZ accounts for the transaction as a secured borrowing (reverse repurchase) and not a purchase of a security.

ABC is contractually required to maintain collateral with a fair value that ranges between 98–102% of the cash borrowed. If the fair value of the collateral falls below 98%, ABC is required to provide XYZ with additional collateral.

XYZ has determined that it may apply the practical expedient related to collateral maintenance provisions.

XYZ elects to apply the practical expedient for collateral maintenance provisions, and uses a probability of default/loss given default approach to estimate losses on any uncollateralized amounts. XYZ estimates that the probability of default is 15% and the loss given default is 60%.

At December 31, the fair value of the collateral has declined to $980. XYZ determines the allowance for credit losses for the $1,000 reverse repurchase agreement as follows.

— For the portion of the financial asset that is collateralized ($980), XYZ does not recognize an allowance for credit losses.
— For the portion of the financial asset that is uncollateralized ($20), XYZ calculates its allowance for credit losses as $20 × 15% × 60% = $1.80.

11. Troubled debt restructurings

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #
Item moved from another chapter without significant change: ●

Comparison to legacy US GAAP

11.1 How the standard works

Topic 326 does not affect how a TDR is defined. However, it does affect the timing of TDR identification and potentially how the allowance for credit losses is determined when a financial asset is determined to be a TDR.

For TDRs that are included in an entity's historical loss experience, the estimated effect of these TDRs is included in the initial and subsequent measurement of the allowance for credit losses. TDRs involving principal forgiveness are generally included in an entity's historical loss experience.

For TDRs that are not included in an entity's historical loss experience, the estimated effect of these TDRs is included in the allowance for credit losses once an entity has a reasonable expectation that a specific financial asset will be modified as a TDR. TDRs involving extensions, more than insignificant delays in payments or interest rate concessions are generally not included in an entity's historical loss experience.

Subtopic 326-20 permits an entity to estimate expected credit losses using different methods, however it is required to use a discounted cash flow method when that is the only method that will capture the effects of the TDR.

Effect of ASU 2022-02**

This chapter does not address the amendments in ASU 2022-02, Financial Instruments—Credit Losses: Troubled Debt Restructurings and Vintage Disclosures, which was issued by the FASB in March 2022. The ASU affects this chapter because it eliminates separate recognition and measurement guidance for TDRs, as well as the related guidance in Subtopic 326-20 for measuring credit losses on TDRs. The guidance in this chapter applies as follows after adoption of ASU 2022-02.

Section	Applicability of guidance after adoption of ASU 2022-02
11.2 Identifying a TDR	Not applicable. After ASU 2022-02 is adopted, a loan modification is not evaluated to determine whether it is a TDR. An entity also does not evaluate whether a TDR is reasonably expected when determining its contractual term.
11.3 Estimating credit losses for a TDR	The guidance applies when the entity adopts ASU 2022-02 using the prospective transition approach. In this situation, the guidance in this section applies to loans that: — were modified in TDRs before adoption; and — have not been subsequently modified after adoption.

See section 25.5 for guidance about ASU 2022-02's effective dates and transition.

11.2 Identifying a TDR (before adoption of ASU 2022-02)

11.2.10 Overview

Excerpt from ASC 310-40

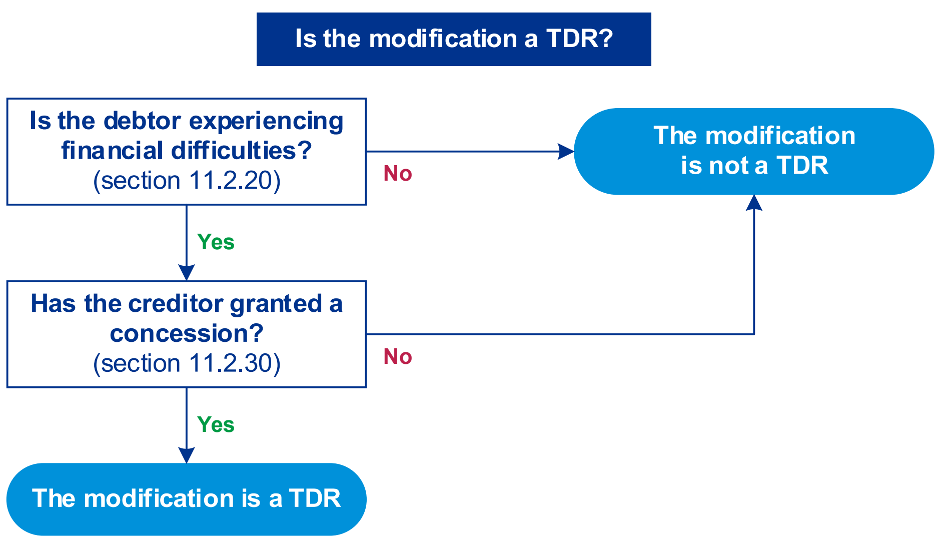
>> Troubled Debt Restructuring

15-5 A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic 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.

Lenders and borrowers may agree to modify the terms of existing loans, receivables or debt securities. These modifications are made for a variety of reasons. In some cases, the terms may be modified to accommodate the borrower’s financial difficulties. For example, in an effort to maximize collections, a lender might reduce or defer the cash payments due in the hope that a troubled borrower might be able to repay amounts due under the revised contractual terms.

Subtopic 326-20 does not change current guidance on whether a loan modification constitutes a TDR. A modification is a TDR 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. For additional guidance around defining TDRs, see sections 11.2.20 and 11.2.30.

The following decision tree highlights the key steps in evaluating whether a modification is a TDR.



Other modifications could be the result of renegotiations or refinancings with borrowers that are not experiencing financial difficulty. For example, a borrower who is in good financial standing may wish to take advantage of a low interest rate environment and negotiate with the lender to reduce the interest rate on the loan. The lender may wish to continue the relationship with the customer and agree to the revised terms. These modifications are not TDRs. [310-40-15-5]

If a debt modification is not a TDR, a lender accounts for the modification as either a continuation of the original financial asset or a derecognition of the original financial asset and the recognition of a new financial asset, depending on the nature and extent of the modification. Further guidance on non-TDR modifications can be found in paragraphs 310-20-35-9 to 35-11.

Effect of ASU 2022-02**

This section 11.2 does not address the amendments in ASU 2022-02 regarding TDRs. See section 11.1.

Question 11.2.05●

Must an entity evaluate whether financial asset modifications made to PCD assets are TDRs?

Interpretive response: Yes. An entity may have individual financial assets that meet the definition of a PCD asset for which expected credit losses are estimated on a collective basis. For additional discussion of PCD financial assets, see chapter 12. Unlike legacy US GAAP, Subtopic 326-20 requires an entity to evaluate whether modifications of PCD assets meet the definition of a TDR. [310-30-40-1, 310-40-15-11(d)]

However, an entity does not reassess whether modifications to individual acquired financial assets within pools accounted for as purchased credit impaired (PCI) under Subtopic 310-30 before the adoption of Topic 326 are TDRs as of the date of adoption.

Further, the TRG clarified that an entity may elect to maintain previously existing pools of PCI financial assets accounted for under Subtopic 310-30 at the date of, and subsequent to, the adoption of Topic 326. If an entity elects to maintain the previously existing pools, it retains the concept of the pool being the unit of account. Therefore, consistent with legacy US GAAP, modifications to individual acquired financial assets accounted for in those pools subsequent to the adoption date of Topic 326 do not need to be evaluated to determine whether they are TDRs. For further discussion of transition, see chapter 25. [326-10-65-1(d), TRG 06-17.3, TRG 06-17.6]

11.2.20 Determining whether the debtor is experiencing financial difficulties#

Excerpt from ASC 310-40

> Determining Whether a Debtor is Experiencing Financial Difficulties

15-20 In evaluating whether a receivable is a troubled debt restructuring, a creditor must determine whether the debtor is experiencing financial difficulties. In making this determination, a creditor shall consider the following indicators:

a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.
b. The debtor has declared or is in the process of declaring bankruptcy.
c. There is substantial doubt as to whether the debtor will continue to be a going concern.
d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

The first characteristic of a TDR is that the debtor is experiencing financial difficulties. The list of indicators in paragraph 310-40-15-20 is not exhaustive. After adopting ASU 2022-02, an entity uses these same indicators to determine whether a borrower is experiencing financial difficulty when evaluating whether incremental disclosures are required about the loan modification. For guidance on indicators to consider in determining whether a borrower is experiencing financial difficulty, see section 10.2.20. [310-40-15-20]

11.2.30 Determining whether a creditor has granted a concession

Excerpt from ASC 310-40

> Determining Whether a Creditor Has Granted a Concession

15-13 A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. In that situation, and if the payment of principal at original maturity is primarily dependent on the value of collateral, an entity shall consider the current value of that collateral in determining whether the principal will be paid.

15-14 A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring. When additional guarantees are received in a restructuring, an entity shall evaluate both a guarantor's ability and its willingness to pay the balance owed.

15-15 If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

15-16 A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below market interest rates for new debt with similar risk characteristics. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

> Evaluating Whether a Restructuring Results in a Delay in Payment That Is Insignificant

15-17 A restructuring that results in only a delay in payment that is insignificant is not a concession. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
    1. The frequency of payments due under the debt
    2. The debt's original contractual maturity
    3. The debt's original expected duration.

15-18 If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

The second characteristic of a TDR is that the creditor has granted a concession. When a restructuring occurs, the creditor needs to consider all aspects of the financial asset that have changed to determine if it is granting a concession. The interest rate on a financial asset does not need to be decreased for a restructuring to be considered a concession. Similarly, a temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession, because the new contractual interest rate could still be below the market interest rate for new debt with similar risk characteristics.

Paragraphs 310-40-15-14 to 15-18 provide specific factors for a creditor to consider when making this evaluation. One of the factors is whether a delay in payment is insignificant, because a restructuring due to an insignificant delay in payment is not a TDR. Determining whether payment delays are insignificant requires judgment as illustrated in the following example. [340-10-15-15 – 15-17]

Excerpt from ASC 310-40

>> Example 5: Commercial Line of Credit – Short-Term Extension before the Finalization of Renegotiated Terms

55-23 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

55-24 A commercial debtor has a revolving line of credit with a creditor with an original term of five years. The terms of the line of credit require interest payments every 90 days on the average daily balance of the line. As the line of credit nears maturity, the debtor and creditor begin renegotiating the terms of a new line of credit. Because of a temporary cash shortfall due to a delay in collections from two key customers, the debtor is unable to make the final interest payment before the two parties finish renegotiating the terms of the new line of credit. The terms of the renegotiated line of credit are expected to be similar to the current line of credit, which are comparable to terms available to debtors with similar risk characteristics. The creditor expects the debtor to recover quickly from this temporary cash flow shortage. Accordingly, the creditor extends a 3-month payment deferral by adding the missed interest payment to the balance of the line and requiring the debtor to make its first interest payment 90 days after the new line of credit is finalized, or 180 days after the due date of the missed interest payment.

55-25 The restructuring results in a delay in payment that is insignificant. Although the debtor is unable to make the contractual payment at the time it is due, thereby resulting in the three-month deferral, the creditor still expects to collect all amounts due, including interest at the contractual rate. Furthermore, the delay in timing of payment represents only one payment cycle under the terms of the line, which is insignificant relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.

Example 11.2.20

Evaluating whether a concession was granted

Assume the same facts as in Example 10.2.05.

In addition, because of the financial difficulty that Developer is experiencing, Bank agrees to modify the loan by extending the interest-only period by one year and reducing the interest rate to 6.5%, which is below the current market rate. Bank expects that Developer will have sufficient rental income to pay the interest-only portion of the modified loan.

Developer believes that by the end of the additional one-year interest-only period, the building will be 85% leased and it will be able to make full principal and interest payments.

Bank concludes that the loan modification resulted in two concessions:

— Bank agreed to extend the two-year interest-only period by one additional year, which is more than an insignificant delay in payment.
— Bank agreed to reduce the interest rate from 7.5% to 6.5%, which is below the current market rate.

11.2.40 Timing of TDR identification

An entity includes reasonably expected TDRs within its estimate of expected credit losses under Subtopic 326-20. [326-20-30-6]

Question 11.2.10

Does an entity include an estimate of future TDRs in its estimate of expected credit losses?

Interpretive response: It depends. When the effect of previous TDRs have been included in the entity's historical loss experience that is used to develop the estimate of expected credit losses, an entity should continue to include that effect. In other words, the historical loss experience should not be adjusted to remove the effect of historical TDRs. In that situation, an entity should consider its expectations for future TDRs, and the effect that those TDRs will have on credit loss amounts, and adjust its historical loss experience accordingly.

For example, if an entity has previously entered into TDRs involving the forgiveness of principal amounts, those TDRs should be included in the entity's historical loss experience. The entity would then consider whether the historical loss experience should be adjusted based on its expectations for future TDRs that similarly involve forgiveness of principal amounts.

In a September 2017 FASB meeting the Board discussed when the effects of TDRs that have not been included in the entity's historical loss experience should be included in the allowance for credit losses. The Board determined that these types of TDRs should be included in the estimate of expected credit losses when the entity has a reasonable expectation that a specific financial asset will be modified as a TDR. At that time, all of the effects of the TDR, including the cost of the concession and the effect of extending the contractual term (if applicable), are recognized. [TRG 6-17.6A]

For example, if an entity has previously entered into TDRs involving only a payment extension or deferral, the effect of those types of TDRs are generally not included in the entity's historical loss experience. The entity would therefore not include the estimated effect of these TDRs until it reasonably expects that a specific financial asset will be modified as a TDR. At that time, the cost of the concession and the effect of extending the contractual term (if applicable) would be recognized.

Question 11.2.20
What is a 'reasonably expected' TDR?

Interpretive response: While Subtopic 326-20 does not define reasonable expectation of a TDR, we believe that a TDR would always be reasonably expected before execution. Furthermore, there may be indications of a reasonably expected TDR before individual negotiations with a borrower begin. [TRG 6-17.6A]

Determining the exact timing of when a reasonably expected TDR exists requires judgment. However, we believe that an entity will typically have processes in place to assist in identifying certain financial assets that it would like to modify through a TDR to mitigate potential losses. These processes may differ between entities or asset types based on the risk characteristics of the financial assets and the types of modifications that an entity expects to offer.

For example, an entity may have a policy that requires a modification to be considered for all loans past a certain delinquency threshold. An entity may even have additional policies that specify the kinds of concessions that should be offered depending on the borrowers' specific circumstances. [TRG 6-17.6A]

An entity may need to develop new policies, processes and controls to identify when a TDR is reasonably expected.

Question 11.2.30
May modifications be evaluated on a program basis to identify TDRs?

Interpretive response: Yes. Some lenders have engaged in large loss mitigation programs or strategies that, by design, provide concessions to borrowers currently experiencing or expected to experience financial difficulty – e.g. when the interest rate on a loan 'resets' to a higher rate at a future date.

In those situations, it may be appropriate for the lender to conclude that these modifications meet the definition of a TDR at the program level. Similarly, it may be appropriate for the lender to presume that all loan modifications made pursuant to specifically defined loss mitigation strategies meet the definition of a TDR. As discussed in Questions 11.2.10 and 11.2.20, the lender identifies the TDR when it is reasonably expected at the individual financial asset level, rather than waiting until the TDR has been executed.

Lenders often evaluate residential mortgage and consumer loan modifications on a program basis. For example, as part of a modification program, a lender may provide the same standard concessions to a group of borrowers that are currently experiencing or are expected to experience financial difficulty. In contrast, commercial loan modifications generally are evaluated on an individual basis because of the unique features of each loan and the borrower-specific modifications that may be negotiated.

11.3 Estimating credit losses for a TDR

11.3.10 Overview

Excerpt from ASC 310-40

> Impairment

35-10 A loan restructured in a troubled debt restructuring shall not be accounted for as a new loan because a troubled debt restructuring is part of a creditor's ongoing effort to recover its investment in the original loan. Topic 326 provides guidance on measuring credit losses on financial assets and requires credit losses to be recorded through an allowance for credit loss account, including concessions given to the borrower upon a troubled debt restructuring.

35-11 The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 do not allow the lender to look-back to credit losses measured and recorded under Topic 326 for purposes of measuring the cumulative loss previously recognized in determining the gain to be recognized on the increase in fair value less cost to sell of a foreclosed property under paragraph 360-10-35-40.

> Effective Interest Rate for a Restructured Loan

35-12 The **effective interest rate** for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. As indicated in paragraph 310-40-35-10, a troubled debt restructuring does not result in a new loan but rather represents part of a creditor's ongoing effort to recover its investment in the original loan. Therefore, the interest rate used to discount expected future cash flows on a restructured loan shall be the same interest rate used to discount expected future cash flows on the original loan.

A TDR is a continuation of an existing financial asset rather than a new financial asset. Any unamortized deferred fees or costs from the original financial asset are carried forward and recognized over the asset's remaining term. Therefore, the EIR after the modification is based on the original contractual rate and not the modified contractual rate for estimating expected credit losses. See Question 4.4.70 for further information regarding the EIR for TDRs. [310-40-35-10, 35-12]

Effect of ASU 2022-02**

This section 11.3 does not address the amendments in ASU 2022-02 regarding TDRs. See section 11.1.

The guidance in this section 11.3 applies when the entity has not adopted ASU 2022-02. It also applies when the entity adopted ASU 2022-02 using the prospective transition approach. In this latter situation, the guidance in this section applies to loans that:

— were modified in TDRs before adoption; and
— have not been subsequently modified after adoption.

Comparison to legacy US GAAP
Estimating credit losses for TDRs

The following table compares the accounting for TDRs under legacy US GAAP to Subtopic 326-20. The differences included in this table are discussed in further detail throughout this section.

Legacy US GAAP (before adoption of ASU 2016-13)	Subtopic 326-20 (before adoption of ASU 2022-02[1])
Collective assessment is permitted, but not required, when impaired loans, including TDRs, share common risk characteristics [310-10-35-21]	Collective assessment is required when the financial assets share similar risk characteristics.
Impairment measured using a discounted cash flow method, except when an entity is eligible to apply the practical expedient for collateral-dependent loans. [310-10-35-22]	Different methods permitted to estimate expected credit losses; however, a discounted cash flow method is required when that is the only method that will capture the effects of the TDR. Estimated expected credit losses are required to be measured using the fair value of the collateral when foreclosure is probable, and permitted when the borrower is experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral.

Note:

1. Also applies when the entity adopts ASU 2022-02 using the prospective transition approach. In this situation, the guidance in this section applies to loans that were modified in TDRs before adoption and have not been subsequently modified after adoption.

Question 11.3.10
Are TDRs assessed for expected credit losses on a collective basis?

Interpretive response: Yes, notwithstanding the discussion in Question 11.2.10 regarding the identification of TDRs, if TDRs share similar risk characteristics they are assessed on a collective basis.

Under Subtopic 326-20, expected credit losses are estimated on a collective (pool) basis when they share similar risk characteristics. If a TDR financial asset shares similar risk characteristics with other financial assets, it is evaluated with those other financial assets on a collective basis. If it does not share similar risk characteristics with other financial assets, it is evaluated individually. [326-20-30-2]

The FASB initially decided not to require a discounted cash flow method for estimating expected credit losses from TDRs. However, as discussed in Question 11.3.40, in a September 2017 FASB meeting, the Board agreed that a discounted cash flow method or a reconcilable method is required to measure the effect of certain types of TDRs, mainly interest rate concessions that can only be captured using a discounted cash flow method (or reconcilable method). [ASU 2016-13.BC105, TRG 6-17.6A]

The FASB intended that entities be able to pool TDRs to estimate expected credit losses in circumstances such as when broad-based modification programs are used to provide relief to troubled borrowers that share similar risk characteristics. It may be difficult to pool TDRs that require a discounted cash flow method with those that do not. [ASU 2016-13.BC105]

Question 11.3.20

Are TDRs pooled separately from non-TDRs when estimating expected credit losses?

Interpretive response: It depends. TDRs do not need to be pooled separately from non-TDRs when they share similar risk characteristics. We believe a financial asset that previously experienced a TDR could share similar risk characteristics with non-TDR financial assets. However, when TDRs and non-TDRs do not share similar risk characteristics, they should be pooled separately.

Because the same method could be used to estimate expected credit losses for TDRs and non-TDRs, entities that have had to segregate TDRs for subsequent measurement because of different methods being used (e.g. discounted cash flows versus loss rate) even though they had similar risk characteristics may no longer need to do so. However, as discussed in Question 11.3.40, in a September 2017 FASB meeting, the Board agreed that a discounted cash flow method or a reconcilable method is required to measure the effect of certain types of TDRs, mainly interest rate concessions that can only be captured using a discounted cash flow method (or reconcilable method). It may be difficult to pool TDRs that require a discounted cash flow method with financial assets that do not. [TRG 6-17.6A]

Question 11.3.30

Does an entity consider interest rate concessions and more than insignificant delays in payments when estimating expected credit losses?

Interpretive response: Yes. Subtopic 326-20 requires the effect of an interest rate concession or a more than insignificant delay in payments (i.e. term extension or forbearance) in a TDR to be included in the allowance for credit losses. This is despite the fact that interest rate concessions and more than insignificant delays in payments generally do not directly result in losses of the amortized cost basis of the financial asset at the time of the TDR. Because they represent concessions, they are required to be included in the estimate of expected credit losses. [310-40-35-10, ASU 2016-13.BC104]

Question 11.3.40

Is a specific method prescribed to estimate expected credit losses for TDRs?

Interpretive response: It depends. In a September 2017 FASB meeting, the Board agreed that a discounted cash flow method or a reconcilable method is required to measure the effect of certain types of TDRs, mainly interest rate concessions that can only be captured using a discounted cash flow method (or reconcilable method). We believe that when a TDR includes an interest rate concession or more than insignificant delay in payments (i.e. term extension or forbearance), a discounted cash flow method should be used to determine the effect of the interest rate concession on the allowance for credit losses. [TRG 6-17.6A]

In addition, there may be circumstances where a financial asset modified as a TDR could be collateral dependent. For example, subsequent to the TDR the borrower may not be performing in accordance with the modified terms and the lender may determine that foreclosure is probable. Under Subtopic 326-20, entities are required to estimate expected credit losses using the fair value of collateral when foreclosure is probable. Moreover, they are permitted to use the fair value of the collateral as a practical expedient in determining credit losses when repayment is expected to be provided substantially by the collateral and the borrower is experiencing financial difficulty. See section 10.2 on identifying and accounting for collateral-dependent financial assets.

Question 11.3.42

May an entity discount some, but not all, cash flows when estimating expected credit losses for a TDR that involves an interest rate concession?

Background: ABC Corp. estimates its allowance for credit losses using a method other than a discounted cash flow method. ABC has a portfolio of loans that share similar risk characteristics. It modifies one of the loans in the portfolio and the modification is determined to be a TDR. The modification reduces the interest rate on that loan from 5% to 3%. Instead of removing the modified loan from the pool and determining the allowance using a discounted cash flow method, ABC develops its estimate of expected credit losses in two separate components.

- The first component captures the expected credit losses on the entire portfolio, including the modified loan. This component is estimated using a method other than a discounted cash flow method.
- The second component captures the effect of the interest rate concession. ABC calculates the difference in present values between the contractual cash flows of the loan pre-modification (discounted at the loan's original effective rate of 5%) and the contractual cash flows of the loan post-modification (discounted at that same rate).

ABC designs the calculation of the second component with the expectation that it will produce the same allowance effect (specific to the interest rate concession) that a full discounted cash flow method would produce. For that reason, ABC considers its method for estimating expected credit losses to be 'reconcilable' to a discounted cash flow method.

Interpretive response: It depends. If the method is designed to produce the same allowance effect (specific to the interest rate concession) as a discounted cash flow method, then we believe that method would be permitted.

As discussed in Question 11.3.40, the FASB agreed that a discounted cash flow method or a reconcilable method is required to measure the effects of certain types of TDRs, mainly interest rate concessions that can only be captured using a discounted cash flow method (or a reconcilable method). We believe that ABC's approach in the background example would be considered to be a reconcilable method.

ASU 2016-13 allows entities to assess credit risk on TDRs individually, or in a pool using other expected credit loss methods, such as loss rates. Further, to the extent those estimates may be more easily determinable with approaches other than the discounted cash flow method, the FASB preferred to provide that flexibility. [ASU 2016-13.BC105]

Permitting an approach in which the measurement of the concession requires discounting, but the rest of the allowance does not, maintains both of the FASB's objectives. This is because it ensures (1) the effect of the interest rate concession is measured in the allowance, and (2) the flexibility to continue to pool the loans in a collective assessment using other methods is retained. However, we believe this approach for measuring the allowance for expected credit losses for TDR financial assets is effectively an exception to the general requirement that discounting must be applied to either all or none of the cash flows (see Question 4.3.20).

Question 11.3.45

How is the allowance for credit losses measured when the collateral-dependent practical expedient is applied for a loan previously modified through a TDR?

Interpretive response: When the collateral-dependent practical expedient is applied, if the fair value is less than the amortized cost, the allowance for credit losses is measured based on the excess of the amortized cost basis over the fair value of collateral (less estimated costs to sell, if applicable). For additional discussion on the application of the practical expedient when fair value is greater than amortized cost, see section 10.2.30.

The FASB agreed that a discounted cash flow method or a reconcilable method is required to measure the effect of certain types of TDRs – mainly interest rate concessions that can only be captured using a discounted cash flow (or a reconcilable) method (see Question 11.3.40).

However, we do not believe the FASB's decision precludes using the collateral-dependent practical expedient as long as:

— the repayment of the loan is expected to be provided substantially through the operation or sale of the collateral; and

— the borrower is experiencing financial difficulty.

Further, we do not believe the measurement of the allowance for credit losses that results from applying the collateral-dependent practical expedient should be adjusted to reflect the effects of the TDR – e.g. the effect of a concession that reduced the contractual interest rate.

Question 11.3.60

May a TDR financial asset be placed on nonaccrual status at the time of or subsequent to modification?

Interpretive response: Yes, a TDR can be placed on nonaccrual status at the time of or subsequent to the modification consistent with an entity's nonaccrual policies.

Additionally, depending on the entity's policy for payment application – cost recovery method, cash basis method or some combination of those methods – the amortized cost basis of the TDR could be reduced, which would affect the required allowance for credit losses.

12. Purchased financial assets with credit deterioration

Detailed contents

Item significantly updated in this edition: #

Example

12.1 How the standard works

An entity records purchased financial assets with credit deterioration (PCD assets) at the purchase price plus the allowance for credit losses expected at the time of acquisition.

Under this method, there is no credit loss expense affecting net income on acquisition. Changes in estimates of expected credit losses after acquisition are recognized as credit loss expense (or reversal of credit loss expense) in subsequent periods as they arise.

In this chapter:

— sections 12.2 to 12.5 discuss identifying and accounting for PCD assets under Subtopic 326-20, and apply to assets that are newly acquired or to an entity that elects not to maintain previously existing pools on adoption of Topic 326; and
— section 12.6 discusses transition considerations, including the accounting when an entity elects to maintain previously existing pools on adoption of Topic 326.

For PCD assets that are beneficial interests in the scope of Subtopic 325-40, see chapter 20; and for PCD assets that are AFS securities in the scope of Subtopic 326-30, see chapter 19.

The following table highlights the differences between the accounting for PCI assets under legacy US GAAP and PCD assets under Subtopic 326-20.

Comparison to legacy US GAAP
Accounting for PCI and PCD assets

Legacy US GAAP	Subtopic 326-20
No allowance recognized at acquisition. [310-30-30-1]	Allowance recognized on acquisition through a gross-up that increases the amortized cost basis of the asset with no effect on net income.
Discounted cash flow method required for estimating credit losses. [310-30-30-1]	No specific method required for estimating expected credit losses.
Effective yield increased when subsequent changes in expected cash flows are both probable and significantly favorable. [310-30-35-10]	Subsequent changes (favorable and unfavorable) in expected cash flows are recognized immediately in net income by adjusting the allowance.
Allowance recognized immediately through net income when there is a subsequent decrease in expected cash flows. [310-30-35-10]	
Purchased credit impaired (PCI) accounting for non-PCI assets permitted to be applied by analogy. [AICPA DIEP 12-09]	PCD accounting for non-PCD assets not permitted to be applied by analogy.

12.2 Definition and scope

12.2.10 Overview

Excerpt from ASC 326-20

20 Glossary

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. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

> Purchased Financial Assets with Credit Deterioration

30-15 An entity shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets in accordance with paragraphs 326-20-30-1 through 30-10 and 326-20-30-12. An entity shall not apply the guidance in paragraphs 326-20-30-13 through 30-14 for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination.

Financial assets in the scope of Subtopic 326-20 can be identified as PCD assets, including the following: [326-20-15-2(a)]

- financing receivables;
- HTM debt securities;
- receivables resulting from revenue transactions;
- reinsurance recoverables;
- receivables relating to repurchase agreements and securities lending agreements; and
- net investments in leases.

For additional discussion of the scope of Subtopic 326-20, including the types of assets excluded from its scope, see chapter 2.

An asset in the scope of Subtopic 326-20 is a PCD asset if, on the acquisition date, it has experienced a more-than-insignificant deterioration in credit quality since origination or issuance. A single asset can be deemed a PCD asset, or a group of assets acquired together that have similar risk characteristics can be deemed PCD assets. [326-20 Glossary]

The definition of PCD assets in Subtopic 326-20 encompasses more assets than the definition of PCI assets under legacy US GAAP. However, PCD accounting is not permitted to be applied by analogy to purchased assets that do not meet the definition of PCD assets.

A purchased financial asset that does not qualify as a PCD asset is accounted for similar to an originated financial asset. Generally, this means that an entity recognizes the allowance for credit losses for non-PCD assets through net income on acquisition. [326-20-30-15]

Question 12.2.10

When has an acquired financial asset experienced a more-than-insignificant deterioration in credit quality since origination or issuance?

Interpretive response: PCD accounting applies to 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 or issuance, as determined by an acquirer's assessment.

The FASB did not define the term 'more-than-insignificant deterioration in credit quality'. It stated that it did not intend for PCD accounting to be limited to financial assets that are considered nonaccrual or impaired under legacy US GAAP; instead, it intended the term to also include additional assets that have experienced a more-than-insignificant level of credit deterioration since origination. [ASU 2016-13.BC90]

However, the FASB decided not to extend PCD accounting to purchased assets when there is an insignificant increase in credit risk since origination or issuance. This is because: [ASU 2016-13.BC88]

— the credit risk may be difficult to reliably isolate from other discounts reflected in the purchase price when it is insignificant;
— the cost of separating the credit and non-credit discount may outweigh the benefits; and
— the accretion of the credit discount into income would be insignificant.

Without a definition of 'more-than-insignificant deterioration in credit quality', judgment is required to determine which assets meet this condition.

Specifically, the evaluation of whether the acquired assets meet the PCD definition is based on the acquirer's assessment at the time of acquisition and is a relative comparison of:

— the credit quality of the assets at the time the assets were originated or issued; to
— the credit quality of the assets at the time of acquisition.

The assessment may be operationally challenging for the acquirer because it requires an assessment of the credit quality of the asset at the date of origination or issuance even though the acquirer was not a party to the asset.

Question 12.2.12

What does an entity evaluate to determine whether PCD accounting should be applied to an HTM debt security?

Interpretive response: When an entity acquires an HTM debt security, we believe the entity should determine whether, as of the date of acquisition, the security has experienced a more-than-insignificant deterioration in credit quality since it was originally issued.

Although the definition of PCD specifically refers to origination, and not issuance, we believe the date of issuance for a debt security is effectively the same as the date of origination.

Question 12.2.13

What changes in a financial asset's credit quality does an entity evaluate to determine whether PCD accounting should be applied?

Interpretive response: We believe an entity should consider changes in all aspects of a financial asset's credit quality since origination. This includes the borrower's ability to repay and collateral values, if applicable. We believe there may be scenarios in which PCD accounting should be applied solely because of declines in the collateral value since origination.

Question 12.2.15

Does an entity apply PCD accounting to net investments in leases with more-than-insignificant credit deterioration at the date of acquisition?

Interpretive response: Yes. We believe an entity should apply PCD accounting to all assets in the scope of Subtopic 326-20 that have experienced a more-than-insignificant deterioration in credit quality since origination. Topic 326 and the basis for conclusions do not indicate that net investments in leases are excluded from the scope of PCD accounting.

Question 12.2.17

What does an entity evaluate to determine whether PCD accounting should be applied to a net investment in a lease?

Background: A net investment in a lease includes the following: [842-30-25-1, 25-3 – 25-8, 30-1 – 30-2, 40-1]

— for sales-type leases, the lease receivable and an unguaranteed residual asset; and

— for direct financing leases, the lease receivable and an unguaranteed residual asset; however, the net investment is reduced by any deferred selling profit.

A lessor assesses the entire net investment in the lease (i.e. including the unguaranteed residual asset) for impairment and recognizes any impairment loss under Subtopic 326-20.

Interpretive response: The FASB decided that the net investment in a sales-type or direct financing lease should be treated as a single unit of account for purposes of assessing impairment and recording a loss allowance. Similarly, the entire net investment is evaluated as a single unit of account when determining if PCD accounting should be applied.

Therefore, when an entity acquires a net investment in a lease and evaluates whether PCD accounting should be applied, we believe the entity should consider changes since origination in both the credit risk of the lease receivable and the estimated residual value of the leased asset. This means an entity should evaluate both increases in credit risk and declines in the estimated residual value since origination.

We believe there may be scenarios in which PCD accounting should be applied solely because of declines in the residual value since origination. For example, as part of a business combination, an entity may acquire a net investment in a lease in which the change in the estimated residual value of the leased asset caused a more than insignificant decline in the overall credit risk.

Comparison to legacy US GAAP

PCI definition compared to PCD definition

ASU 2016-13 eliminates the separate accounting model for PCI assets and replaces it with new guidance for PCD assets. The definition of PCD assets under Subtopic 326-20 is different from the definition of PCI assets under legacy US GAAP (i.e. Subtopic 310-30).

PCI assets under legacy US GAAP	PCD assets under Subtopic 326-20
PCI assets are loans and debt securities with evidence of deterioration of credit quality since origination for which it is *probable*, at acquisition, that the investor will be unable to collect all contractually required payments receivable. [310-30-15-2]	The definition of PCD assets does not include a probability threshold regarding collection and requires only that there be a more-than-insignificant deterioration in an asset's credit quality since origination or issuance. Consequently, the PCD definition encompasses more assets than the PCI definition.
PCI accounting under Subtopic 310-30 may be applied by analogy to certain assets that do not meet the PCI definition. [AICPA DIEP 12-09]	PCD accounting under Subtopic 326-20 cannot be applied by analogy to assets that do not meet the PCD definition.

Question 12.2.20

Does an entity apply the PCD definition at the individual asset or portfolio level?

Interpretive response: An entity may evaluate whether purchased assets meet the definition of PCD assets either at the individual asset level or at the portfolio level. However, if the evaluation is done at the portfolio level, the assets in the portfolio need to have similar risk characteristics. For further discussion of similar risk characteristics, see section 5.2.

Subtopic 326-20 is not explicit on whether all of the individual assets in the portfolio need to have a more-than-insignificant deterioration in credit quality. The FASB acknowledged that it chose to permit a portfolio-level assessment because it was unrealistic to expect that an entity would be able to individually evaluate each asset in a portfolio to determine if the asset had a more-than-insignificant deterioration in credit quality since origination or issuance. [ASU 2016-13.BC89]

Therefore, when a portfolio-level assessment is performed, an entity is not required to demonstrate that each individual asset in the portfolio has a more-than-insignificant deterioration in credit quality since origination or issuance. However, it is equally evident that the FASB did not intend for the guidance on PCD assets to be applied to purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination or issuance. As a result, we believe the portfolio-level assessment should not be applied at such a high level that the asset grouping would reasonably be expected to include individual assets that do not have any credit deterioration or have an insignificant credit deterioration since origination or issuance.

Comparison to legacy US GAAP

Pooling criteria for PCD assets compared to pooling criteria for PCI assets

The following table compares the guidance for assembling PCI assets in a pool under legacy US GAAP with that for PCD assets under Subtopic 326-20 – assuming an entity does not elect to maintain previously existing pools on adoption of Topic 326 (see section 12.6.20).

PCI assets under legacy US GAAP	PCD assets under Subtopic 326-20
Entities are permitted to aggregate loans acquired in the same fiscal quarter – provided they share common risk characteristics – for purposes of applying the guidance related to loans and debt securities acquired with deteriorated credit quality. [310-30-15-6]	Subtopic 326-20 does not specifically permit aggregation of loans acquired in the same fiscal quarter for purposes of applying PCD accounting, and only indicates that credit losses should be evaluated on a collective (pool) basis when similar risk characteristics exist.
Common risk characteristics include similar credit risk or risk ratings, and one or more predominant risk characteristics such as financial asset type, collateral type, size, interest rate, date of	Subtopic 326-20 expands on this list of risk characteristics. Risk characteristics under Subtopic 326-20 include internal or external (third-party) credit score or credit ratings, risk ratings or classification,

PCI assets under legacy US GAAP	PCD assets under Subtopic 326-20
origination, term and geographic location. [310-30-15-6]	financial asset type, collateral type, size, EIR, term, geographical location, industry of the borrower, vintage, historical or expected credit loss patterns, and reasonable and supportable forecast periods as risk characteristics that could be considered when pooling financial assets.

With the exception of electing to maintain previously existing pools on adoption, pooling financial assets acquired in the same fiscal quarter is permitted under Subtopic 326-20 only when the financial assets share similar risk characteristics with each other. In addition, the acquired financial assets should be pooled with other financial assets already held by an entity if they share similar risk characteristics.

However, to make the provisions of Subtopic 326-20 operational, an entity may consider pooling assets at a more granular level – e.g. first by similar risk characteristics and then by a non-risk-based characteristic such as quarter of acquisition. To do that, the entity needs to demonstrate (either qualitatively or quantitatively) that the estimate of expected credit losses based on the more granular, non-risk-based, level of pooling would yield similar results to the higher level of aggregation required by Subtopic 326-20. For further discussion of collective assessments, see section 5.2.

An entity should monitor the risk characteristics of the financial assets in a pool and adjust the pool on an ongoing basis as the risk characteristics of the individual financial assets change over time.

Further, an entity needs to choose which risk characteristics to apply under Subtopic 326-20 for the purpose of aggregating financial assets into pools. As discussed in Question 5.2.10, although Subtopic 326-20 does not specifically require an entity to consider a financial asset's primary credit quality indicator when aggregating financial assets, we generally expect an entity to factor in some credit-related characteristics. Because Subtopic 326-20 includes some of the same risk characteristics as Subtopic 310-30, an entity could continue to use the same risk characteristics under Subtopic 326-20. However, it could also choose to consider different risk characteristics when pooling under Subtopic 326-20.

Regardless of the risk characteristics an entity chooses to consider under Subtopic 326-20, it is required to review all the financial assets in a pool at each reporting period to ensure they share similar risk characteristics. Because of the requirement to adjust pools for changes in risk (such as credit deterioration), the composition of the resulting pools could be different from legacy US GAAP, even when an entity uses the same risk characteristics as the basis for defining the pools.

Question 12.2.30

Can a financial asset recognized at a premium be a PCD asset?

Interpretive response: Yes. An entity is required to gross up the amortized cost basis of a PCD asset for the initial estimate of credit losses (see section 12.3.10); this guidance does not distinguish between financial assets purchased at a premium or discount. Therefore, we believe that a financial asset purchased at a premium can be a PCD asset. [326-20-30-13]

PCD assets are generally purchased at a discount because of credit deterioration. However, there are less frequent situations in which non-credit factors (e.g. a declining interest rate environment) result in a financial asset being purchased at a premium even when it has experienced a more-than-insignificant deterioration in credit quality since origination or issuance.

Similarly, there also are situations in which a financial asset is purchased at a small discount to par or the principal amount, but is initially recognized at a premium because of the PCD gross-up of the amortized cost basis for the initial estimate of credit losses. This occurs when the initial estimate of credit losses exceeds the purchase price discount.

Question 12.2.40

May an entity apply the accounting for PCD assets at the time a loan is transferred from held-for-sale to held-for-investment?

Interpretive response: No. PCD accounting only applies at the date of acquisition and should not be applied at the time of a transfer of a loan from the held-for-sale category to the held-for-investment category.

When a loan is classified as held-for-sale at origination/purchase, it is not in the scope of Subtopic 326-20. Instead, it is accounted for at the lower of cost or fair value under either Subtopic 310-10 (nonmortgage loans) or Topic 948 (mortgage loans). When the loan is reclassified as held-for-investment, it is accounted for under Subtopic 326-20 similar to any originated loan even if it experienced a more-than-insignificant deterioration in credit quality before the transfer. [310-10-35-48, 948-310-35-1]

Question 12.2.50

Does the transferee (buyer) need to evaluate whether a transfer of financial assets meets the requirements for sale accounting when determining whether PCD accounting should be applied?

Interpretive response: Yes. We believe that PCD accounting is appropriate only when the transferee (buyer) has determined that the transfer meets the requirements for sale accounting. Unless the requirements for sale accounting are met, the transferee records a newly originated financial asset due from the transferor (seller), as opposed to recording a purchase of the underlying credit deteriorated financial asset that was transferred.

This view is consistent with views expressed by the SEC staff. [2017 AICPA Conf]

Example 12.2.10
Transfer accounted for as a secured borrowing

Retailer originates installment loans when it sells goods to its customers. Retailer later transfers those installment loans to Finance Co. That transfer does not meet the sale accounting criteria of Topic 860 and therefore is accounted for as a secured borrowing.

Finance Co. should not consider its loan receivable from Retailer to be a PCD asset, even if the underlying consumer loans have experienced a more-than-insignificant deterioration in credit quality since they were originated by Retailer. This is because Finance Co. accounts for the transfer as a newly originated loan receivable from Retailer rather than as a purchase of the underlying consumer loan receivables.

Question 12.2.70
Does a seller apply PCD accounting when it re-recognizes a previously sold financial asset that has experienced a more-than-insignificant credit deterioration?

Background: A seller evaluates Topic 860's derecognition criteria and applies sale accounting if certain criteria are met. These criteria are required to be met not only at the time a financial asset is transferred, but also subsequent to the transfer.

Subsequent analysis is required when the seller initially applies sale accounting because events may occur that result in a seller regaining control of the previously transferred financial asset. For example, this can occur when a seller has a unilateral call option that is contingent on the underlying borrower's default and the underlying borrower subsequently defaults. The seller accounts for such an event as the purchase of a new financial asset. [860-20-25-8 – 25-9]

Interpretive response: Yes. The re-recognition of the previously transferred asset is accounted for in the same manner as a purchase (i.e. a new acquisition). Therefore, we believe that PCD accounting should be applied by the seller if the financial asset is in the scope of Topic 326 and has experienced a more-than-insignificant deterioration in credit quality since it was originated.

12.3 Initial measurement

12.3.10 Overview

Excerpt from ASC 326-20

> Purchased Financial Assets with Credit Deterioration

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

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

PCD accounting is called 'gross-up accounting' because, at acquisition, an entity grosses up the amortized cost basis of the PCD asset for the initial estimate of credit losses. This Day 1 allowance for credit losses is established without an income statement effect. [326-20-30-13]

Amortized cost basis = **Purchase price** + **Day 1 allowance for credit losses**

After the Day 1 allowance is established for a pool of assets, that allowance is then allocated to the individual assets in the pool; this is because the unit of account under Subtopic 326-20 is the individual asset even though measurement of an allowance can occur on a collective basis. Allocating the allowance to the individual assets in a pool establishes the amortized cost basis of each asset. This amortized cost basis is then used to allocate any non-credit premium or discount to the individual assets. However, if an entity elects to maintain previously existing pools on adoption, the pool continues to be the unit of account, and the allowance and non-credit discount or premium is not allocated to the individual assets (see section 12.6.20). [326-20-30-13]

Example 12.3.10
Initial measurement of PCD assets

ABC Corp. acquires a portfolio of loans with the intention of holding the loans for investment. It pays $700,000 to the seller for the loans, which have a total par amount (face value) of $1,000,000.

ABC determines that the entire portfolio consists of loans with similar risk characteristics that have experienced a more-than-insignificant deterioration in credit quality since origination. It uses a method other than a discounted cash flow method (e.g. loss-rate method) to estimate the credit losses in the portfolio.

ABC's initial estimates are as follows.

Total contractual principal cash flows that it expects to collect:	$800,000
Allowance for credit losses based on unpaid principal balance (par):	$200,000
Non-credit discount:	$100,000

ABC records the following journal entry to account for the acquisition of these loans.

	Debit	*Credit*
Loans	1,000,000	
Cash		700,000
Allowance for credit losses		200,000
Loans – non-credit discount		100,000
To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.		

Example 12.3.12
Initial measurement of PCD assets acquired at a premium

ABC Corp. acquires a portfolio of fixed-rate mortgage loans that were originated during a period of high interest rates compared to the current environment, paying $15,000,000. The remaining unpaid principal balance is $14,750,000.

ABC determines that the entire portfolio consists of loans with similar risk characteristics that have experienced a more-than-insignificant deterioration in credit quality since origination. It uses a method other than a discounted cash flow method (e.g. loss-rate method) to estimate the credit losses in the portfolio.

ABC's initial estimates are as follows.

Total contractual principal cash flows it expects to collect:	$14,000,000
Allowance for credit losses based on the unpaid principal balance (par):	$750,000
Non-credit premium:	$1,000,000

ABC records the following journal entry to account for the acquisition of the portfolio of fixed-rate mortgage loans.

	Debit	Credit
Loans	14,750,000	
Loans – non-credit premium[1]	1,000,000	
Cash		15,000,000
Allowance for credit losses[2]		750,000
To record acquisition of PCD loans, estimate of expected credit losses and non-credit premium.		

Notes:

1. The 'loans – non-credit premium' account is part of the loans financial statement caption and has been broken out for illustrative purposes only. The loans – non-credit premium is the difference between the unpaid principal balance ($14,750,000) and the amortized cost basis of $15,750,000 (the amount paid ($15,000,000) plus the allowance for credit loss ($750,000)).
2. The allowance for credit losses is the difference between the total remaining unpaid principal balance ($14,750,000) and the total contractual principal cash flows expected to be collected ($14,000,000).

Question 12.3.10

What is the effect of using the gross-up method for PCD assets?

Interpretive response: The gross-up method results in no Day 1 credit loss recognition in net income for PCD assets.

The FASB chose the gross-up method to enhance the comparability of allowance amounts between PCD and non-PCD assets, and to allow preparers to use the same tools and methods for estimating credit losses for all assets in the scope of Subtopic 326-20. [ASU 2016-13.BC86]

However, the use of a gross-up method creates a difference in the effect that purchases of PCD and non-PCD assets have on the income statement. When PCD assets are purchased, there is no Day 1 credit loss recognition in net income. In contrast, credit losses are recognized in net income on Day 1 when assets are purchased that do not have a more-than-insignificant credit deterioration.

Comparison to legacy US GAAP

Recognition of allowance for credit losses on acquisition now required

The following table compares PCI accounting under legacy US GAAP with PCD accounting under Subtopic 326-20.

Legacy US GAAP	Topic 326 and Subtopic 325-40 (as amended)
Establishing an allowance on acquisition is prohibited; instead, the loss allowance reflects only those losses incurred by the acquirer after acquisition. [310-30-30-1]	An allowance for credit losses is recognized on acquisition of a PCD asset through a gross-up of the asset's amortized cost basis for the initial estimate of expected credit losses, without a corresponding charge to net income.
The acquirer in a business combination records identifiable assets acquired at acquisition-date fair values. No separate valuation allowance for the assets acquired is recognized because the effects of uncertainty about the assets' future cash flows are included in the assets' fair value measure. [805-20-30-4]	A loss allowance is established for PCD assets acquired in a business combination, similar to recognizing a loss allowance for acquired non-PCD assets. However, the loss allowance for PCD assets is recognized through a gross-up of the assets' amortized cost basis and the loss allowance for non-PCD assets is recognized in net income even though acquired in a business combination.

Question 12.3.35

How does an acquirer/purchaser account for financial assets previously written off by the acquiree/seller?

Background: As discussed in Question 12A.2.70, PCD accounting is applied by the acquirer/purchaser to financial assets previously written off by the acquiree/seller if it has the contractual rights to cash flows at the acquisition date.

Interpretive response: If the financial assets are deemed PCD, the acquirer/purchaser should:

— recognize the addition of an allowance for credit losses and make a corresponding adjustment to the assets' amortized cost basis;

— apply its writeoff policy and immediately write off the individual PCD assets that are deemed uncollectible under its policy; and

— recognize expected recoveries of amounts previously written off and/or expected to be written off in its allowance for credit losses (see section 12.4.20).

Question 12.3.37

How is the gross-up and immediate writeoff of a PCD asset included in the roll-forward of the allowance for credit losses?

Background: As discussed in Question 12.3.35, an acquirer/purchaser:

— recognizes the addition of an allowance for credit losses and a corresponding adjustment to the PCD asset's amortized cost basis if the asset was previously written off (either in whole in or part) by the acquiree/seller; and

— if the PCD asset's amortized cost, or a portion of its amortized cost, is deemed uncollectible, immediately writes off the PCD asset and the corresponding allowance for credit losses.

Interpretive response: Subtopic 326-20 does not prescribe how an entity should disclose the addition of an allowance for credit losses and immediate writeoff of that amount in the allowance roll-forward. To provide meaningful information to financial statement users, we believe it is important to distinguish writeoffs that were recorded at the date of acquisition/purchase of PCD assets from the entity's other writeoffs.

We believe that one of the following approaches, consistently applied, is acceptable.

— Include the writeoffs of PCD assets at the date of acquisition/purchase together with the amounts for other financial assets in the roll-forward of the allowance for credit losses. Include a note after the roll-forward indicating the amount of writeoffs of PCD assets that were recognized at the date of acquisition/purchase.

— Present writeoffs of PCD assets at the date of acquisition/purchase as a separate line item in the roll-forward of the allowance for credit losses.

— Exclude both the addition of the allowance and related writeoff from the roll-forward of the allowance for credit losses. Include a note after the roll-forward indicating the amount of allowance that was added and immediately written off.

12.3.20 Valuation methods

Similar to estimating the allowance for credit losses for non-PCD assets, Subtopic 326-20 provides an entity with flexibility on the method used to estimate the Day 1 allowance for credit losses for PCD assets. An entity is required to estimate the Day 1 allowance for credit losses under paragraphs 326-20-30-2 to 30-12, which permit the use of a variety of methods as discussed in section 4.2.

Question 12.3.40

May the initial estimate of the allowance for credit losses for PCD assets vary based on the method used?

Interpretive response: Yes. Subtopic 326-20 gives flexibility on the method that an entity may use to estimate expected credit losses. Generally, an entity may use a discounted cash flow method or other methods that do not project and discount cash flows – e.g. a loss rate applied to the unpaid principal balance. Different methods may produce differing results. For specific considerations when an entity elects to maintain previously existing pools on adoption of Topic 326, see section 12.6.20. [326-20-30-3, 30-13 – 30-14]

For PCD assets, differences in amounts calculated using different methods will lead to differences in the split between the credit discount (recognized as the Day 1 allowance) and the non-credit discount/premium (recognized subsequently as part of interest income). This difference will affect the timing of interest income recognition.

Question 12.3.50

How does an entity estimate expected credit losses for PCD assets if a discounted cash flow method is not used?

Interpretive response: If a discounted cash flow method is not used, the allowance for expected credit losses on PCD assets should be estimated on the basis of the unpaid principal balance of the asset(s). [326-20-30-14]

In contrast, for originated assets or acquired assets that do not have a more-than-insignificant deterioration in credit quality since origination or issuance, Subtopic 326-20 requires the allowance for credit losses to be estimated on the basis of the amortized cost of the assets when a discounted cash flow method is not used. [326-20-30-5]

The FASB decided that it could not use the same approach for PCD assets because it would give rise to a circularity issue. In earlier deliberations, the FASB had defined the initial amortized cost basis for PCD assets as the sum of the purchase price and the allowance for credit losses. Because the amortized cost for PCD assets includes the allowance for credit losses, the amortized cost basis could not in turn be used in estimating the allowance. Consequently, the FASB decided that when discounted cash flows are not used, the allowance for credit losses on PCD assets should be estimated using the amount of the unpaid principal balance of the asset(s) that is not expected to be collected.

Subtopic 326-20 generally requires the method chosen to initially estimate expected credit losses on PCD assets to be consistently applied for subsequent measurement. For example, if a method other than a discounted cash flow method (e.g. loss-rate method) is applied to initially estimate expected credit losses based on a PCD asset's unpaid principal balance, the same method should be consistently applied when subsequently measuring the allowance for credit losses.

The FASB made certain decisions to enable entities to apply consistent tools and methods for both PCD and non-PCD assets. However, using unpaid principal balances as the basis for estimating expected credit losses for PCD assets will create a difference between PCD assets and non-PCD assets – for which the amortized cost is the basis for estimating expected credit losses – when discounted cash flows are not used. This difference may add practical challenges if an entity combines, for subsequent measurement purposes, both PCD assets and non-PCD assets that share similar risk characteristics in one collective assessment. See chapter 5 for more discussion of collective assessments. [ASU 2016-13.BC86]

Example 12.3.30
Initial measurement of PCD assets using a discounted cash flow method

ABC Corp. acquires a portfolio of loans for $600,000 that have the following characteristics.

Term:	Five years
Amortizable?	Yes
Prepayable?	No
Initial par amount:	$1,000,000
Coupon:	5%
Annual payments:	$ 230,975

ABC acquires these loans at the end of Year 1 of their five-year life. ABC determines that the loans all share similar risk characteristics and have experienced a more-than-insignificant deterioration in credit quality at the time of acquisition compared to their origination date. Therefore, ABC concludes that it will account for the loans under the guidance for PCD assets.

ABC does not pay or receive any fees or incur any transaction costs associated with this acquisition.

The amortization table based on contractual cash flows at the origination date is as follows.

Year	Beginning balance	Payments	Interest	Principal	Ending balance
1	$1,000,000	$ 230,975	$ 50,000	$ 180,975	$819,025
2	819,025	230,975	40,951	190,024	629,001
3	629,001	230,975	31,450	199,525	429,476
4	429,476	230,975	21,474	209,501	219,975
5	219,975	230,975	11,000	219,975	0
	Total	**$1,154,875**	**$154,875**	**$1,000,000**	

When ABC acquires this portfolio at the end of Year 1, the outstanding principal balance of the portfolio is $819,025.

After considering the historical loss experience and reasonable and supportable forecasts over the remaining term of these loans, ABC expects that it will collect the full contractual amount due in Year 2, but only 70% of the payments due in Years 3 to 5.

ABC uses a discounted cash flow method to estimate expected credit losses. It determines that the EIR is 7.97% (rounded), which is the rate that equates the present value of its expected cash flows with the purchase price of $600,000. ABC uses the 7.97% EIR to discount the expected credit losses and estimates that the allowance for expected credit losses at the time of acquisition is $165,464.

ABC's initial cash flow expectations and estimate of credit losses are presented in the following table.

Year	Expected cash flows	Expected credit losses	Present value of expected credit losses
2	$230,975	$ 0	$ 0
3	161,682	69,293	59,436
4	161,682	69,293	55,047
5	161,681	69,293	50,981
			$165,464

ABC records the following journal entry at the date of acquisition.

	Debit	*Credit*
Loans	819,025	
Cash		600,000
Allowance for credit losses		165,464
Loans – non-credit discount		53,561
To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.		

The amortized cost at acquisition is $765,464, which is the sum of the purchase price and the initial allowance for credit losses ($600,000 + $165,464). The non-credit discount of $53,561 represents the difference between the principal balance and the amortized cost ($819,025 – $765,464).

ABC subsequently recognizes interest income at the EIR of 7.97% used to discount the expected credit losses.

Example 12.3.40

Initial measurement of PCD assets using a non-discounted cash flow method

This example uses the basic facts set out in Example 12.3.30.

However, in contrast to Example 12.3.30, ABC Corp. uses a loss-rate method to estimate its expected credit losses. It estimates its allowance based on the unpaid principal balance and expects losses equal to 30% of the principal payments due in Years 3 to 5. It estimates an allowance for credit losses of $188,700 as shown in the following table.

Year	Contractual principal payments due	Contractual principal payments not expected to be collected
2	$190,024	$ 0
3	199,525	59,857
4	209,501	62,850
5	219,975	65,993
	$819,025	**$188,700**

The allowance of $188,700 equates to a loss rate of 23.04% on the unpaid principal balance of $819,025 at the acquisition date.

ABC records the following journal entry at the date of acquisition.

	Debit	*Credit*
Loans	819,025	
Cash		600,000
Allowance for credit losses		188,700
Loans – non-credit discount		30,325
To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.		

The amortized cost at acquisition is $788,700, which is the sum of the purchase price and the initial allowance for credit losses ($600,000 + $188,700). The non-credit discount of $30,325 represents the difference between the principal balance and the amortized cost ($819,025 – $788,700).

ABC determines that the EIR at which it will subsequently recognize interest income is 6.64% (rounded). This is the rate that equates the present value of the remaining contractual cash flows on the loans ($230,975 × 4) to the amortized cost at acquisition ($788,700).

12.4 Subsequent measurement

12.4.10 Overview

Excerpt from ASC 326-20

> Reporting Changes in Expected Credit Losses

35-1 At each reporting date, an entity shall record an allowance for credit losses on **financial assets** (including **purchased financial assets with credit deterioration**) within the scope of this Subtopic. An entity shall compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded. An entity shall 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). The method applied to initially measure expected credit losses for the assets included in paragraph 326-20-30-14 generally would be applied consistently over time and shall faithfully estimate expected credit losses for financial asset(s).

PCD assets that are held-for-investment or classified as HTM are subsequently measured at amortized cost with expected credit losses estimated at each reporting date. Amortized cost in this instance is:

Amortized cost basis = **Purchase price** + **Day 1 allowance for credit losses** ± **Subsequent adjustments – e.g. accretion, amortization**

Any changes in estimates of expected credit losses (both positive and negative) are recognized immediately as a credit loss expense or a reversal of credit loss expense in the period in which they arise. [326-20-35-1]

The non-credit discount or premium at the date of acquisition of PCD assets is accreted or amortized respectively as interest income as discussed in section 12.5. [326-20-35-1, 310-10-35-53B]

Regardless of the method used to determine the Day 1 allowance for credit losses an entity will recognize the same amount of net income – through a combination of interest income and credit loss expense – over the life of the PCD assets. However, the amount of interest income and credit loss expense recognized each period will differ based on whether an entity uses a discounted cash flow or a non-discounted cash flow method (e.g. a loss-rate method) to estimate its expected credit losses.

Example 12.4.10

Subsequent measurement of PCD assets using a discounted cash flow method

This example uses the basic facts set out in Example 12.3.30.

Continuing with that Example, ABC Corp. subsequently accounts for the loan portfolio from Years 2 to 5 of its life as illustrated below. For simplicity, the following assumptions are made.

- ABC's initial expectation of credit losses remains the same throughout the entire remaining life of the portfolio and that actual losses in each year are in line with initial expectations.
- All loans share the same terms (par amount, term, interest coupon) and have the same credit risk characteristics. Therefore, interest income calculated at the pool level approximates interest income calculated at the individual loan level.
- ABC writes off accrued interest receivable by recognizing credit loss expense – i.e. against the allowance for credit losses (see Question 4.2.50).

Year	Amort. cost beg. bal.	Cash pmts rec'd[2]	Interest income[3]	Interest rec'd[4]	Principal rec'd[5]	Writeoffs[6]	Amort. cost end. bal.[7]
2	$765,464[1]	$230,975	$61,037	$40,951	$190,024	$ 0	$595,526
3	595,526	161,682	47,486	22,015	139,667	69,293	412,037
4	412,037	161,682	32,855	15,031	146,651	69,293	213,917
5	213,917	161,681	17,057	7,699	153,982	69,293	0
	Total	**$716,020**	**$158,435**	**$85,696**	**$630,324**	**$207,879**	

Notes:

1. Amortized cost at acquisition is the sum of the purchase price and the initial allowance for expected credit losses ($600,000 + $165,464).
2. Actual cash received is 100% of the contractual amount for Year 2 and 70% of the contractual amounts for Years 3 to 5.
3. Interest income is calculated as beginning amortized cost balance × the EIR of 7.97% (rounded).
4. Interest received is 100% of the contractual interest due in Year 2, and 70% of the contractual interest due in Years 3 to 5.
5. Principal received is 100% of the contractual principal due in Year 2, and 70% of contractual principal due in Years 3 to 5.
6. Amounts written off are the contractual principal and interest amounts deemed uncollectible.
7. Amortized cost ending balance = (amortized cost beginning balance + interest income) – (cash payments received + writeoffs of principal and interest).

ABC records the following journal entries for Year 3.

	Debit	*Credit*
Loans – accrued interest[1]	31,450	
Loans – non-credit discount[2]	16,036	
Interest income		47,486
To record interest income at EIR.		

	Debit	Credit
Cash	161,682	
Loans		139,667
Loans – accrued interest		22,015
To record receipt of cash (principal and interest) at 70% of contractual amounts due.		
Credit loss expense[3]	14,246	
Allowance for credit losses		14,246
To record change in present value of expected credit losses due to passage of time.		
Allowance for credit losses	69,293	
Loans		59,857
Loans – accrued interest		9,436
To record writeoff of principal and interest deemed uncollectible (30% of contractual amounts due in Year 3).		

Notes:

1. The accrued interest is the interest due in Year 3 per the original contractual cash flow schedule.
2. The non-credit discount accreted is the difference between the total interest income of $47,486 less the $31,450 original contractual interest due.
3. ABC elects to report the entire change in present value as a credit loss expense.

The following table shows the roll-forward of the allowance for credit losses.

Year	Beginning balance	Change in present value due to passage of time[1]	Writeoffs	Ending balance[2]
2	$165,464	$13,194	$ 0	$178,658
3	178,658	14,246	69,293	123,611
4	123,611	9,857	69,293	64,175
5	$ 64,175	$ 5,118	$69,293	0

Notes:

1. Represents the periodic effect on the allowance due to the passage of time, calculated as the beginning balance of the allowance × the EIR of 7.97% (rounded). ABC may present this change in present value attributable to passage of time either as credit loss expense or as a reduction of interest income. [326-20-45-3]
2. Ending balance = beginning balance + change in the present value due to the passage of time – writeoffs of principal and interest.

Example 12.4.20
Subsequent measurement of PCD assets using a non-discounted cash flow method

This example uses the basic facts set out in Example 12.3.30, as modified by Example 12.3.40.

Continuing with Example 12.3.40, ABC Corp. subsequently accounts for the loan portfolio from Years 2 to 5 of its life as illustrated below. For simplicity, the following assumptions are made.

— ABC's initial expectation of credit losses remains the same throughout the entire remaining life of the portfolio and that actual losses in each year are in line with initial expectations.

— The loans remain on accrual status throughout their life; therefore, the accrued interest is included in the estimate of expected credit losses when, and only when, recognized.

— All loans share the same terms (par amount, term, interest coupon) and have the same credit risk characteristics. Therefore, interest income calculated at the pool level approximates interest income calculated at the individual loan level.

— ABC measures an allowance for credit losses for accrued interest receivable. Additionally, ABC writes off accrued interest receivable by recognizing credit loss expense – i.e. against the allowance for credit losses (see Question 4.2.50).

Year	Amort. cost beg. bal.	Cash pmts rec'd[2]	Interest income[3]	Interest rec'd[4]	Principal rec'd[5]	Writeoffs[6]	Amort. cost end. bal.[7]
2	$788,700[1]	$230,975	$ 52,396	$40,951	$190,024	$ 0	$610,121
3	610,121	161,682	40,533	22,015	139,667	69,293	419,679
4	419,679	161,682	27,881	15,031	146,651	69,293	216,585
5	216,585	161,681	14,389	7,699	153,982	69,293	0
	Total	**$716,020**	**$135,199**	**$85,696**	**$630,324**	**$207,879**	

Notes:

1. Amortized cost at acquisition is the sum of the purchase price and the initial allowance for expected credit losses ($600,000 + $188,700).
2. Actual cash received is 100% of the contractual amount for Year 2 and 70% of the contractual amounts for Years 3 to 5.
3. Interest income is calculated as beginning amortized cost balance × EIR of 6.64% (rounded). The rate of 6.64% (rounded) is the rate that equates the present value of the contractual payments ($230,975 × 4) to the initial amortized cost ($788,700).
4. Interest received is 100% of the contractual interest due in Year 2, and 70% of the contractual interest due in Years 3 to 5.
5. Principal received is 100% of the contractual principal due in Year 2, and 70% of contractual principal amount due in Years 3 to 5.
6. Amounts written off are the contractual principal and interest amounts deemed uncollectible.
7. Amortized cost ending balance = (amortized cost beginning balance + interest income) less (cash payments received + writeoffs of principal and interest).

ABC records the following journal entries for Year 3.

	Debit	*Credit*
Loans – accrued interest[1]	31,450	
Loans – non-credit discount[2]	9,083	
Interest income		40,533
To record interest income at EIR.		
Cash	161,682	
Loans		139,667
Loan – accrued interest		22,015
To record receipt of cash (principal and interest) at 70% of contractual amounts due.		
Credit loss expense	9,436	
Allowance for credit losses		9,436
To record credit losses for accrued interest not expected to be collected.		
Allowance for credit losses	69,293	
Loans		59,857
Loans – accrued interest		9,436
To record writeoff of principal and interest amounts deemed uncollectible (30% of contractual amounts due in Year 3).		

Notes:

1. The accrued interest is the interest due in Year 3 per the original contractual cash flow schedule.
2. The non-credit discount accreted is the difference between the total interest income of $40,533 less the $31,450 original contractual interest due.

The following table shows the roll-forward of the allowance for credit losses.

Year	Beginning balance	Credit loss expense[1]	Writeoffs of principal and interest	Ending balance[2]
2	$188,700	$ 0	$ 0	$188,700
3	188,700	9,436	69,293	128,843
4	128,843	6,443	69,293	65,993
5	65,993	3,300	69,293	0

Notes:

1. Represents the additional provision to be recognized for the accrued interest not expected to be collected in each of the years – i.e. 30% of contractual interest amounts due each year.
2. Ending balance = beginning balance + credit loss expense – writeoffs of principal and interest.

Question 12.4.10

Why are subsequent changes in expected credit losses for PCD assets recognized immediately in net income?

Interpretive response: All subsequent changes in expected credit losses for PCD assets are recognized immediately in net income. The FASB established this requirement to eliminate legacy US GAAP's asymmetrical treatment of favorable and unfavorable changes in expected cash flows. [326-20-35-1]

Specifically, for PCI assets, legacy US GAAP (i.e. Subtopic 310-30) requires that if it is probable that there is a significant increase in cash flows previously expected to be collected, that increase is recognized – after reducing any remaining allowance previously established – prospectively as interest income by adjusting the accretable yield. Therefore, when it is probable that expected cash flows have increased, credit related changes in expected cash flows are included in interest income. In contrast, Subtopic 310-30 requires decreases in expected cash flows to be recognized immediately in net income as a provision for credit losses. [310-30-35-10]

Stakeholders expressed concerns to the FASB about the asymmetrical treatment in legacy US GAAP and observed that the requirement to adjust the accretable yield prospectively is complex and difficult to implement. In response to these concerns, the FASB decided to require all subsequent changes in expected credit losses (both positive and negative) for PCD assets to be recognized immediately by adjusting the allowance account and reflecting the periodic changes as credit loss expense (or reversal of credit loss expense) in net income. [326-20-35-1, ASU 2016-13.BC84]

Question 12.4.20

Must an entity maintain the integrity of a PCD pool?

Interpretive response: No. The integrity of a pool of PCD assets is not required to be maintained. New assets may be added to the pool as long as all the assets in the pool share similar risk characteristics. Similarly, if certain assets no longer share similar risk characteristics with the other assets in the pool, they should be removed from the original pool and included in another pool. For further discussion of collective assessments, see section 5.2. [326-20-35-2]

The integrity of a pool need not be maintained because under Subtopic 326-20 the individual assets represent the unit of account even though they are pooled together for the purpose of estimating expected credit losses. As discussed in section 12.3.10, the allowance for credit losses is allocated to the individual PCD assets in the pool to determine each individual asset's amortized cost and non-credit premium or discount, which is consistent with the individual assets being the unit of account. [326-20-30-13]

For guidance on maintaining previously existing pools of financial assets on an ongoing basis subsequent to the adoption of Topic 326, see section 12.6.20.

Comparison to legacy US GAAP#
Maintaining integrity of pools no longer required

The following table compares the guidance for pool integrity and the unit of account for PCI assets under legacy US GAAP with that for PCD assets under Subtopic 326-20 – assuming an entity does not elect to maintain previously existing pools on adoption of Topic 326.

Legacy US GAAP	Subtopic 326-20
Once a pool of assets with similar risk characteristics is formed, the pool becomes the unit of account for subsequent measurement purposes. This means that the integrity of a pool of PCI loans is maintained subsequent to initial recognition – i.e. individual loans generally cannot be removed from the pool except in the event of sale, foreclosure, settlement or writeoff of a loan. [310-30-40-1]	The integrity of a pool of PCD assets is not required to be maintained. This is because the individual assets represent the unit of account even though they are pooled together for the purpose of estimating credit losses.
No specific guidance for accounting for writeoffs.	Writeoffs are determined at the individual asset level.
Modification to an individual PCI asset in a pool is not assessed to determine if it is a TDR. [310-30-15-6, 310-40-15-11]	Modification to an individual PCD asset is not assessed to determine if it is a TDR. However, before adoption of ASU 2022-02, a modification to an individual PCD asset is assessed to determine if it is a TDR.

12.4.20 Expected recoveries of PCD assets

Excerpt from ASC 326-20

> Purchased Financial Assets with Credit Deterioration

30-13A The allowance for credit losses for purchased financial assets with credit deterioration shall include expected recoveries of amounts previously written off and expected to be written off by the entity and shall not exceed the aggregate of amounts previously written off and expected to be written off by the entity.

a. If the entity estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30- 4, expected recoveries shall not include any amounts that result in an acceleration of the noncredit discount.
b. The entity may include increases in expected cash flows after acquisition.

(See Examples 18 and 19 in paragraphs 326-20-55-86 through 55-90.)

As discussed in section 3.3.10, an entity is required to recognize writeoffs (full or partial) of financial assets in the period in which they are deemed uncollectible. Further, the allowance for credit losses is required to include expected recoveries of amounts previously written off and expected to be written off, which may result in the allowance for credit losses being negative (i.e. a debit balance). The negative allowance for credit losses may not exceed amounts previously written off (or expected to be written off). [326-20-30-1, 30-13A, 35-8]

Subtopic 326-20 includes incremental guidance for recognizing expected recoveries of PCD assets. The incremental guidance clarifies that an entity: [326-20-30-13A]

— should not include in expected recoveries any amounts that result in an acceleration of the non-credit discount when a method other than a discounted cash flow method is used to estimate expected credit losses; and

— may include increases in expected cash flows after acquisition.

Question 12.4.30

When using a method other than a discounted cash flow method, how does an entity ensure expected recoveries on PCD assets do not accelerate recognition of the non-credit discount?

Interpretive response: Recognition of amounts previously written off and expected to be written off on PCD assets by an entity must not result in an accelerated recognition of the non-credit discount. We believe one acceptable approach to prevent accelerated recognition of the non-credit discount for previously written-off PCD assets is to: [326-20-30-13A, 55-86 – 55-90]

— deduct the non-credit discount that existed immediately before the writeoff from the total recoveries expected to be received on those assets; and

— apply recoveries received first to the negative allowance, with additional income recognized when recoveries received exceed the negative allowance.

Under this approach, in periods following a writeoff, the negative allowance continues to reflect total expected recoveries less the non-credit discount. As a result, increases in expected recoveries generally result in an increase in the negative allowance and a reduction in credit loss expense.

The Board's intent when providing this limit on recognition of expected recoveries was to ensure that an entity does not accelerate recognition of income when it writes off a PCD asset. Reducing expected recoveries by the non-credit discount achieves this objective. [ASU 2019-11.BC10]

We believe other approaches to prevent accelerated recognition of the non-credit discount may be acceptable depending on the specific facts and circumstances.

Example 12.4.30

Recognizing expected recoveries of PCD assets when a method other than a discounted cash flow method is used to estimate credit losses

This example illustrates one method (as described in Question 12.4.30) of recognizing expected recoveries of amounts previously written off for a PCD asset over its life.

Assumptions

Bank acquires a non-interest bearing loan on January 1, Year 1 and determines that the loan has experienced a more-than-insignificant deterioration in credit quality at that date as compared to its origination date. Therefore, Bank concludes it will account for the loan under the guidance for PCD assets. Bank uses a method other than a discounted cash flow method to estimate its expected credit losses.

The loan has the following attributes at acquisition.

Remaining par amount:	$10,000,000
Purchase price:	2,000,000
Expected collections of the unpaid principal balance:	2,500,000
Contractual payments not expected to be collected	7,500,000

Journal entry at acquisition

Bank records the following journal entry at the date of acquisition.

	Debit	*Credit*
Loan	10,000,000	
Cash		2,000,000
Allowance for credit losses		7,500,000
Loan – non-credit discount		500,000
To record purchase of a PCD loan, estimate of expected credit losses and non-credit discount.		

Year 1

During Year 1, no collections are received. Bank records the following journal entry to accrete a portion of the non-credit discount into interest income for Year 1; this is because Bank has a reasonable expectation about the amounts expected to be collected.

	Debit	*Credit*
Loans – non-credit discount	150,000	
Interest income		150,000
To record accretion of non-credit discount.		

During Year 1, Bank decreases its estimate of expected collections of the unpaid principal balance from $2,500,000 to $2,100,000, resulting in an increase in expected credit losses of $400,000. Bank records the following journal entry.

	Debit	*Credit*
Credit loss expense	400,000	
Allowance for credit losses		400,000
To record increase in expected credit losses.		

At the end of Year 1, Bank's financial statements include the following amounts related to the loan:

Account	Year 1
Balance sheet – assets	
Principal balance	$10,000,000
Non-credit discount (unamortized portion)	(350,000)
Amortized cost	**$9,650,000**
Allowance for credit losses	(7,900,000)
Net carrying amount	**$1,750,000**
Income statement	
Interest income	$150,000
Credit loss expense	400,000

Year 2

During Year 2, Bank determines that the loan is uncollectible and writes off the entire balance in accordance with its writeoff policy. While the individual loan is considered uncollectible, it becomes part of the pool of charged-off loans for which Bank's expectation, consistent with previous experience, is that it will receive recoveries from some individual loans within the pool. However, Bank does not yet know for which specific loans there will be a recovery.

For simplicity, this example illustrates an expected recovery of $2,100,000 at the individual loan level even though it would be measured at the aggregate pool level. It is assumed that no additional interest income is recognized and no payments are received during this period.

Bank records the following journal entries.

	Debit	*Credit*
Credit loss expense	1,750,000	
Allowance for credit losses		1,750,000
To increase allowance for credit losses to equal loan's amortized cost.		

	Debit	Credit
Loan – non-credit discount	350,000	
Allowance for credit losses	9,650,000	
Loans		10,000,000
To record writeoff of PCD loan.		
Allowance for credit losses[1]	1,750,000	
Credit loss expense		1,750,000
To record expected recovery of fully written-off PCD loan.		

Note:

1. Expected recovery ($2,100,000) – non-credit discount existing at the date of writeoff ($350,000). As required, the $1,750,000 negative allowance for credit losses recognized is less than the loan's amortized cost basis that was written off ($9,650,000).

At the end of Year 2, Bank's balance sheet includes the following amount related to the loan. No amounts are reported in its income statement related to the loan.

Account	Year 2
Balance sheet – assets	
Allowance for credit losses[1]	$1,750,000

Note:

1. The $1,750,000 amount represents a negative allowance for credit losses.

Year 3

During Year 3, Bank increases its estimate of expected collections of the unpaid principal balance from $2,100,000 to $5,000,000. As a result, it increases the negative allowance to reflect the new estimate of expected recoveries less the non-credit discount that existed immediately prior to a writeoff. It is assumed that no payments are received during this period.

Bank records the following journal entry.

	Debit	Credit
Allowance for credit losses[1]	2,900,000	
Credit loss expense		2,900,000
To record expected recovery of PCD loan that results in negative allowance.		

Note:

1. Expected recovery ($5,000,000) – non-credit discount existing at the date of writeoff ($350,000) – existing negative allowance ($1,750,000). As required, the $4,650,000 negative allowance for credit losses recognized is less than the loan's amortized cost basis that was written off ($9,650,000).

At the end of Year 3, Bank's financial statements include the following amounts related to the loan.

Account	Year 3
Balance sheet – assets	
Allowance for credit losses[1]	$4,650,000
Income statement	
Credit loss expense (negative amount)	($2,900,000)
Note: 1. The $4,650,000 amount represents a negative allowance for credit losses.	

Year 4

During Year 4, Bank receives $3,000,000 in recoveries. Its expected collections of the unpaid principal balance remain unchanged from Year 3 – i.e. its remaining estimate of expected cash flows is $2,000,000; this represents its estimate in Year 3 of $5,000,000 less recoveries received of $3,000,000.

Bank records the following journal entry.

	Debit	*Credit*
Cash	3,000,000	
Allowance for credit losses		3,000,000
To record recovery received.		

At the end of Year 4, Bank's balance sheet includes the following amount related to the loan. No amounts are reported in its income statement related to the loan.

Account	Year 4
Balance sheet – assets	
Allowance for credit losses – negative[1]	$1,650,000
Note: 1. Expected recovery ($2,000,000) – non-credit discount existing at the date of writeoff ($350,000). The $1,650,000 amount represents a negative allowance for credit losses. As required, the negative allowance for credit losses recognized is less than $6,650,000, which represents the loan's amortized cost basis that was written off ($9,650,000), net of recoveries received ($3,000,000).	

Year 5

During Year 5, Bank receives $2,000,000 in recoveries. It does not expect to receive any further recoveries on the loan.

Bank records the following journal entry.

	Debit	*Credit*
Cash	2,000,000	
Allowance for credit losses		1,650,000
Income[1]		350,000
To record recovery received.		

Note:

1. Presentation of this amount in the income statement is not specified by Subtopic 326-20.

At the end of Year 5, Bank's balance sheet no longer includes any amounts related to the loan and its income statement includes $350,000 of income.

By recording a negative allowance for credit losses only for the excess of expected recoveries at each reporting date over the unamortized non-credit discount at the date of writeoff, Bank avoided accelerating recognition of the non-credit discount into earnings.

FASB Examples

FASB Examples 18 and 19 illustrate including expected recoveries of amounts previously written off and expected to be written off in the allowance for credit losses. In each of these examples, the negative allowance is recognized for the excess of expected recoveries at the reporting date over the unamortized non-credit discount at the date of writeoff, which is less than the amortized cost written off in both examples. This prevents an entity from accelerating the non-credit discount into earnings.

Excerpt from ASC 326-20

>> Example 18: Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration with No Change in Credit Conditions

55-86 The following Example illustrates the application of the guidance in paragraph 326-20-30-13A for purchased financial assets with credit deterioration. For purposes of this Example, the acquired portfolio of loans is assumed to share similar risk characteristics and is evaluated for credit losses on a collective basis.

55-87 Bank Q purchases a portfolio of loans with a par amount of $10 million for $2 million. At acquisition, Bank Q expects to collect $2.5 million on the loan portfolio. Bank Q estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4. The acquisition-date journal entry is as follows.

Loan – par amount	$ 10,000,000	
Loan – noncredit discount		$ 500,000
Allowance for credit losses		7,500,000
Cash		2,000,000

55-88 After acquisition, Bank Q determines that each loan is deemed uncollectible on an individual unit-of-account basis and, therefore, writes off the loan portfolio. The following journal entries are recorded.

Provision expense	$ 2,000,000	
Allowance for credit losses		$ 2,000,000
Allowance for credit losses	$ 9,500,000	
Loan – noncredit discount	500,000	
Loan – par amount		$ 10,000,000

55-89 Although deemed uncollectible on an individual basis, when grouped together, the group of loans is expected to have some recoveries on an aggregate basis. Therefore, Bank Q records a negative allowance in accordance with paragraph 326-20-30-13A. Because Bank Q's expectation of credit conditions has not changed since acquisition, the expected recoveries of $2.5 million must not result in the acceleration of the noncredit discount that existed immediately before being written off. Therefore, the following journal entry is recorded.

Allowance for credit losses	$ 2,000,000	
Provision expense		$ 2,000,000

> > Example 19: Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration after a Change in Credit Conditions

55-90 Assume the same facts from Example 18. Bank Q subsequently determines that a change in credit conditions has occurred and expects to collect an additional $600,000 (for a total of $3.1 million) on the group of loans. Because Bank Q's expectation of credit conditions has changed and it is determining the amount that it expects to collect using a method other than a discounted cash flow method, the expected recoveries of $3.1 million would be reduced by the noncredit discount of $0.5 million (that has not been accreted). This would result in Bank Q having an overall negative allowance of $2.6 million. Therefore, the following journal entry is recorded.

Allowance for credit losses	$ 600,000	
Provision expense		$ 600,000

12.5 Interest income recognition

12.5.10 Overview

Excerpt from ASC 310-10

>> Interest Income

35-53A Except as noted in paragraphs 310-10-35-53B through 35-53C, this Subsection does not address how a creditor should recognize, measure, or display interest income on a financial asset with a credit loss. Some accounting methods for recognizing income may result in an amortized cost basis of a financial asset that is less than the amount expected to be collected (or, alternatively, the fair value of the collateral). Those accounting methods include recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those methods.

35-53B When recognizing interest income on **purchased financial assets with credit deterioration** within the scope of Topic 326, an entity shall not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition. The entity shall accrete or amortize as interest income the non-credit-related discount or premium of a purchased financial asset with credit deterioration in accordance with existing applicable guidance in Section 310-20-35 or 325-40-35.

35-53C Recognition of income on purchased financial assets with credit deterioration is dependent on having a reasonable expectation about the amount expected to be collected. Subsequent to purchase, this Subtopic does not prohibit placing financial assets on nonaccrual status, including use of the cost recovery method or cash basis method of income recognition, when appropriate. For example, if the timing of either a sale of the financial asset into the secondary market or a sale of collateral in essentially the same condition as received upon foreclosure is indeterminate, the creditor likely does not have the information necessary to reasonably estimate cash flows expected and shall cease recognizing income on the financial asset. However, the ability to place a financial asset on nonaccrual shall not be used to circumvent recognition of a credit loss. If the financial asset is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or improving the collateral for resale. Consistent with paragraph 310-20-35-18, interest income shall not be recognized to the extent that the net investment in the financial asset would increase to an amount greater than the payoff amount.

Under Subtopic 310-10, interest income for a PCD asset is recognized by accreting the non-credit premium or discount of the PCD asset using the interest method. In contrast, the Day 1 allowance for credit losses does not result in an accretable discount. [310-10-35-53B]

Recognition of income requires a reasonable expectation about the amounts expected to be collected. When an entity does not have a reasonable expectation about the amount expected to be collected, nonaccrual policies are applied. [310-10-35-53C]

Question 12.5.10

May an entity recognize interest income for PCD assets at the pool level?

Interpretive response: Generally, no. Any non-credit discount or premium resulting from acquiring a pool of PCD assets is allocated to individual assets in the pool. Further, the non-credit related discount or premium of a PCD asset is accreted or amortized as interest income under the existing guidance in Sections 310-20-35 or 325-40-35. However, if an entity elects to maintain previously existing pools on adoption of Topic 326, the pool continues to be the unit of account (see section 12.6.20). [326-20-30-13, 310-10-35-53B]

Comparison to legacy US GAAP

Maintaining integrity of pools no longer required for interest income recognition

The following table compares pooling and the unit of account for interest income recognition for PCI assets under legacy US GAAP with PCD assets under Subtopic 326-20 – assuming an entity does not elect to maintain previously existing pools on adoption of Topic 326.

Legacy US GAAP	Subtopic 326-20
Permits an entity to initially and subsequently account for PCI loans on an individual or pool basis, including for purposes of interest income recognition. If PCI loans are accounted for in pools, it requires that the integrity of a pool be maintained subsequent to initial recognition – i.e. individual loans generally cannot be removed from the pool except in the event of sale, foreclosure, settlement or writeoff of a loan. [310-30-15-6, 40-1]	PCD pools created for estimating expected credit losses under Subtopic 326-20 are not permitted to be maintained for interest income recognition. Instead, interest income – including the effect of allocated non-credit discounts and premiums – is recognized at the individual asset level.

Question 12.5.20

May a PCD asset be placed on nonaccrual status?

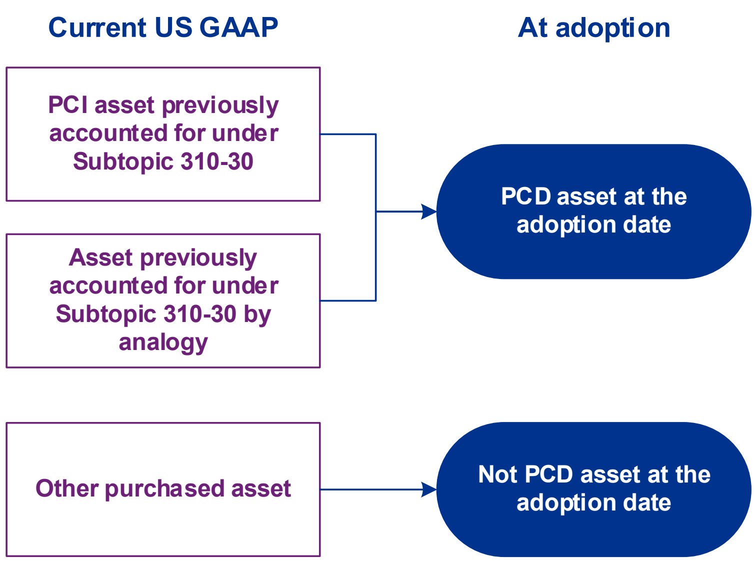
Interpretive response: It depends. An entity applies nonaccrual policies to PCD assets when it does not have a reasonable expectation about the amounts expected to be collected. However, placing a financial asset on nonaccrual status cannot be used to circumvent recognition of a credit loss. [310-10-35-53C]

12.6 Transition considerations

12.6.10 Definition of PCI vs PCD

The definition of PCD assets under Topic 326 is different from the definition of PCI assets under Subtopic 310-30 of legacy US GAAP (see section 12.2). Despite these different definitions, when adopting Topic 326, generally an entity does not evaluate any existing assets to determine whether they meet the PCD definition. Rather, except as discussed in Question 12.6.05, any existing PCI assets accounted for under Subtopic 310-30, including where an entity has applied that guidance by analogy, automatically become PCD assets. Further, any existing assets not accounted for under Subtopic 310-30 are not treated as PCD assets even if they meet the PCD definition.

The following diagram illustrates this transition relief for purchased assets that exist at the adoption date. [ASU 2016-13.BC118]



Question 12.6.05

Does an entity apply PCD accounting to all assets to which it applied PCI accounting?

Interpretive response: Not necessarily. We believe an entity generally should apply PCD accounting to assets for which it applied PCI accounting in the following situations:

- the asset was in the scope of Subtopic 310-30; or
- the asset meets the conditions in the letter sent by the AICPA Depository Institutions Expert Panel (DIEP) to the SEC Office of the Chief Accountant in December 2009.

The DIEP letter confirmed the SEC staff's position that it would not object to an entity making an accounting policy election to apply PCI accounting to certain acquired loans that do not meet the scope criteria of Subtopic 310-30. The letter applies to loans that: [AICPA DIEP 12-09]

— are acquired in a business combination or an asset purchase;
— result in the recognition of a discount attributable, at least in part, to credit quality; and
— are not subsequently accounted for at fair value.

In our experience, certain entities have applied the PCI accounting model to assets that were not in the scope of either Subtopic 310-30 or the DIEP letter. For example, some transferees applied the PCI accounting model to receivables that were treated as originated assets (rather than acquired assets) because they resulted from transfers of financial assets that did not meet the sale accounting criteria (see Question 12.2.50). The SEC staff has indicated that it may not be appropriate to apply PCD accounting in those situations. [2017 AICPA Conf]

12.6.20 Accounting for PCI assets at and after adoption

An entity applies Topic 326 prospectively to assets previously accounted for under Subtopic 310-30. At the adoption date, an entity applies PCD accounting by recognizing the addition of an allowance for credit losses and making a corresponding adjustment to the assets' amortized cost basis. Therefore, the entity does not recognize a credit loss in net income or record a cumulative-effect adjustment to retained earnings on the adoption date for these assets. The assets' amortized cost basis – as adjusted for the allowance for credit losses on the adoption date – is used to determine the EIR, which is used to subsequently accrete any non-credit discount or premium. [326-10-65-1(d)]

The transition provisions in Topic 326 permit an entity to elect to maintain pools of loans accounted for under Subtopic 310-30. Additionally, the TRG agreed that after adoption an entity can elect to continue to maintain previous (legacy GAAP) pools on a pool-by-pool basis. [326-10-65-1(d), TRG 06-17.3, TRG 06-17.6]

If an entity does not elect to maintain existing pools, pools maintained under legacy GAAP are assessed to determine whether they share similar risk characteristics and whether some or all of the assets should be assessed collectively with other loans that share similar risk characteristics. [326-20-30-2]

If an entity elects to maintain the legacy GAAP pools after adoption, it does not reassess the pool composition of the loans for purposes of estimating expected credit losses. [TRG 06-17.3, TRG 06-17.6]

Additionally, the TRG clarified that those paragraphs of legacy US GAAP guidance that are relevant to the pool as the unit of account – which include paragraphs 310-30-15-6, 310-30-35-15, and 310-30-40-1 to 310-30-40-2 (reproduced below) – continue to be relevant when an entity elects to maintain the pool as the unit of account subsequent to adopting Topic 326. However, other aspects of Topic 326 will apply regardless of whether an entity elects to maintain pools of loans accounted for under Subtopic 310-30. [TRG 06-17.3, TRG 06-17.6]

Because the TRG guidance was meant as an accommodation to permit entities to continue to use existing systems and processes, we would generally expect entities to continue leveraging their existing discounted cash flow methodology when applying this guidance.

Excerpt from ASC 310-30 (superseded)

> Other Considerations

15-6 For purposes of applying the recognition, measurement, and disclosure provisions of this Subtopic for loans that are not accounted for as debt securities, investors may aggregate loans acquired in the same fiscal quarter that have **common risk characteristics** and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. It is not intended for this aggregation to be analogized for purposes other than this Subtopic. To be eligible for aggregation, each loan first should be determined individually to meet the scope criteria of paragraph 310-30-15-2. After determining that certain acquired loans are within the scope as defined in that paragraph, the investor may evaluate whether such loans have common risk characteristics, thus permitting the aggregation of such loans into one or more pools. The aggregation shall be based on common risk characteristics that include similar credit risk or risk ratings, and one or more predominant risk characteristics. A portion of the total cost of acquired assets shall be assigned to each unit of accounting acquired on the basis of its relative fair value at the date of acquisition. The excess of the contractually required payments receivable over the investor's **initial investment** (whether **accretable yield** or **nonaccretable difference**) for a specific loan or a pool of loans with one set of common risk characteristics shall not be considered available to offset changes in cash flows expected to be collected from a different loan or an assembled pool of loans with another set of common risk characteristics.

> Pool of Multiple Loans

35-15 If a loan is removed from a pool of loans, the difference between the loan's carrying amount and the fair value of the collateral or other assets received shall not affect the percentage yield calculation used to recognize accretable yield on the pool of loans.

> Pool of Multiple Loans

40-1 Once a pool of loans is assembled, the integrity of the pool shall be maintained. A **loan** shall be removed from a pool of loans only if either of the following conditions is met:

a. The investor sells, forecloses, or otherwise receives assets in satisfaction of the loan.
b. The loan is written off.

A refinancing or restructuring of a loan shall not result in the removal of a loan from a pool.

40-2 A loan removed from a pool in accordance with the preceding paragraph shall be removed at its carrying amount. See paragraph 310-30-35-15 for further guidance on removing a loan from a pool.

Comparison to legacy US GAAP#

Integrity of pools are maintained after adoption

The following table compares PCI accounting under legacy US GAAP to (1) Subtopic 326-20 when an entity elects not to maintain previously existing pools after adoption, and (2) Subtopic 326-20 when an entity elects to maintain previous (legacy GAAP) pools after adoption.

Legacy US GAAP	Subtopic 326-20 – other than legacy GAAP pools maintained after adoption	Subtopic 326-20 – for legacy GAAP pools maintained after adoption
At the acquisition date, PCI loans are recorded at an initial carrying amount without establishing an allowance for loan losses. [310-30-30-1]	Allowance recognized on adoption through a gross-up that increases the amortized cost basis of the asset. [326-10-65-1(d)] The effect of any non-credit discount or premium is allocated to or recognized at the individual asset level. [326-20-30-13]	Allowance recognized on adoption through a gross-up that increases the amortized cost basis of the asset. [326-10-65-1(d)] The effect of any non-credit discount or premium is recognized at the pool level.
After acquisition, allowance is recognized at the present value of all cash flows expected at acquisition that are not expected to be received (discounted approach). [310-30-35-8]	Allowance for lifetime expected credit losses is recognized using either a discounted or undiscounted approach. [326-20-30-3]	Allowance for lifetime expected credit losses is generally expected to be recognized using a discounted approach to leverage systems and processes developed under legacy GAAP.
Decreases in expected cash flows recognized immediately in net income as a provision for credit losses. [310-30-35-10] If it is probable that there is a significant increase in cash flows previously expected to be collected, that increase is recognized – after reducing any remaining allowance previously established – prospectively as interest income by adjusting the accretable yield. [310-30-35-10]	Subsequent changes (favorable and unfavorable) in expected cash flows are recognized immediately in net income by adjusting the allowance. [326-20-35-1]	Consistent with Subtopic 326-20 when legacy pools are not maintained.
Individual loans generally cannot be removed from the pool except in the event of sale, foreclosure, settlement or writeoff of a loan. [310-30-40-1]	Integrity of the pool is not maintained. If an asset no longer shares similar risk characteristics, it is removed from the pool. [326-20-30-2]	Consistent with legacy US GAAP.

Legacy US GAAP	Subtopic 326-20 – other than legacy GAAP pools maintained after adoption	Subtopic 326-20 – for legacy GAAP pools maintained after adoption
No specific guidance for accounting for writeoffs.	Writeoff determined at the individual asset level. [326-20-35-8]	Largely consistent with legacy US GAAP. However, an entity needs to consider whether writeoff policies should be revised to address changes following the adoption of Subtopic 326-20. For example, an entity will need to consider when allowance amounts established at transition through the initial PCD gross-up should be written off.
Modification to an individual PCI asset in a pool is not assessed to determine if it is a TDR. [310-30-15-6, 310-40-15-11]	Modification to an individual PCD asset is not assessed to determine if it is a TDR. However, before adoption of ASU 2022-02, modification to an individual PCD asset is assessed to determine if it is a TDR (or reasonably expected TDR).	If an entity continues to apply a discounted approach, modification to an individual PCI asset in a pool is not assessed to determine if it is a TDR. See Question 12.6.30 if a method other than a discounted cash flow method is applied.

Question 12.6.10

If an allowance for loan losses was recognized under legacy US GAAP for PCI loans, how is the gross-up journal entry on adoption of Topic 326 determined?

Interpretive response: If an entity recognized an allowance for loan losses under legacy US GAAP for its PCI loans, the gross-up journal entry at adoption of Topic 326 reflects the additional amount (if any) needed to cause the allowance for credit losses to equal the amount estimated under Topic 326.

For example, assume an entity's allowance for loan losses before adoption was $50,000 and that the allowance for credit losses under Subtopic 326-20 is $75,000. The related gross-up journal entry on adoption would be $25,000. [ASU 2016-13.BC119]

Example 12.6.10

Journal entries on adoption for loans measured at amortized cost and PCI loans

ABC Corp. is a calendar year-end PBE that is an SEC filer. January 1, 2020 is the beginning of the first reporting period in which Topic 326 is applicable for ABC. On that date, ABC has the following portfolio:

- loans measured at amortized cost: $600,000.
- loans previously accounted for under Subtopic 310-30: $50,000.

Loans measured at amortized cost

ABC estimates that the allowance for credit losses is $25,000 – $20,000 allowance under legacy US GAAP and a $5,000 additional allowance under Subtopic 326-20. As of January 1, 2020, ABC records the following journal entry.

	Debit	*Credit*
Retained earnings	5,000	
Allowance for credit losses		5,000
To record cumulative effect adjustment of estimate of expected credit losses on loans measured at amortized cost.		

Loans previously accounted for under Subtopic 310-30 (PCI loans)

The loans previously accounted for under Subtopic 310-30 are considered PCD assets at the adoption date. ABC makes an accounting policy election to maintain pools of financial assets previously accounted for under Subtopic 310-30.

The allowance for credit losses required by Subtopic 326-20 and the non-credit discount are $10,000 and $2,000, respectively. As of January 1, 2020, ABC records the following journal entry.

	Debit	*Credit*
Loans	12,000	
Allowance for credit losses		10,000
Loans – non-credit discount		2,000
To adjust amortized cost basis of loans for addition of allowance for credit losses and to recognize related non-credit discount.		

After recognizing the adjustment for credit losses of $10,000, ABC determines the EIR on the pool of loans and accretes the $2,000 non-credit discount using the new EIR. For simplicity, it is assumed that the quarterly accretion is $200. Premiums and discounts are accounted for based on other applicable guidance for interest income in Section 310-20-35 in periods after adoption.

As of March 31, 2020, ABC records the following journal entry.

	Debit	Credit
Loans – non-credit discount	200	
Interest income		200
To record quarterly accretion of interest income after adoption.		

Question 12.6.15

If an entity uses a discounted cash flow method to estimate credit losses for PCD assets, what EIR does it use when adopting Topic 326?

Background: Under Subtopic 310-30, the EIR for PCI assets is the rate that equates the present value of expected future cash flows at the acquisition date with the purchase price of the asset. The EIR is increased when subsequent changes in expected cash flows are both probable and significantly favorable. As a result, the EIR for PCI assets may increase between their acquisition date and the date an entity adopts Topic 326. [310-30-35-2, 35-10]

Interpretive response: We believe an entity should discount cash flows using the EIR it used to recognize interest income under Subtopic 310-30 immediately before adopting Topic 326.

The transition provisions of Topic 326 require an entity to recognize interest income on PCD assets after adoption based on the EIR determined after the adjustment for credit losses (i.e. the gross-up journal entry) has been recorded. However, they do not specify the appropriate EIR when an entity uses a discounted cash flow method to determine the allowance for credit losses. [326-10-65-1(d)]

The EIR required by Subtopic 326-20 when using a discounted cash flow approach is the rate that equates the present value of the expected future cash flows with the purchase price of the asset. We believe an asset's amortized cost basis immediately before adoption of Topic 326 is effectively its 'purchase price' when determining the EIR at adoption; as a result, the EIR that should be used for estimating expected credit losses is the EIR applicable to those assets immediately before adoption.

This is also consistent with the transition provisions that require an entity to prospectively apply Topic 326 to PCD assets. Further, it aligns the EIR used for recognizing interest income with that used for determining the allowance for credit losses. [326-20-35-14, 65-1(d)]

However, if the EIR under Subtopic 310-30 immediately before adoption did not reflect all increases in expected cash flows (e.g. because the increases were not deemed significant), we believe the EIR at adoption should be increased to reflect those increases.

Question 12.6.20#

Does an entity capture the effects of previous interest rate concessions for PCI assets when estimating expected credit losses on adoption of ASU 2016-13?

Background: Under legacy US GAAP, entities that apply Subtopic 310-30 do not evaluate whether modifications to individual acquired financial assets within pools are TDRs.

Interpretive response: No. On adoption of ASU 2016-13, an entity does not reassess whether modifications to individual acquired financial assets within pools accounted for as PCI under Subtopic 310-30 are TDRs as of the date of adoption. Because the guidance for assessing if modifications of PCI assets are TDRs is applied prospectively, an entity does not estimate the impact of previous interest rate concessions entered into before adoption. Further, ASU 2022-02 eliminates separate recognition and measurement guidance for TDRs; therefore, an entity that adopts ASU 2022-02 in connection with adopting ASU 2016-13 also does not assess whether modifications of PCI assets are TDRs after adoption (i.e. prospectively). [326-10-65-1(d), 65-5(c)]

Question 12.6.30#

If an entity uses a method other than a discounted cash flow method, does it capture the effect of TDRs when estimating expected credit losses?

Interpretive response: Yes. We believe an entity is required to capture the effect of TDRs, including interest rate concessions, entered into following the adoption date of ASU 2016-13 (until adoption of ASU 2022-02; see 'Effect of ASU 2022-02' below) when estimating expected credit losses using a method other than a discounted cash flow method.

As noted in section 12.6.20, the TRG agreed that after adoption an entity may elect to continue maintaining previously existing pools of PCI assets on a pool-by-pool basis. The TRG clarified that when that election is made, those paragraphs of legacy US GAAP guidance that are relevant to the pool as the unit of account continue to be relevant; this includes the guidance indicating that TDR identification is not required for individual loans in the pool.

We believe the TRG guidance contemplates that an entity should continue to leverage its existing processes, including methodologies that discounted expected cash flows. When a discounted cash flow method is applied, the effects of TDRs, including interest rate concessions, is captured in the estimate of expected credit losses. Therefore, if an entity is *not* retaining its existing discounted cash flow method, we believe it needs to ensure that the new method captures the effect of TDRs, including interest rate concessions entered into (or reasonably expected) following the adoption date.

Effect of ASU 2022-02

ASU 2022-02 eliminates separate recognition and measurement guidance for TDRs, as well as the related guidance in Subtopic 326-20 for measuring credit losses on TDRs. After ASU 2022-02 is adopted, a loan modification is not evaluated to determine whether it is a TDR. Some entities will adopt ASU 2022-02 in connection with adopting ASU 2016-13 and, as a result, will not evaluate loan modifications after adoption of ASU 2016-13.

In addition, the requirement to capture the effects of TDRs when estimating expected credit losses using a method other than a discounted cash flow method does not apply after adoption of ASU 2022-02 unless the entity adopts the ASU using the prospective transition approach. If an entity adopts the ASU using the prospective transition approach, that requirement applies to loans that:

- were modified in TDRs before adoption, and
- have not been subsequently modified after adoption.

See section 25.5 for guidance about ASU 2022-02's effective dates and transition.

12A. Business combinations and asset acquisitions

Detailed contents

12A.1 How the standard works

Subtopic 326-20 requires lifetime expected credit losses of a financial asset in the scope of 326-20 to be recognized when the asset is purchased. This applies to acquisitions of financial assets in connection with:

- a business combination (Subtopics 805-10 to 805-30); and
- purchases outside of a business combination, such as asset acquisitions in the scope of Subtopic 805-50.

This chapter focuses on aspects of applying the expected credit loss model to financial assets that are specific to assets purchased in a business combination or asset acquisition.

12A.2 Scope and initial measurement

When an acquirer obtains control of an acquiree in a business combination, it recognizes the identifiable assets acquired, liabilities assumed and noncontrolling interests at fair value, with limited exceptions. When an acquirer obtains assets in connection with an asset acquisition (which does not meet the definition of a business), the acquirer measures the acquired assets based on their cost, which is generally allocated to the assets on a relative fair value basis. [805-20-30-1 – 30-2, 805-50-30-1]

Subtopic 326-20 provides additional guidance on how to initially recognize financial assets acquired that are in its scope, including the effect of PCD accounting, if applicable.

Question 12A.2.10

Is an agreement to acquire a business that holds financial assets in the scope of Subtopic 326-20?

Background: Some entities enter into an agreement to acquire a business at a future date, and many such businesses hold financial assets. Subtopic 805-20 provides guidance on the accounting for an acquired set of assets and activities that constitutes a business, requiring acquisition accounting to be applied at the date of acquisition. The accounting for business combinations is the subject of KPMG Handbook, Business Combinations.

Question 13.2.20 discusses forward commitments to purchase loans that are not in connection with the acquisition of a business.

Interpretive response: No. We do not believe an agreement to acquire a business in a future business combination that will be in the scope of Subtopic 805-20 is in the scope of Subtopic 326-20. This is regardless of whether the business to be acquired holds financial assets.

The scope of Subtopic 326-20 applies only to off-balance sheet loan commitments, standby letters of credit, financial guarantees (not accounted for as insurance or a derivative) and other similar instruments. We do not believe an agreement to acquire a business should be considered the same as, or ‘similar’ to, any of the off-balance sheet credit exposures listed in Subtopic 326-20, including loan commitments. [326-20-15-2(c)]

This view is consistent with the guidance in Subtopic 805-20 that prohibits the recognition of liabilities that will be incurred upon the consummation of a business combination until the acquisition date. [805-20-55-50 – 55-51]

Question 12A.2.20

Does the allowance for credit losses equal the credit portion of a purchase discount when estimating the fair value of a financial asset?

Interpretive response: Generally, no. The allowance for expected credit losses and the credit portion of a purchase discount when measuring the fair value of a financial asset are different estimates with distinctly different objectives.

Some of the key differences between the estimates are as follows.

— The allowance for credit losses is the estimate of lifetime expected credit losses. In contrast, the credit portion of a purchase discount when estimating fair value typically represents the *change* in the estimate of lifetime credit losses since origination and/or the change in the market's appetite for that credit risk (market credit spreads). For example, on the date that a loan is originated, there will be an allowance for credit losses based on estimated lifetime expected credit losses. However, there would not be a purchase discount related to credit risk on the date of origination because there would not have been any credit deterioration since origination.

— The allowance for credit losses does not consider whether the expected interest payments are adequate compensation for the credit risk assumed by the lender. In contrast, a fair value measurement considers whether the expected interest payments are adequate compensation for the credit risk assumed by the lender.

— The allowance for credit losses is based on an entity's own estimate of expected credit losses. In contrast, a fair value measurement is based on market participant assumptions, including assumptions about credit risk.

The calculation of the allowance for credit losses is different from that generally used for measuring fair value. When a discounted cash flow method is used, the allowance for credit losses is calculated as the difference between the amortized cost (which is effectively the present value of *contractual* cash flows discounted at the financial asset's effective interest rate) and the present value of *expected* cash flows discounted at the financial asset's effective interest rate. In contrast, a fair value measurement using a discounted cash flow method is generally based on either (1) contractual cash flows discounted at a market interest rate, inclusive of credit spreads, or (2) credit-adjusted cash flows discounted at an interest rate that excludes credit spreads. [326-20-30-4, CON 7.42–54]

Question 12A.2.30

Can an entity use the same inputs to estimate the allowance for credit losses and determine the fair value of financial assets acquired?

Interpretive response: It depends. The allowance for credit losses is based on an entity's own estimate of expected credit losses. In contrast, fair value measurements are based on market participant assumptions, including assumptions about credit risk. That is, fair value is a market-based measurement, not an entity-specific measurement. Therefore, we believe if an entity uses the same inputs to determine fair value as it used to estimate the allowance for credit losses, it needs to support that the inputs (e.g. probability of default and loss-given-default) are based on assumptions that are consistent with market participant assumptions.

Question 12A.2.40

Can an entity offset an unamortized purchase discount against its expectation of credit losses?

Excerpt from ASC 326-20

30-5 If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including all of the following…:

Interpretive response: No. When financial assets are acquired with a fair value less than the unpaid principal balance, a purchase discount is recorded and subsequently accreted into interest income. An entity may not use the unamortized discount to offset or otherwise reduce its estimate of expected credit losses. [326-20-30-5]

Question 12A.2.50

How does an entity recognize an allowance for credit losses related to loan commitments assumed in a business combination?

Interpretive response: An entity is required to recognize a liability for the fair value of assumed loan commitments when recording a business combination. We believe Subtopic 326-20 requires an entity to separately recognize, through earnings, a liability related to the credit exposure arising from these commitments. This means that any liability established through acquisition accounting related to these commitments does not offset the entity's estimate of expected credit losses. [326-20-30-5, ASU 2016-13.BC97]

This outcome is similar to the treatment of non-PCD loans acquired in a business combination whereby a discount established through acquisition accounting does not offset the entity's estimate of expected credit losses. Further, the recognition of expected credit losses is not an acquisition accounting adjustment that affects goodwill (see Question 12A.2.60).

Because the liability established at fair value as part of the business combination is accounted for separately, we believe that liability is subsequently accounted for in a manner similar to a commitment fee that is subject to the guidance in Subtopic 310-20. Under that guidance, a commitment fee generally is deferred and recognized as an adjustment of yield when the commitment is exercised; an exception arises if the likelihood of exercise is remote, in which case it is recognized on a straight-line basis. [310-20-35-3]

Example 12A.2.10
Loan commitment assumed in a business combination

Bank ABC acquires Bank DEF in a transaction accounted for as a business combination. As part of the business combination, ABC assumes an unfunded loan commitment that it cannot cancel. ABC determines the fair value of the commitment to be a liability of $30,000 and recognizes that amount in applying acquisition accounting.

Separately, in applying Subtopic 326-20, ABC estimates the liability for off-balance sheet credit losses related to the loan commitment to be $25,000. ABC records a liability for off-balance sheet credit losses for that amount through earnings.

As a result, ABC's financial statements reflect the following amounts after the business combination related to the unfunded loan commitment.

Account	Amount
Balance sheet – liabilities	
Commitment to extend credit	$ 30,000
Liability for off-balance sheet credit losses	$ 25,000
Income statement	
Credit loss expense	$ 25,000

Subsequently, ABC accounts for the commitment to extend credit (i.e. commitment fee) based on the guidance on Subtopic 310-20. Further, it accounts for the liability for off-balance sheet credit losses based on the guidance in Subtopic 326-20 – i.e. with changes in its estimate of expected credit losses recognized in earnings.

Question 12A.2.60

Does PCD accounting apply to assets acquired in a business combination?

Excerpt from ASC 805-20

>> Assets with Uncertain Cash Flows (Valuation Allowance)

30-4 The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure, unless the assets acquired are financial assets for which the acquirer shall refer to the guidance in paragraphs 805-20-30-4A through 30-4B.

30-4A For acquired financial assets that are not purchased financial assets with credit deterioration, the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date.

30-4B For assets accounted for as purchased financial assets with credit deterioration (which includes beneficial interests that meet the criteria in paragraph 325-40-30-1A), an acquirer shall recognize an allowance in accordance with Topic 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the acquisition date.

>> Purchased Financial Assets with Credit Deterioration

30-26 An acquirer shall recognize purchased financial assets with credit deterioration (including beneficial interests meeting the conditions in paragraph 325-40-30-1A) in accordance with Section 326-20-30 for financial instruments measured at amortized cost or Section 326-30-30 for available-for-sale debt securities. Paragraphs 326-20-55-57 through 55-78 illustrate how the guidance is applied for purchased financial assets with credit deterioration measured at amortized cost. Paragraphs 326-30-55-5 through 55-7 illustrate how the guidance is applied to available-for-sale debt securities. An acquirer shall not accrete into interest income the credit losses embedded in the purchase price for purchased financial assets with credit deterioration.

Interpretive response: Yes. PCD accounting is applied if, on the acquisition date of the business combination or asset acquisition, the asset has experienced a more-than-insignificant deterioration in credit quality since origination or issuance. See section 12.2 for additional guidance on the definition and scope of PCD assets. If PCD accounting applies the acquired PCD assets are grossed up for the acquirer's initial estimate of expected credit losses. Due to the gross-up, the Day 1 expected credit losses do not result in acquisition accounting adjustments impacting goodwill. [805-20-30-4B]

For non-PCD assets acquired in a business combination, the assets are not grossed up. Instead, the estimate of expected credit losses is recorded in net income on the acquisition date. [805-20-30-4A]

Example 12A.2.20
Acquisition of bank with PCD assets

Bank ABC acquires Bank DEF in a business combination, paying $1,500,000.

The following are the fair values of the assets acquired and liabilities assumed. In this example, deferred income taxes are ignored.

Cash:	$1,000,000
Loans:	$2,000,000
Land, building, furniture and equipment:	$1,100,000
Core deposit intangibles:	$350,000
Deposit liabilities:	$(3,840,000)

ABC determines that the entire portfolio consists of loans that have experienced a more-than-insignificant deterioration in credit quality since origination. In applying PCD accounting to these loans, it uses a method other than a discounted cash flow method (e.g. loss-rate method) to estimate the credit losses in the portfolio.

ABC determines the following amounts for the loans and related allowance:

- Total remaining unpaid principal balance: $3,000,000
- Total contractual principal cash flows that it expects to collect: $2,500,000
- Allowance for credit losses based on the unpaid principal balance (par amount): $350,000
- Non-credit discount: $650,000.

ABC records the following journal entry to account for the acquisition of DEF.

	Debit	*Credit*
Cash (acquired)	1,000,000	
Loans[1]	2,350,000	
Land, building, furniture, equipment	1,100,000	
Core deposit intangibles	350,000	
Goodwill	890,000	
Deposit liabilities		3,840,000
Cash (consideration)		1,500,000
Allowance for credit losses		350,000
To record acquisition of DEF.		

Note:

1. The loans are recorded at their initial amortized cost basis, which is calculated as fair value ($2,000,000) + the allowance for credit losses ($350,000). The loan balance is increased for the initial estimate of expected credit losses because the loans are PCD assets. This amount is net of the non-credit discount of $650,000.

Example 12A.2.30
Acquisition of bank with assets that are not PCD

Bank ABC acquires Bank DEF in a business combination, paying $8,000,000.

The following are the fair values of the assets acquired and liabilities assumed. In this example, deferred income taxes are ignored.

Cash:	$ 2,000,000
Loans:	$ 25,000,000
Land, building, furniture and equipment:	$ 3,100,000
Core deposit intangibles:	$ 350,000
Deposit liabilities:	$ (23,840,000)

ABC determines that the entire portfolio consists of loans that have not experienced a more-than-insignificant deterioration in credit quality since origination. Therefore, PCD accounting does not apply. ABC uses a method other than a discounted cash flow method (e.g. loss-rate method) to estimate the credit losses.

ABC records the following journal entry to account for the acquisition of the bank.

	Debit	*Credit*
Cash (acquired)	2,000,000	
Loans[1]	25,000,000	
Land, building, furniture, equipment	3,100,000	
Core deposit intangibles	350,000	
Goodwill	1,390,000	
Deposit liabilities		23,840,000
Cash (consideration)		8,000,000
To record acquisition of DEF.		

Note:
1. The loans are recorded net of premiums and discounts, if any.

ABC's initial estimate of expected credit losses for the loans is $600,000.

Because it is not applying PCD accounting, ABC recognizes its initial estimate of expected credit losses on the acquired loans through net income.

	Debit	*Credit*
Credit loss expense	600,000	
Allowance for credit losses		600,000
To record estimate of expected credit losses on consumer loans.		

Question 12A.2.70

Does an acquirer/purchaser apply PCD accounting to financial assets previously written off by the acquiree/seller?

Interpretive response: It depends. We believe the acquirer/purchaser should apply PCD accounting to financial assets previously written off by the acquiree/seller if the acquirer/purchaser has the contractual right to cash flows at the acquisition date. In contrast, PCD accounting would not apply if, for example, a loan was acquired through a business combination and the borrower had been previously discharged of its obligation by either the acquired entity or a court of law. In this case, the instrument would no longer be a financial asset.

Question 12A.2.80

Does the PCD accounting model apply to off-balance sheet credit exposures assumed in a business combination?

Interpretive response: No. The PCD accounting model applies only to acquired financial assets, while an off-balance sheet credit exposure is required to be recorded as a liability. As a result, PCD accounting should not be applied to off-balance sheet credit exposures, such as loan commitments or standby letters of credit, assumed in a business combination (see also Question 12A.2.50). [326-20 Glossary, 326-20-30-11, 30-13]

Question 12A.2.90

If pushdown accounting is elected, is PCD accounting at the parent level pushed down in the stand-alone financial statements of the acquiree?

Interpretive response: Yes. If the acquired entity elects to apply pushdown accounting, PCD accounting at the parent level is pushed down in the acquired entity's stand-alone financial statements.

In applying pushdown accounting, the carrying amounts of the assets and liabilities in the financial statements of the acquired entity are adjusted to reflect the acquisition accounting adjustments recorded (or that would have been recorded) in the consolidated financial statements of the parent entity as of the date control was obtained. [805-50-25-4, 805-50-30-10, 805-50-35-2]

If pushdown accounting is applied, the separate financial statements of the acquired entity must reflect all of the acquisition adjustments; partial pushdown accounting is not permitted. [805-50-25-4, 805-50-30-10, 805-50-35-2]

12A.3 Measurement period considerations for a business combination

Excerpt from ASC 805-10

> The Measurement Period

25-13 If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, in accordance with paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.

25-14 During the measurement period, the acquirer also shall recognize additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.
…

25-19 After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Topic 250.

There may be business combinations in which the information necessary to enable an acquirer to complete the identification and measurement of assets acquired and liabilities assumed is unavailable for a period of time following the acquisition date. In addition, if a business combination is consummated shortly before the acquirer's reporting date or the acquiree's operations are extensive or unusually complex, the acquirer may require additional time to obtain all of the data required to complete the acquisition accounting.

In these cases, the acquirer reports provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer is provided a reasonable period of time to obtain the information necessary to enable it to complete the accounting for a business combination. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period cannot exceed one year from the acquisition date. There is no measurement period for an acquisition of assets that does not constitute a business combination. [805-10-25-13 – 25-14]

Question 12A.3.10

During the measurement period, can an acquirer reevaluate and change assets to which PCD accounting is applied?

Background: PCD accounting applies to 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 or issuance, as determined by the acquirer's assessment.

Interpretive response: It depends. We believe an acquirer generally will have the information at the acquisition date to determine whether PCD accounting applies, and that the PCD criteria were intended to be applied in the reporting period that includes the business combination.

From a practical perspective, the FASB concluded that it was unrealistic to expect that an entity could individually measure credit losses for each purchased financial asset within the reporting deadlines to determine whether each individually qualifies as PCD. Therefore, to facilitate meeting their reporting deadlines, the FASB provided entities with the ability to assess whether groups of financial assets with similar risk characteristics qualify as having experienced a more than insignificant deterioration in credit quality since origination, as opposed to requiring an assessment at the individual asset level. [ASU 2016-13.BC89]

In most cases, we believe an acquirer will have the information necessary to make its assessment in the first reporting period that includes the acquisition date and that the measurement period would not be extended solely to provide the acquirer with additional time to assess that information. As a result, the measurement period for PCD accounting should generally not extend beyond that first reporting date. For example, if an acquirer intends to evaluate whether assets have more-than-insignificant credit deterioration based solely on a comparison of credit metrics at origination and acquisition, and those credit metrics are available internally during the first reporting period that includes the business combination, we generally would expect that the measurement period would not extend beyond the first reporting period.

In contrast, there may be limited circumstances in which the acquirer in a business combination has not yet obtained the information required for its assessment, such as third-party appraisals. In these cases, the acquirer should make a provisional assessment based on available information in the first reporting period that includes the business combination, and complete its assessment once the new information has been obtained (subject to limitations on the length of the measurement period). Any accounting changes resulting from changes in the determination of which assets meet the PCD criteria are recognized in the period in which the new information is obtained. [805-10-25-13 – 25-18]

After the measurement period is closed, if the acquirer obtains information that indicates that its previous determinations of which assets met the PCD criteria at the acquisition date were not correct, any changes in the assessment of which assets were credit deteriorated at acquisition are not a measurement period adjustment. Instead, the acquirer applies the guidance on error corrections in Topic 250; see chapter 4 of KPMG Handbook, Accounting changes and error corrections.

Example 12A.3.10
Applying the measurement period guidance to purchased financial assets

Bank ABC, a calendar year reporting entity, acquires Bank DEF in a business combination on March 1, Year 1. DEF's assets include a portfolio of 100 loans all of which are collateralized.

ABC concludes that its determination of whether each loan in the portfolio has more-than-insignificant deterioration in credit quality since origination depends, in part, on the fair value of the collateral at the acquisition date. (Question 4.2.20 discusses whether potential changes in collateral values are included in the estimate of expected credit losses.)

ABC places an order for this appraisal information from a third party, but it does not receive the information from the third party by the time it issues its Year 1 first quarter financial statements.

For purposes of those first quarter financial statements, ABC performs a provisional assessment using the information available at the time that compares the credit quality of each loan at the acquisition date and the origination date to determine whether there is a more-than-insignificant deterioration in credit quality since origination. Based on information available at the date the first quarter financial statements are issued, ABC determines there has not been a more-than-insignificant deterioration in credit quality in any of the loans since origination. Therefore, it does not apply PCD accounting to such loans in those financial statements and provides the necessary measurement period disclosures related to this provisional assessment.

ABC receives the appraisal information from the third party on June 15, Year 1, and finalizes its assessment using that information. ABC's finalized assessment is that, because of lower-than-expected collateral values, 5 of the 100 loans experienced a more-than-insignificant deterioration in credit quality from origination to the acquisition date.

Based on ABC's final assessment, it changes 5 loans from non-PCD to PCD and records the necessary adjustment in its Year 1 second quarter financial statements. ABC also discloses in the notes to the financial statements the impact of the measurement period adjustment.

Question 12A.3.20
How are measurement period adjustments related to PCD assets accounted for?

Interpretive response: We believe there are two types of adjustments related to acquired financial assets that may be made during the measurement period when the acquirer obtains additional information about facts and circumstances that existed as of the acquisition date:

— moving assets between non-PCD and PCD (see Question 12A.3.10); and
— changing the allowance for credit losses for PCD assets.

We believe the above adjustments should be reflected as indicated in the following table. For simplicity, the table ignores the impact on interest income as a result of the change in the amortized cost basis of the asset and income taxes.

Type of adjustment	Impact
Moving assets from non-PCD to PCD (without a change in the amount of the related allowance).	Increase the amortized cost basis with a corresponding decrease to credit loss expense.
Moving assets from PCD to non-PCD (without a change in the amount of the related allowance).	Decrease the amortized cost basis with a corresponding increase to credit loss expense.
Changing the amount of the allowance for credit losses recognized at the date of acquisition for PCD assets.	Adjust the allowance for credit losses with a corresponding adjustment to the amortized cost basis of the PCD asset.

13. Off-balance sheet credit exposures

Detailed contents

Item significantly updated in this edition: #

Examples

13.3.05	Credit card portfolio with balances that fluctuate seasonally
13.3.10	Contractual term
13.3.20	Irrevocable loan commitment
13.3.30	Revocable loan commitment
13.3.40	[Not used]
13.3.50	Forward commitment to purchase non-PCD loans
13.3.60	Forward commitment to purchase PCD assets

13.1 How the standard works

The expected credit loss model under Subtopic 326-20 applies to off-balance sheet credit exposures such as unfunded loan commitments and standby letters of credit.

A liability for expected credit losses for off-balance sheet credit exposures is recognized if both of the following conditions are met:

— the entity has a present contractual obligation to extend the credit; and
— the obligation is not unconditionally cancellable by the entity.

Loan commitments may have a funded and an unfunded portion.

Portion	Accounting
Funded portion	— Expected credit losses are estimated under the same guidance used for estimating expected credit losses for other financial assets in the scope of Subtopic 326-20. — The expected credit losses for funded portions are reported in an allowance for credit losses.
Unfunded portion of loan commitments that are not unconditionally cancellable by the lender	— Expected credit losses are estimated over the contractual term of the loan that will be originated. Subtopic 326-20 requires the estimate of expected credit losses to consider both: – the likelihood that funding will occur; and – an estimate of expected credit losses on commitments expected to be funded. — The expected credit losses for unfunded portions are reported as a liability for off-balance sheet credit losses.
Unfunded portion of loan commitments that are unconditionally cancellable by the lender	An estimate of expected credit losses is not established.

13.2 Scope

13.2.10 Overview

Excerpt from ASC 326-20

15-2 The guidance in this Subtopic applies to the following items: ...

c. Off-balance-sheet credit exposures not accounted for as insurance. Off-balance-sheet credit exposure refers to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments, except for instruments within the scope of Topic 815 on derivatives and hedging.

The expected credit loss model under Subtopic 326-20 applies to off-balance sheet credit exposures. The term 'off-balance sheet credit exposures' refers to credit exposures on off-balance sheet loan commitments, standby letters of credit, financial guarantees (not accounted for as insurance contracts or a derivative) and other similar instruments. [326-20-15-2(c)]

Subtopic 326-20 requires measurement of the risk of loss from credit-related events and not due to events related to other risks. [326-20-15-2(c), 326-20-55-81 – 55-82]

Question 13.2.10#

Is a loan commitment for a nonmortgage loan in the scope of Subtopic 326-20 if the loan will be held-for-sale upon funding?

Background: When a loan commitment relates to the origination of a loan that will be held-for-sale, the issuer (i.e. the potential lender) accounts for the commitment at fair value if: [815-10-15-71, 825-10-15-4]

- the commitment relates to mortgage loans;
- the fair value option is elected; or
- fair value accounting is required based on industry-specific guidance – e.g. broker-dealer accounting.

If the loan commitment does not qualify for fair value accounting, US GAAP does not prescribe an accounting treatment. However, before the adoption of ASU 2016-13, two accounting policy alternatives were used in practice: record the loan commitment either (a) as a loss contingency under Subtopic 450-20 if a loss was probable and reasonably estimable, or (b) at the lower of cost or fair value.

Interpretive response: It depends. We believe that if an entity's accounting policy before adoption of ASU 2016-13 was to recognize and measure contingent losses related to the loan commitment under Subtopic 450-20, the entity should apply:

— Subtopic 326-20 upon adoption of ASU 2016-13 for off-balance sheet exposure; and
— Subtopic 450-20 for the contingent losses from non-credit risks.

Once the commitment has been funded and the loan is classified as held-for-sale, the off-balance sheet credit exposure on the loan commitment no longer exists and the associated held-for-sale loan is not in the scope of Subtopic 326-20 (see Question 2.2.40).

In contrast, if the entity's accounting policy was to recognize and measure a loan commitment at the lower of cost or fair value, we believe the loan commitment is not in the scope of Subtopic 326-20. An entity should continue to measure these loan commitments using the lower of cost or fair value after the adoption of ASU 2016-13.

Question 13.2.20

Is a forward commitment to purchase loans in the scope of Subtopic 326-20?

Interpretive response: Yes. Similar to a loan commitment, we believe a forward commitment to purchase loans (including loans that are deemed PCD assets) represents an off-balance sheet credit exposure in the scope of Subtopic 326-20 if the forward: [326-20-30-11, 815-10-15-83]

— is not accounted for as a derivative under Topic 815; and
— is not unconditionally cancellable by the purchaser.

13.3 Measurement

13.3.10 Overview

Excerpt from ASC 326-20

>> Off-Balance-Sheet Credit Exposures

30-11 In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures. For that period of exposure, the estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life. If an entity uses a discounted cash flow method to estimate expected credit losses on off-balance-sheet credit exposures, the discount rate used should be consistent with the guidance in Section 310-20-35.

> Reporting Changes in Expected Credit Losses

35-3 An entity shall adjust at each reporting period its estimate of expected credit losses on off-balance-sheet credit exposures. An entity shall report in net income (as credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures at each reporting date.

An entity estimates a liability for expected credit losses for off-balance sheet credit exposures if it:

— has a present contractual obligation to extend the credit; and
— cannot unconditionally cancel the obligation. [326-20-30-11]

Therefore, a liability is recognized for off-balance sheet credit exposure such as a loan commitment when all or a portion of the loan is unfunded and the entity cannot unconditionally cancel the commitment. No liability is recognized for any unfunded portion that is unconditionally cancellable by the entity. [326-20-30-11]

If a loan commitment has a funded and an unfunded portion, an allowance for credit losses for the funded portion is estimated under the same guidance used for estimating expected credit losses for other financial assets (see chapters 4 to 8). The liability for credit losses for the unfunded portion of a loan commitment is determined by estimating the expected credit losses over the contractual term of the loan that will be originated. In estimating this liability, the entity considers both the likelihood that funding will occur and the estimate of expected credit losses on commitments expected to be funded. [326-20-30-11]

At each reporting date, the liability is adjusted for management's current estimate of expected credit losses. Any changes in the estimate are immediately recognized in net income as credit loss expense or reversal of credit loss expense. [326-20-35-3]

Question 13.3.10

When a loan commitment is unconditionally cancellable, does an entity consider its previous loss experience related to these types of loan commitments?

Interpretive response: No, in relation to the unfunded portion; yes, in relation to the funded portion.

Because the commitment is unconditionally cancellable, an entity does not estimate expected credit losses for the unfunded portion. Therefore, we believe an entity should not estimate expected credit losses for the unfunded portion of a loan commitment that is unconditionally cancellable – even if it has a history of incurring losses on additional amounts funded before loan commitments were cancelled. Similarly, we do not believe that an entity's history of not exercising its unconditional right to cancel in the past is relevant. In these instances, only after a loan commitment is funded does the entity recognize an allowance for credit losses for the funded portion.

An entity considers its historical loss experience when estimating the expected credit losses for the funded portion.

This answer is consistent with Example 10 from Subtopic 326-20, which indicates that a liability should not be recorded even though the entity has had a past practice of allowing drawdowns on credit cards before it has detected borrower defaults.

Excerpt from ASC 326-20

>> Example 10: Application of Expected Credit Losses to Unconditionally Cancellable Loan Commitments

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

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

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

Example 13.3.05

Credit card portfolio with balances that fluctuate seasonally

Bank has a portfolio of credit card accounts (i.e. revolving lines of credit). It can unconditionally cancel the unused portion of each credit card line of credit.

Bank is estimating its allowance for credit losses at the end of Q2. Its historical experience has demonstrated that the funded balances of the portfolio are higher during Q4 (related to the holiday shopping season) and lower during Q2 (after tax refunds are received).

Bank estimates expected credit losses only on the funded balances of these credit cards at the end of Q2. Because Bank can unconditionally cancel the unused portion, it does not recognize any amount of expected credit losses related to that unused portion even though it expects that funded balances will increase over the remainder of the year and that it will experience credit losses on certain of those additional future drawdowns.

Further, Bank does not make a qualitative adjustment that records expected credit losses related to those unfunded loan commitments.

Question 13.3.20

What is the contractual term used for estimating expected credit losses for loan commitments?

Interpretive response: Expected credit losses for loan commitments are estimated over the contractual term of the loan that will be originated. [326-20-30-11]

Example 13.3.10

Contractual term

Bank provides a 90-day $100,000 loan commitment. If funded, Bank would provide a 10-year loan. Bank determines the likelihood that the loan commitment will be drawn is 50% and the 10-year loan would have a probability of default of 2% and a loss given default of 40%.

Bank calculates its liability for off-balance sheet credit exposure as $100,000 × 2% (probability of default for a 10-year loan) × 40% (loss given default) × 50% (likelihood of funding) = $400.

Example 13.3.20

Irrevocable loan commitment

Bank provides a four-year $100,000 irrevocable loan commitment to Customer.

Bank uses a loss-rate method to determine its allowance for credit losses. It calculates a loss rate of 0.4% based on historical loss experience adjusted for asset-specific risk characteristics, current conditions and reasonable and supportable forecasts. Further, it determines the likelihood that the unfunded amount will be drawn is 50%.

At the end of Year 1, the funded amount is $60,000 and the unfunded amount is $40,000. Bank records the following journal entries.

	Debit	Credit
Credit loss expense	320	
Allowance for credit losses[1]		240
Liability for off-balance sheet credit losses[2]		80
To record expected credit losses for funded and unfunded loan commitment.		

Notes:
1. $60,000 (funded portion) × 0.4% (loss rate) = $240.
2. $40,000 (unfunded portion) × 0.4% (loss rate) × 50% (likelihood that the unfunded amount will be drawn) = $80.

At the end of Year 1, Bank's financial statements reflect the following amounts.

Account	Amount
Balance sheet – assets	
Loans	$60,000
Allowance for credit losses	$(240)
Balance sheet – liabilities	
Liability for off-balance sheet credit losses	$80
Income statement	
Credit loss expense	$320

Bank subsequently funds the remaining $40,000. At the end of Year 2, the funded amount is $100,000 and the unfunded amount is $0. Bank's loss rate remains unchanged.

	Debit	Credit
Credit loss expense[1]	80	
Liability for off-balance sheet credit losses[2]	80	
Allowance for credit losses[3]		160
To record expected credit losses for unfunded amount that was funded.		

Notes:
1. The difference between the additional allowance for credit losses recognized at the reporting date and the previously established liability for off-balance sheet credit losses.
2. Reversal of previously recognized liability as a result of the unfunded amount being funded.
3. $40,000 (additional funded portion) × 0.4% (loss rate) = $160.

At the end of Year 2, Bank's financial statements reflect the following amounts.

Account	Amount
Balance sheet – assets	
Loans	$100,000
Allowance for credit losses	$ (400)
Income statement	
Credit loss expense	$ 80

The drawdown of additional amounts on the loan commitment during Year 2 results in the following.

— **Increased credit loss expense.** This is because the same loss rate is applied to both the funded and unfunded portions, but expected credit losses for unfunded amounts are adjusted for the likelihood that the unfunded amount will be drawn.

— **Reclassification of the liability** for off-balance sheet credit losses on the unfunded portion to the allowance for credit losses upon full funding of the loan.

Example 13.3.30
Revocable loan commitment

Assume the same facts as in Example 13.3.20 (Year 1), except that Bank has the discretion to cancel the loan commitment at any time without providing advance notice to Customer.

At the end of Year 1, the funded amount is $60,000 and the unfunded amount is $40,000. Bank records the following journal entry for the funded portion.

	Debit	*Credit*
Credit loss expense	240	
Allowance for credit losses[1]		240
To record expected credit losses for funded portion of revocable loan commitment.		

Note:
1. $60,000 (funded portion) × 0.4% (loss rate) = $240.

For the unfunded portion, Bank does not calculate an estimate of expected credit losses because the loan commitment is unconditionally cancellable by Bank.

Question 13.3.45

How does an entity account for the acquisition of a partially funded, noncancellable line of credit that relates to a funded PCD loan?

Background: Entity purchases a loan that was partially funded at acquisition. The funded portion of the loan has experienced a more-than-insignificant deterioration in credit quality since origination.

Interpretive response: An entity separately considers the credit exposure on the funded and unfunded portions of a line of credit that is acquired. [326-20-30-11]

If the funded portion of the line of credit has experienced a more-than-insignificant deterioration in credit quality since origination, the entity recognizes an allowance for credit losses related to the funded PCD asset using the gross-up method (see section 12.3).

In contrast, the unfunded portion of the line of credit is not eligible for PCD accounting (see Question 12A.2.80). Therefore, the entity separately recognizes, through earnings, a liability related to the unfunded portion's off-balance sheet credit exposure. [326-20-30-13]

Question 13.3.50

How does an entity account for the drawdown of a noncancellable line of credit that was partially funded and PCD at acquisition?

Interpretive response: PCD accounting should not be applied to the undrawn (i.e. unfunded) line of credit (see Question 12A.2.80). However, we believe that as the line of credit is drawn down and the commitment is funded, the newly funded portion should be combined with the funded PCD asset because a funded loan is a single unit of account. Therefore, as a line of credit is drawn down, the entity reverses the related liability for off-balance sheet credit exposure, and it estimates and recognizes an allowance for credit losses for the entire funded loan.

Question 13.3.60

How does an entity recognize and measure the liability for off-balance sheet credit exposure on a forward commitment to purchase loans?

Background: As discussed in Question 13.2.20, we believe a forward commitment to purchase loans is in the scope of Subtopic 326-20 if it is: [326-20-30-11, 815-10-15-83]

— not accounted for as a derivative under Topic 815; and
— not unconditionally cancellable by the purchaser.

Interpretive response: We believe the recognition and measurement of the liability for credit losses related to a forward commitment to purchase loans depends on whether the loans are non-PCD or PCD.

— For non-PCD loans, the liability for credit losses and the related credit loss expense should be recognized at the inception of the commitment and determined by estimating the expected credit losses over the contractual term of the loan that will be purchased.

— For PCD loans, there is no liability for credit losses recognized at the inception of the commitment. However, an entity should monitor cash flows expected to be collected from the underlying loans and assess whether a liability for credit losses and related credit loss expense should be recorded for adverse changes in expected cash flows since inception of the commitment.

For PCD loans, we believe the entity's estimate of expected credit losses at the commitment date of the forward purchase contract should be recorded through a balance sheet gross-up entry when the underlying loans are acquired. This ensures consistency between purchases of PCD loans via a forward commitment and purchases of PCD loans without a forward commitment.

Because this amount will not be recognized in the income statement, we believe it should not be included in the measurement of the liability for off-balance sheet credit exposure.

Example 13.3.50
Forward commitment to purchase non-PCD loans

On January 15, Year 1, Bank enters into a commitment to purchase loans from a seller in 90 days at a fixed price. There is no consideration exchanged when the commitment is entered into. The commitment may not be unconditionally cancelled by Bank and does not meet the definition of a derivative because the net settlement characteristic is not met.

Bank determines that the loans to be purchased are not PCD assets because they have not experienced a more-than-insignificant deterioration in credit quality since their origination date. On January 15, Year 1, Bank's initial estimates for the loans to be purchased are as follows.

Total amortized cost of loans to be purchased under the forward:	$100,000
Allowance for credit losses based on amortized cost:	$ 2,000

For simplicity, this example assumes there is no change in the liability for off-balance sheet credit losses during the commitment period. Bank records the following journal entry at the commitment date.

	Debit	Credit
Credit loss expense	2,000	
Liability for off-balance sheet credit loss		2,000
To record expected credit losses on forward commitment.		

On April 15, Year 1, the $100,000 in loans are purchased for cash and Bank records the following journal entry.

	Debit	Credit
Loans	100,000	
Liability for off-balance sheet credit loss	2,000	
Allowance for credit losses		2,000
Cash		100,000
To record purchase of loans under forward commitment.		

Example 13.3.60
Forward commitment to purchase PCD assets

On January 15, Bank enters into a commitment to purchase loans from a seller in 90 days for $700,000. There is no consideration exchanged when the commitment is entered into. The commitment may not be unconditionally cancelled by Bank and does not meet the definition of a derivative because the net settlement characteristic is not met.

Bank determines that the loans to be purchased have experienced a more-than-insignificant deterioration in credit quality since their origination date. Therefore, Bank concludes that it will account for the loans under the guidance for PCD assets at the date of acquisition.

On January 15, Bank's initial estimates for the loans to be purchased are as follows.

Total face amount (face value):	$1,000,000
Total contractual principal cash flows that it expects to collect:	$ 800,000
Allowance for credit losses based on unpaid principal balance (par):	$ 200,000
Non-credit discount:	$ 100,000

During the 90-day commitment period (January 15 to April 15), Bank monitors cash flows expected to be collected from the underlying loans. On March 31, Bank determines that expected cash flows decreased by $50,000 to $750,000, which requires Bank to record the following journal entry.

	Debit	Credit
Credit loss expense	50,000	
Liability for off-balance sheet credit loss		50,000
To record expected credit losses on forward commitment.		

On April 15, the loans are purchased for cash and Bank records the following journal entry.

	Debit	Credit
Loans	1,000,000	
Liability for off-balance sheet credit loss	50,000	
Cash		700,000
Allowance for credit losses		250,000
Loans – non-credit discount		100,000
To record purchase of loans under forward commitment.		

Question 13.3.70

When does an entity recognize and measure the liability for off-balance sheet credit exposure on a forward commitment to purchase loans that have not been specifically identified?

Background: As discussed in Question 13.2.20, we believe a forward commitment to purchase loans is in the scope of Subtopic 326-20 if it is: [326-20-30-11, 815-10-15-83]

- not accounted for as a derivative under Topic 815; and
- not unconditionally cancellable by the purchaser.

Interpretive response: We believe the liability for off-balance sheet credit exposure should be recognized when the forward commitment is entered into even if the loans are not specifically identified.

Generally, these forward commitments include specific criteria/guidelines related to the type and quality of loans to be purchased. Before identifying the specific loan, the purchaser should use these criteria/guidelines to estimate which loans will be PCD and to estimate the expected credit losses on the loans that will be later identified and delivered.

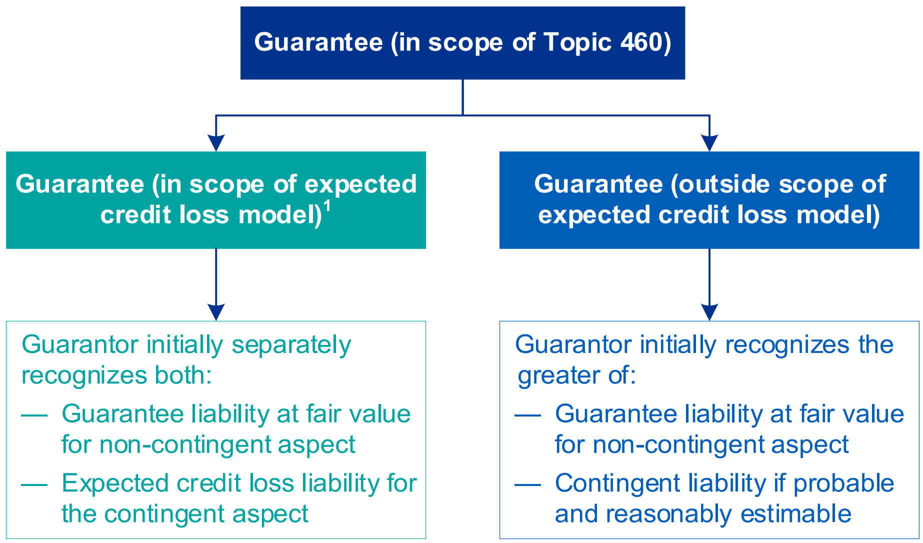
14. Guarantees

Detailed contents

14.1 How the standard works

Guarantees in the scope of Topic 460 that create off-balance sheet credit exposure for the guarantor are also in the scope of Subtopic 326-20.

The contingent aspect of these guarantees is accounted for separately from the guarantee liability (non-contingent stand-ready aspect) accounted for under Topic 460. Subtopic 326-20's expected credit loss model is applied to the contingent aspect.



Note:

1. Guarantees that create off-balance sheet credit exposure are in the scope of Subtopic 326-20.

This chapter addresses only the accounting by the guarantor (the issuer).

The following table summarizes the initial and subsequent measurement guidance applicable to guarantees in the scope of Topic 460 that are also in the scope of Subtopic 326-20.

Initial measurement	Subsequent measurement
Non-contingent stand-ready component	
Fair value is recognized as a liability.	Typically the liability is reduced through net income as the guarantor is released from its obligation. Three methods are used in practice to recognize the liability in net income: — in full upon either expiration or settlement of the guarantee; — systematic and rational amortization method; or — changes in the fair value of the guarantee.

Initial measurement	Subsequent measurement
Contingent component	
Expected credit losses are estimated under Subtopic 326-20 and are recognized as a separate liability.	At each reporting date, expected credit losses are estimated and related adjustments to the liability are made through net income.

14.2 Guarantees subject to Subtopic 326-20

14.2.10 Overview

The guidance in Subtopic 326-20 applies to a subset of the guarantees that are in the scope of Topic 460. Only guarantees that create off-balance sheet credit exposure for the guarantor are in the scope of Subtopic 326-20. Examples of guarantees that create off-balance sheet credit exposure include financial standby letters of credit and other types of guarantees that relate to the non-payment of a financial obligation – e.g. a borrower's obligation under a loan or debt security. [460-10-15-4, 326-20-15-2(c)]

Question 14.2.10

What type of guarantees are in the scope of Subtopic 326-20?

Interpretive response: Guarantees that create off-balance sheet credit exposure, but are not accounted for as either derivatives or insurance, are in the scope of Subtopic 326-20. We believe that guarantees create off-balance sheet credit exposure if they require the guarantor to make a payment due to a failure of another party to satisfy its required payment obligation.

Guarantees that may be in the scope of Subtopic 326-20 include:

— a franchisor's guarantee of a franchisee's lease obligation;
— a standby letter of credit issued by a financial institution;
— an investor's guarantee of an investee's debt obligation; and
— a manufacturer's guarantee of a customer loan used to finance the purchase of goods from the manufacturer.

However, a guarantee of an entity's own performance or its own obligation, including a parent's guarantee of the performance of a consolidated subsidiary (from the perspective of the consolidated financial statements), is not in the scope of Subtopic 326-20.

14.3 Initial recognition and measurement

14.3.10 Overview

Excerpt from ASC 460-10

General

25-2 The issuance of a guarantee obligates the guarantor (the issuer) in two respects:

a. The guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect).

b. The guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

For guarantees that are not within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, no bifurcation and no separate accounting for the contingent and noncontingent aspects of the guarantee are required by this Topic. For guarantees that are within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) shall be measured and accounted for in addition to and separately from the fair value of the guarantee (the noncontingent aspect) in accordance with paragraph 460-10-30-5.

25-3 Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of Section 450-20-25 regarding a guarantor's contingent obligation under a guarantee should not be interpreted as prohibiting a guarantor from initially recognizing a liability for a guarantee even though it is not **probable** that payments will be required under that guarantee. Similarly, for guarantees within the scope of Subtopic 326-20, the requirement to measure a guarantor's expected credit loss on the guarantee should not be interpreted as prohibiting a guarantor from initially recognizing a liability for the noncontingent aspect of a guarantee.

25-4 At the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. This Subsection does not prescribe a specific account for the guarantor's offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See paragraph 460-10-55-23 for implementation guidance.

> Fair Value Objective

30-2 Except as indicated in paragraphs 460-10-30-3 through 30-5, the objective of the initial measurement of a guarantee liability is the fair value of the guarantee at its inception. For example:

a. If a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee shall be the premium received or receivable by the guarantor as a practical expedient.
b. If a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, a guarantor shall consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party as a practical expedient.
c. If a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee shall be measured at its fair value, consistent with the requirement to measure the contribution made at fair value, as prescribed in Section 720-25-30. For related implementation guidance, see paragraph 460-10-55-14.

> Guarantees within the Scope of Subtopic 326-20

30-5 At the inception of a guarantee within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, the guarantor is required to recognize both of the following as liabilities:

a. The amount that satisfies the fair value objective in accordance with paragraph 460-10-30-2
b. The contingent liability related to the expected credit loss for the guarantee measured under Subtopic 326-20.

General

45-1 Paragraph 326-20-45-2 states that an accrual for credit loss on a financial instrument with off-balance-sheet risk (including financial guarantees and **financial standby letters of credit**) shall be a liability that is recorded separate from a valuation account related to a recognized financial instrument.

A guarantee in the scope of Subtopic 326-20 consists of two components, one of which is recognized and measured under Topic 460 and the other under Subtopic 326-20. These two components are: [460-10-25-2]

— a *non-contingent* obligation to stand ready to perform – i.e. the stand-ready obligation; and
— a *contingent* obligation to make future payments if specific conditions occur.

Non-contingent stand-ready obligation

A liability for the non-contingent obligation of a guarantee is recognized under Topic 460 at fair value at inception. The fair value of a guarantee inherently includes a market participant's assumptions regarding credit risk in the guarantee. [460-10-25-3, 30-5]

Contingent obligation

A separate liability for off-balance sheet credit risk is recognized under Subtopic 326-20 for expected credit losses related to the contingent obligation. The FASB decided that this approach was necessary to appropriately present expected credit losses on guarantees without affecting the fee recognition that results from the accounting for the non-contingent obligation. [460-10-25-3, 30-5, ASU 2016-13.BC97]

There are two aspects of the guarantor's estimation of expected credit losses for the contingent obligation:

— the likelihood that the guarantor will have to fulfill the obligation; and
— an estimate of expected credit losses on the obligation.

The estimate of expected credit losses on the obligation considers the attributes of the guarantee. For example, an issuer of a financial standby letter of credit guarantees an obligor's payment to a third party. The issuer considers any recourse it may have to the obligor when estimating the expected credit losses on its obligation.

Comparison to legacy US GAAP

Initial recognition of guarantee liabilities

The following table provides a summary comparison of the presentation requirements under Subtopic 326-20 and legacy US GAAP.

Legacy US GAAP	Subtopic 326-20
Guarantor initially recognizes the greater of: — guarantee liability at fair value for non-contingent stand-ready aspect; or — contingent liability if probable and reasonably estimable. [460-10-30-2, 450-20-25-2]	Guarantor initially separately recognizes both: — guarantee liability at fair value for non-contingent stand-ready aspect; and — liability for off-balance sheet credit losses for the contingent aspect.

Example 14.3.10

Financial standby letter of credit: up-front cash premium

Exporter sells goods to Foreign Buyer and Foreign Buyer promises to pay within two years. Guarantor issues a stand-alone arm's-length $1,000,000 financial standby letter of credit to guarantee that Exporter will receive payment on time and in the correct amount if Foreign Buyer does not make payments to Exporter. Guarantor receives an up-front cash premium of $30,000.

In accordance with Topic 460, Guarantor determines that the fair value of the financial guarantee liability recognized at inception is the premium received. This is because the guarantee was issued in a stand-alone arm's-length transaction.

Guarantor estimates the expected credit loss for the financial guarantee to be $5,000.

It records the following journal entry to account for the guarantee at inception.

	Debit	*Credit*
Cash	30,000	
Credit loss expense	5,000	
Financial guarantee liability – non-contingent		30,000
Liability for off-balance sheet credit losses – contingent		5,000
To record fair value of financial guarantee (non-contingent aspect) and associated liability for off-balance sheet credit losses (contingent aspect).		

Example 14.3.20
Financial standby letter of credit: premium receivable

Assume the same fact pattern as in Example 14.3.10 except that the premium of $30,000 is a receivable (cash not paid up-front).

In accordance with Topic 460, Guarantor determines that the fair value of the financial guarantee liability recognized at inception is the premium receivable. This is because the guarantee was issued in a stand-alone arm's-length transaction.

Guarantor estimates the expected credit loss for the financial guarantee to be $5,000, and the expected credit loss for the premium receivable to be $1,000.

It records the following journal entry to account for the guarantee at inception.

	Debit	*Credit*
Premium receivable	30,000	
Credit loss expense	6,000	
Financial guarantee liability – non-contingent		30,000
Liability for off-balance sheet credit losses – contingent		5,000
Allowance for credit losses – premium receivable		1,000
To record fair value of financial guarantee (non-contingent aspect) and associated liability for off-balance sheet credit losses (contingent aspect), and related premium receivable with associated allowance for credit losses.		

14.4 Subsequent measurement

14.4.10 Overview

Excerpt from ASC 460-10

General

35-1 This Subsection does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured after its initial recognition. The liability that the guarantor initially recognized under paragraph 460-10-25-4 would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee.

35-2 Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee using one of the following three methods:

a. Only upon either expiration or settlement of the guarantee
b. By a systematic and rational amortization method
c. As the fair value of the guarantee changes.

Although those three methods are currently being used in practice for subsequent accounting, this Subsection does not provide comprehensive guidance regarding the circumstances in which each of those methods would be appropriate. A guarantor is not free to choose any of the three methods in deciding how the liability for its obligations under the guarantee is measured subsequent to the initial recognition of that liability. A guarantor shall not use fair value in subsequently accounting for the liability for its obligations under a previously issued guarantee unless the use of that method can be justified under generally accepted accounting principles (GAAP). For example, fair value is used to subsequently measure guarantees accounted for as derivative instruments under Topic 815.

35-4 The discussion in paragraph 460-10-35-2 about how a guarantor typically reduces the liability that it initially recognized does not encompass the recognition and subsequent adjustment of the contingent liability related to the contingent loss for the guarantee. The contingent aspect of the guarantee shall be accounted for in accordance with Subtopic 450-20 unless the guarantee is accounted for as a derivative instrument under Topic 815 or the guarantee is within the scope of Subtopic 326-20 on financial instruments measured at amortized cost. For guarantees within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) of the guarantee shall be accounted for in accordance with that Subtopic in addition to and separately from the fair value of the guarantee liability (the noncontingent aspect) accounted for in accordance with paragraph 460-10-30-5.

The subsequent measurement of the contingent and non-contingent components of guarantees within the scope of Subtopic 326-20 differ because the non-contingent portion is measured under Topic 460 and the contingent portion is measured under Subtopic 326-20.

14.4.20 Non-contingent aspect (stand-ready obligation)

Topic 460 does not prescribe accounting guidance for the non-contingent aspect of guarantees subsequent to initial recognition. Rather, it describes that the liability is typically reduced through net income as the guarantor is released from risk under the guarantee and identifies three methods used in practice for making that reduction:

- only in full upon either expiration or settlement of the guarantee;
- systematic and rational amortization method; or
- through changes in the fair value of the guarantee.

The selection of the appropriate method depends on the nature of the guarantee. Additionally, a liability cannot be subsequently measured at fair value unless fair value is required or permitted by other relevant guidance. [460-10-35-1 – 35-2]

We believe the selection of a method to account for the stand-ready obligation is an accounting policy election that should be followed consistently once it is selected.

14.4.30 Contingent aspect

Measurement of the guarantee liability for the contingent aspect of the guarantee is determined under Subtopic 326-20. At each reporting date, an entity estimates expected credit losses and adjusts the liability for off-balance sheet credit losses through net income. [460-10-35-4, 326-20-30-11]

Example 14.4.10
Accounting for a default put option

Bank (the transferor) originates a loan for its $100 par amount. On January 1, Year 1, Bank transfers the loan in a transaction that is accounted for as a sale. Bank receives cash of $115 from Purchaser (the transferee). In connection with the sale, Bank obligates itself to repurchase the loan for its unpaid principal balance if the loan defaults.

The repurchase arrangement is a financial guarantee in the scope of Subtopic 326-20 (see Question 2.2.90) and Topic 460. Therefore, a liability for the non-contingent (stand-ready) obligation is recognized under Topic 460 and a separate liability is recognized under Subtopic 326-20 for expected credit losses related to the contingent obligation.

The fair value of the repurchase arrangement is $8 on January 1, Year 1.

Bank measures the contingent component (i.e. liability for off-balance sheet credit exposure) based on the likelihood of the loan defaulting and the amount of loss Bank will incur in the event of a default. If a default occurs, a loss arises because the repurchase price equals the loan's unpaid principal balance, while the repurchased loan is required to be initially recognized at fair value. Bank estimates its liability for the off-balance sheet credit exposure related to the repurchase arrangement as $5 on January 1, Year 1.

For simplicity, journal entries pertaining to the subsequent measurement of the non-contingent liability are omitted from this example.

Bank records the following journal entries on January 1, Year 1.

	Debit	Credit
Cash	115	
Financial guarantee liability (recourse arrangement) – non-contingent		8
Loans		100
Gain on sale of loans		7
To recognize sale of loan, including fair value of related financial guarantee (recourse arrangement).		
Credit loss expense	5	
Liability for off-balance sheet credit exposure (repurchase arrangement) – contingent		5
To recognize liability for off-balance sheet credit exposure (contingent aspect) associated with repurchase arrangement.		

At the end of Year 1, when the loan's fair value is $80, the credit quality of the loan has deteriorated. Bank expects a loss of $20 related to its repurchase arrangement, which represents the loss Bank will have if the credit event occurs. Bank records the following journal entry.

	Debit	Credit
Credit loss expense[1]	15	
Liability for off-balance sheet credit exposure (repurchase arrangement) – contingent		15
To record change in expected credit losses associated with repurchase arrangement.		

Note:
1. Difference between the expected loss ($20) and the liability for off-balance sheet credit exposure recorded on January 1, Year 1 ($5).

On January 1, Year 2, the borrower on the loan defaults and Bank repurchases the loan for its par amount of $100. At that date:

— The loan's fair value is $80.
— Bank determines that the loan meets the definition of PCD, because the borrower has defaulted since the loan was originated.
— Bank estimates credit losses for the loan using a non-discounted cash flow method. It expects to collect $87 of the $100 unpaid principal balance.

Bank records the following journal entries.

	Debit	Credit
Loan[1]	80	
Liability for off-balance sheet credit exposure (repurchase arrangement) – contingent	20	
Cash		100
To record repurchase of loan pursuant to		

	Debit	Credit
repurchase arrangement (financial guarantee).		
Loan	20	
Allowance for credit losses[2]		13
Loan – non-credit discount[3]		7
To record gross-up entry for PCD loan determination.		

Notes:

1. A transferor that regains control of a transferred financial asset initially measures the asset at its fair value. [860-20-30-3]
2. Difference between the par amount of the loan ($100) and the cash flows expected to be collected ($87).
3. Difference between the cash flows expected to be collected ($87) and the loan's fair value ($80).

14.5 Effect of adoption of Subtopic 326-20

14.5.10 Overview

As noted in section 14.3.10, the guarantor (issuer) of a guarantee recognizes a guarantee liability (the non-contingent stand-ready aspect) at fair value under Topic 460. Under Subtopic 326-20, it also estimates and accounts for an allowance for credit losses (the contingent aspect) separately from the guarantee liability.

Legacy US GAAP is not specific about whether the carrying amount of the liability includes either the non-contingent or contingent component (whichever is greater) or whether a separate, independent liability is recognized for each component. As a result, the liability (or liabilities) related to a guarantee at adoption may reflect only the contingent component, only the non-contingent component, or both the contingent and non-contingent components.

The following table summarizes the adjustment(s) that are required on adoption of Topic 326, depending on the amounts recognized under legacy US GAAP.

Legacy US GAAP scenario	Adjustment(s) required on adoption of Topic 326
Legacy policy is to recognize either the non-contingent or contingent component – whichever is greater	
Contingent component recognized – i.e. contingent component is greater than non-contingent component.	— Contingent component is remeasured based on the guidance in Subtopic 326-20. — Non-contingent component is established.
Non-contingent component recognized – i.e. non-contingent component is greater than contingent component.	— Contingent component is recognized and measured based on the guidance in Subtopic 326-20.

Legacy US GAAP scenario	Adjustment(s) required on adoption of Topic 326
	— No adjustment is required for the non-contingent component.
Legacy policy was to recognize a separate, independent liability for each component	
Both contingent and non-contingent components recognized.	— Contingent component is remeasured based on the guidance in Subtopic 326-20. — No adjustment is required for the non-contingent component.

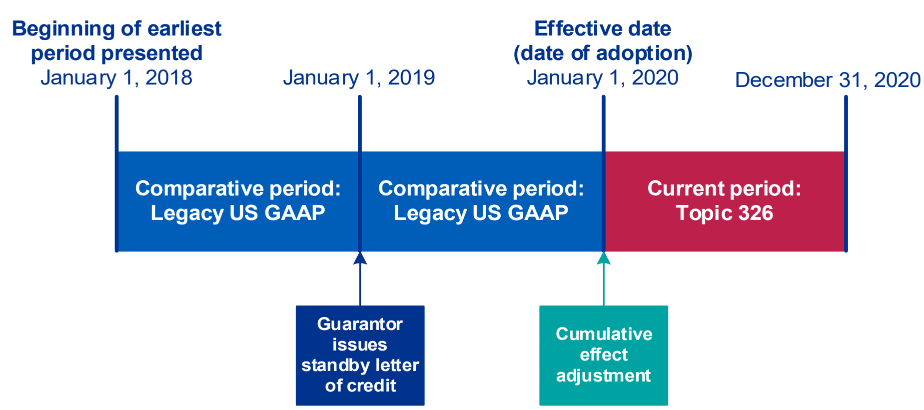
Example 14.5.10
Journal entries on adoption for a guarantee

Guarantor is a calendar year-end PBE that is an SEC filer.

An exporter sells goods to a foreign buyer and the foreign buyer promises to pay within two years. Guarantor issues a stand-alone arm's-length $1,000,000 financial standby letter of credit to guarantee that the exporter will receive payment on time and in the correct amount if the foreign buyer does not make payments to the exporter. Guarantor receives an up-front cash premium of $30,000.

In accordance with Topic 460, Guarantor determines that the fair value of the guarantee liability recognized at inception is the premium received. This is because the guarantee was issued in a stand-alone arm's-length transaction.

Guarantor's policy is to amortize the non-contingent component using the straight-line method over the life of the guarantee. As of December 31, 2019, the unamortized balance of the non-contingent component is $15,000.



Scenario 1: Guarantor's policy under legacy US GAAP is to recognize a liability for the greater of the non-contingent or contingent component; amount reflected as of Dec. 31, 2019 is the non-contingent component

The following table reflects the assumptions used in this scenario.

	Balance recognized under legacy US GAAP	Balance on adoption of Subtopic 326-20
Contingent component	$ 0	$30,000
Non-contingent component	15,000	15,000
Total	**$15,000**	**$45,000**

As of January 1, 2020 (adoption of Topic 326), Guarantor records the following journal entry to recognize expected credit losses.

	Debit	Credit
Retained earnings	30,000	
Liability for off-balance sheet credit losses – contingent[1]		30,000
To record cumulative effect adjustment of estimate of expected credit losses on guarantee.		

Note:

1. Represents off-balance sheet credit losses under Topic 326 (contingent component), because no amount was recorded for the contingent component before adoption.

Scenario 2: Guarantor's policy under legacy US GAAP is to recognize a liability for the greater of the non-contingent or contingent component; amount reflected as of Dec. 31, 2019 was the contingent component

The following table reflects the assumptions used in this scenario.

	Balance recognized under legacy US GAAP	Balance on adoption of Subtopic 326-20
Contingent component	$25,000	$30,000
Non-contingent component	0[1]	15,000
Total	**$25,000**	**$45,000**

Note:

1. The reported balance under legacy US GAAP is $0 because the contingent component ($25,000) is greater than the non-contingent component ($15,000) and Guarantor's policy is to recognize only the greater of the two components.

As of January 1, 2020 (adoption of Topic 326), Guarantor records the following journal entry to recognize expected credit losses and to establish the non-contingent component balance.

	Debit	Credit
Retained earnings	20,000	
Guarantee liability – non-contingent[1]		15,000
Liability for off-balance sheet credit losses – contingent[2]		5,000
To record cumulative effect adjustment of estimate of expected credit losses on guarantee and reestablish non-contingent component.		

Notes:

1. Represents the amount needed to establish a liability for the non-contingent component.
2. Represents off-balance sheet credit losses under Topic 326 (contingent component) of $30,000 less amount of contingent component recognized before adoption of $25,000.

Scenario 3: Guarantor's policy under legacy US GAAP is to recognize separate liabilities for the non-contingent and contingent components

The following table reflects the assumptions used in this scenario.

	Balance recognized under legacy US GAAP	Balance on adoption of Subtopic 326-20
Contingent component	$25,000	$30,000
Non-contingent component	15,000	15,000
Total	**$40,000**	**$45,000**

As of January 1, 2020 (adoption of Topic 326), Guarantor records the following journal entry to recognize expected credit losses.

	Debit	Credit
Retained earnings	5,000	
Liability for off-balance sheet credit losses – contingent[1]		5,000
To record cumulative effect adjustment of estimate of expected credit losses on guarantee.		

Note:

1. Represents off-balance sheet credit losses under Topic 326 (contingent component) of $30,000 less the amount of the contingent component recognized before adoption of $25,000.

15. Other investments in equity method investees

Detailed contents

15.1 How the standard works

This chapter illustrates the interaction between Topic 326 and Subtopic 323-10 regarding equity method investments.

This interaction occurs when an entity (investor) holding an equity method investment provides additional financial support through financial assets subject to Topic 326 – e.g. a loan to the investee or an investment in debt securities issued by the investee.

15.2 Allocating equity method investment losses to additional investments

15.2.10 Overview

Excerpt from ASC 323-10

> Equity Method Losses

35-19 An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. An equity method investor shall continue to report losses up to the investor's investment carrying amount, including any additional financial support made or committed to by the investor. Additional financial support made or committed to by the investor may take the form of any of the following:

a. Capital contributions to the investee
b. Investments in additional common stock of the investee
c. Investments in preferred stock of the investee
d. Loans to the investee
e. Investments in debt securities (including mandatorily redeemable preferred stock) of the investee
f. Advances to the investee.

See paragraphs 323-10-35-24 and 323-10-35-28 for additional guidance if the investor has other investments in the investee.

35-20 The investor ordinarily shall discontinue applying the equity method if the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.

35-21 An investor shall, however, provide for additional losses if the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.

35-22 If the investee subsequently reports net income, the investor shall resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

>> Investee Losses If the Investor Has Other Investments in the Investee

35-23 The guidance in the following paragraph applies to situations in which both of the following conditions exist:

a. An investor is not required to advance additional funds to an investee.
b. Previous losses have reduced the common stock investment account to zero.

35-24 In the circumstances described in the preceding paragraph, the investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30 to the other investments, as applicable.

35-25 The cost basis of the other investments is the original cost of those investments adjusted for the effects of write-downs, unrealized holding gains and losses on debt securities classified as trading in accordance with Subtopic 320-10 or equity securities accounted for in accordance with Subtopic 321-10 and amortization of any discount or premium on debt securities or financing receivables. The adjusted basis is the cost basis adjusted for the allowance for credit losses account recorded in accordance with Topic 326 on measurement of credit losses for an investee financing receivable and debt security and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded shall be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior investments first).

35-26 If the investor has other investments in the investee (including, but not limited to, preferred stock, debt securities, and loans to the investee) that are within the scope of Subtopic 310-10, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

a. Apply this Subtopic to determine the maximum amount of equity method losses.
b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
    1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.
    2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30) illustrates the application of (b)(2).

c. After applying this Subtopic, apply Subtopics 310-10, 320-10, 321-10, 326-20, and 326-30 to the adjusted basis of the other investments in the investee, as applicable.
d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scope of Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

When losses from an equity method investment have reduced the equity method investment's carrying amount to zero, the investor generally stops recognizing further equity method losses unless it either has guaranteed the investee's obligations or is obligated to provide additional financial support to the investee. [323-10-35-19 – 35-20]

When an investor has provided additional financial support to an investee and its equity method investment has been reduced to zero, equity method losses continue to be recognized to the extent of (and as an adjustment to the adjusted basis of) other investments in the order of their seniority. [323-10-35-23 – 35-26]

If additional financial support is in the form of a financial instrument in the scope of Topic 326, it is subject to one of the credit loss models under that Topic. For example, credit losses are recognized under Topic 326 for the following forms of additional financial support:

- loans made to an equity method investee (Subtopic 326-20);
- investments in HTM debt securities issued by the investee (Subtopic 326-20); and
- investments in AFS debt securities issued by the investee (Subtopic 326-30).

Subtopic 323-10 explains how losses are allocated to additional investments in the investee and how these allocations affect subsequent recognition of equity method income.

Question 15.2.10

Is an additional investment's allowance for credit losses estimated before or after allocating equity method losses?

Interpretive response: After allocating equity method losses. Consistent with legacy US GAAP, the allowance for credit losses is estimated after equity method losses are allocated to the investments in the scope of Topic 326. [323-10-35-25 – 35-26]

Subtopic 323-10 indicates the sequence in which US GAAP should be applied when an entity has an equity method investment and an additional investment in an investee. The sequence can be summarized as follows. [323-10-35-25 – 35-26]

- Apply Subtopic 323-10 to determine the maximum amount of equity method losses.

— Determine whether the adjusted basis[1] of the additional investment is positive.

  – If the adjusted basis of the additional investment is positive, it is allocated equity method losses based on the investments' seniority.

  – If the adjusted basis has been reduced to zero, equity method losses generally are no longer allocated. However, the amount of unreported equity method losses is tracked for other purposes, such as for recognizing future equity method income.

— Apply Subtopics 310-10 (loans, receivables, etc.), 320-10 (debt securities), 321-10 (equity securities), 326-20 and 326-30 to the adjusted basis of the other investments in the investee, as applicable.

— Apply relevant US GAAP to other investments that are outside the scope of Subtopics 310-10, 320-10, 321-10, 326-20 or 326-30.

The allowance for credit losses reflects an entity's expected credit losses of the amortized cost basis. Because allocating equity method losses to an investment in the scope of Topic 326 adjusts the investment's amortized cost, recognition of equity method losses may affect the recognition of credit losses. [326-20-30-4 – 30-5]

Note:

1. For this step, the adjusted basis is the original cost as previously adjusted in previous periods for the following:
   — the effects of writedowns, unrealized holding gains and losses on debt securities classified as trading or equity securities accounted for under Subtopic 321-10 (equity securities);
   — amortization of any discount or premium on debt securities or financing receivables;
   — the allowance for credit losses (if applicable); and
   — the cumulative equity method losses applied to the other investments.

Example 15.2.10 illustrates how to account for both credit losses and equity method losses attributable to other investments that are financial instruments subject to Subtopic 326-20. Also see Example 4 (investee losses when investor has other investments in the investee) and Example 5 (percentage used to determine equity method losses) in Section 323-10-55. [323-10-55-30 – 55-57]

Example 15.2.10

Interaction of Subtopic 326-20 and Subtopic 323-10

Investor owns 40% of the outstanding common stock of Investee. Because Investor has significant influence over Investee, it accounts for its common stock investment using the equity method.

Investor's carrying amount in its common stock investment in Investee has been reduced to zero by the beginning of Year 1 because of its recognition of its share of previous losses incurred by Investee.

At the beginning of Year 1, Investor extends $100 in loans to Investee, which represents 20% of all loans extended to Investee. Investor is not obligated to provide additional funding to Investee.

Investor's accounting policy is to recognize equity method losses based on the ownership level of Investee's security, loan or advance held by Investor to which equity method losses are being applied.

Investee's operating income (loss) for Years 1 through 3 is as follows.

Year	Investee operating income (loss)
1	$(300)
2	(150)
3	450

Expected credit losses related to Investor's loans to Investee (estimated based on the $100 principal balance) at the end of Years 1 through 3 are as follows.

Year	Calculated based on $100 principal balance	
	Amount expected to be collected	Expected credit losses[1]
1	$30	$70
2	20	80
3	60	40

Note:

1. These amounts do not necessarily represent the allowance for credit losses because the allowance reflects an entity's expected credit losses of the amortized cost basis, which takes into consideration allocation of equity method losses.

A roll-forward of Investor's loans to Investee during Years 1 through 3 is as follows.

Year	Beginning adjusted loan basis[1]	Investor's share of operating income (loss) applicable to the loan[2]	Credit loss expense[3]	Ending adjusted loan basis[4]
1	$100	$(60)	$10	$30
2	30	(30)	0	0
3	0	90	30	60

Notes:

1. The adjusted basis is its original cost ($100) adjusted for the allowance for credit losses account and cumulative equity method losses allocated to the loan. [323-10-35-25]
2. Investor's share of operating income (loss) is calculated as follows. [323-10-35-26(b)]
   - In periods of loss, 20% (Investor's share of Investee loans outstanding) of Investee's losses once Investor's common stock investment has been reduced to $0. The loss is limited to the beginning adjusted loan basis, with unreported equity method losses tracked.

- In periods of income, 20% of income, but limited to the amount required to restore the balance (i.e. to reverse cumulative equity method losses), after consideration of unreported equity method losses.

3. The amount needed to adjust the allowance for credit losses to expected credit losses under Subtopic 326-20 (from table above) after considering cumulative equity method losses allocated to the loan.
4. Beginning adjusted loan basis + Investor's share of operating income (loss) applicable to the loan – credit loss expense.

Journal entries for Year 1

At the end of the Year 1, Investor records the following journal entries.

	Debit	*Credit*
Equity method loss[1]	60	
Loan to Investee		60
To record equity method loss for Investee.		
Credit loss expense[2]	10	
Allowance for credit losses		10
To record expected credit losses on loan to Investee.		

Notes:

1. $300 (Investee's operating loss in Year 1) × 20% (Investor's share of loans extended to Investee).
2. Expected credit losses at the end of Year 1 of $70 less $60 equity method losses allocated to the loan.

At the end of Year 1, Investor's financial statements reflect the following amounts.

Account	Amount
Balance sheet – assets	
Investment in Investee common stock	$0
Loan to Investee	$40
Allowance for credit losses	$(10)
Income statement	
Credit loss expense	$(10)
Income (loss) from equity method investment in Investee	$(60)

Journal entries for Year 2

At the end of Year 2, Investor records the following journal entry.

	Debit	Credit
Equity method loss[1]	30	
Loan to Investee		30
To record equity method loss for Investee.		

Note:

1. $150 (Investee's operating loss in Year 2) × 20% (Investor's share of loans extended to Investee) = maximum equity method loss of $30. This is compared to the adjusted basis of Investor's loan of $30. The equity method loss allocated is limited to the $30 adjusted basis. [323-10-35-24 – 35-26]

Because the adjusted basis of the loan was reduced to zero as a result of applying equity method losses to the loan (see Note 1 of the journal entries for Year 2), no entry is needed to reflect the additional expected credit losses of $10 in Year 2 determined under Subtopic 326-20.

At the end of Year 2, Investor's financial statements reflect the following amounts.

Account	Amount
Balance sheet – assets	
Investment in Investee common stock	$0
Loan to Investee	$10
Allowance for credit losses	$(10)
Income statement	
Credit loss expense	$0
Income (loss) from equity method investment in Investee	$(30)

Journal entries for Year 3

At the end of Year 3, Investor records the following journal entries.

	Debit	Credit
Loan to Investee	90	
Equity method income[1]		90
To record equity method income for Investee.		
Credit loss expense[2]	30	
Allowance for credit losses		30
To record expected credit losses on loan to Investee.		

Notes:

1. $450 (Investee's operating income in Year 3) × 20% (Investor's share of loans extended to Investee) = maximum equity method income of $90. The limit to the amount of Investee's income that Investor is permitted to recognize is $90, which is the amount required to reverse cumulative equity method losses recognized [Year 1 ($60) + Year 2 ($30) = ($90)]. This is allocated to Investor's investments in Investee in reverse order of the application of equity method losses. [323-10-35-22, 35-25]

2.	Expected credit losses as of the end of Year 3 of $40 less cumulative equity method losses allocated to the loan ($60 + $30 – $90) and previously recognized credit losses of ($10) = $30.

At the end of Year 3, Investor's financial statements reflect the following amounts.

Account	Amount
Balance sheet – assets	
Investment in Investee common stock	$0
Loan to Investee	$100
Allowance for credit losses	$(40)
Income statement	
Credit loss expense	$(30)
Income (loss) from equity method investment in Investee	$90

16. Net investment in leases

Detailed contents

Item significantly updated in this edition: #

16.1 How the standard works

When a lessor classifies a lease as a sales-type or direct financing lease under Topic 842 (leases), it recognizes a net investment in the lease.

The net investment in the lease is subject to the impairment guidance in Subtopic 326-20. A lessor estimates a loss allowance on its entire net investment in the lease, including the unguaranteed residual value.

Unlike net investments in leases that are classified as sales-type or direct financing leases, receivables arising from operating leases are outside the scope of Subtopic 326-20.

For an in-depth analysis of the accounting for leases under Topic 842, see KPMG Handbook, Leases.

16.2 Measuring impairment

16.2.10 Overview

Excerpt from ASC 326-20

>> Net investment in Leases

55-8 This Subtopic requires that an entity recognize an allowance for credit losses on net investment in leases recognized by a lessor in accordance with Topic 842 on leases. An entity should include the unguaranteed residual asset with the lease receivable, net of any deferred selling profit, if applicable (that is, the net investment in the lease). When measuring expected credit losses on net investment in leases, the lease term should be used as the contractual term. When measuring expected credit losses on net investment in leases using a discounted cash flow method, the discount rate used in measuring the lease receivable under Topic 842 should be used in place of the **effective interest rate**.

Excerpt from ASC 842-30

20 Glossary

Lease Receivable – A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

Net Investment in the Lease – For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset.

For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

Unguaranteed Residual Asset – The amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

>> Loss Allowance on the Net Investment in the Lease

35-3 A **lessor** shall determine the loss allowance related to the **net investment in the lease** and shall record any loss allowance in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to receive (or derive) from the **lease receivable** and the **unguaranteed residual asset** during and following the end of the remaining **lease term**.

For sales-type and direct financing leases, a lessor generally recognizes a net investment in the lease on its balance sheet and derecognizes the leased asset.

The net investment in the lease includes the following. [842-30-25-1, 25-3 – 25-8, 30-1 – 30-2, 40-1]

— For sales-type leases, the lease receivable and an unguaranteed residual asset.
— For direct financing leases, the lease receivable and an unguaranteed residual asset, reduced by any deferred selling profit on the lease.

A lessor assesses its entire net investment in the lease for impairment – i.e. including the unguaranteed residual value – and recognizes any impairment loss under Subtopic 326-20. A lessor does not separately evaluate the unguaranteed residual asset for impairment unless it sells the lease receivable and retains the unguaranteed residual asset. For a discussion of the accounting for a retained unguaranteed residual asset after the sale of a lease receivable, see section 16.3. [ASU 2016-02.BC311]

When estimating the loss allowance for a net investment in the lease, the lessor considers the collateral relating to the net investment in the lease. The collateral represents the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term – e.g. from sale or re-lease of the asset for the remainder of the lease term, including an expected lump-sum payment related to the residual value of the asset at the end of the lease term (see Question 16.2.20). [842-30-35-3]

If an entity uses a discounted cash flow method to estimate impairment, it uses the same discount rate that it uses to measure the lease receivable. [326-20-55-8]

Question 16.2.10

Why is the unguaranteed residual asset included with the lease receivable when measuring impairment of the net investment in the lease?

Interpretive response: In its deliberations of the new leases standard, the FASB decided that even though the unguaranteed residual asset does not meet the definition of a financial asset, it would be overly complex and provide little benefit to assess the components of the net investment – i.e. lease receivable and unguaranteed residual asset – under different impairment models. [ASU 2016-02.BC310]

The FASB concluded that it would be appropriate to assess the entire net investment under the financial instruments impairment model because most of the net investment comprises the lease receivable. The FASB also considered that lessors generally look to realize any expected residual value from the asset through a sale of the asset to the lessee or another party. Therefore, treating the entire net investment as a future cash flow stream when evaluating impairment is consistent with how lessors generally view their net investment in a lease. [ASU 2016-02.BC311]

Question 16.2.20#

Does the lessor consider the cash flows it expects from the leased asset after the end of the lease term when measuring its loss allowance?

Interpretive response: Yes. A lessor considers the collateral relating to the net investment in the lease when estimating the loss allowance, if any, for its net investment in the lease.

Paragraph 842-30-35-3 (as amended by ASU 2018-10) states that collateral "represents the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term." This reflects the FASB's intent that the cash flows that could be obtained from sale or re-lease of the leased asset following the end of the lease term are to be considered as part of the collateral relating to the net investment in the lease when assessing the net investment for impairment.

Because a lessor assesses the entire net investment in the lease (which includes any unguaranteed residual value of the leased asset) for impairment, not considering expected cash flows to be derived following the lease term would result in impairment recognition even when no loss is expected. This situation would occur because the impairment assessment would potentially ignore cash flows from sale or re-lease of the leased asset.

Therefore, a lessor's determination of its loss allowance for a net investment in a lease includes an assumed lump-sum payment amount based on the expected cash flows associated with the residual asset following the lease term. If the asset is expected to be re-leased, the assumed lump-sum payment amount consists of the net present value of:

— gross expected cash flows from expected re-lease; and
— expected payment for the residual value of the asset at the end of the re-lease term.

The estimate of these assumed cash inflows considers the possible amounts that the lessor might realize from the residual asset based on its expected market value at the end of the lease (e.g. from sale of the asset at auction). As a result, impairment of the net investment in the lease under Subtopic 326-20 is estimated considering both credit risk and non-credit risk relating to the unguaranteed residual asset.

Example 16.2.10

Estimating the loss allowance for a pool of leases

The following example is not intended to prescribe any specific method for estimating expected losses for a lease portfolio. Rather, it is intended to demonstrate one potential method that an entity could apply.

Lessor (LR) is in the business of leasing bulldozer model XYZ for use in construction. LR has aggregated its leases into five pools (see chapter 5) for collective measurement of impairment based on similar risk characteristics.

LR analyzes its historical loss experience for each pool to develop loss rates. This example focuses on one of those pools (Pool A). All of the leases in Pool A have the same remaining duration (five years), original contractual term, lessee credit risk rating and leased asset type (bulldozer model XYZ).

LR considers the current and forecasted direction of the economic environment, and develops historical loss rates using historical periods that are closest to its expectations.

In calculating the historical loss rates, LR determines separate loss rates for each of the following risks.

— **Credit risk.** This loss rate represents both the probability that lessees will default on making their lease payments and the magnitude of the losses experienced when these defaults occur.
  - The magnitude of the losses experienced when these defaults occur is affected by both the amount of the net investment in the lease and the fair value of the leased asset at the date of default. In many circumstances, the magnitude may be higher when the default occurs earlier in the lease term. This is because lease payments are typically made on a straight-line basis while the asset's decline in fair value may be more significant in the earlier periods. This creates the potential for greater credit loss exposure in the earlier periods.
  - For this risk, LR has chosen to determine the loss rate as a percentage of the original pool balance. The original pool balance comprises the sum of the net investment in the lease balances for all leases in Pool A – i.e. the lease receivable and unguaranteed residual asset balances – as of the origination date.

— **Non-credit risk.** This loss rate represents the likelihood that a loss will occur on a leased asset despite the lessee making all contractual lease payments.
  - As explained in Question 16.2.10, this risk is considered because the net investment in the lease includes a nonfinancial (unguaranteed residual asset) component.
  - For this risk, LR has chosen to determine the loss rate as a percentage of the unguaranteed residual asset balance (undiscounted).

LR chooses to determine these loss rates separately because it believes that they will differ significantly. This is because (1) the loss rate related to credit risk is significantly affected by changes in the likelihood of lessees making their lease payments, and (2) the magnitude of the losses (when they occur) has differed between those occurring during the lease term and those occurring at the end of the lease term.

For Pool A, the relevant historical experience based on the remaining duration of the leases demonstrated the following.

— **Credit risk.** The lessees defaulted on 5% of leases (i.e. probability of default), and losses experienced on those leases averaged 22% of the original net investment in the lease balance (i.e. loss given default). The average amount includes both leases that experienced a loss upon default and leases that defaulted but did not result in a loss because the fair value of the leased asset exceeded the net investment in the lease. This results in a credit risk loss rate of 1.10% of the historical pools' original balance (5% × 22%).

- **Non-credit risk.** For the remaining 95% of leases on which the lessees did not default, LR experienced losses averaging 11% of the original unguaranteed residual asset balance on those leases. This results in a non-credit risk loss rate of 10.45% of the historical pools' unguaranteed residual asset balances (95% × 11%).

In determining whether the historical loss rates should be adjusted, LR concludes the following.

- No adjustments are necessary for differences in current asset-specific risk characteristics – e.g. underwriting standards, portfolio mix or asset term within the pool.
- The following primary factors could affect expected collectibility.
  - **GDP growth rate.** The GDP growth rate is expected to affect the likelihood of a lessee defaulting. LR concludes that GDP growth is expected to be worse than experienced in the historical period, and as a result there will be an increase in the probability that a lessee will default.

    LR determines that an increase of 1% should be made to the pool's probability of default to reflect current conditions and reasonable and supportable forecasts.

    To prevent double-counting, a corresponding decrease is made to the non-credit risk historical rate. This is because a lease is assumed to terminate at the date of default. As a result, there cannot be both a loss on default and a loss at the end of the lease term.
  - **Bulldozer model XYZ fair values.** The fair values of bulldozer model XYZ will affect the magnitude of losses experienced. LR concludes that bulldozer model XYZ fair values are expected to depreciate more quickly than expected at lease inception, and also more quickly than what was experienced in the historical period. This will result in an increase in the estimated magnitude of losses – i.e. the loss given default for credit risk and loss if no default occurs for non-credit risk – occurring for both credit and non-credit risk.

    LR determines that an adjustment should be made to increase the magnitude of expected losses by 2% for credit risk and 0.5% for non-credit risk.
- LR is able to obtain a reasonable and supportable forecast of economic conditions for the remaining duration of the Pool A assets. As a result, no reversion adjustment is necessary.

LR calculates its estimate of the loss allowance as follows.

Risk	Historical rates (before adjust.)	Adjustments[1] GDP growth rate	Adjustments[1] Bulldozer model XYZ values	Expected rates[4]	Original balance[5]	Expected credit losses
Credit risk						
Probability of default	5%	1%		6%		
Loss given default[6]	22%		2%	24%		
Total loss rate[2,6]	1.10%			1.44%	$12,000,000	$172,800
Non-credit risk						
Original unguaranteed residual balance	$840,000					
Probability no default will occur	95%	-1%		94%		
Loss if no default occurs[7]	11%		0.5%	11.5%		
Total loss rate[3,7]	10.45%			10.81%	$840,000	$90,804
					Pool A – Total expected losses	**$263,604**

Notes:

1. Adjustments for current conditions, and reasonable and supportable forecasts.
2. Probability of default × loss given default.
3. Probability no default will occur × loss if no default occurs.
4. Unadjusted historical loss rates + adjustments for current conditions and reasonable and supportable forecasts.
5. The original balance comprises:
   – for credit risk, the original net investment in the lease balance, including lease receivables and unguaranteed residual asset amounts; and
   – for non-credit risk, the original balance of unguaranteed residual assets (undiscounted).
6. These rates are expressed as a percentage of the original net investment in the lease balance.
7. These rates are expressed as a percentage of the original balance of unguaranteed residual assets.

Question 16.2.30#

Does a lessor consider expected gains from the subsequent disposal of leased assets when measuring its loss allowance?

Background: A lessor's estimate of the loss allowance for a net investment in the lease considers the cash flows that the lessor expects to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term. When a leased asset is returned to the lessor on early termination of the lease or at the end of the lease term, the lessor may either sell or re-lease the asset. Sometimes, a lessor realizes a gain when it disposes of a leased asset – e.g. it sells the asset at the end of the lease term for an amount greater than the balance of the unguaranteed residual asset.

Interpretive response: Yes. If a lessor's consideration of past events, current conditions and reasonable and supportable forecasts result in the lessor expecting to realize gains from the subsequent disposal of leased assets, those gains from disposal are to be reflected in the lessor's loss allowance except as noted below. [TRG 06-18.7, TRG 06-18.13]

When determining the loss allowance, paragraph 842-30-35-3 requires the lessor to consider the cash flows it expects from the collateral, but does not indicate whether it applies to both gains and losses on disposal. The FASB staff believes expected gains and losses should be considered regardless of whether the loss allowance is measured for an individual lease or a pool of leases. [842-30-35-3, TRG 06-18.7, TRG 06-18.13]

When measuring it's loss allowance, we believe a lessor includes expected gains and losses on disposal and expected credit losses on its lease receivable. However, expected gains may not be included in the loss allowance to the extent such gains would result in the allowance being negative (a debit balance). An entity evaluates whether expected gains would result in a negative allowance at the level at which it aggregates its leases for measurement of the loss allowance based on similar risk characteristics. See chapter 5 for guidance on collective assessments.

Example 16.2.20

Estimating the loss allowance when a gain is expected upon disposition of leased assets

This example is a modification of Example 16.2.10.

In that example, Lessor (LR) develops separate loss rates for each credit and non-credit risk for one pool (Pool A) of its leases. LR develops loss rates based on (1) its historical experience as adjusted for current conditions, and (2) reasonable and supportable forecasts related to the GDP growth rate and to bulldozer model XYZ fair values. LR is able to obtain a reasonable and supportable forecast of economic conditions for the remaining duration of Pool A assets.

Unlike that example, it is now assumed that LR's historical experience for non-credit risk is that LR experienced gains averaging 5% (rather than losses averaging 11%) of the original unguaranteed residual balance on those leases. This results in a non-credit risk rate of -4.75% (i.e. a gain related to non-credit risk) of the historical pools' unguaranteed residual asset balances (95% × -5%).

LR calculates its estimate of the loss allowance as follows.

Risk	Historical rates (before adjust.)	Adjustments[1]		Expected rates[4]	Original balance[5]	Expected credit losses
		GDP growth rate	Bulldozer model XYZ values			
Credit risk						
Probability of default	5%	1%		6%		
Loss given default[6]	22%		2%	24%		
Total loss rate[2,6]	1.10%			1.44%	$12,000,000	$172,800
Non-credit risk						
Original unguaranteed residual balance	$840,000					
Probability no default will occur	95%	-1%		94%		
Loss (gain) if no default occurs[7]	-5%		0.5%	-4.5%		
Total loss (gain) rate[3,7]	-4.75%			-4.23%	$840,000	$(35,532)
					Pool A – Total expected losses	**$137,268**

Notes:

1. Adjustments for current conditions, and reasonable and supportable forecasts.
2. Probability of default × loss given default.
3. Probability that no default will occur × loss (gain) if no default occurs.
4. Unadjusted historical rates + adjustments for current conditions and reasonable and supportable forecasts.
5. The original balance comprises:
   - for credit risk, the original net investment in the lease balance, including lease receivables and unguaranteed residual asset amounts; and
   - for non-credit risk, the original balance of unguaranteed residual assets (undiscounted).
6. These rates are expressed as a percentage of the original net investment in the lease balance.
7. These rates are expressed as a percentage of the original balance of unguaranteed residual assets.

Question 16.2.35

What is the ‘contractual term’ for a net investment in a lease when estimating the loss allowance?

Excerpt from ASC 326-20

30-6A For net investment in leases recognized by a lessor in accordance with Topic 842, instead of applying the guidance in paragraph 326-20-30-6, an entity shall use the lease term as the contractual term.

Interpretive response: The contractual term used when estimating the loss allowance for a net investment in a lease should be the ‘lease term’ of the lease. The lease term includes the non-cancellable period of the lease together with periods covered by all of the following: [326-20-30-6A]

— an option held by the lessor to extend (or not terminate) the lease;

— an option held by the lessee to extend the lease if it is reasonably certain the lessee will exercise the option to extend; and

— an option held by the lessee to terminate the lease if it is reasonably certain the lessee will not exercise the option to terminate.

This definition is consistent with the definition of lease term in Topic 842. As a result, we believe an entity applies all of the related guidance in Topic 842 when applying this definition (see section 5.3 of KPMG Handbook, Leases). [842-10-30-1]

Question 16.2.40

Does a lessor consider a third-party residual value guarantee when measuring a loss allowance?

Interpretive response: Yes. A lessor includes expected cash flows from a third-party residual value guarantee when measuring its loss allowance. A lessor’s estimate of the loss allowance for a net investment in a lease considers the cash flows that the lessor expects to receive (or derive) from the lease receivable and the unguaranteed residual asset. [326-20-55-8]

The cash flows from the lease receivable include the sum of the present value of: [842-30 Glossary]

— future lease payments from the lessee; and
— any residual value guarantee provided by the lessee or a third party.

The FASB decided the net investment should be treated as a single unit of account for purposes of measuring the loss allowance. Further, the net investment specifically includes the guaranteed residual value of the leased asset. Therefore, even if the third-party guarantee was considered a freestanding contract, we believe the guidance that precludes an entity from considering freestanding contracts for the purposes of estimating expected credit losses does not apply to third-party guarantees of the residual value of the leased asset in sales-type and direct financing leases. [ASU 2018-10.BC33, 326-20-30-12]

Question 16.2.50

When does the collateral-dependent practical expedient apply for measuring a loss allowance for a net investment in a lease?

Background: When an entity determines that foreclosure is probable, it is required to use the collateral's fair value to estimate the financial asset's expected credit losses for the current reporting period. [326-20-35-4]

When foreclosure is not probable, an entity can elect the practical expedient if: [326-20-35-5]

- repayment is expected to be provided substantially through the operation or sale of the collateral; and
- the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date.

Interpretive response: We believe the applicability of the practical expedient depends on the financial condition of the lessee and how the lessor expects to realize its net investment in the lease.

- If the lessee is expected to perform and make all rental payments, and the leased asset is expected to be returned to the lessor at the end of the lease term in accordance with the lease contract, we do not believe the collateral-dependent practical expedient may be applied.

- If it is probable that the lessee will default on its lease rentals, and therefore the lessor will take (or retake) possession of the leased asset before the end of the lease term, we believe a lessor must apply the collateral-dependent practical expedient.

- If the lessee is experiencing financial difficulty *and* the net investment in the lease is expected to be realized substantially through the sale of the leased asset or through repossession and re-lease to a third-party lessee, we believe the collateral-dependent practical expedient may be applied. Importantly, just because the lessee is experiencing financial difficulty does not mean the lessee is expected to default on the lease; and if it is not expected to default, the lessor does not expect to realize the net investment in the lease principally through the sale or re-lease of the leased asset – i.e. it still expects to realize the net investment substantially through the lease payments.

16.3 Sale of the lease receivable

16.3.10 Overview

Excerpt from ASC 842-30

>> Sale of the Lease Receivable

35-4 If a **lessor** sells substantially all of the **lease receivable** associated with a **sales-type lease** or a **direct financing lease** and retains an interest in the **unguaranteed residual asset**, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining **lease term**. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

The entire net investment in a lease (including the unguaranteed residual asset) is generally in the scope of Subtopic 326-20. However, if a lessor sells the lease receivable and retains an interest in the unguaranteed residual asset, Subtopic 326-20 no longer applies to the unguaranteed residual asset.

On the sale of all, or substantially all, of the lease receivable, the lessor reports any remaining unguaranteed residual asset at its carrying amount at the sale date. It also applies Topic 360 (property, plant and equipment) – rather than Subtopic 326-20 – to determine whether the unguaranteed residual asset is impaired. [842-30-35-4]

16.4 Lease termination

16.4.10 Overview

Excerpt from ASC 842-30

>> Lease Termination

40-2 If a **sales-type lease** or a **direct financing lease** is terminated before the end of the **lease term**, a **lessor** shall do all of the following:

a. Measure the **net investment in the lease** for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost and record any credit loss identified
b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the **lease receivable** (less any amounts still expected to be received by the lessor) and the residual asset
c. Account for the **underlying asset** that was the subject of the **lease** in accordance with other Topics.

If a sales-type or direct financing lease is terminated before the end of the lease term, the lessor first applies the guidance in Subtopic 326-20 to determine if any additional impairment (including related credit losses) should be recognized. [842-30-40-2(a)]

After recognizing its estimate of expected losses, the lessor reclassifies the net investment in the lease (which is comprised of the carrying amounts of the lease receivable – less amounts the lessor still expects to receive – and the residual asset) to the appropriate category of asset and accounts for it under other US GAAP. [842-30-40-2(b) – 40-2(c)]

By first applying Subtopic 326-20, the lessor ensures that the carrying amount is accurate before it is reclassified to other categories.

17. Specific considerations for insurance entities

Detailed contents

17.1 How the standard works

This chapter focuses on aspects of the expected credit loss model for financial assets in the scope of Subtopic 326-20 that are specific to insurance entities.

This chapter first addresses whether certain financial assets typically held by insurance entities are in the scope of Subtopic 326-20. It then addresses the following issues in the context of insurance related receivables and reinsurance recoverables:

- which risks are included in the estimate of expected credit losses;
- how to consider similar risk characteristics to collectively estimate expected credit losses;
- how to determine whether a credit enhancement is considered when estimating expected credit losses;
- whether a collateral maintenance provision can support an expected credit loss of zero; and
- how to consider certain insurance specific items, including the unearned premium reserve and government indemnification programs.

17.2 Scope

17.2.10 Overview

Excerpt from ASC 326-20

> Instruments

15-2 The guidance in this Subtopic applies to the following items:

a. Financial assets measured at amortized cost basis, including the following:
   1. **Financing receivables**
   2. Held-to-maturity **debt securities**
   3. 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
   4. Subparagraph superseded by Accounting Standards Update No. 2019-04.
   5. Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860

   ….

d. **Reinsurance recoverables** that result from insurance transactions within the scope of Topic 944 on insurance.

20 Glossary

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.

As more fully explained in chapter 2, financial assets measured at amortized cost are subject to the expected credit loss guidance in Subtopic 326-20.

Insurance entities commonly hold the following types of financial assets in the scope of Subtopic 326-20:

— financing receivables; [326-20-15-2(a)(1)]]
— HTM debt securities; and [326-20-15-2(a)(2)]
— reinsurance recoverables that result from insurance transactions in the scope of Topic 944 (insurance). [326-20-15-2(d), 944-40-25-34]

An asset is a financing receivable if the balance represents a contractual right to receive money on demand or on fixed or determinable dates – e.g. a mortgage loan and note receivable are financing receivables. [326-20 Glossary, 310-10-55-14]

The following table illustrates certain insurance-specific financial assets commonly held by an insurance entity and whether they are in the scope of Subtopic 326-20.

Financial asset	Within the scope of Subtopic 326-20?
Premiums receivable	Yes. Premiums receivable are trade accounts receivable. Trade accounts receivable are specifically listed as a type of financing receivable in Subtopic 310-10.

Financial asset	Within the scope of Subtopic 326-20?
	Because premiums receivable generally meet the definition of a financing receivable, they are financial assets measured at amortized cost and are in the scope of Subtopic 326-20. [310-10-55-14(b)]
Policy loan receivables	No. Policy loan receivables are explicitly excluded from the scope of Subtopic 326-20. [326-20-15-3(d)]
Funds withheld assets	Yes. Funds withheld assets may arise in certain reinsurance contracts. Funds withheld assets are financial assets measured at amortized cost and therefore are in the scope of Subtopic 326-20. [310-10-55-14(b)]
Retrospective premiums receivable	Yes. Retrospective premiums receivable arise when an entity receives an initial premium from the contract holder and, at the end of the policy year (or longer period), the initial premium is adjusted to reflect the actual loss experience of the contract. Depending on the terms of the insurance contract, the estimate of this receivable may include the estimate of incurred-but-not-reported losses in addition to actual paid losses. Retrospective premiums receivable are financial assets measured at amortized cost and therefore are in the scope of Subtopic 326-20. [310-10-55-14(b)]
Reinsurance recoverables for pooling arrangements with entities under common control	No. Because loans and receivables between entities under common control are explicitly excluded from the scope of Subtopic 326-20, reinsurance recoverables between entities under common control are not in the scope of Subtopic 326-20. The consideration of common control should follow the guidance in Topic 810 and EITF Issue No. 02-5 (see Question 2.3.20). [326-20-15-3(f)]

Subtopic 326-20 requires an entity to estimate and recognize lifetime expected credit losses for financial assets in its scope. Certain of these financial assets are specific to insurance entities and require particular consideration.

17.3 Measurement

17.3.10 Exposure to risks other than credit risk

Subtopic 326-20 requires an entity to bifurcate credit risk from other risks that affect the collectibility of a reinsurance recoverable. [450-20-25, 326-20-55-81 – 55-82]

- An allowance for credit losses (i.e. losses due to credit risk of the reinsurer) is recognized and estimated under the expected credit loss model.
- A separate valuation allowance for the remaining risk (e.g. dispute risk, litigation risk) is recognized under Topic 450 (contingencies) if the loss associated with those risks is probable and can be reasonably estimated.

17.3.20 Collective measurement

Excerpt from ASC 326-20

>> Example 17: Identifying Similar Risk Characteristics in Reinsurance Recoverables

55-81 Reinsurance recoverables may comprise a variety of risks that affect collectibility including:

a. Credit risk of the reinsurer/assuming company
b. Contractual coverage disputes between the reinsurer/assuming company and the insurer/ceding company including contract administration issues
c. Other noncontractual, noncoverage issues including reinsurance billing and allocation issues.

55-82 This Subtopic only requires measurement of expected losses related to the credit risk of the reinsurer/assuming company**.**

55-83 In situations in which similar risk characteristics are not present in the reinsurance recoverables, the ceding insurer should measure expected credit losses on an individual basis. Similar risk characteristics may not exist because any one or a combination of the following factors exists, including, but not limited to:

a. Customized reinsurance agreements associated with individual risk geographies
b. Different size and financial conditions of reinsurers that may be either domestic or international
c. Different attachment points among reinsurance agreements
d. Different collateral terms of the reinsurance agreements (such as collateral trusts or letters of credit)
e. The existence of state-sponsored reinsurance programs.

55-84 However, similar risk characteristics may exist for certain reinsurance recoverables because any one or combination of the following exists:

a. Reinsurance agreements that have standardized terms
b. Reinsurance agreements that involve similar insured risks and underwriting practices
c. Reinsurance counterparties that have similar financial characteristics and face similar economic conditions.

55-85 Judgment should be applied by ceding insurers in determining if and when similar risks exist within their reinsurance recoverables.

An entity is required to estimate expected credit losses of financial assets with similar risk characteristics on a collective (pool) basis. This includes insurance contract-related receivables and reinsurance recoverables. Example 17 in Section 326-20-55 (reproduced above) provides factors to consider when making this determination for reinsurance recoverables. For additional discussion of collective assessments, see chapter 5. [326-20-30-2]

Question 17.3.05

What risk characteristics are evaluated when determining if reinsurance recoverables have similar risk characteristics?

Interpretive response: An entity is required to estimate expected credit losses of reinsurance recoverables with similar risk characteristics on a collective (pool) basis. An entity uses its judgment to determine if and when reinsurance recoverables have similar risk characteristics. [326-20-55-83, 55-85]

Example 17 in Section 326-20-55 (reproduced above) provides factors to consider when making this determination for reinsurance recoverables. In addition to those factors, we believe an entity should also consider the:

- reinsurer's credit ratings from reputable rating agencies or its internal credit rating review process;
- geographic concentration of the business written by the reinsurer – e.g. a specific geographic region or global;
- size of the reinsurer, which might be indicative of the reinsurer's financial condition; and
- types and terms of other agreements the reinsurer has written.

Generally, we believe that significant differences in these factors indicate that the reinsurance recoverables do not have similar risk characteristics.

For additional discussion of collective assessment, see chapter 5. [326-20-30-2]

17.3.30 Credit enhancements

As discussed in chapter 9, an entity considers whether credit enhancements (e.g. financial guarantees) affect its estimate of expected credit losses. For a credit enhancement to be considered in an expected credit loss estimate, it cannot be a freestanding contract. Separate, freestanding contracts that serve to mitigate credit losses – such as purchased credit default swaps or certain types of insurance – are not considered for the purposes of estimating expected credit losses.

The determination of whether a credit enhancement is freestanding is based on the definition of a freestanding contract. Section 9.2.10 includes a decision tree that provides one acceptable method for performing the analysis to determine whether the credit enhancement is freestanding. Under that method, the credit enhancement is freestanding if either of the following conditions is met: [326-20 Glossary]

- the contract was entered into separate and apart from – rather than in conjunction with – some other transaction; or
- if the contract was entered into in conjunction with some other transaction, the contract is legally detachable and is separately exercisable.

An entity should evaluate the specific nature of each credit enhancement to determine whether it is freestanding. For further guidance about the evaluation of whether a credit enhancement is freestanding, see chapter 9.

Examples

The following example demonstrates how to evaluate whether credit enhancements are embedded or freestanding in the specified circumstances. Credit enhancements having different forms and/or different terms may result in different conclusions regarding whether they are embedded or freestanding.

Example 17.3.20
Evaluation of whether a letter of credit for a reinsurance contract is a freestanding or embedded credit enhancement

Insurer is a property and casualty insurance company that writes worker's compensation insurance policies. Insurer has entered into quota share reinsurance contracts with Reinsurer where Insurer retains 75% of the risk and cedes 25% of the risk. Insurer also owns a fixed maturity security of Reinsurer.

Insurer recognizes reinsurance recoverables related to the quota share reinsurance contracts that reflect the amount of ceded risk. Insurer manages exposure to Reinsurer's credit risk in part by requiring that Reinsurer obtain and provide a letter of credit.

The following table provides an evaluation of whether two examples of credit enhancements in the form of a letter of credit are considered to be freestanding contracts. However, an insurance entity needs to evaluate its individual facts and circumstances when evaluating whether a credit enhancement is considered freestanding.

	Scenario 1: Embedded	Scenario 2: Freestanding
Description of the credit enhancement	Reinsurer is required under the terms of the reinsurance contract to provide Insurer with a letter of credit equal to a specified percentage (102%) of ceded reserves. The reinsurer receives a letter of credit from Bank to satisfy the requirement.	Reinsurer enters into a letter of credit that is not specifically related to the reinsurance contract and can be used to cover general credit exposure to the reinsurer – i.e. both the reinsurance contract and the fixed maturity security of Reinsurer owned by Insurer.
Is the credit enhancement entered into separate and apart from, or in conjunction with, the coinsurance reinsurance contract?	The letter of credit is specific to the reinsurance contract and Reinsurer names Insurer as the beneficiary. The letter of credit is issued as specifically required by the reinsurance contract. The letter of credit is entered into at the timing required by the contract – e.g. contemporaneously with the execution of the reinsurance contract, contemporaneously	The letter of credit is entered into separate and apart from the reinsurance contract. Insurer enters into two contractually distinct instruments with separate, unrelated counterparties. — The quota share reinsurance contract is entered into with Reinsurer.

	Scenario 1: Embedded	Scenario 2: Freestanding
	with the effective date of the reinsurance contract, or when the related reinsurance recoverable is recognized.	— The letter of credit is entered into with Bank, a separate financial institution. Therefore, the letter of credit is considered a freestanding contract.
Is the credit enhancement legally detachable and separately exercisable?	The letter of credit is specific to the parties to the reinsurance contract and is not separately exercisable. If the reinsurer defaults and the letter of credit is used to satisfy its obligation to Insurer, Insurer has no remaining claim against the reinsurer. If the reinsurance contract is terminated, the letter of credit is also terminated. Therefore, the credit enhancement is not legally detachable and separately exercisable.	N/A When an instrument is entered into separate and apart from other transactions, it is considered freestanding and this evaluation is not required.
Is the credit enhancement freestanding?	No, the letter of credit is not freestanding.	Yes, the letter of credit is freestanding.
Consideration of credit enhancement in estimating credit losses	The credit enhancement should be considered in estimating expected credit losses because it is not a freestanding contract. Bank's financial condition and ability to pay on the letter of credit should be considered in the estimate. See also the discussion of collateral maintenance provisions in section 17.3.40.	The credit enhancement should *not* be considered in estimating expected credit losses because it is considered a freestanding contract.

The following example demonstrates a trust account that is an embedded credit enhancement. However, individual facts and circumstances should be evaluated, as credit enhancements with different forms and/or terms may result in different conclusions. For further guidance about evaluating whether a credit enhancement is freestanding, see chapter 9.

Example 17.3.30

Evaluation of whether a trust account for a reinsurance contract is a freestanding or embedded credit enhancement

Life Insurer writes term life insurance policies. Life Insurer enters into a coinsurance reinsurance contract with Reinsurer whereby Life Insurer retains 60% of the risk and cedes 40% of the risk.

Life Insurer recognizes reinsurance recoverables related to the reinsurance contract that reflect the amount of ceded risk. It manages exposure to Reinsurers' credit risk in part by requiring Reinsurer to fund a trust account.

The coinsurance reinsurance contract requires Reinsurer to hold assets in a designated trust account for Life Insurer's benefit based on a specified percentage of ceded reserves (e.g. 105%). The trust agreement addresses the administration of the trust account and, if the assets held at the end of any reporting period are less than the specified percentage of ceded reserves, requires that Reinsurer transfer additional assets to the trust account to fund the shortfall within five business days.

The trust agreement is:

- specifically referred to in the coinsurance reinsurance contract;
- entered into in conjunction with the related coinsurance reinsurance contract;
- not transferable separately from the coinsurance reinsurance contract; and
- not separately exercisable.

Further, if Reinsurer defaults and the trust assets are used to satisfy its obligation to Life Insurer, then Life Insurer has no remaining claim against Reinsurer.

Therefore, the credit enhancement is not legally detachable and separately exercisable. The trust account is not a freestanding credit enhancement and should be considered in estimating expected credit losses. Reinsurer's financial condition and ability to fund trust assets should be considered in the estimate of expected credit losses.

17.3.40 Collateral maintenance provisions

Excerpt from ASC 326-20

> Financial Assets Secured by Collateral Maintenance Provisions

35-6 For certain **financial assets**, the borrower may be required to continually adjust the amount of the collateral securing the financial assets as a result of **fair value** changes in the collateral. In those situations, an entity may use, as a practical expedient, a method that compares the **amortized cost basis** with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary. If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, an entity shall limit the allowance for credit losses on the financial asset to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

Certain reinsurance contracts require the reinsurer to continually adjust the amount of collateral securing the financial asset as a result of changes in the fair value of the collateral. An example is a clause that requires the fair value of assets in a designated trust to equal or exceed 102% of ceded reserves. If certain conditions are met, including frequency of collateral replenishment, a reinsurance contract may qualify for the collateral maintenance provisions practical expedient. [326-20-35-6]

An insurance entity may determine that the allowance for credit losses for reinsurance recoverables is zero if (1) the reinsurer is required to continually replenish the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the reinsurance recoverable asset and (2) the insurance entity expects the reinsurer to continue to replenish the collateral as necessary. [326-20-35-6]

Question 17.3.10

Does the monthly or quarterly evaluation of a trust account for required collateral replenishment meet the requirement to continually adjust the amount of collateral?

Interpretive response: No. We believe the term 'continually' implies a frequency that would generally align with daily or weekly evaluation of a trust account for required adjustments to the amount of collateral securing the financial asset. For specific considerations related to the frequency of collateral replenishment, see Question 10.3.15.

17.3.50 Other insurer-specific items

Subtopic 326-20 does not prescribe a specific method for estimating expected credit losses. An entity uses its judgment to develop an approach that faithfully reflects expected credit losses for financial assets and can be applied consistently over time. As discussed in section 3.1, there is no credit loss recognition threshold and up-front loss recognition is required under Subtopic 326-20. Therefore, upon initial recognition of a financial asset in the scope of Subtopic 326-20 (e.g. premiums receivable), a credit loss expense is recognized. Methods to estimate expected credit losses are discussed in chapter 4. [326-20-55-7]

Question 17.3.30

What effect does the unearned premium reserve have on the estimate of expected credit losses for premiums receivable?

Excerpt from ASC 944-605

Short-Duration Contracts

25-1 Premiums from short-duration contracts shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the **contract period**, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

Background: Under Subtopic 326-20, an entity recognizes an allowance for expected credit losses on its premium receivable. The allowance for credit losses reduces the premium receivable to the net amount expected to be collected from the contract holder. [326-20-30-1]

Under Topic 944, an entity records a premium receivable at the inception of a short-duration insurance contract for the amount of contractual premiums due. Simultaneously, an unearned premium reserve (liability) is recorded for the portion of those contractual premiums requiring future performance (i.e. not yet earned). The unearned premium reserve is then recognized in earnings over the period of risk in proportion to the amount of insurance protection provided. [944-605-25-1]

Typically, premiums are due from the contract holder before the coverage period of the insurance contract. The premium payments may be due annually, semi-annually, quarterly or monthly. Commonly, an insurance contract includes a grace period for the contract holder to pay outstanding premium – e.g. 30 or 60 days. An entity has no future performance obligation upon cancellation – i.e. no requirement to provide future insurance coverage. Generally, an entity cancels the insurance contract upon non-payment at the end of any contractual grace period. At the cancellation date, the entity reverses any related unearned premium reserve with a correlated entry to reverse the related premium receivable.

Interpretive response: In estimating the allowance for credit losses, we believe an entity should consider the unearned premium reserve related to the insurance contract that is recorded under Topic 944. We believe that credit losses are recognized only on the portion of the premium receivable that exceeds (or is projected to exceed) the related unearned premium reserve that is reversed.

As a result, we believe an entity's estimation of the allowance for credit losses for a premium receivable should consider:

- the projected balance of the unearned premium reserve associated with the underlying premium receivable at the time a future credit loss is expected to occur; and
- any contractual requirements (i.e. grace period) or jurisdictional laws that extend the contract coverage (i.e. performance obligation) beyond the date that the credit loss is expected to occur. This is because that additional coverage period will reduce the amount of the unearned premium reserve to be reversed against the related premium receivable.

We believe that when the unearned premium reserve is projected to be equal to or greater than the underlying premiums receivable at the time a future credit event is expected to occur, the entity has no credit loss exposure for which an allowance for credit losses should be recognized. This is because a contract holder default before recognizing premium revenue would lead to the derecognition of the premiums receivable and related unearned premium reserve, as opposed to the recognition of a credit loss. [326-20-30-1]

Question 17.3.40

What is considered when assessing the collectability of reinsurance recoverables?

Excerpt from ASC 944-10 Glossary

10 Glossary

Reinsurance - A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

Excerpt from ASC 944-20

Assumption Reinsurance

40-4 Reinsurance contracts in which a ceding entity is not relieved of the legal liability to its policyholder shall not result in removal of the related assets and liabilities from the ceding entity's financial statements.

Background: When the entity issuing the insurance contract remains liable to the insured for payment of policy benefits because the legal rights of the insured are not affected by the reinsurance contract, it records a reinsurance recoverable for the estimated amount recoverable from the reinsurer. Generally, the reinsurance recoverable is not due from the reinsurer until the entity pays the claim on the underlying reinsured contract. [944-10 Glossary, 944-20-40-4]

The entity estimates expected credit losses of reinsurance recoverables based on the credit risk of the reinsurer. The allowance for credit losses reduces the carrying amount of the reinsurance recoverable asset to the net amount expected to be collected from the reinsurer. [326-20-30-1, 55-82]

Interpretive response: An entity considers relevant available information about past events, current conditions and reasonable and supportable forecasts to assess the collectability of cash flows from the reinsurer. The entity uses this information to develop an estimate of the allowance for credit losses of reinsurance recoverables. [326-20-30-7, 30-12]

When assessing the collectability of reinsurance recoverables, we believe the entity should consider available information, including:

- the reinsurer's external credit and claims paying ratings from reputable rating agencies;
- information from an established internal credit rating review process;
- the expected claim payment pattern and related exposure period; and
- any credit enhancements that are not freestanding (e.g. embedded letters of credit or trust accounts), funds withheld, recapture or commutation settlement provisions, and other reinsurance agreement provisions that may impact the collectability of reinsurance recoverables.

An entity may purchase an annuity from a third party to fund future payments due on an underlying insurance contract – e.g. structured settlements. The entity may classify that annuity within reinsurance recoverables on the balance sheet. When assessing the collectability of this reinsurance recoverable, we believe the entity should also consider any coverage available from state guaranty funds; this is because such coverage is not a freestanding contract. This coverage is not freestanding because it is available for the annuity contract purchased (i.e. it is not entered into separate and apart from the annuity contract) and is not legally detachable nor separately exercisable.

For further guidance about credit enhancement for insurance entities, see section 17.3.30.

Question 17.3.50

How are government established indemnification programs considered when estimating expected credit losses?

Background: Certain state governments have established mandatory indemnification mechanisms (indemnification programs) that require membership from all entities selling certain types of insurance in their jurisdiction. Typically, the indemnification program has an administrator that collects annual assessments from active members (i.e. insurers) based on the estimated average cost of all program members' incurred indemnifications. Typically, the insurer recognizes a receivable from the program administrator for reimbursements of qualifying claim losses and associated expenses paid in accordance with the legal requirements of the indemnification program. Statutes and regulations often allow active members to recoup their assessments from underlying policyholders either through policy surcharges or premium rate adjustments.

There may be other types of government-established indemnification programs. An entity evaluates receivables from programs similar to the indemnification program to determine the allowance for credit losses to be recognized.

Interpretive response: We believe an entity should evaluate each receivable related to a government-established indemnification program to determine the allowance for credit losses to be recognized. This evaluation is performed whether or not the government-established indemnification program is accounted for as reinsurance.

When estimating the allowance for credit losses, we believe an entity should consider the program's features, including:

— whether the indemnification program and its administrators have the right and capacity to assess its members for the program's expected indemnification obligations;

— whether members are assessed for the full amount of losses and loss expenses expected to be incurred each year, and whether those assessments are fully passed along to the underlying policyholders – i.e. if the assessments are not fully passed along to policyholders, the insurer retains credit exposure;

— program members' credit loss experience since program inception and whether losses are expected based on current conditions and reasonable and supportable forecasts;

— historical and expected future performance of the program's administration and servicing functions, including billing and collection of assessments and indemnification payments to members; and

— evaluation of available information regarding the program's financial condition and whether financial resources are available to support the program's obligations.

We believe an entity should monitor the potential for future legislation or other changes that could impact the nature of the program, result in the indemnification not being provided, or change the expectation of potential nonpayment to the extent that they could impact the amount of expected credit losses.

If there is an expectation that a financial asset qualifies for the zero loss exception, an entity is not required to estimate or recognize an allowance for credit losses. For discussion about the zero loss expectation exception, see section 8.2.

18. Specific considerations for commercial entities and trade receivables

Detailed contents

18.1 How the standard works

Topic 326 applies to all entities, including commercial entities, if they hold financial assets in its scope. The scope of Subtopic 326-20, which is described in more detail in chapter 2, specifically includes receivables that result from revenue transactions in the scope of Topic 606.

The following chart contains references to other chapters in this publication that address common activities of commercial entities:

Type of activities	Relevant chapters
Lending activities	3 - 8
Investments in HTM debt securities	3 - 8
Investments in AFS debt securities	19
Other investments in equity method investees	15
Guarantees	14

The commercial entities that are most likely to be significantly affected by Topic 326 are those that:

— engage in lending activities, exclusive of accounts receivable arrangements;
— invest in debt securities that are classified as either HTM or AFS; or
— provide guarantees that create off-balance sheet credit exposure, but are not accounted for as either derivatives or insurance.

18.2 Topic 606 assets in the scope of Subtopic 326-20

18.2.10 Overview

Excerpt from ASC 606-10

45-3 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a **contract asset**, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

45-4 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of **revenue** recognized shall be presented as a credit loss expense.

20 Glossary

Contract Asset – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Receivables that result from revenue transactions in the scope of Topic 606 include contract assets as well as trade receivables, both of which are in the scope of Subtopic 326-20. [606-10-45-3, 45-4]

Topic 606 initially stated that an entity assesses a contract asset for impairment under Topic 310 on receivables. ASU 2016-13 amended Topic 606 to require an entity to estimate credit losses for both receivables and contract assets under Subtopic 326-20. [326-20-15-2(a)(3), 606-10-45-3 – 45-4]

— Receivables are unconditional rights to consideration. A right is unconditional if only the passage of time is required before payment becomes due.

— Contract assets are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time.

Subtopic 326-20 cannot be early adopted by calendar year-end entities before January 1, 2019, and the new revenue standard becomes effective for PBEs before that date. Therefore, many entities will not apply the provisions of

Subtopic 326-20 when they initially apply the new revenue standard. [606-10-65, 326-10-65]

For further discussion of the new revenue standard, see KPMG Handbook, Revenue recognition.

18.3 Estimating credit losses for Topic 606 assets

18.3.10 Overview

Generally, due to the relatively short duration of contract assets and trade receivables, the effect of switching from an incurred loss model to a lifetime expected loss model may not be significant. In addition, commonly used methods for estimating credit losses on trade receivables, such as aging schedules, may continue to be followed under Subtopic 326-20.

As further discussed in chapter 3, there is no credit loss recognition threshold and up-front loss recognition is required under Subtopic 326-20. Therefore, upon initial recognition of the contract asset or trade receivable, a credit loss expense is recognized.

Question 18.3.10

If an entity is currently using an aging schedule to estimate its allowance for doubtful accounts for short-term trade receivables, what are some key considerations in determining whether changes are required to adopt Topic 326?

Interpretive response: An entity should consider whether its current process for developing loss rates using an aging schedule is consistent with the guidance on developing historical loss experience in Subtopic 326-20, and whether any adjustments should be made to those loss rates to reflect current economic conditions and reasonable and supportable forecasts of future economic conditions.

Under Subtopic 326-20 the starting point for estimating the allowance for doubtful accounts is the entity's historical loss experience. An entity currently using aging schedules should ensure that the historical periods used to develop the loss rates in the aging schedule are consistent with the guidance in chapter 7.

Historical credit loss experience is adjusted for differences in asset-specific risk characteristics, current economic conditions, and reasonable and supportable forecasts of future economic conditions. An entity therefore considers whether there are:

— differences in the nature of the trade receivables that existed in the historical period and those that exist at the reporting date; and [326-20-30-8]
— differences in economic conditions between the period used to develop the historical loss rates and those that exist at the reporting date and over the reasonable and supportable forecast period. [326-20-30-8 – 30-9]

For example, the trade receivables in the historical period might have been of different credit quality (i.e. the financial condition of the entity's customers may have changed) or a different duration (i.e. 30-day receivables versus 60-day receivables). For more information on adjusting historical loss experience for differences in asset-specific risk characteristics, see section 7.3.

Under Subtopic 326-20, an entity considers reasonable and supportable forecasts of future economic conditions. We believe that many entities may conclude that their trade receivables are so short-term in nature that future changes in economic conditions will not have a significant effect on the estimate; however, each entity needs to assess its specific facts and circumstances at each reporting date. For more information on adjusting historical loss experience for differences in economic conditions, see section 7.3.20. [326-20-30-8 – 30-9]

Excerpt from ASC 326-20

>> Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule

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

55-38 Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 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:

a. 0.3 percent for receivables that are current
b. 8 percent for receivables that are 1–30 days past due
c. 26 percent for receivables that are 31–60 days past due
d. 58 percent for receivables that are 61–90 days past due
e. 82 percent for receivables that are more than 90 days past due.

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

55-40 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**

Question 18.3.20

How does an entity estimate expected credit losses for trade receivables recognized under Topic 606 when the associated revenue has not been recognized?

Background: In some cases, an entity has an unconditional right to consideration (i.e. a receivable) before it has transferred goods or services to the customer. In these arrangements, the entity may have the intent and ability to refuse to deliver those goods or services if the customer defaults on its payment(s) even if the entity does not have the unconditional right to cancel the contract.

For example, an entity might enter into a non-cancellable contract to provide maintenance that entitles the entity to bill and collect the consideration before the service period begins. The entity recognizes a receivable and corresponding contract liability with no effect on net income before the service is transferred to the customer. If the customer defaults on its payment, the entity can refuse to provide or stop providing maintenance services. [606-10-45-2]

Interpretive response: We believe an allowance for expected credit losses should be estimated for a trade receivable only to the extent that the related revenue has been recognized. When an entity has recognized a receivable and a corresponding contract liability with no income statement impact, it has no credit loss exposure for which an allowance for expected credit losses should be recognized. This is because a customer default before recognizing revenue would lead to the derecognition of the trade receivable and related contract liability, as opposed to the recognition of a credit loss.

Question 18.3.30

Does an entity estimate expected credit losses on sales tax receivables from customers?

Background: When an entity recognizes a receivable related to a sale of goods or services, the receivable may include amounts to be collected from the customer pertaining to sales tax imposed by a taxing authority. In those situations, the entity also recognizes a corresponding liability to remit sales tax to the taxing authority. In some cases, the entity is not obligated to pay amounts to the taxing authority if the customer defaults on the receivable.

Interpretive response: It depends. We believe an allowance for expected credit losses should be estimated for sales tax receivables from customers only to the extent the entity is obligated to remit to the taxing authority amounts not actually collected from the customer.

When an entity is not obligated to remit amounts not actually collected, the entity has no credit loss exposure for which an allowance for credit losses should be recognized. A customer default leads to derecognition of the sales tax receivable and the related liability to the taxing authority, and not the recognition of a credit loss.

18.4 Purchase of financial assets

18.4.10 Overview

When an entity acquires a financial asset in the scope of Topic 326, it determines whether, as of the date of the acquisition, the asset has experienced a more-than-insignificant deterioration in credit quality since origination or issuance. If there has been a more-than-insignificant deterioration in credit quality, based on the acquirer's assessment, the asset is identified as a PCD asset. For additional discussion on the scope and accounting for PCD assets, see chapter 12. [326-20 Glossary]

When an entity acquires financial assets that are not PCD assets, it recognizes:

- the acquired financial asset at fair value; and
- an allowance for remaining lifetime expected credit losses.

Subtopic 326-20 precludes an entity from using a purchase discount to offset its expectation of credit losses (see Question 12A.2.40). Instead, an entity estimates the effect that the discount will have on the expected credit losses of the amortized cost basis, as illustrated in Examples 4.3.10 and 4.3.20. The purchase discount is accreted into interest income. [326-20-30-5]

In addition, an entity recognizes a writeoff (full or partial) of financial assets in the period in which they are deemed uncollectible. [326-20-35-8]

Example 18.4.10
Acquisition of a company with trade receivables

ABC Corp. acquires DEF Corp. in a business combination, paying $2,000,000 on January 1, Year 1.

The following are the fair values of the assets acquired and liabilities assumed. In this example, deferred income taxes are ignored.

Cash	$200,000
Trade receivables	$900,000
Land, building, furniture and equipment	$2,000,000
Long-term debt	$(1,500,000)

ABC determines that the entire portfolio consists of trade receivables that have not experienced a more-than-insignificant deterioration in credit quality since origination. Therefore, PCD accounting does not apply.

ABC uses a method other than the discounted cash flow method (e.g. loss-rate method) to estimate the credit losses. The trade receivables have an estimated life of less than 90 days such that they will be paid off in the same reporting period as the acquisition.

ABC determines the following amounts for the trade receivables:

— Total remaining unpaid amount: $1,000,000
— Fair value: $900,000
— Amount expected to be collected: $950,000.

ABC records the following journal entry to account for the acquisition of DEF.

	Debit	*Credit*
Cash (acquired)	200,000	
Trade receivables[1]	1,000,000	
Land, building, furniture and equipment	2,000,000	
Goodwill	400,000	
Long-term debt		1,500,000
Trade receivables – discount		100,000
Cash (consideration)		2,000,000
To record acquisition of DEF.		

Note:

1. The trade receivables are recorded at the fair value of $900,000. For illustrative purposes, the total unpaid amount of $1,000,000 and the purchase discount of $100,000 are shown gross.

ABC calculates its allowance for credit losses related to the trade receivables as $50,000: $1,000,000 (contractual amounts due) – $950,000 (amount expected to be collected). ABC may not offset the allowance of $50,000 by the purchase discount of $100,000. Therefore, ABC recognizes the initial estimate of expected losses on the acquired trade receivables through net income.

	Debit	Credit
Credit loss expense	50,000	
Allowance for credit losses		50,000
To record estimate of expected credit losses on trade receivables.		

During the reporting period, ABC determines that $50,000 is uncollectible, collects the unpaid amount of $950,000 and accretes the $100,000 discount. ABC does not have a nonaccrual policy. Nonaccrual policies, when applicable, may affect the recognition of interest income for specific trade receivables that have a credit loss.

	Debit	Credit
Trade receivables - discount	100,000	
Interest income		100,000
To record accretion of discount.		
Allowance for credit losses	50,000	
Trade receivables		50,000
To record writeoff of uncollectible amount.		
Cash	950,000	
Trade receivables		950,000
To record collection of cash for unpaid amount.		

19. Targeted changes for AFS debt securities

Detailed contents

New item added in this edition: **

Questions

Example

19.1 How the standard works

Although Subtopic 326-30 replaces the legacy US GAAP OTTI model with a credit loss model, it retains an essential aspect of that model – that entities are required to determine the amount of credit losses, if any, when securities are impaired.

Subtopic 326-30 also retains the fundamental nature of the OTTI model, including the requirement to assess AFS debt securities at the individual security level. However, it differs from the OTTI model in the following respects.

New concepts under Subtopic 326-30
— Credit loss recognized through an allowance account, thereby permitting reversals of previously recognized credit losses through net income in the period they occur. — Writeoffs are recorded when either of the following occurs: 1. Amounts are deemed uncollectible. 2. The entity intends to sell (or more likely than not will be required to sell) the debt security before recovery of the amortized cost basis. — Credit loss limited to difference between security's amortized cost basis and fair value ('fair-value floor'). — Evaluation of whether credit loss exists does not consider: 1. Length of time fair value has been less than amortized cost. 2. Changes in fair value after reporting date. 3. Historical or implied volatility of fair value. — Evaluation of whether a purchased AFS debt security should be considered PCD.

19.2 Scope of Subtopic 326-30

19.2.10 Overview

Excerpt from ASC 326-30

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Instruments

15-2 The guidance in this Subtopic applies to **debt securities** classified as **available-for-sale securities**, including **loans** that meet the definition of *debt securities* and are classified as available-for-sale securities.

The guidance in Subtopic 326-30 applies to all AFS debt securities and loans accounted for as AFS debt securities. The scope includes AFS debt securities purchased with credit deterioration (PCD), but the Subtopic contains separate guidance for these securities (see section 19.8). [326-30-15-2]

Question 19.2.10

Why does Topic 326 include a separate model for AFS debt securities?

Interpretive response: The fair value measurement attribute for AFS debt securities necessitates a credit loss model separate from the model in Subtopic 326-20 because an entity may realize the value of the securities either through collection of contractual cash flows or through sales of the securities. [ASU 2016-13.BC81]

Subtopic 326-20's expected credit loss model is designed to estimate credit losses over the contractual life of a financial asset. The FASB decided that this model may not be suitable for financial assets that an entity may not intend to hold to maturity. [ASU 2016-13.BC80]

Lastly, the amount of credit losses that can be realized on AFS debt securities is limited to the amount that fair value is less than amortized cost; this is because an entity can sell the securities at fair value to avoid realization of credit losses. The ability to limit the credit losses means the credit loss model for AFS debt securities needs to be applied at the individual instrument level. Therefore, the collective evaluation in Subtopic 326-20 is not appropriate for these securities. [ASU 2016-13.BC81]

Question 19.2.20**

Is a forward or option to purchase AFS debt securities in the scope of Subtopic 326-30?

Excerpt from ASC 815-10

Certain Contracts on Debt and Equity Securities

> Instruments

15-141 The guidance in the Certain Contracts on Debt and Equity Securities Subsections applies only to those forward contracts and purchased options having all of the following characteristics:

a. The contract is entered into to purchase securities that will be accounted for under either Topic 320 or Topic 321.
b. The contract's terms require physical settlement of the contract by delivery of the securities.
c. The contract is not a **derivative instrument** otherwise subject to this Subtopic.
d. The contract, if a purchased option, has no intrinsic value at acquisition.

25-17 Forward contracts and purchased options on debt securities within the scope of this Subsection (see the Certain Contracts on Debt and Equity Securities Subsection of Section 815-10-15) shall, at inception, be designated as held to maturity, available for sale, or **trading** in a manner consistent with the accounting prescribed by Topic 320 for debt securities. Such forward and option contracts are not eligible to be hedging instruments.

35-5 Forward contracts and purchased options on debt securities within the scope of this Subsection shall be measured subsequently according to their initial classification as follows:

…

b. Available for sale:
    1. Changes in the fair value of the forward contract or purchased option shall be recognized as part of the separate component of shareholders' equity under Topic 320 as they occur. Credit losses on the underlying securities in a forward contract shall be recorded through an allowance for credit losses in accordance with Subtopic 326-30 on measuring credit losses on available-for-sale debt securities. Credit losses on the underlying securities in a purchased option shall be recorded through an allowance for credit losses in accordance with Subtopic 326-30 and shall be limited by the amount of the option premium.
    2. Debt securities purchased under a forward contract shall be recorded at their fair values at the settlement date.
    3. Debt securities purchased by exercising an option shall be recorded at the option strike price plus the fair value of the option at the exercise date.
    4. If the option expires worthless and the same debt security is purchased in the market, the security shall be recorded at its market price plus any remaining carrying amount for the option premium.

Interpretive response: It depends. A forward or option to purchase debt securities (including debt securities deemed PCD) is in the scope of Subtopic 326-30 if it meets the following conditions: [815-10-15-141, 815-10-25-17]

— it is not accounted for as a derivative under Topic 815;
— the underlying securities will (when purchased) be subject to Topic 320 (investments in debt securities);
— the contract's terms require physical settlement; and
— if the contract is a purchase option contract, it has no intrinsic value at acquisition.

Under Subtopic 815-10, credit losses on securities underlying the contract are recorded through an allowance for credit losses under Subtopic 326-30. [815-10-35-5(b)]

For accounting considerations about forwards and options to purchase debt securities, see section 2.3.50 of KPMG Handbook, Derivatives and Hedging.

19.3 Determining whether a security is impaired

Excerpt from ASC 326-30

>> Identifying and Accounting for Impairment

35-1 An investment is impaired if the **fair value** of the investment is less than its **amortized cost basis**.

Pending Content:

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

<u>**35-1A** An entity shall not consider a basis adjustment related to an existing portfolio layer method hedge designated in accordance with paragraph 815-20-25-12A when measuring impairment of the individual investments or individual beneficial interest included in a closed portfolio hedged using the portfolio layer method.</u>

35-2 For individual **debt securities** classified as **available-for-sale securities**, an entity shall determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. An entity shall record impairment relating to credit losses through an allowance for credit losses. However, the allowance shall be limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses shall be recorded through other comprehensive income, net of applicable taxes. An entity shall consider the guidance in paragraphs 326-30-35-6 and 326-30-55-1 through 55-4 when determining whether a credit loss exists.

35-4 Impairment shall be assessed at the individual security level (referred to as an investment). Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities. (For example, debt securities bearing the same Committee on Uniform Security Identification Procedures [CUSIP] number that were purchased in separate trade lots may be aggregated by a reporting entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses for the debt securities.) Providing a general allowance for an unidentified impairment in a portfolio of debt securities is not appropriate.

Pending Content:

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

35-4 Impairment shall be assessed at the individual security level (referred to as an investment). The impairment assessment of the individual securities or individual beneficial interest in a closed portfolio hedged using the portfolio layer method shall not consider the basis adjustment related to an existing portfolio layer method hedge. Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities.

35-5 An entity shall not combine separate contracts (a debt security and a guarantee or other credit enhancement) for purposes of determining whether a debt security is impaired or can contractually be prepaid or otherwise settled in such a way that the entity would not recover substantially all of its cost.

19.3.10 Overview

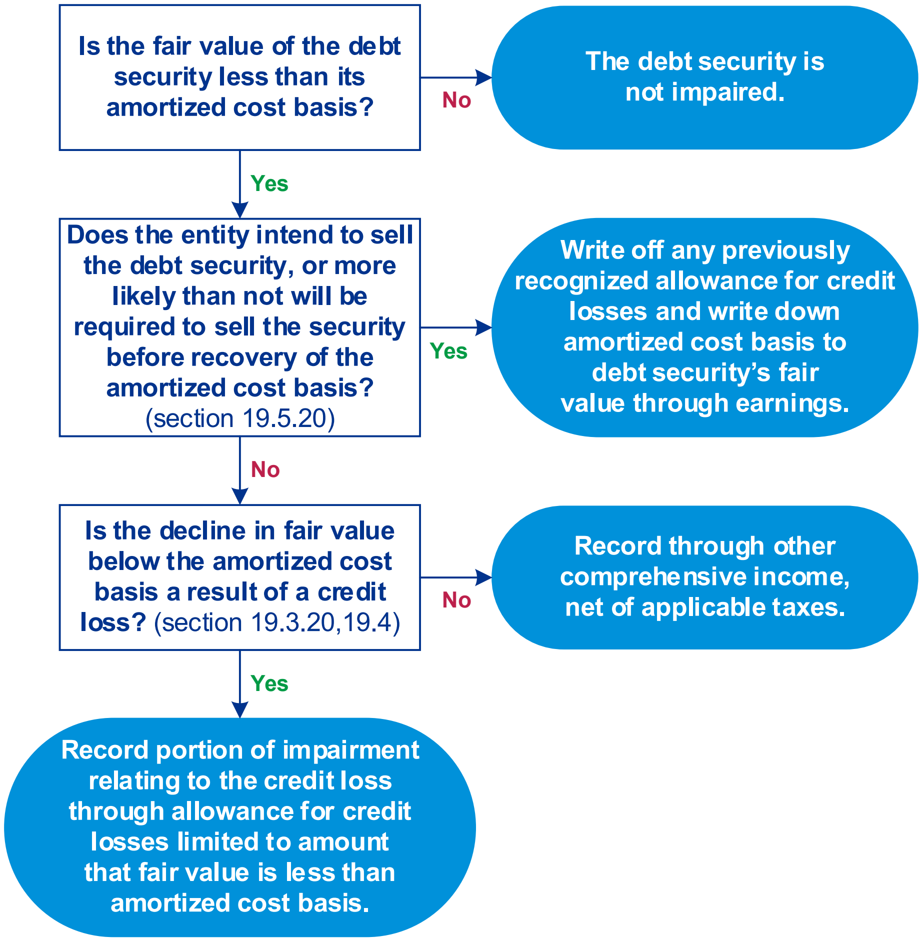
An AFS debt security is impaired when its fair value declines below its amortized cost basis. This decline is due to a credit loss to the extent the entity does not expect to recover the amortized cost basis. A credit loss is recognized through net income. Any portion of the decline that is due to factors other than a credit loss – such as changes in market interest rates – is recognized in other comprehensive income, net of applicable taxes. [326-30-35-1-35-2]

Impairment is determined on an individual security basis. Therefore, an AFS debt security cannot be combined with other securities to determine whether the collective securities are impaired. Similarly, it cannot be considered for impairment with any guarantees or other credit enhancements that are evidenced by separate contracts. [326-30-35-4 – 35-5]

Individual security means the level and method of aggregation used by the entity to measure realized and unrealized gains and losses on its debt securities. For example, debt securities with the same Committee on Uniform Security Identification Procedures (CUSIP) numbers that were purchased separately may be aggregated using an average cost basis if that is how an entity measures realized and unrealized gains and losses. [326-30-35-4]

Section 19.3.20 explains how to determine if a decline in a security's fair value below the amortized cost basis is due to a credit loss.

The following decision tree provides an overview of the process an entity undertakes each reporting period for its AFS debt securities.



Question 19.3.05

When does an entity recognize in earnings decreases in an AFS debt security's fair value due to changes in foreign currency rates?

Background: Under legacy US GAAP's OTTI model, an entity was required to consider whether changes in fair value of an AFS debt security due to changes in foreign currency rates were other-than-temporary. If they were, those changes were recognized as OTTI (i.e. in earnings), even if the entity did not intend to sell (and it was not more likely than not the entity would be required to sell) the security. This requirement was eliminated under the amendments in the credit losses standard.

Interpretive response: It depends.

When an entity intends to sell (or more likely than not will be required to sell) an AFS debt security before recovery of the security's amortized cost basis, the entity recognizes the difference between fair value and amortized cost in net income and as a writedown of the amortized cost basis.

When an entity does not intend to sell (and it is not more likely than not that the entity will be required to sell) an AFS debt security, we believe either of the following approaches, consistently applied, is acceptable: [326-30-35-10, 320-10-35-1(b), 450-20-25-2, TRG 11-18.18]

— **Recognize losses only when they are realized**. As amended by the credit losses standard, Subtopic 320-10 (investments – debt securities) indicates that changes in fair value that are not recorded in the allowance for credit losses are recognized in AOCI. Unless the entity intends to sell (or will more likely than not be required to sell) the security, those changes generally are recognized in earnings when realized (e.g. security matures).

— **Recognize losses when it is *probable* they will be ultimately realized**. We believe an entity is permitted (but not required) to apply the guidance in Subtopic 450-20 (loss contingencies) to unrealized losses on AFS debt securities that are due to changes in foreign currency rates. Under that guidance, an entity would recognize a loss in earnings when it is probable that a loss will be ultimately realized due to changes in foreign currency rates of an AFS debt security.

  For example, assume an entity owns an AFS debt security whose value has significantly decreased due to changes in foreign exchange rates since acquisition. Also assume the entity does not intend to sell (and it is not more likely than not the entity will be required to sell) the security before it matures. If the entity determines it is probable the decrease in value will not be recovered before the security's maturity, the entity would recognize the unrealized loss due to changes in foreign currency rates in net income.

19.3.20 Assessing whether a credit loss exists

Excerpt from ASC 326-30

>>> Impairment in Earnings and Other Comprehensive Income

35-6 In assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. 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 shall be recorded for the credit loss, limited by the amount that the **fair value** is less than amortized cost basis. Credit losses on an impaired security shall continue to be measured using the present value of expected future cash flows.

35-7 In determining whether a credit loss exists, an entity shall consider the factors in paragraphs 326-30-55-1 through 55-4 and use its best estimate of the present value of cash flows expected to be collected from the **debt security**. One way of estimating that amount would be to consider the methodology described in paragraphs 326-30-35-8 through 35-10. Briefly, the entity would discount the expected cash flows at the **effective interest rate** implicit in the security at the date of acquisition.

>> Information Considered When Estimating Credit Losses

55-1 There are numerous factors to be considered in determining whether a credit loss exists. The length of time a security has been in an unrealized loss position should not be a factor, by itself or in combination with others, that an entity would use to conclude that a credit loss does not exist. The following list is not meant to be all inclusive. All of the following factors should be considered:

a. The extent to which the **fair value** is less than the **amortized cost basis**
b. 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:
   1. Changes in technology
   2. 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
   3. Changes in the quality of the credit enhancement.
c. The payment structure of the debt security (for example, nontraditional 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
d. Failure of the issuer of the security to make scheduled interest or principal payments
e. Any changes to the rating of the security by a rating agency.

Subtopic 326-30 eliminates the concept of OTTI in legacy US GAAP and focuses on whether a credit loss exists within the security. Specifically, it provides guidance on how to assess, either quantitatively or qualitatively, whether a credit loss exists when the fair value of an AFS debt security is below its amortized cost basis at the reporting date.

An entity determines whether a credit loss exists only if the security is impaired – i.e. if the security's fair value is less than the amortized cost. [326-30-35-1]

Comparison to legacy US GAAP

Legacy US GAAP	Subtopic 326-30
Credit losses recognized through a direct writedown of the amortized cost basis. [320-10-35-34E]	Allowance approach, with amounts written off when deemed uncollectible or when the entity intends to sell (or more likely than not will be required to sell) the debt security before recovery of the amortized cost basis.
Credit losses can exceed total unrealized losses. [320-10-35-34D]	Fair value floor for credit losses.

Legacy US GAAP	Subtopic 326-30
No immediate reversals of previously recognized credit losses. [320-10-35-34E, 320-10-35-35]	Reversals of credit losses are recognized immediately. However, the allowance for credit losses cannot be negative.
Consider the length of time the fair value has been less than the amortized cost of a security, changes in fair value after the reporting date, and the historical or implied volatility of the fair value in evaluating whether a credit loss exists. [320-10-35-33F]	The length of time a security has been in an unrealized loss position, changes in fair value after the reporting date, and the historical or implied volatility of the fair value are not factors, individually or in combination with others, in evaluating whether a credit loss exists.

Question 19.3.10

Can a qualitative assessment be performed to determine whether a credit loss exists?

Interpretive response: Yes. Subtopic 326-30 requires an entity to determine whether it will recover the entire amortized cost basis of an impaired debt security – i.e. any debt security with a fair value below amortized cost – by comparing: [326-30-35-6]

- the best estimate of the present value of cash flows expected to be collected from the security; with
- the amortized cost basis of the security.

Based on an assessment of the qualitative factors in paragraphs 326-30-55-1 to 55-4, an entity may determine that it expects to receive all of the contractual cash flows from an impaired debt security. For example, it may be evident that a decrease in fair value below amortized cost is caused by factors such as an increase in market interest rates or liquidity factors – and not associated with any credit concerns of the issuer of the debt security.

If an entity's best estimate is that it will receive all of the contractual cash flows from an impaired debt security when contractually due, the present value of the expected future cash flows will equal the amortized cost basis of the debt security. In that case, we believe an entity could conclude that a credit loss does not exist without performing a quantitative assessment of the present value of expected future cash flows to be collected and comparing it to the amortized cost basis of the impaired debt security.

When this conclusion is reached qualitatively, we believe an entity should document:

- the basis for concluding that it will receive all of the contractual cash flows from an impaired debt security when contractually due; and
- that a net present value calculation of the cash flows expected to be collected would therefore result in an amount equal to the amortized cost basis of the debt security.

Question 19.3.20
What factors cannot be considered when assessing whether a credit loss exists?

Interpretive response: Subtopic 326-30 eliminates some of the factors under legacy US GAAP that entities consider when determining whether a credit loss exists for an AFS debt security. [326-30-55-1]

The FASB decided to prohibit an entity from considering the length of time that the fair value of an AFS debt security has been less than its amortized cost basis. Many entities may be using this factor to assess OTTI under legacy US GAAP, and the change under Subtopic 326-30 may result in an earlier recognition of a credit loss. [326-30-55-1]

Furthermore, in determining whether a credit loss exists, while not specifically prohibited, we believe an entity should no longer consider the historical and implied volatility and recoveries or additional declines in the fair value of an AFS debt security after the reporting date. [ASU 2016-13.BC82, 326-30-55-1]

19.4 Estimating the allowance for credit losses

Excerpt from ASC 326-30

>>> Impairment in Earnings and Other Comprehensive Income

35-7A As an accounting policy election for each major security type of debt securities classified as available-for-sale securities, an entity may adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments.

35-8 The estimates of expected future cash flows shall be the entity's best estimate based on past events, current conditions, and on reasonable and supportable forecasts. Available evidence shall be considered in developing the estimate of expected future cash flows. The weight given to the information used in the assessment shall be commensurate with the extent to which the evidence can be verified objectively. If an entity estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

35-9 Available information would include existing environmental factors, for example, existing industry, geographical, economic, and political factors that are relevant to the collectibility of that debt security.

>> Information Considered When Estimating Credit Losses

55-2 An entity should consider available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected. That information should include all of the following:

a. The remaining payment terms of the security
b. Prepayment speeds
c. The financial condition of the issuer(s)
d. Expected defaults
e. The value of any underlying collateral.

55-3 To achieve the objective in paragraph 326-30-55-2, the entity should consider, for example, all of the following to the extent they influence the estimate of expected cash flows on a security:

a. Industry analyst reports and forecasts
b. Credit ratings
c. Other market data that are relevant to the collectibility of the security

55-4 An entity also should consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract as discussed in paragraph 326-30-35-5), the willingness of the guarantor to pay, and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. 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; see paragraph 825-10-55-1). Thus, 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). 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.

19.4.10 Overview

Subtopic 326-30 requires an entity to use a discounted cash flow method to estimate a credit loss. Therefore, an entity determines whether it will recover the entire amortized cost basis of an impaired debt security – i.e. any debt security with a fair value below amortized cost – by comparing: [326-30-35-6]

— the present value of cash flows expected to be collected from the security; with
— the amortized cost basis of the security.

The estimate of expected future cash flows is the entity's best estimate based on past events, current conditions, and reasonable and supportable forecasts. [326-30-35-8]

Paragraphs 326-30-55-2 to 55-4 describe the factors to consider when estimating a credit loss. Those factors are generally consistent with legacy US GAAP.

Question 19.4.10

How does an entity determine a best estimate of credit losses?

Interpretive response: We believe an entity should determine the best estimate of credit losses by selecting one of the following two approaches and applying it consistently:

— single most-likely amount in a range of possible estimated amounts (or most-likely). This approach is based on the definition of best estimate in FASB Concepts Statement 7 (CON 7); or

— using a probability-weighted approach, which is the sum of the probability-weighted amounts in a range of possible estimated amounts. This approach is based on the expected cash flow method in CON 7.

However, as noted in Question 19.4.20, we do not believe a decrease in the present value of cash flows due solely to an increase in expected prepayments should result in credit losses for AFS debt securities, unless the securities are beneficial interests in the scope of Subtopic 325-40. See chapter 20 for more information on beneficial interests. [326-30-35-7]

The discount rate used to determine the present value of expected cash flows is the AFS debt security's EIR. Some considerations related to calculating the EIR include the following.

— **Expected prepayments.** An entity is permitted to make an accounting policy election to adjust the EIR used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments. This policy election should be applied consistently for debt securities at the major security type level. [326-30-35-7A]

— **Variable (floating) rate securities.** An entity is permitted to use the floating rate as it changes over the life of the security, or a fixed rate equal to the rate that was in effect at the date the entity determined that a credit loss existed. Further, an entity may be permitted to elect to project future interest rates. These elections are discussed in section 19.4.20.

The EIR used to discount expected cash flows when estimating credit losses is not necessarily the EIR used for interest income recognition. For further discussion of the EIR, see section 4.4.

When the most-likely approach is used to estimate cash flows, the discount rate is the AFS debt security's EIR as described above. If the probability-weighted approach is used, the discount rate should consider the AFS debt security's EIR as described above, but exclude those adjustments already considered in the probability weightings. The resulting discount rate would be expected to lie between the AFS debt security's EIR and the risk-free rate at the security's acquisition date.

Question 19.4.20

Does a decrease in expected cash flows solely due to an increase in expected prepayments result in a credit loss?

Interpretive response: No, we do not believe a decrease in expected cash flows resulting solely from an increase in expected prepayments can result in a credit loss for an AFS debt security that is not a beneficial interest in the scope of Subtopic 325-40; for additional discussion of the scope of Subtopic 325-40, see chapter 20. For example, this could occur with a prepayable asset-backed security purchased at a premium if prepayments result in a reduction in interest collected over the life of the security when compared with the cash flows originally expected at the purchase date.

We do not believe increases in prepayment expectations are an indicator of credit impairment based on the factors outlined in paragraphs 326-30-55-1 to 55-4. Under legacy US GAAP, a decrease in cash flows expected to be collected caused by a change in prepayment speeds does not cause an OTTI for AFS debt securities other than beneficial interests. We believe that the FASB did not intend to change current practice in this area. [320-10-35-33E]

Further, as discussed in Question 19.4.10, an entity is permitted to make an accounting policy election to apply a prepayment-adjusted EIR when discounting expected cash flows. This election would have the effect of eliminating differences between the present value of the expected cash flows and the amortized cost due to changes in prepayment expectations. [326-30-35-7A]

We believe that if an entity instead chooses to use the original EIR when estimating a credit loss, a decrease in cash flows expected to be collected on a non-beneficial interest AFS debt security that results solely from an increase in prepayments will not result in a credit loss.

For a discussion on the effect of prepayments on credit loss estimates for investments in beneficial interests, see chapter 20.

Example 19.4.10

Impairment of AFS securities

ABC Corp. holds non-prepayable AFS debt securities that bear the same CUSIP number.

At the end of Year 1, the debt securities have the following characteristics.

Fair value:	$875,000
Par value:	$1,000,000
Amortized cost basis:	$952,000
Coupon:	5%
EIR at acquisition date:	6.8%
Maturity date:	End of Year 4

Principal due:	Only on maturity

ABC does not intend to sell the debt securities, and it is not more likely than not that it will be required to sell the securities before recovering the amortized cost basis.

Scenario 1: Recording impairment related to credit and non-credit losses

At the end of Year 1, the securities are impaired because their fair value is less than their amortized cost basis. ABC considers the guidance in paragraph 326-30-35-6 and paragraphs 326-30-55-1 to 55-4 to determine if a credit loss exists. After considering information about past events, current conditions, and reasonable and supportable forecasts, ABC develops the following estimate of future expected cash flows.

Year	Expected cash flows	Present value of future expected cash flows
2	$ 45,000	$ 42,127
3	45,000	39,437
4	975,000	799,912
		$881,476

Because the present value of cash flows expected to be collected ($881,476) is less than the amortized cost basis of the securities ($952,000), ABC determines that a credit loss exists and records the following journal entries.

	Debit	*Credit*
Credit loss expense[1]	70,524	
Allowance for credit losses		70,524
To record impairment related to credit losses.		
Unrealized loss on AFS debt securities (other comprehensive income)[2]	6,476	
AFS debt securities – fair value adjustment		6,476
To record non-credit related losses.		

Notes:

1. The difference between the amortized cost basis ($952,000) and the present value of cash flows expected to be collected ($881,476).
2. The difference between the present value of cash flows expected to be collected ($881,476) and the fair value of the AFS debt securities ($875,000).

Scenario 2: Impairment limited by fair value floor

Assume the same fact pattern as in Scenario 1, except that the fair value of the AFS debt securities only declined to $895,000 rather than $875,000.

In this scenario, ABC records the following journal entry because the allowance for credit losses is limited to the amount that the fair value is less than the amortized cost basis.

	Debit	Credit
Credit loss expense[1]	57,000	
Allowance for credit losses		57,000
To record impairment related to credit losses.		

Note:

1. The difference between the amortized cost basis ($952,000) and the fair value of the AFS debt securities ($895,000).

Question 19.4.25**

How are credit losses for a forward contract to purchase AFS debt securities accounted for?

Interpretive response: Expected credit losses for the underlying securities are recognized at the date the forward contract is entered into to purchase the AFS debt securities. We believe the estimate of credit losses on the underlying securities should be calculated using the amortized cost basis of the debt securities expected to be recognized at settlement of the forward (i.e. forward exercise price plus cost of the forward, if applicable). We believe an entity recognizes the allowance as follows. [815-10-35-5(b)]

— For non-PCD AFS debt securities, an allowance for credit losses is recognized with an offset to credit loss expense.
— For PCD AFS debt securities, an allowance for credit losses is recognized with a balance sheet gross up to the initial cost basis of the forward contract.

We believe the allowance is limited by the amount that the underlying security's amortized cost basis exceeds fair value. As a result, an entity will need to track the amortized cost and fair values of the underlying AFS debt securities.

Example 19.4.15**

Forward contract to purchase PCD AFS debt securities

On January 1, Year 1 (contract inception), ABC Corp. enters into a forward contract to acquire a portfolio of debt securities. The exercise price of the forward contract is $750,000. The transaction settles on March 31, Year 1 (settlement date). No amounts were paid or received to enter into the forward contract and the contract has a fair value of $0 on inception and settlement date.

The forward is in the scope of Topic 320 because it is not accounted for as a derivative under Topic 815 and the securities (once acquired) will be in the scope of Topic 320. ABC will classify the debt securities as AFS upon acquisition. Therefore, the forward contract is designated as AFS at inception.

ABC evaluates the individual debt securities in the portfolio to be purchased against the indicators in Subtopic 326-30 to determine which securities, if any, are considered PCD (see section 19.8.20)

The debt securities with the following characteristics are considered PCD.

Par value:	$1,000,000
Fair value (at inception and settlement of forward):	$750,000

ABC estimates the allowance for credit losses to be $143,130. The non-credit discount of $106,870 is the difference between the par value of $1,000,000 and the amortized cost basis of $893,130 ($750,000 purchase price plus the allowance for credit losses of $143,130). There is no change in the allowance estimate between contract inception and settlement.

The allowance for credit losses is not limited by the fair value floor because the amortized cost basis of the underlying securities ($893,130) exceeds the fair value ($750,000) by $143,130.

ABC records the following journal entries at inception of the forward (January 1, Year 1).

	Debit	*Credit*
Forward contract – AFS debt securities	143,130	
Allowance for credit losses		143,130
To record the allowance for credit losses on Jan 1.		

ABC records the following journal entries at settlement (March 31, Year 1).

	Debit	*Credit*
AFS debt securities[1]	1,000,000	
Cash		750,000
AFS debt securities – non-credit discount		106,870
Forward contract – AFS debt securities		143,130
To recognize debt securities and payment of cash on the settlement date (Dec 31).		

Note:

1. At settlement, no journal entry is made to the allowance for credit losses because the allowance for credit losses related to the AFS debt securities was recognized during the period that the forward contract was outstanding.

19.4.20 Specific considerations for variable rate securities

Excerpt from ASC 326-30

>>> Impairment in Earnings and Other Comprehensive Income

35-11 If the security'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 security's effective interest rate (used to discount expected cash flows as described in paragraph 326-30-35-7) may be calculated based on the factor as it changes over the life of the security or is projected to change over the life of the security, or may be fixed at the rate in effect at the date an entity determines that the security has a credit loss as determined in accordance with paragraphs 326-30-35-1 through 35-2. The entity's choice shall be applied consistently for all securities whose contractual interest rate varies based on subsequent changes in an independent factor. An entity is not required to project changes in the factor for purposes of estimating expected future cash flows. If the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall use the same projections in determining the effective interest rate used to discount those cash flows. In addition, if the entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments in accordance with paragraph 326-30-35-7A. Subtopic 310-20 on receivables—nonrefundable fees and other costs provides guidance on the calculation of interest income for variable rate instruments.

Entities often hold variable rate AFS debt securities. A variable rate can add complexity to the determination of the EIR for these types of securities. However, Subtopic 326-30 simplifies the calculation by permitting an entity to use one of the following rates when a security's contractual interest rate varies based on an independent factor: [326-30-35-11]

- the floating rate as it changes over the life of the security; or
- a fixed rate equal to the rate that was in effect at the date the entity determined that a credit loss existed.

Selecting one of these rates amounts to a policy election that requires use of that rate on all AFS securities whose interest rate is based on an independent factor. [326-30-35-11]

Further, an entity is permitted to use its projections of future interest rates when estimating expected future cash flows on variable rate financial assets. If the entity makes such projections, the same projections are also used in determining the EIR for discounting those cash flows. Under this alternative, the entity also adjusts the EIR for expected prepayments (see Questions 19.4.10 and 19.4.20). [326-30-35-11]

Question 19.4.30
What does an entity consider when determining the EIR for a variable rate debt security?

Interpretive response: The alternatives provided by Subtopic 326-30 may either create or eliminate volatility in the estimation of a credit loss, depending on the extent to which the cash flows expected to be collected include interest payments that will adjust based on changes in a floating interest rate index.

Therefore, when making an accounting policy election related to the EIR used to determine the present value of the expected cash flows, an entity should consider the potential effect on the estimation of credit losses in future periods.

The option to fix the rate at the date the entity determined that a credit loss existed is only available for AFS securities and is not available for HTM securities.

19.4.30 Accrued interest receivable

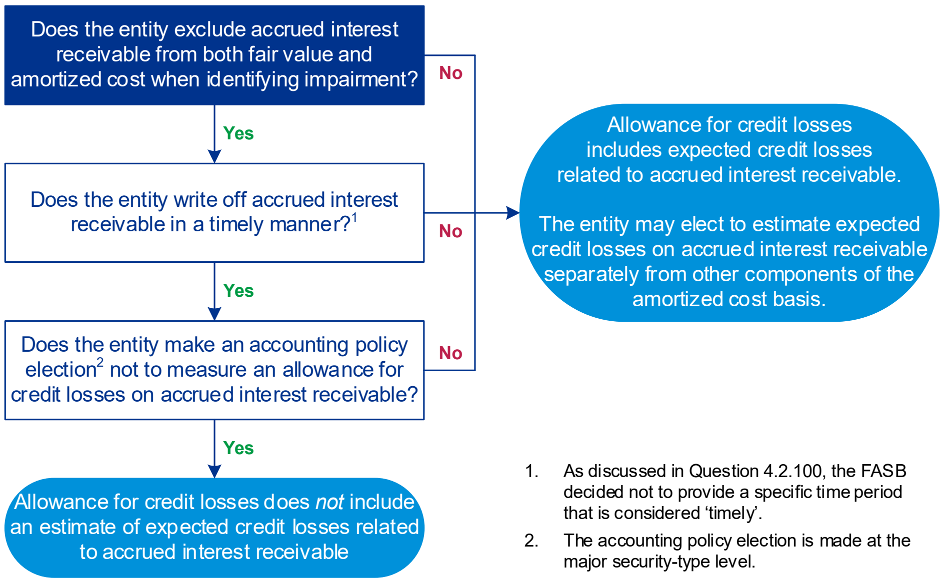
Excerpt from ASC 326-30

30-1A If for the purposes of identifying and measuring an impairment the applicable accrued interest is excluded from both the **fair value** and the **amortized cost basis** of the available-for-sale debt security, 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 applicable accrued interest component from the other components of amortized cost basis.

30-1B If an entity excludes applicable accrued interest from both the fair value and the amortized cost basis of the available-for-sale debt security, the entity may make an accounting policy election, at the major security-type level, not to measure an allowance for credit losses for accrued interest receivables if it writes off the uncollectible accrued interest receivable balance in a timely manner. An entity that elects the accounting policy in this paragraph shall meet the disclosure requirements in paragraph 326-30-50-3C. This accounting policy election shall be considered separately from the accounting policy election in paragraph 326-30-35-13A. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

A debt security's amortized cost includes the related accrued interest receivable. In response to stakeholder concerns, the FASB provided relief from identifying and measuring impairment on accrued interest receivable in certain situations.

If an entity determines that a credit loss exists, as discussed in section 19.3.20, it estimates an allowance for credit losses. The following decision tree summarizes whether an entity's allowance for credit losses should include an estimate of credit losses related to accrued interest receivable balances for AFS debt securities with a credit loss. [326-30-30-1A – 30-1B]



1. As discussed in Question 4.2.100, the FASB decided not to provide a specific time period that is considered 'timely'.
2. The accounting policy election is made at the major security-type level.

In addition to the relief summarized in the decision tree, the FASB provided relief related to how an entity may write off accrued interest receivable (see Question 19.6.30) and relief from certain presentation and disclosure requirements (see Question 23.2.05 and section 24.3.100, respectively).

19.5 Accounting for a credit loss

19.5.10 Overview

Excerpt from ASC 326-30

>> Identifying and Accounting for Impairment

35-2 For individual **debt securities** classified as **available-for-sale securities**, an entity shall determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. An entity shall record impairment relating to credit losses through an allowance for credit losses. However, the allowance shall be limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses shall be recorded through other comprehensive income, net of applicable taxes. An entity shall consider the guidance in paragraphs 326-30-35-6 and 326-30-55-1 through 55-4 when determining whether a credit loss exists.

35-3 At each reporting date, an entity shall record an allowance for credit losses that reflects the amount of the impairment related to credit losses, limited by the amount that fair value is less than the amortized cost basis. Changes in the allowance shall be recorded in the period of the change as credit loss expense (or reversal of credit loss expense).

Once a credit loss is estimated for an impaired AFS debt security, it is recognized through an allowance rather than as a direct writeoff of the security's amortized cost basis, unless the amount is deemed uncollectible (see Question 19.6.20). [326-30-35-2]

There is an exception for AFS securities that meet one of the following conditions:

- the entity intends to sell the security; or
- it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis.

The treatment of an impairment of an AFS debt security that meets one of these conditions is discussed in section 19.5.20.

When a credit loss is recognized through an allowance, the amount of the allowance is limited by the amount that the security's amortized cost basis exceeds the security's fair value – called the 'fair value floor'. [326-30-35-2]

19.5.20 Credit losses when an entity intends to sell, or more likely than not will be required to sell, a debt security

Excerpt from ASC 326-30

>>> Impairment in Earnings and Other Comprehensive Income

35-10 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 shall be written off and the amortized cost basis shall be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings. If an entity does not intend to sell the debt security, the entity shall 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). In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, the entity shall consider the factors in paragraphs 326-30-55-1 through 55-2.

Subtopic 326-30 does not change the legacy guidance for recognizing impairment when an entity intends to sell a debt security, or more likely than not will be required to sell a debt security before recovery of its amortized cost basis. Under these circumstances, consistent with legacy US GAAP, an entity recognizes the difference between the fair value and amortized cost in net income and as a writedown of the amortized cost of the AFS security. [326-30-35-10]

Example 19.5.10

Accounting for impairment when it is more likely than not that an entity will be required to sell the security before recovery

Assuming the same fact pattern and future cash flows as in Example 19.4.10 Scenario 1, ABC Corp. determines at the beginning of Year 2 that it is more likely than not that it will be required to sell the securities before recovery of the amortized cost basis.

As a result, the previously recognized allowance for credit losses is written off and the amortized cost basis is written down to the debt securities' fair value with any incremental impairment reported in net income.

ABC records the following journal entries related to the debt securities.

	Debit	*Credit*
Allowance for credit losses	70,524	
AFS debt securities – fair value adjustment	6,476	
AFS debt securities – amortized cost		77,000
To write off allowance for credit losses, reverse fair value adjustment, and adjust amortized cost basis.		
Impairment loss	6,476	
Unrealized loss on AFS debt securities (other comprehensive income)		6,476
To record additional impairment loss in net income.		

19.6 Accounting for a debt security subsequent to credit impairment

19.6.10 Overview

Excerpt from ASC 326-30

> Accounting for Debt Securities after a Credit Impairment

35-12 An entity shall reassess the credit losses each reporting period when there is an allowance for credit losses. An entity shall record subsequent changes in the allowance for credit losses on available-for-sale debt securities with a corresponding adjustment recorded in the credit loss expense on **available-for-sale debt securities**. An entity shall not reverse a previously recorded allowance for credit losses to an amount below zero.

35-13 An entity shall recognize writeoffs of available-for-sale debt securities in accordance with paragraph 326-20-35-8.

35-13A If for the purposes of identifying and measuring an impairment the applicable accrued interest is excluded from both the fair value and the amortized cost basis of the available-for-sale debt security, an entity may make an accounting policy election, at the major security-type level, to write off accrued interest receivables by reversing interest income or recognizing credit loss expense, or a combination of both. This accounting policy election shall be considered separately from the accounting policy election in paragraph 326-30-30-1A. An entity that elects this accounting policy shall meet the disclosure requirements in paragraph 326-30-50-3D. An entity may not analogize this guidance to components of amortized cost basis other than accrued interest.

AFS debt securities are evaluated for credit losses each reporting period using the guidance discussed in this chapter and the allowance for credit losses is adjusted accordingly. [326-30-35-12]

Reductions in the allowance for credit losses can be due to either (1) improvements in credit or (2) increases in the security's fair value that are independent of improvements in credit (i.e. changes to the fair value floor). Both types of reductions in the allowance are recorded through credit loss expense, and not in other comprehensive income. Unlike financial assets carried at amortized cost (including HTM debt securities), at no point should the allowance for credit losses be reduced below zero. [326-30-35-12, ASU 2019.04.BC43]

As previously discussed (see section 19.4.10), Subtopic 326-30 requires that credit losses be estimated using a discounted cash flow method. When applying this method, an entity can elect to report the change in the allowance for credit losses attributed to the passage of time as either interest income or credit loss expense (or benefit). This is a new election available under Subtopic 326-30 for AFS debt securities (see section 23.2). [326-30-45-3]

Question 19.6.10

Does an entity continue to accrue interest income for AFS debt securities with credit losses?

Interpretive response: It depends. Subtopic 326-30 does not address when a holder of an AFS debt security should place the debt security on nonaccrual status or how to subsequently report income on the nonaccrual debt security.

We believe an entity should apply the guidance in paragraph 310-10-35-53C for PCD assets to all AFS debt securities that are not beneficial interests when assessing when they should be placed on nonaccrual status. For further discussion of the application of nonaccrual status, see Question 19.8.20. We believe an entity should consistently apply its policies for placing AFS debt securities on nonaccrual status.

Additionally, the payment application method an entity uses for nonaccrual debt securities – cost recovery method, cash basis method or some combination of those methods – will affect the pattern in which payments reduce a security's amortized cost basis. Payment application methods that delay reductions in amortized cost basis may lead to larger credit losses than methods that do not delay the reduction. [310-10-35-53A]

Question 19.6.20

Does an entity have to account for writeoffs under Subtopic 326-30?

Interpretive response: Yes. Subtopic 326-30 requires the recognition of writeoffs of AFS debt securities. [326-30-35-13]

Writeoffs of AFS debt securities are recorded in the period in which they are deemed uncollectible. Because of this new requirement, entities need to develop new processes, policies and controls for AFS debt securities. This includes policies addressing the timing of recognition for writeoffs. [326-30-35-13, 326-20-35-8]

Unlike financial assets measured at amortized cost, an entity is prohibited from recognizing a negative allowance for credit losses for AFS debt securities. [326-30-35-12]

Question 19.6.30

Must an entity write off accrued interest receivable as a deduction from the allowance for credit losses?

Interpretive response: No. In response to stakeholder concerns about changing the current nonaccrual practice of reversing accrued interest receivable through interest income, the FASB provided relief from the requirement to deduct writeoffs of accrued interest receivable from the allowance for credit losses.

The relief is available to an entity that excludes accrued interest receivable from both the fair value and amortized cost basis of debt securities for purposes of identifying and measuring impairment. Under the relief, an entity may make an accounting policy election to write off accrued interest receivable in any of the following ways; this election is made separately for each major security type: [326-20-35-13A]

— reversing interest income;
— recognizing credit loss expense; or
— a combination of both.

An entity's accounting policy election for writing off accrued interest receivable is made separately from its accounting policy election about whether its allowance for credit losses includes expected credit losses of accrued interest receivable (see section 19.4.30). See also Question 4.2.50, which includes a summary of how expected credit losses of accrued interest receivable may be reflected in an entity's income statement.

Example 19.6.10

Subsequent accounting for impairment of individual AFS securities

Assuming the same fact pattern as in Example 19.4.10, Scenario 1, ABC Corp. performs its assessment of credit losses related to its AFS debt securities at the end of Year 2. In doing so, ABC considers the factors in paragraph 326-30-35-6 and paragraphs 326-30-55-1 to 55-4 and develops the following estimate of future expected cash flows.

Year	Expected cash flows	Present value of future expected cash flows
3	$ 60,000	$ 56,169
4	1,000,000	876,378
		$932,547

Also assume that at the end of Year 2 the debt security has an amortized cost basis of $967,000 and a fair value of $910,000.

At the end of Year 2, the present value of cash flows expected to be collected is still less than the amortized cost basis of the security and ABC estimates that the credit loss is now $34,453 – i.e. amortized cost of $967,000 less present value of expected cash flows of $932,547. This credit loss is less than the previously recognized allowance for credit losses of $70,524. Therefore, the allowance for credit losses is reduced by $36,071.

ABC records the following journal entries related to the credit and non-credit losses that exist at the end of Year 2.

	Debit	*Credit*
Allowance for credit losses	36,071	
Credit loss expense		36,071
To record recovery in credit losses.		
Unrealized loss on AFS debt securities (other comprehensive income)	16,071	
AFS debt securities – fair value adjustment		16,071
To record non-credit related losses.		

ABC calculates the above entries as follows.

	Year 1	Year 2	Difference
Allowance for credit losses	$(70,524)	$(34,453)	$36,071
Unrealized loss (other comprehensive income)[1]	(6,476)	(22,547)	16,071

Note:

1. The unrealized loss (other comprehensive income) at the end of Year 2 is the difference between the fair value of $910,000 and the amortized cost basis of $967,000, less the allowance for credit losses of $34,453.

19.6.20 Accounting subsequent to a writedown to fair value

Excerpt from ASC 326-30

> Accounting after a Write-Down Resulting from an Intent to Sell or a More-Likely-Than-Not Requirement to Sell

35-14 Once an individual **debt security** has been written down in accordance with paragraph 326-30-35-10, the previous **amortized cost basis** less writeoffs, including non-credit-related impairment reported in earnings, shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in **fair value**.

35-15 For debt securities for which impairments were reported in earnings as a writeoff 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 shall be accreted in accordance with existing applicable guidance as interest income. An entity shall continue to estimate the present value of cash flows expected to be collected over the life of the debt security. For debt securities accounted for in accordance with Subtopic 325-40, an entity should look to that Subtopic to account for changes in cash flows expected to be collected. For all other debt securities, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, those changes shall be accounted for as a prospective adjustment to the yield. Subsequent increases in the fair value of available-for-sale securities after the write-down shall be included in other comprehensive income. (This Section does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security.)

After recording impairment related to an AFS debt security because of an intent to sell or a more-likely-than-not requirement to sell before recovery of its amortized cost basis, the amortized cost basis of the debt security is reduced to the security's fair value (see section 19.5.20). [326-30-35-14]

Similar to legacy US GAAP, the difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income over the life of the AFS debt security. To do this, an entity forecasts the cash flows associated with the AFS debt security each period until it is sold or paid in full. [326-30-35-15]

If there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, those increases are accounted for as a prospective adjustment to the yield on the AFS security. Beneficial interest debt securities accounted for in the scope of Subtopic 325-40 (see chapter 20) are not subject to this guidance. [326-30-35-15]

Question 19.6.40

How are decreases in expected cash flows from an AFS debt security accounted for when an entity no longer intends to sell the security?

Background: An entity should write down the amortized cost basis of an AFS debt security to fair value when it either (1) has an intent to sell the security or (2) it is more likely than not that it will be required to sell the security before recovery of the security's amortized cost basis. The fair value represents the new amortized cost basis of the debt security. An entity continues to recognize interest income for the difference between the cash flows expected to be collected over the life of the security and the amortized cost basis. [326-30-35-10, 35-15]

Subsequent to writing down the amortized cost basis of an AFS debt security to fair value, an entity may determine that it no longer has an intent to sell the security, or it is not more likely than not that it will be required to sell the security before recovery of the security's amortized cost basis. In these cases, specific guidance requires subsequent increases in expected cash flows to be accounted for as prospective adjustments to the security's yield. [326-30-35-15]

Interpretive response: We believe subsequent decreases in expected cash flows of an AFS debt security in this scenario should be accounted for as follows:

— recognize a decrease in the present value of expected cash flows through the allowance for credit losses, to the extent those changes in the present value of expected cash flows are not limited by the fair value floor; and [326-30-35-1 – 35-4, 35-6 – 35-7]

— consider whether the AFS debt security should be placed on nonaccrual status based on the entity's nonaccrual policy.

19.7 Comparison of accounting for debt securities as AFS and HTM

Because ASU 2016-13 introduces different accounting models for AFS and HTM debt securities, the resulting credit losses for the same security could be different under each model. The following table summarizes the key differences that could result in different estimates of credit losses for debt securities.

	AFS		HTM
	Intent to sell or more likely than not required to sell	**No intent to sell; not more likely than not required to sell**	
Unit of account	Individual security/CUSIP.	Individual security/CUSIP.	Collective (pool) assessment when similar risk characteristics exist.
Is there a threshold for evaluating if credit losses exist?	No, when the security is impaired – i.e. fair value is less than amortized cost – that impairment is recognized in net income.	Yes, evaluate when the security is impaired – i.e. fair value is less than amortized cost.	No threshold for evaluation. All securities are evaluated for recognition of a lifetime loss allowance.
Can a qualitative assessment be made to determine if credit losses exist?	Not applicable, because the entire impairment is recognized in net income.	It depends. If an assessment of the qualitative factors results in the expectation that all contractual cash flows will be received, a quantitative assessment is not required. Otherwise, a quantitative assessment should be performed.	No, the expected credit loss model requires a quantitative assessment of the expected credit losses at each reporting date.
Credit loss estimate	No separate estimate required. The entire difference between the fair value and amortized cost is written off.	Difference between present value of expected cash flows and the amortized cost basis, limited by the difference between fair value and amortized cost (i.e. fair value floor). At no point should the allowance be reduced below zero.	Credit loss expected to be incurred over the life of the financial asset, not constrained by the fair value of the financial asset. The allowance may be reduced below zero for expected recoveries.
Method to estimate credit losses	Not applicable, because the entire difference between the fair value and amortized cost is written off.	Discounted cash flow method.	Various methods may be appropriate as included in Subtopic 326-20.

19.8 Purchased AFS securities with credit deterioration

Excerpt from ASC 326-30

> Purchased financial assets with credit deterioration

30-2 A purchased **debt security** classified as available-for-sale shall be considered to be a **purchased financial asset with credit deterioration** when the indicators of a credit loss in paragraph 326-30-55-1 have been met. The allowance for credit losses for purchased **financial assets** with credit deterioration shall be measured at the individual security level in accordance with paragraphs 326-30-35-3 through 35-10. The **amortized cost basis** for purchased financial assets with credit deterioration shall be considered to be the purchase price plus any allowance for credit losses. See paragraphs 326-30-55-1 through 55-7 for implementation guidance.

30-3 Estimated credit losses shall be discounted at the rate that equates the present value of the purchaser's estimate of the security's future cash flows with the purchase price of the asset.

30-4 An entity shall record the **holding gain or loss** through other comprehensive income, net of applicable taxes.

19.8.10 Overview

Special accounting provisions apply to PCD AFS securities.

When an entity acquires a PCD AFS debt security, it applies the 'gross up' method. Under this method, the Day 1 allowance for credit losses is added to the purchase price to determine the initial amortized cost basis. Therefore, there is no credit loss expense affecting net income on acquisition. [326-30-30-2]

19.8.20 Identifying purchased AFS securities with credit deterioration

Whether AFS securities should be considered PCD is determined at the individual security level.

PCD accounting applies to a purchased AFS security that experienced a credit loss. To determine if a security has experienced a credit loss, an entity considers the following indicators: [326-30-30-2, 55-1]

- the extent to which the fair value is less than the par value of the security – this comparison is likely not relevant for zero coupon bonds;
- adverse conditions specifically related to the security, an industry or geographic area;
- the payment structure of the debt security and the likelihood of the issuer being unable to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments; and
- any changes to the rating of the security by a rating agency.

Question 19.8.10

Are there different concepts for assessing whether AFS and HTM debt securities qualify for PCD accounting?

Interpretive response: Yes, an entity applies different concepts to determine when to use PCD accounting for an AFS and a HTM debt security.

HTM debt securities

For a HTM debt security, PCD accounting applies when, at the date of acquisition, the security has experienced a more-than-insignificant deterioration in credit quality since its initial issuance. [326-20 Glossary]

The FASB stated that it did not intend for PCD accounting to be limited to financial assets that were considered nonaccrual or impaired under legacy US GAAP. Instead, the FASB intended it to also apply to assets that had experienced a more-than-insignificant level of credit deterioration since origination. For a more detailed discussion, see chapter 12. [ASU 2016-13.BC90]

AFS securities

In contrast, as explained in Question 19.8.20, PCD accounting applies to a purchased AFS security when indicators of a credit loss exist at the time of acquisition. [326-30-30-2]

Excerpt from ASC 326-30

>> Example 1: Identifying Purchased Financial Assets with Credit Deterioration

55-5 This Example illustrates one way an entity may identify purchased financial assets with credit deterioration.

55-6 Entity A purchases a portfolio of debt securities with varying levels of credit quality that it classifies as available for sale. When determining which individual available-for-sale debt securities should be considered to be in the scope of the guidance for purchased financial assets with credit deterioration, Entity A considers the indicators of impairment in paragraph 326-30-55-1. Entity A also considers its practices for identifying credit losses on available-for-sale debt securities. If Entity A determines that, on an individual basis, the purchased debt securities are purchased financial assets with credit deterioration, it should classify them as such.

55-7 Entity A also considers the securities that are within the scope of Subtopic 325-40 on beneficial interests in securitized financial assets. Entity A purchases a residual tranche and determines that there is a significant difference between contractual cash flows and expected cash flows. In accordance with paragraph 325-40-30-1A(a), Entity A applies the accounting for purchased financial assets with credit deterioration to the residual tranche.

19.8.30 Initially measuring purchased AFS securities with credit deterioration

When recognizing interest income on PCD financial assets, it is not appropriate to accrete from the purchase price to the contractual cash flows. [ASU 2016-13.BC85]

Under Subtopic 326-30, the discount embedded in the purchase price attributable to a credit loss at the date of acquisition of a PCD AFS security is not recognized as interest income, but rather is recorded as an allowance for credit losses. [326-30-30-2]

Example 19.8.10
PCD AFS debt securities – initial measurement

ABC Corp. acquires a portfolio of debt securities that have varying levels of credit quality and classifies them as AFS.

ABC evaluates the individual debt securities in the portfolio against the criteria in Subtopic 326-30 to determine which securities, if any, should be considered PCD. ABC does not pay or receive any fees or incur any transaction costs, associated with this acquisition.

ABC considers the criteria in paragraphs 326-30-30-2 and 55-1 and determines that debt securities with the following characteristics should be considered PCD.

Par value:	$1,000,000
Purchase price:	$750,000
Contractual term (acquired at the end of Year 1):	Five years
Coupon:	5%
Principal due:	Only at maturity

After considering information about past events, current conditions, and reasonable and supportable forecasts, ABC determines the following initial cash flow expectations related to the PCD debt securities.

Year	Contractual cash flows	Expected cash flows	Credit losses	Present value of credit losses
2	$ 50,000	$ 40,000	$ 10,000	$ 9,238
3	50,000	35,000	15,000	12,802
4	50,000	35,000	15,000	11,827
5	1,050,000	900,000	150,000	109,263
			Total	**$143,130**

Under the guidance in paragraph 326-30-30-3, ABC determines the EIR to be 8.24% (rounded). This is the rate that equates the present value of the security's estimated future cash flows with the purchase price of $750,000.

ABC estimates the allowance for credit losses to be $143,130 and the amortized cost basis of the debt securities to be $893,130 – i.e. $750,000 purchase price plus the allowance for credit losses of $143,130.

ABC records the following journal entry at acquisition.

	Debit	Credit
AFS debt securities	1,000,000	
Allowance for credit losses		143,130
AFS debt securities – non-credit discount		106,870
Cash		750,000
To record acquisition of PCD AFS debt securities, and estimates of credit losses and non-credit discount.		

19.8.40 Subsequently measuring purchased AFS securities with credit deterioration

Excerpt from ASC 326-30

>> Purchased Financial Assets with Credit Deterioration

35-16 An entity shall measure changes in the allowance for credit losses on a **purchased financial asset with credit deterioration** in accordance with paragraph 326-30-35-6. The entity shall report changes in the allowance for credit losses in net income as credit loss expense (or reversal of credit loss expense) in each reporting period.

35-17 This Subtopic does not address how an entity shall recognize interest income. See paragraphs 310-10-35-53A through 35-53C for guidance on recognition of interest income on purchased financial assets with credit deterioration.

Excerpt from ASC 310-10

>> Interest Income

35-53A Except as noted in paragraphs 310-10-35-53B through 35-53C, this Subsection does not address how a creditor should recognize, measure, or display interest income on a financial asset with a credit loss. Some accounting methods for recognizing income may result in an amortized cost basis of a financial asset that is less than the amount expected to be collected (or, alternatively, the fair value of the collateral). Those accounting methods include recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those methods.

35-53B When recognizing interest income on **purchased financial assets with credit deterioration** within the scope of Topic 326, an entity shall not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition. The entity shall accrete or amortize as interest income the non-credit-related discount or premium of a purchased financial asset with credit deterioration in accordance with existing applicable guidance in Section 310-20-35 or 325-40-35.

35-53C Recognition of income on purchased financial assets with credit deterioration is dependent on having a reasonable expectation about the amount expected to be collected. Subsequent to purchase, this Subtopic does not prohibit placing financial assets on nonaccrual status, including use of the cost recovery method or cash basis method of income recognition, when appropriate. For example, if the timing of either a sale of the financial asset into the secondary market or a sale of collateral in essentially the same condition as received upon foreclosure is indeterminate, the creditor likely does not have the information necessary to reasonably estimate cash flows expected and shall cease recognizing income on the financial asset. However, the ability to place a financial asset on nonaccrual shall not be used to circumvent recognition of a credit loss. If the financial asset is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or improving the collateral for resale. Consistent with paragraph 310-20-35-18, interest income shall not be recognized to the extent that the net investment in the financial asset would increase to an amount greater than the payoff amount.

Subsequent to initial measurement, an entity determines the estimate of credit losses using the same model as other AFS debt securities. Subsequent changes in the allowance for credit losses for PCD AFS debt securities are recorded as credit loss expense (or reversal), except that an entity may present the change in present value related to the passage of time as interest income (see section 23.3.10). [326-30-35-16, 45-3]

Question 19.8.20

Can an entity place a purchased AFS debt security with credit deterioration on nonaccrual status?

Interpretive response: It depends. An entity applies nonaccrual policies to PCD assets when it does not have a reasonable expectation about the amounts expected to be collected. However, placing a financial asset on nonaccrual status cannot be used to circumvent recognition of a credit loss. [310-10-35-53C]

20. Beneficial interests

Detailed contents

Questions

Example

Comparison to legacy US GAAP

20.5 Transition considerations

Question

20.1 How the standard works

This chapter addresses the scope of Subtopic 325-40 and how to account for credit losses on beneficial interests that are in the scope of Subtopic 325-40, including how changes in credit losses affect accretable yield.

The appropriate accounting treatment for beneficial interests depends on whether they are classified as HTM or AFS and whether they are purchased financial assets with credit deterioration (PCD) beneficial interests.

The credit loss guidance on PCD financial assets applies to a beneficial interest that meets the definition of PCD or that has a significant difference between contractual and expected cash flows at the date of recognition.

The following table summarizes the four different accounting models applicable to beneficial interests that are in the scope of Subtopic 325-40.

Beneficial interests classification	Accounting for PCD assets is applied	Accounting for PCD assets is <u>not</u> applied
Held-to-maturity	Initial estimate of expected credit losses is recognized as an allowance through a gross-up that increases the amortized cost basis of the asset with no effect on net income at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If a favorable change in expected cash flows is not fully recognized through a decrease to the allowance (including a negative allowance), the accretable yield is adjusted on a prospective basis.	No allowance is recognized at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If a favorable change in expected cash flows is not fully recognized through a decrease to the allowance (including a negative allowance), the accretable yield is adjusted on a prospective basis.
Available-for-sale	Initial estimate of expected credit losses is recognized as an allowance through a gross-up that increases the amortized cost basis of the asset with no effect on net income at initial recognition. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If the allowance has been reduced to zero (due to favorable changes) or met the fair value floor (due to adverse changes), the accretable yield is adjusted on a prospective basis.	No allowance is recognized at initial recognition. If a decline in fair value below amortized cost results from credit losses, an allowance is recognized through net income. Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If the allowance has been reduced to zero (due to favorable changes) or met the fair value floor (due to adverse changes), the accretable yield is adjusted on a prospective basis.

20.2 Scope of Subtopic 325-40

20.2.10 Overview

Excerpt from ASC 325-40

> Instruments

15-2 The guidance in this Subtopic applies to a transferor's interests in securitization transactions that are accounted for as sales under Topic 860 and purchased **beneficial interests** in securitized financial assets.

15-3 The guidance in this Subtopic applies to beneficial interests that have all of the following characteristics:

a. Are either debt securities under Subtopic 320-10 or required to be accounted for like debt securities under that Subtopic pursuant to paragraph 860-20-35-2.
b. Involve securitized financial assets that have contractual cash flows (for example, loans, receivables, debt securities, and guaranteed lease residuals, among other items). Thus, the guidance in this Subtopic does not apply to securitized financial assets that do not involve contractual cash flows (for example, common stock equity securities, among other items). See paragraph 320-10-35-38 for guidance on beneficial interests involving securitized financial assets that do not involve contractual cash flows.
c. Do not result in consolidation of the entity issuing the beneficial interest by the holder of the beneficial interests.
d. Subparagraph superseded by Accounting Standards Update No. 2016-13.
e. Are not beneficial interests in securitized financial assets that have both of the following characteristics:
    1. Are of high credit quality (for example, guaranteed by the U.S. government, its agencies, or other creditworthy guarantors, and loans or securities sufficiently collateralized to ensure that the possibility of credit loss is remote)
    2. Cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

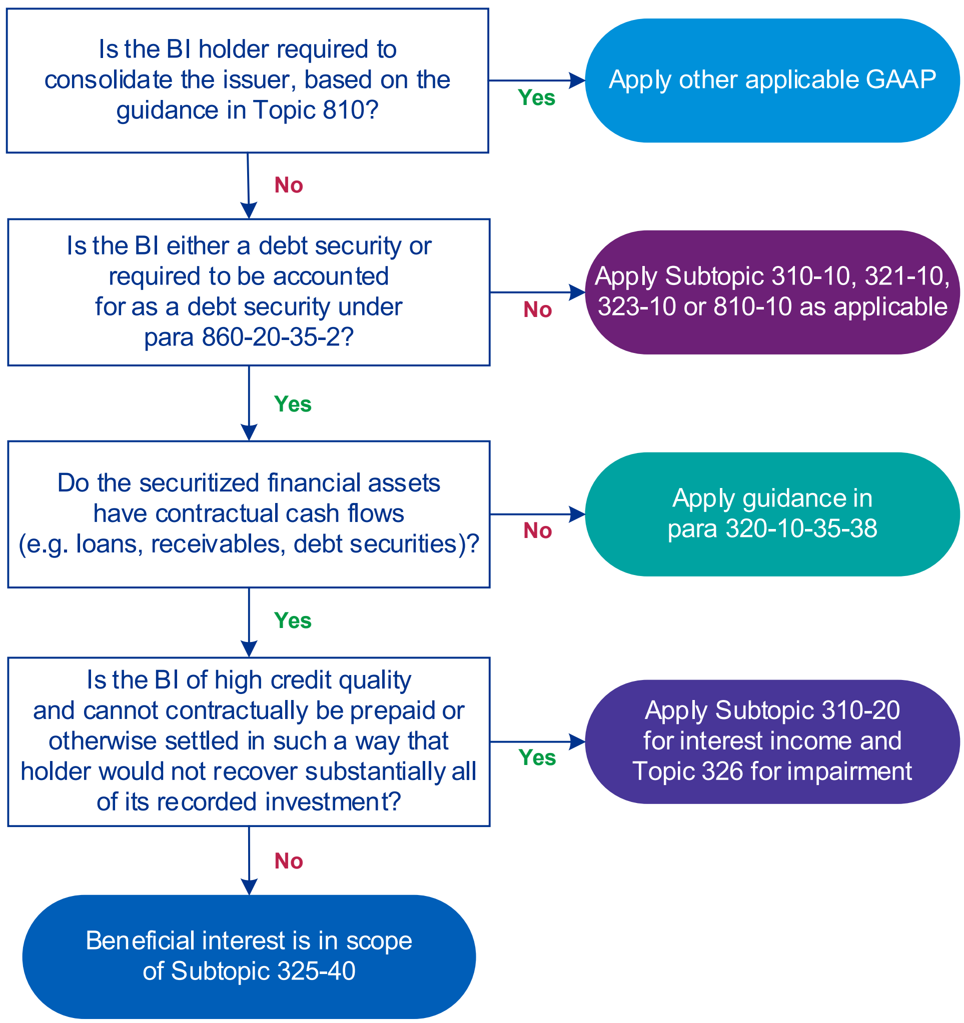
Beneficial interests are rights to receive all or portions of specified cash inflows received by a trust or other entity. These cash flows can include senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through; premiums due to guarantors; commercial paper obligations; and residual interests, whether in the form of debt or equity. [325-40 Glossary]

There are two types of beneficial interests in the scope of Subtopic 325-40:

— beneficial interests obtained by a transferor in a securitization transaction that is accounted for as a sale under Topic 860; and
— purchased beneficial interests, including beneficial interests purchased with deteriorated credit quality.

Subtopic 325-40 does not apply to a transferor's beneficial interest in a securitization transaction treated as a secured borrowing. This is because in a secured borrowing, the transferor continues to report the transferred financial asset – rather than the beneficial interest – on its balance sheet. [325-40-15-2 – 15-3]

There are additional requirements that a beneficial interest needs to satisfy to be in the scope of Subtopic 325-40. Those requirements are reflected in the following decision tree. [325-40-15-3]



Question 20.2.10

What does 'high credit quality' mean when determining whether a beneficial interest is in the scope of Subtopic 325-40?

Interpretive response: Subtopic 325-40 does not apply to a beneficial interest that is of high credit quality and not contractually prepayable or otherwise settleable in a way that the holder would not recover substantially all of its recorded investment. [325-40-15-3(e)]

Consistent with current practice in applying legacy US GAAP, we believe the definition of high credit quality, as that term is used in paragraph 325-40-15-3(e), includes only beneficial interests rated AA or better or unrated securities that have credit quality similar to securities rated AA or better.

Paragraph 325-40-15-3(e)(1) includes examples of beneficial interests in securitized financial assets considered to be of high credit quality, such as:

- securities guaranteed by the US government, its agencies or other creditworthy guarantors; and
- loans or securities sufficiently collateralized to ensure that the possibility of credit loss is remote.

According to an SEC staff speech, it appeared to the staff that the EITF intended this guidance to exclude from the scope of Subtopic 325-40 only those beneficial interests for which the likelihood of loss is remote. The SEC staff has indicated that an AA rating is defined by the rating agencies as "the obligor's capacity to meet its financial commitment on the obligation is very strong." This definition is consistent with the possibility of credit loss being remote. In contrast, credit ratings lower than AA are not consistent with this possibility. Therefore, the SEC staff believes that only beneficial interests rated AA or better should be deemed to be of high credit quality for purposes of applying the scope language in paragraph 325-40-15-3(e). [2003 AICPA Conf]

Question 20.2.20

Is a beneficial interest initially considered of high credit quality included in the scope of Subtopic 325-40 if the credit quality subsequently declines?

Interpretive response: Potentially. On acquisition, an entity assesses a beneficial interest in securitized financial assets to determine whether it is in the scope of Subtopic 325-40. However, Section 325-40-15 does not specify whether an entity should reevaluate this assessment after acquisition for subsequent adverse events, such as a decline in credit quality or market price.

When applying legacy US GAAP, in our experience entities have interpreted this issue differently and have developed policies on the application of Section 325-40-15 after acquisition. We believe these policies will continue to be acceptable with some changes to reflect the issuance of Topic 326. The following are the common methods for assessing whether beneficial interests in securitized financial assets are in the scope of Subtopic 325-40.

Assessment method	Application	KPMG commentary
One-time assessment	Determine if a beneficial interest is in the scope of Subtopic 325-40 at the date of acquisition and do not reassess based on future events.	
Assessment at acquisition and upon recognition of credit losses	Determine if a beneficial interest is in the scope of Subtopic 325-40 at the date of acquisition and reassess only on the date(s) credit losses are recognized under Subtopic 326-30.	This method is not available for beneficial interests that are HTM because an allowance for credit losses is recognized at acquisition. Therefore, it applies only to AFS beneficial interests. An entity that previously applied this policy for beneficial interests classified as HTM will need to elect a different accounting policy on adoption of Topic 326.
Continuous assessment	Determine if a beneficial interest is in the scope of Subtopic 325-40 at the date of acquisition and reassess at each reporting date.	We generally believe that the continuous assessment policy is preferable.

An entity should document and consistently apply its assessment policy. It should also disclose its policy in its financial statement notes.

Except as noted above for HTM securities for which an entity previously applied the assessment at acquisition and upon recognition of credit losses method, an entity should not change its elected policy related to the application of its assessment unless it is changing to a preferable policy. We generally believe that applying the 'continuous assessment' policy is preferable.

Lastly, because the reevaluation of whether a beneficial interest is in the scope of Subtopic 325-40 is not an acquisition, a beneficial interest cannot be accounted for as PCD as a result of an entity's reassessment of whether it is in the scope of Subtopic 325-40.

20.3 Initial measurement

Excerpt from ASC 325-40

> Initial Investment

30-1 If the holder of the **beneficial interest** is the transferor, the initial investment would be the fair value of the beneficial interest as of the date of transfer, as required by paragraph 860-20-30-1.

30-1A An entity shall apply the initial measurement guidance for **purchased financial assets with credit deterioration** in Subtopic 326-20 to a beneficial interest classified as held-to-maturity and in Subtopic 326-30 to a beneficial interest classified as available-for-sale, if it meets either of the following conditions.

a. There is a significant difference between contractual cash flows and expected cash flows at the date of recognition.
b. The beneficial interests meet the definition of purchased financial assets with credit deterioration.

> Accretable Yield

30-2 For beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of *all cash flows expected to be collected* attributable to the beneficial interest estimated at the acquisition-transaction date (the transaction date) over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition-transaction date (the transaction date) over the amortized cost basis (the purchase price plus the initial allowance for credit losses).

30-3 At the transaction date, *all cash flows expected to be collected* means the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under Topic 860.

20.3.10 Overview

The initial measurement of beneficial interests in the scope of Subtopic 325-40 depends on whether these interests are treated as PCD. The following beneficial interests are treated as PCD and therefore are referred to as 'PCD beneficial interests'. [325-40-30-1A]

— Beneficial interests that meet the definition of PCD – i.e. those that have experienced a more-than-insignificant deterioration in credit quality since origination (see chapter 12).

— Beneficial interests that have a significant difference between contractual cash flows and expected cash flows at the date of recognition.

20.3.20 PCD beneficial interests

PCD beneficial interests are initially measured using the 'gross-up' method used for PCD assets in general. The gross-up method (described below) is applied to a PCD beneficial interest regardless of whether it is classified as HTM or AFS. [326-20-30-13, 326-30-30-2]

Under the gross-up method, the initial estimate of expected credit losses is recognized as an allowance and there is no Day 1 credit loss expense. The initial amortized cost basis of a PCD beneficial interest is determined as follows.

Initial amortized cost basis = **Purchase price** + **Initial allowance for credit losses**

At acquisition, the accretable yield is measured as the excess of all contractual cash flows attributable to the beneficial interest over the amortized cost basis. This amount is not presented on the balance sheet. [325-40-30-2, 45-1]

Comparison to legacy US GAAP

Effect of PCD measurement requirements

Because the amortized cost basis includes the allowance for credit losses, the effect of the PCD guidance may be a substantial change compared with the legacy balance sheet presentation. The balance sheet amounts for some beneficial interests could be significantly greater under Topic 326 than under legacy US GAAP, especially when they are residual interests or other beneficial interests purchased at a deep discount from par. [325-40-30-2, 326-20-30-13]

Question 20.3.10

Why is a beneficial interest accounted for as a PCD beneficial interest when there is a significant difference between its contractual and expected cash flows?

Interpretive response: The FASB concluded that beneficial interests that have a significant difference between contractual and expected cash flows should be subject to the guidance for PCD assets because these interests pose the same core issue as PCD assets. In the FASB's view, it would be inappropriate to recognize interest income on the basis of contractual cash flows when a significant portion of those cash flows is not expected to be collected. As a result, the FASB decided that certain beneficial interests should qualify for the gross-up method at acquisition even if they do not meet the definition of a PCD asset because there has not been any credit deterioration since origination. [ASU 2016-13.BC94–BC95]

Question 20.3.20
Could beneficial interests other than residual interests have a significant difference between their contractual and expected cash flows?

Interpretive response: Yes. Subtopic 325-40 does not provide guidance on how to determine whether a difference between contractual and expected cash flows is 'significant'.

As a result, this determination will require judgment.

— 'Residual interest' is a term used to refer to the most subordinated interests in securitized financial assets that are issued by a trust or other entity. Typically, the holders of the residual interest are entitled to receive cash flows after contractually specified cash flows have been paid to all other interest holders. Residual interests are likely to have a significant difference between their contractual and expected cash flows (see also Question 20.3.30).

— Additionally, interests other than residual interests should be evaluated to determine whether there is a significant difference between their contractual and expected cash flows.

Question 20.3.30
How are contractual cash flows determined when evaluating whether the PCD guidance should be applied to a beneficial interest that does not have specified contractual cash flows?

Interpretive response: When evaluating whether the PCD guidance should be applied to beneficial interests, Subtopic 325-40 does not provide guidance on how to determine whether there is a significant difference between contractual and expected cash flows when the instrument itself does not have contractual cash flows – e.g. when a beneficial interest holder is entitled to receive only the residual cash flows of a securitization structure.

If contractual cash flows of a beneficial interest are not specified, a holder should look through to the contractual cash flows of the underlying financial assets and determine what cash flows would be paid to the holder of that beneficial interest if all of the underlying assets paid in accordance with their contractual terms. Additionally, as explained in Question 20.3.40, a holder should consider expected prepayment of the underlying financial assets when determining contractual cash flows. [TRG 06-17.6]

The holder would then compare the contractual cash flows with the cash flows expected to be collected to determine whether there is a significant difference between contractual and expected cash flows at acquisition. If a significant difference exists, the PCD guidance should be applied.

Question 20.3.40

What prepayment assumptions should be used when determining a beneficial interest's contractual cash flows?

Interpretive response: The holder's expected prepayment assumptions at acquisition should be used.

The TRG discussed how prepayments should be considered when determining contractual cash flows for purposes of:

— assessing whether beneficial interests meet the scope to be PCD beneficial interests; and
— initially estimating expected credit losses for PCD beneficial interests.

For both of the above purposes, the TRG generally agreed that contractual cash flows should consider the holder's initial expectations for prepayments. However, contractual cash flows should not consider any expected credit losses.

A beneficial interest is a PCD beneficial interest if there is a significant difference between contractual and expected cash flows. The impact of including initially expected prepayments in the determination of contractual cash flows will generally result in fewer beneficial interests being considered PCD beneficial interests.

The initial estimation of expected credit losses reflects the difference between contractual cash flows and expected cash flows. Expected cash flows are required to consider expected prepayments. By also considering expected prepayments in contractual cash flows, the initial estimate of expected credit losses will not be impacted by expected prepayments. As a result, the allowance for credit losses will generally be smaller than if prepayments were not considered in contractual cash flows. [TRG 06-17.2, TRG 06-17.6]

Additionally, the TRG noted that although expected prepayments should not be included in the initial estimation of expected credit losses, all subsequent changes in expected cash flows (due to both credit and prepayments) should be included in the estimation of expected credit losses in future periods. Subsequent favorable (or unfavorable) changes in expected cash flows first decrease (or increase) the allowance. If the allowance is reduced to zero or – for AFS debt securities – has met the fair value floor, the accretable yield is adjusted on a prospective basis.

Example 20.3.10

Initial measurement of PCD beneficial interests

ABC Corp. acquires a beneficial interest in a residual tranche of a securitization structure that meets the conditions to be in the scope of Subtopic 325-40. ABC classifies the beneficial interest as AFS.

ABC pays $700,000 to the seller and determines that there is a significant difference between expected cash flows and the contractual cash flows attributable to the residual tranche based on the underlying financial assets that were securitized. Assume that there are no embedded derivatives that need to be bifurcated and accounted for separately.

ABC uses discounted cash flows to estimate expected credit losses, as required by Subtopic 325-40 (see section 20.4.10). It determines the EIR – which is the rate that equates the present value of expected cash flows at acquisition with the purchase price of $700,000 – to be 9.29% (rounded). ABC uses the 9.29% EIR to discount expected credit losses and determines the allowance for credit losses at the time of acquisition is $175,000.

The following table reflects:

— contractual cash flows attributable to the residual tranche based on the underlying securitized financial assets, assuming zero credit losses and considering expected prepayments;
— ABC's initial cash flow expectations, considering both expected credit losses and prepayments; and
— expected credit losses at the date of acquisition.

Year	Contractual cash flows	Expected cash flows	Expected credit losses[1]
1	$ 280,000	$224,000	$ 56,000
2	300,000	240,000	60,000
3	260,000	208,000	52,000
4	180,000	144,000	36,000
5	65,881	52,705	13,176
Total	**$1,085,881**	**$868,705**	**$217,176**
Purchase price		$700,000	
Original EIR (rounded)	9.29%		9.29%
Present value at EIR	$ 875,000		$175,000
Accretable yield (non-credit discount)	$ 210,881		

Note:
1. Expected credit losses represent cash flows *not* expected to be collected.

ABC records the following journal entry to account for the acquisition of the beneficial interest.

	Debit	*Credit*
Beneficial interests – AFS	1,085,881	
Cash		700,000
Allowance for credit losses		175,000
Beneficial interests – AFS – non-credit discount (accretable yield)		210,881
To record acquisition of beneficial interests, estimate of expected credit losses and non-credit discount (accretable yield).		

The non-credit discount (accretable yield) of $210,881 is the difference between all contractual cash flows attributable to the beneficial interest at the transaction date ($1,085,881) and the amortized cost basis ($875,000 – i.e. purchase price plus the initial allowance for credit losses).

Immediately after acquisition, ABC's balance sheet reflects the following.

Account	Amount
Balance sheet – assets	
Beneficial interests – AFS (amortized cost of $875,000, allowance for credit losses of $175,000)	$700,000

The beneficial interests are presented net of the non-credit discount as the accretable yield is not permitted to be presented on the balance sheet. [325-40-45-1]

20.3.30 Beneficial interests that are not PCD

Beneficial interests for which PCD accounting is not applied are initially measured at fair value. [325-40-30-1]

At acquisition, the accretable yield is initially measured as the excess of all cash flows expected to be collected attributable to the beneficial interest over the fair value. Cash flows expected to be collected include estimates of both the amount and timing of principal and interest payments to be received. [325-40-30-2, 35-3]

As further discussed in section 20.4.10, Subtopic 325-40 requires an entity to use a discounted cash flow method to estimate expected credit losses for all investments in beneficial interests in its scope; this is regardless of whether they are classified as HTM or as AFS. Additionally, it requires an entity to recognize credit losses when there has been an adverse change in the net present value of cash flows expected to be collected when compared to net present value of cash flows expected at the date of initial recognition. As a result, an entity will not recognize an allowance for credit losses at initial recognition of beneficial interests that are not PCD because there will not have been an adverse change at that time. [325-40-35-6 – 35-7]

20.3.40 Comparison to legacy US GAAP

Comparison to legacy US GAAP
Initial measurement of beneficial interests

The following table provides a summary comparison of Topic 326 and Subtopic 325-40 (as amended) to legacy US GAAP.

Legacy US GAAP	Topic 326 and Subtopic 325-40 (as amended)
Balance sheet	
No allowance recognized at acquisition. [325-40-30-1]	For PCD beneficial interests – both AFS and HTM – allowance recognized at acquisition through a gross-up that increases the amortized cost of the assets with no effect on net income. For non-PCD beneficial interests, no allowance recognized at initial recognition, similar to legacy US GAAP.
Income statement	
No impairment losses recognized in net income at initial recognition. [325-40-30-1]	No impairment losses recognized in net income at initial recognition, similar to legacy US GAAP.

20.4 Subsequent measurement

Excerpt from ASC 325-40

> Accretable Yield

35-1 The holder shall recognize accretable yield as interest income over the life of the **beneficial interest** using the effective yield method. The holder of a beneficial interest shall continue to update, over the life of the beneficial interest, the expectation of cash flows to be collected.

35-3 After the transaction date, cash flows expected to be collected are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current conditions and reasonable and supportable forecasts.

35-4 If upon evaluation of a held-to-maturity classified beneficial interest there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the investor shall first apply the guidance in Subtopic 326-20 on financial instruments measured at amortized cost to account for that favorable (or adverse) change. After application of the guidance in Subtopic 326-20, if the amount of the favorable (or adverse) change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses in accordance with Subtopic 326-20, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.

35-4A If upon evaluation of an available-for-sale classified beneficial interest there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the investor shall apply the guidance in Subtopic 326-30 on measuring credit losses on available-for-sale debt securities to account for that favorable (or adverse) change. After application of the guidance in Subtopic 326-30, if the amount of the favorable (or adverse) change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses in accordance with Subtopic 326-30, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.

35-4B The reference amount in paragraphs 325-40-35-4 through 35-4A is equal to the initial investment (or initial amortized cost basis for beneficial interests that apply the accounting for purchased financial assets with credit deterioration) minus cash received to date minus writeoff of amortized cost basis plus the yield accreted to date.

35-4C In this Subtopic, a favorable (or an adverse) change in cash flows expected to be collected is considered in the context of both timing and amount of the cash flows expected to be collected. Based on cash flows expected to be collected, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety. The adjustment shall be accounted for prospectively as a change in estimate in conformity with Topic 250, with the amount of periodic accretion adjusted over the remaining life of the beneficial interest.

35-5 Determining whether there has been a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected (taking into consideration both the timing and amount of the cash flows expected to be collected) involves comparing the present value of the remaining cash flows expected to be collected at the initial transaction date (or at the last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date.

35-6 The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest.

> Credit Losses

35-6A An entity shall account for credit losses on beneficial interests classified as held to maturity and available for sale in accordance with Topic 326.

35-7 An entity shall use the present value of expected future cash flows technique to measure credit losses on beneficial interests. If the present value of the original estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable. If the present value of the original estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is greater than the present value of the current estimate of cash flows expected to be collected, the change is considered adverse.

20.4.10 Credit losses

Credit losses on beneficial interests are determined under the guidance in either Subtopic 326-20 (if they are classified as HTM) or Subtopic 326-30 (if they are classified as AFS). However, while 326-20 provides latitude in choosing a method to estimate expected credit losses, Subtopic 325-40 requires an entity to use a discounted cash flow method to estimate expected credit losses for all investments in beneficial interests within its scope, regardless of whether they are classified as HTM or as AFS. The discount rate used in estimating expected credit losses is the same as the rate used for recognizing interest income for these types of instruments. Otherwise, all other aspects of the credit loss models in Subtopics 326-20 and 326-30 are applied to beneficial interests in the scope of Subtopic 325-40. [325-40-35-6 – 35-7]

See chapters 3 to 8 and chapter 19 for measurement guidance regarding HTM and AFS debt securities, respectively.

20.4.20 Accretion

The accretable yield determined at acquisition is recognized as interest income over the life of the beneficial interest. Favorable (or adverse) changes in expected cash flows on beneficial interests subsequent to initial recognition first decrease (or increase) the allowance for credit losses. The accretable yield is adjusted on a prospective basis if either: [325-40-35-1, 35-4 – 35-4A]

— a favorable change in expected cash flows has reduced the allowance for credit losses to zero for AFS beneficial interests or to the limit of the negative allowance for HTM beneficial interests (see section 20.4.30); or

— an adverse change has increased the allowance such that the amortized cost has reached the fair value floor for AFS beneficial interests – i.e. the allowance is limited to the amount by which the amortized cost basis exceeds the fair value. For additional information on the fair value floor, see chapter 19.

Question 20.4.10

Is a change in the timing of cash flows considered when evaluating whether there has been a favorable or adverse change in cash flows expected to be collected?

Interpretive response: Yes. Both the amount and timing of cash flows are considered when determining whether there has been a favorable or adverse change in the cash flows expected to be collected in periods subsequent to initial recognition. Therefore, prepayments or a change in prepayment speeds may affect an entity's estimate of cash flows expected to be collected. [325-40-35-4C]

Additionally, any actual or estimated deferral in the receipt of the cash flows results in an unfavorable change if: [325-40-35-4C]

— the entity receives no interest on the deferred cash flows; or

— the accretion rate – used to discount the cash flows expected to be collected – is higher than the interest rate received on the deferred cash flows.

Example 20.4.10
Subsequent measurement of PCD beneficial interests

Continuing Example 20.3.10, ABC Corp. subsequently accounts for the AFS beneficial interest from Year 1 to Year 5 of its life as follows.

ABC does not exclude accrued interest receivable from the fair value and amortized cost basis of the AFS beneficial interest and, accordingly, measures an allowance for credit losses for accrued interest receivable. Further, ABC writes off accrued interest receivable by reversing the previously recognized allowance (see Question 4.2.50).

The following table represents the projected amortization schedule for the amortized cost of the beneficial interest – which is net of the accretable yield – based on ABC's initial expected cash flows at acquisition.

Year	Amortized cost beginning balance[1]	Cash payments[2]	Interest income[3]	Writeoffs[4]	Amortized cost ending balance[5]
1	$875,000	$224,000	$ 81,269	$ 56,000	$676,269
2	676,269	240,000	62,811	60,000	439,080
3	439,080	208,000	40,781	52,000	219,861
4	219,861	144,000	20,421	36,000	60,282
5	60,282	52,705	5,599	13,176	0
Total		**$868,705**	**$210,881**	**$217,176**	

Notes:

1. Amortized cost at acquisition is the sum of the purchase price and the initial allowance for expected credit losses ($700,000 + $175,000).
2. Cash payments reflect expected cash flows.
3. Interest income is calculated as beginning amortized cost balance × the EIR of 9.29% (rounded).
4. Amounts written off reflect expected writeoffs of amounts deemed uncollectible.
5. Amortized cost ending balance = amortized cost beginning balance + interest income – cash payments – writeoffs.

The following table represents the projected roll-forward of the allowance for credit losses based on ABC's initial expected cash flows at acquisition.

Year	Allowance for credit losses beginning balance	Change in present value due to passage of time[1]	Changes in present value due to changes in expected cash flows	Writeoffs	Allowance for credit losses ending balance[2]
1	$175,000	$16,254	0	$ 56,000	$135,254
2	135,254	12,562	0	60,000	87,816
3	87,816	8,156	0	52,000	43,972
4	43,972	4,084	0	36,000	12,056
5	12,056	1,120	0	13,176	0
Total		**$42,176**	**0**	**$217,176**	

Notes:

1. Represents the periodic effect on the allowance due to the passage of time, calculated as the beginning balance of the allowance × the EIR of 9.29% (rounded). ABC may present this either as credit loss expense or as a reduction of interest income. [326-20-45-3]
2. Ending balance = beginning balance + change in the present value due to both passage of time and to changes in expected cash flows – writeoffs.

The difference between expected cash flows of $868,705 and the purchase price of $700,000 is $168,705. This amount represents the time value of money, which, based on initial expected cash flows, would be reflected in the income statement as:

- $210,881 accretable yield recognized through interest income;
- $42,176 cumulative change in present value of expected credit losses, which may be presented either as credit loss expense or as a reduction of interest income.

For simplicity, it is assumed that actual cash flows during Year 1 were the same as the initial expected cash flows. At the end of the Year 1, the fair value of the residual interest is $504,835 and ABC updates its estimate of expected cash flows.

The following table reflects ABC's updated expectations.

Year	Contractual cash flows	Expected cash flows	Expected credit losses	Increase (decrease) in expected cash flows
2	$300,000	$230,000	$ 70,000	$(10,000)
3	260,000	200,000	60,000	(8,000)
4	180,000	140,000	40,000	(4,000)
5	65,881	50,000	15,881	(2,705)
Total	**$805,881**	**$620,000**	**$185,881**	**$(24,705)**
Original EIR (rounded)	9.29%	9.29%	9.29%	9.29%
Present value at EIR (rounded)	$676,269	$520,207	$156,062	$(20,808)
Remaining accretable yield	$129,612			

The decrease in expected cash flows before the effect of discounting ($24,705) represents the difference between the updated estimate of expected credit losses at the end of Year 1 ($185,881) and the initial estimate of expected credit losses at acquisition for Years 2 through 5 ($161,176) (see Example 20.3.10).

The following table represents the projected amortization schedule for the amortized cost of the beneficial interest – which is net of the accretable yield – based on ABC's expected cash flows at the end of Year 1.

Year	Amortized cost beginning balance[1]	Cash payments[2]	Interest income[3]	Writeoffs[4]	Amortized cost ending balance[5]
1 (actual)	$875,000	$224,000	$81,269	$56,000	$676,269
2	676,269	230,000	62,811	70,000	439,080
3	439,080	200,000	40,781	60,000	219,861
4	219,861	140,000	20,421	40,000	60,282
5	60,282	50,000	5,599	15,881	0

Notes:

1. Amortized cost at acquisition is the sum of the purchase price and the initial allowance for expected credit losses ($700,000 + $175,000).
2. Cash payments reflect expected cash flows.
3. Interest income is calculated as beginning amortized cost balance × the EIR of 9.29% (rounded). This also represents the change in accretable yield.
4. Amounts written off reflect expected writeoffs of amounts deemed uncollectible.
5. Amortized cost ending balance = amortized cost beginning balance + interest income – cash payments – writeoffs.

ABC determines whether there has been a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected. It does this by comparing the present value of the remaining cash flows expected to be collected at the initial transaction date with the present value of the cash flows expected to be collected at the current reporting date.

Year	Original expected cash flows	Current expected cash flows	Favorable (adverse) change
2	$240,000	$230,000	$(10,000)
3	208,000	200,000	(8,000)
4	144,000	140,000	(4,000)
5	52,705	50,000	(2,705)
Total	**$644,705**	**$620,000**	**$(24,705)**
Original EIR (rounded)	9.29%	9.29%	9.29%
Present value at EIR	$541,015	$520,207	$(20,808)

Because the present value of cash flows expected to be collected has decreased, an adverse change has occurred in the amount of $20,808. Because the change in expected cash flows is adverse, the original EIR continues to be the appropriate discount rate.

ABC applies the guidance in Subtopic 326-30 as follows.

— The security is impaired in the amount of $171,434 because its fair value ($504,835) is less than its amortized cost ($676,269).

— ABC reports in net income the amount necessary to adjust the allowance for credit losses to management's current estimate of expected credit losses of $156,062, subject to the fair value floor. Under the fair value floor, the allowance is limited to the amount by which the amortized cost basis exceeds the fair value – i.e. the maximum allowance to be recorded is $171,434.

ABC reports $15,372 as a charge to other comprehensive income, which represents the amount of impairment that is not reflected as an allowance for credit losses – i.e. impairment of $171,434 less allowance for credit losses of $156,062. Because the entire amount of the adverse change in cash flows expected to be collected is reflected in the allowance for credit losses and does not exceed the fair value floor, no adjustment is necessary to the accretable yield.

The following table represents the projected roll-forward of the allowance for credit losses based on the expected cash flows at the end of Year 1.

Year	Allowance for credit losses beginning balance	Change in present value due to passage of time[1]	Changes in present value due to changes in expected cash flows[2]	Writeoffs	Allowance for credit losses ending balance[3]
1 (actual)	$175,000	$16,254	$20,808	$56,000	$156,062
2	156,062	14,495	0	70,000	100,557
3	100,557	9,340	0	60,000	49,897
4	49,897	4,634	0	40,000	14,531
5	14,531	1,350	0	15,881	0

Notes:

1. Represents the periodic effect on the allowance due to the passage of time, calculated as the beginning balance of the allowance × the EIR of 9.29% (rounded). ABC may present this either as credit loss expense or as a reduction of interest income. [326-20-45-3]
2. Represents the periodic effect on the allowance due the changes in expected cash flows.
3. Ending balance = beginning balance + change in the present value due to passage of time and changes in expected cash flows – writeoffs.

ABC records the following journal entries for Year 1.

	Debit	*Credit*
Beneficial interests – AFS – non-credit discount[1]	81,269	
Interest income[1]		81,269
To record interest income at EIR.		
Cash	224,000	
Beneficial interests – AFS		224,000
To record receipt of cash during Year 1.		
Allowance for credit losses	56,000	
Beneficial interests – AFS		56,000
To record writeoffs of contractual cash flows.		
Credit loss expense[2]	37,062	
Allowance for credit losses		37,062
To record changes in present value of estimated credit losses.		
Unrealized loss on beneficial interest – AFS (other comprehensive income)[3]	15,372	
Beneficial interests – AFS		15,372
To record impairment not reflected in allowance for credit losses.		

Notes:

1. Calculated as beginning amortized cost of $875,000 × the EIR of 9.29% (rounded). This also represents the change in the accretable yield during the year.
2. ABC elects to report the entire change in present value (including changes due to both passage of time ($16,254) and changes in expected cash flows ($20,808)) as credit loss expense.
3. The amount of total impairment ($171,434) less the portion of impairment recorded through the allowance for credit losses ($156,062). The effect of taxes is disregarded for simplicity.

The following table represents the roll-forward of the carrying amount of the beneficial interest during Year 1.

Year	**Carrying amount beginning balance[1]**	**Cash payments received**	**Interest income**	**Credit loss expense**	**Unrealized loss (decline in fair value)**	**Carrying amount ending balance[2]**
1 (actual)	$700,000	$224,000	$81,269	$37,062	$15,372	$504,835

Notes:

1. Represents amortized cost ($875,000) less the allowance for credit losses ($175,000).
2. Ending balance (which equals fair value) = beginning balance + interest income – cash payments – credit loss expense – unrealized loss.

At the end of Year 1, ABC's financial statements reflect the following.

Account	Amount
Balance sheet – assets	
Beneficial interests – AFS (amortized cost of $676,269, allowance for credit losses of $156,062)	$504,835
Balance sheet – equity	
Other comprehensive income – unrealized loss on beneficial interest AFS for which an allowance for credit losses has been reported	$(15,372)
Income statement	
Interest income	$81,269
Credit loss expense	$(37,062)

The beneficial interests are presented net of the non-credit discount because the accretable yield is not permitted to be presented in the balance sheet. [325-40-45-1]

Question 20.4.20

How is the effective interest rate recalculated when an adverse change in expected cash flows is not reflected as an increase in the allowance?

Background: When there is an adverse change in cash flows for a beneficial interest, that change is generally reflected as an increase in the allowance. However, when the beneficial interest is an AFS security, there are limits as to how much the allowance can be increased. When a credit loss is recognized through an allowance, the amount of the allowance is limited by the amount that the security's amortized cost basis exceeds the security's fair value – called the 'fair value floor' (see section 19.5.10).

When the allowance has been limited by the fair value floor, the effective interest rate used to recognize interest income is reduced. However, Subtopic 325-40 is not clear about how the reduced rate should be calculated. [325-40-35-4A]

Interpretive response: When an adverse change in cash flows is not recognized as an increase in the allowance because of the fair value floor limitation, we believe the entity should recalculate the effective interest rate as the rate that equates the cash flows expected to be collected to:

- the AFS beneficial interest's reference amount; for non-PCD beneficial interests this is the initial investment less cash received to date less previous writeoffs plus the yield accreted to date; less
- the allowance for credit losses.

When the allowance has been limited by the fair value floor, the AFS beneficial interest's reference amount less the allowance for credit losses will equal the AFS beneficial interest's fair value. As a result, the rate that equates the cash flows expected to be collected to that amount will be the market interest rate.

Ordinarily, a beneficial interest is accreted to the cash flows expected to be collected at its acquisition (or for a PCD beneficial interest, to its contractual cash flows). However, when an AFS beneficial interest's effective interest rate is reduced because the fair value floor is triggered, the beneficial interest is accreted to amounts that are less than those original expected cash flows (or for a PCD beneficial interest, to amounts less than the contractual cash flows). As a result, the entity may also need to develop a writeoff policy to consider this effect.

20.4.30 Writeoffs and recoveries

Topic 326 requires the recognition of writeoffs of both HTM and AFS debt securities. This guidance also applies to beneficial interests in the scope of Topic 325-40. Because of this new requirement, entities will need to develop new processes, policies and controls addressing the timing of recognition for writeoffs of the allowance for expected credit losses related to beneficial interests, including allowance amounts recognized at acquisition of PCD beneficial interests. [326-20-35-8, 326-30-35-13]

An entity is prohibited from recognizing a negative allowance for credit losses for AFS beneficial interests. In contrast, the allowance for credit losses for HTM beneficial interests may, in limited circumstances, be negative (i.e. a debit balance). This is because the allowance for HTM beneficial interests includes expected recoveries of amounts previously written off (and expected to be written off); see section 3.3.10. [326-20-30-1, 35-8; 326-30-35-12]

The negative allowance for HTM beneficial interests may not exceed amounts previously written off. To the extent favorable changes in expected cash flows are not recognized through a decrease to the allowance for credit losses, including recognizing a negative allowance to the extent of prior write offs, the accretable yield is adjusted on a prospective basis. [325-40-4 – 40-4A, 326-20-30-1]

20.4.40 Comparison to legacy US GAAP

Comparison to legacy US GAAP
Subsequent measurement

The following table provides a summary comparison of Topic 326 and Subtopic 325-40 (as amended) to legacy US GAAP.

Legacy US GAAP	Topic 326 and Subtopic 325-40 (as amended)
No immediate reversals of previously recognized credit losses; improvements in expected cash flows are recognized prospectively (i.e. over time) by adjusting the effective yield. [325-40-35-4]	Subsequent favorable or adverse changes in expected cash flows first decrease or increase the allowance for credit losses. If a favorable change in expected cash flows has reduced the allowance to zero for HTM or AFS beneficial interests or an adverse change has caused the allowance to lower the

Legacy US GAAP	Topic 326 and Subtopic 325-40 (as amended)
	amortized cost down to the fair value floor for AFS beneficial interests, the accretable yield is adjusted on a prospective basis.

20.5 Transition considerations

Excerpt from ASC 326-10

> Transition Related to Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, and No. 2019-04 Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-05, Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief

65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, and No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-05, Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief: …

d. An entity shall apply prospectively the pending content that links to this paragraph for purchased financial assets with credit deterioration to financial assets for which Subtopic 310-30 was previously applied. The prospective application will result in an adjustment to the amortized cost basis of the financial asset to reflect the addition of the allowance for credit losses at the date of adoption. An entity shall not reassess whether recognized financial assets meet the criteria of a purchased financial asset with credit deterioration as of the date of adoption. An entity may elect to maintain pools of loans accounted for under Subtopic 310-30 at adoption. An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are troubled debt restructurings as of the date of adoption. The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the effective interest rate determined after the adjustment for credit losses at the adoption date. The same transition requirements should be applied to beneficial interests for which Subtopic 310-30 was applied previously or for which there is a significant difference between the contractual cash flows and expected cash flows at the date of recognition…

Question 20.5.10

Must an entity reevaluate at the date of adoption whether beneficial interests in the scope of Subtopic 325-40 should apply PCD accounting?

Interpretive response: No. When adopting Topic 326, an entity does not evaluate any existing assets, including beneficial interests accounted for under Subtopic 325-40, to determine whether they meet the PCD definition. Instead, as discussed in section 12.6.10, any existing PCI assets (including beneficial interests) accounted for under Subtopic 310-30 under legacy US GAAP, automatically become PCD assets. This includes instruments to which the entity had applied Subtopic 310-30 by analogy. In contrast, any existing PCI assets (including beneficial interests) that were not accounted for under Subtopic 310-30 are not treated as PCD assets. [325-40-15-3(d)]

Based on discussions with the FASB staff, it is our understanding that the same transition approach also applies to the new requirement to apply PCD accounting when there is a significant difference between contractual and expected cash flows. As a result, an entity does not assess whether there is a significant difference between contractual and expected cash flows for beneficial interests held at the date of adoption. Instead, the new requirement is assessed only for beneficial interests initially recognized subsequent to adoption.

21. Subsequent events

Detailed contents

21.1 How the standard works

Subsequent events are events or transactions that occur after the reporting date but before the financial statements are issued (or available to be issued). They fall into two categories: [855-10-25-1, 25-3]

— those that provide additional evidence about conditions that existed at the reporting date, including the estimates inherent in the process of preparing financial statements – known as recognized or Type I subsequent events; and

— those that provide evidence about conditions that did not exist at the reporting date but arose subsequent to that date – known as nonrecognized or Type II subsequent events.

An entity recognizes the effect of Type I subsequent events in the financial statements at the reporting date, but does not recognize the effect of Type II subsequent events in the financial statements. The SEC staff has provided its views about whether information received after the reporting date should be considered to be Type I or Type II.

The guidance in this chapter relates solely to the application of Topic 855 to the estimate of the allowance for expected credit losses and should not be analogized to other circumstances.

Legacy US GAAP	ASC 855-10
Certain subsequent events affecting the realization of assets, including a customer's bankruptcy after the reporting date but before the financial statements are issued (available to be issued), should be reflected in the financial statements (i.e. allowance) at the reporting date. [855-10-55-1]	Changes in estimated credit losses arising after the reporting date but before the financial statements are issued (available to be issued) should not be reflected in the allowance for credit losses at the reporting date.

21.2 Recognition

21.2.10 Overview

Excerpt from ASC 855-10

> Nonrecognized Subsequent Events

55-2 The following are examples of nonrecognized subsequent events addressed in paragraph 855-10-25-3: …

e. Changes in estimated credit losses on receivables arising after the balance sheet date but before financial statements are issued or are available to be issued …

Excerpt from SEC staff speech

Kevin L. Vaughn [2018 AICPA Conf]

Evaluating Subsequent Events in the Current Expected Credit Losses Model

Next, I would like to discuss a recent consultation we received relating to the application of subsequent events guidance[6] following adoption of the new credit losses standard.[7] The consultation submission presented three specific fact patterns that illustrated the unique challenges in applying the subsequent events guidance to the forward-looking estimate of expected credit losses.

As background, with respect to each of these fact patterns, the referenced information was received after the balance sheet date but before the financial statements were issued or were available to be issued. Further, in each fact pattern, the information received was significantly different from management's expectations.

The staff shared its views regarding the appropriate application of US GAAP on the three specific fact patterns as follows.

The first fact pattern related to the receipt of a servicer report that showed the effects of payment experience (e.g., delinquencies and prepayments) that occurred on or before the balance sheet date. The second fact pattern related to the receipt of an appraisal report that showed information about the fair value of loan collateral as of the balance sheet date. In both of these fact patterns, the staff indicated we would object to a registrant not considering this information in its estimate of expected credit losses. An important consideration in both of these fact patterns was that this information was loan-specific information about factual conditions that existed at the balance sheet date.

The third fact pattern related to the U.S. government's announcement of unemployment rates for a period that includes the balance sheet date. The staff indicated that we would not object to a registrant either considering or not considering such rates in its estimate of expected credit losses.

In connection with these three conclusions, we shared our view that in connection with the forward-looking estimate of expected credit losses, there can be recognized and nonrecognized subsequent events.

I understand registrants and auditors have continued to engage in discussions to evaluate how a registrant will consider other potential fact patterns that could arise. While registrants will ultimately of course need to consider materiality and their specific facts and circumstances, I thought it might be helpful to share my views regarding how certain types of information received after the balance sheet date but before financial statements are issued or are available to be issued could be evaluated:

- Loan-specific information about factual conditions that existed at the balance sheet date, such as the servicer reports and appraisal reports I mentioned earlier, would be recognized;
- Information relating to forecasting assumptions used in establishing expected credit losses that is received before the registrant has completed an appropriate estimation process would be permitted to be included in the estimate, unless such information indicates a weakness or a deficiency in the registrant's estimation process, in which case the information would be recognized; and
- Information relating to forecasting assumptions used in establishing expected credit losses that is received after the registrant has completed an appropriate estimation process would not be recognized, unless such information indicates a weakness or a deficiency in the registrant's estimation process, in which case the information would be recognized.

As a reminder, Topic 855 includes required disclosures for nonrecognized subsequent events.[8]

Notes:

[6] ASC Topic 855.
[7] ASU No. 2016-13 included amendments to Topic 855 to reflect the change from an incurred loss model to an expected credit loss model. These amendments did not change the principle for determining a subsequent event that should be recognized in the financial statements.
[8] See ASC 855-10-50-2 and 855-10-50-3.

ASU 2016-13 amended Subtopic 855-10 to provide that changes in estimated credit losses on receivables arising after the reporting date but before the financial statements are issued (available to be issued) are not reflected in the allowance for credit losses at the reporting date. [855-10-55-2(e)]

Those amendments reflect the change from the incurred loss impairment model – which recognizes losses when a probable threshold is met – to the requirement to recognize lifetime expected credit losses immediately when a financial asset is originated or purchased. The amendments did not add examples to illustrate whether information received after the reporting date should be reflected in an entity's estimate of lifetime expected credit losses model as of the reporting date.

The guidance in this chapter relates solely to the application of Topic 855 to the estimate of the allowance for expected credit losses and should not be analogized to other circumstances.

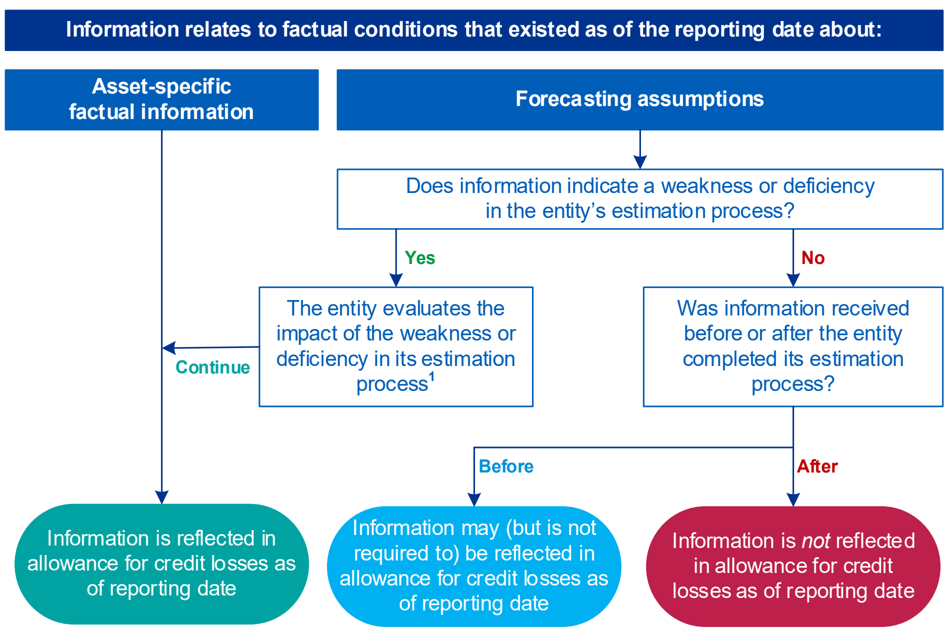
Question 21.2.10

Does an entity adjust its estimate of credit losses for information received after the reporting date but before the financial statements are issued?

Interpretive response: It depends. The SEC staff addressed this issue in a speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments. The SEC staff indicated that whether information received after the reporting date should be reflected in the financial statements depends on whether: [2018 AICPA Conf]

— the information is loan-specific information about factual conditions that existed at the reporting date or relates to forecasting assumptions; and
— information related to forecasting assumptions was received before (or after) the entity has completed an appropriate process for estimating expected credit losses.

The following flowchart summarizes these considerations. [2018 AICPA Conf]



1. If an entity concludes there was a weakness or other breakdown in its estimation process, we believe the entity also considers:
   – the scope of the breakdown(s) in the process and whether there are other adjustments that should be made to the estimate;
   – whether there were also breakdown(s) in previous periods; and
   – whether a deficiency(ies) exists in related internal controls over financial reporting and the severity of the deficiency(ies).

The following table includes examples of the nature of certain types of information received – i.e. whether the information is asset-specific information about factual conditions that existed at the reporting date or relates to forecasting assumptions.

Information received	Nature of information
Servicer report	A servicer report that reflects payment experience (i.e. delinquencies and prepayments) that occurred on or before the reporting date is asset-specific information about factual conditions that existed at the reporting date and should be reflected in the estimate of expected credit losses. [2018 AICPA Conf]
Collateral appraisal	An appraisal that reports on the fair value of collateral underlying a financial asset as of the reporting date is asset-specific information about factual conditions that existed at the reporting date and should be reflected in the estimate of expected credit losses. [2018 AICPA Conf]
Economic data	Economic data (e.g. announcements by the U.S. government of unemployment rates) relates to forecasting assumptions.

When information received after the reporting date is not reflected in an entity's estimate of expected credit losses, the entity considers whether additional disclosures are required to prevent the financial statements from being misleading. This includes consideration of whether it is necessary to disclose pro forma financial data or present pro forma financial statements. [855-10-50-2 – 50-3]

Question 21.2.20

Must an entity incorporate economic data available through the reporting date in its estimate of credit losses?

Interpretive response: Yes. Subtopic 326-20 requires that the estimates be made as of the reporting date. [326-20-30-1]

Some entities may develop or obtain forecasts of future economic conditions earlier than the reporting date to meet tight financial reporting deadlines – e.g. forecasts may be developed or obtained in November for the purpose of December year-end financial reporting. To estimate credit losses, we believe these entities need to consider any new information they may obtain up to and including the reporting date.

Question 21.2.30

Must an entity incorporate economic data available after the reporting date (but before the financial statements are issued) in its estimate of credit losses?

Interpretive response: Economic data relates to forecasting assumptions, rather than representing loan-specific information. As a result, whether an entity should incorporate economic data available after the reporting date depends on whether that information indicates a weakness or deficiency in the entity's estimation process and on whether it is received before (or after) the entity has completed its process for estimating expected credit losses (see Question 21.2.10). [2018 AICPA Conf]

This is the case even if the information includes economic data about a period that includes the reporting date. For example, management's adjustments to historical loss information for current conditions and reasonable and supportable forecasts may be based on estimates of unemployment published by the government. After the reporting date, the government may announce estimates of unemployment – or revise estimates that were made in prior announcements – for periods that include the reporting date. The following table summarizes whether an entity should adjust its estimate of expected credit losses. [2018 AICPA Conf]

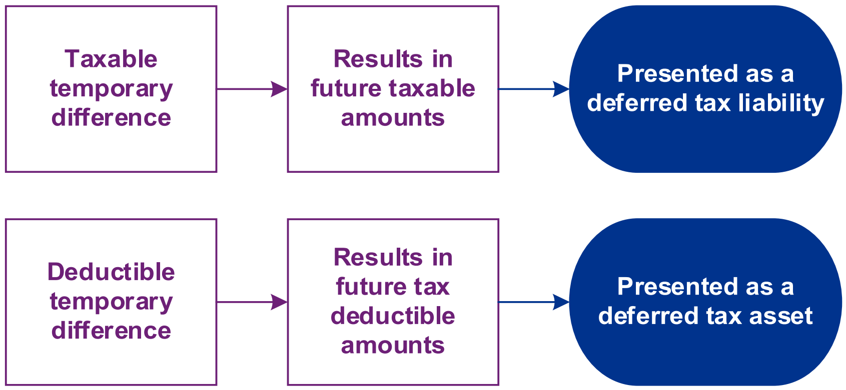
Timing of announcement	Information indicates a weakness or deficiency in the entity's estimation process	Information does not indicate a weakness or deficiency in the entity's estimation process
Before the entity has completed its estimation process	The entity should adjust its estimate of expected credit losses as of the reporting date. Additionally, we believe the entity should evaluate the impact of the weakness or deficiency (see footnote 1 to the flowchart in Question 21.2.10).	The entity is permitted (but not required) to adjust its estimate of expected credit losses as of the reporting date. If the entity does not adjust its estimate, it should consider whether disclosures are necessary to prevent the financial statements from being misleading.
After the entity has completed its estimation process	The entity should adjust its estimate of expected credit losses as of the reporting date. Additionally, we believe the entity should evaluate the impact of the weakness or deficiency (see footnote 1 to the flowchart in Question 21.2.10).	The entity should not adjust its estimate of expected credit losses as of the reporting date (it is a nonrecognized subsequent event). The entity should consider whether disclosures are necessary to prevent the financial statements from being misleading.

22. Income taxes

Detailed contents

22.1 How the standard works

A basic principle of Topic 740 (income taxes), is to recognize deferred taxes for the future tax consequences of events or transactions that are recognized in either the financial statements or the tax returns, but not yet in both. Future tax consequences result from differences between the tax basis and the financial statement carrying amounts of assets and liabilities.



Recognizing an allowance for credit losses under Topic 326 creates a book-tax temporary difference. For federal income tax purposes, except in limited circumstances, there is no deduction for credit losses until there is a writeoff of the financial asset balance or an equivalent accounting event. Therefore, generally an allowance for credit losses is recognized before a tax deduction for the credit losses is permitted, resulting in a deductible temporary difference for which a deferred tax asset is recognized. Similarly, for federal income tax purposes, recovery of an amount previously written off generally does not represent taxable income until it is received. An estimated recovery that reduces the allowance for credit losses likewise reduces the deductible temporary difference associated with the allowance.

Topic 326 is expected to generally increase the allowance for credit losses, which will result in an increase in deferred tax assets.

22.2 Deferred income taxes

22.2.10 Overview

Topic 326 does not contain tax accounting guidance and ASU 2016-13 made no amendments to Topic 740. Nevertheless, the adoption of Topic 326 will likely affect the calculation of an entity's deferred tax assets.

We expect that the following aspects of Topic 326 will have the most significant effect on an entity's accounting for deferred taxes compared to legacy US GAAP.

— The recognition and measurement guidance in Topic 326 will generally increase the allowance for credit losses and therefore the related deferred tax asset will also increase.

— It is not yet clear whether an allowance for credit losses established for an AFS debt security will result in a deferred tax asset. However, if it will, any subsequent reversals of credit losses recognized under Subtopic 326-30 for the AFS debt security when the expected cash flows or fair value floor increase will result in a need to adjust the related deferred tax asset (see section 22.2.20).

— For purchased financial assets with credit deterioration (PCD assets), the amount of any net book-tax basis difference on the acquisition date will likely be the same under Topic 326 as it would have been under legacy US GAAP. Subsequent to the acquisition date, there will be book-tax differences due to differences in the timing and amount of income recognized for book and tax purposes and the timing of tax deductions related to changes to the allowance for credit losses (see section 22.2.30).

Question 22.2.10

Will an increase in deferred tax assets on transition to Topic 326 require additional analysis of the potential need for a valuation allowance?

Interpretive response: It depends. A valuation allowance is required for deferred tax assets if, based on available evidence, it is more likely than not that all or some portion of the asset will not be realized due to the inability to generate sufficient taxable income in the period of the character necessary to realize benefit from the assets. [740-10-30-17]

The following sources of taxable income may be used to realize the benefit of deferred tax assets: [740-10-30-18]

— future reversals of existing taxable temporary differences;
— future taxable income exclusive of reversing temporary differences and carryforwards;
— taxable income in carryback years if carryback is permitted by the tax law; and
— tax-planning strategies.

If carryback is permitted by the tax law, an entity may currently have sufficient taxable income in carryback years and existing deferred tax liabilities to support the realization of its deferred tax assets without looking to other sources of taxable income. For federal income tax purposes, net operating losses arising in tax years ending after December 31, 2017 cannot be carried back. However, such losses can be carried forward indefinitely. Further, for tax years beginning after December 31, 2017, a net operating loss carryforward deduction for a given year can only be used to offset 80% of taxable income.

If the adoption of Topic 326 increases the deferred tax assets, the entity may need to reassess its need for a valuation allowance. For example, management may need to consider tax-planning strategies if it can no longer support the realization of the entire asset through taxable income in carryback years and projections of future taxable income.

Question 22.2.20

Will the requirement to estimate expected credit losses on a collective basis affect the timing of federal income tax deductions?

Interpretive response: Potentially yes. It is unlikely that an allowance for credit losses established based on a collective assessment will support a tax deduction.

Under legacy US GAAP, an entity identifies individual impaired loans when it is probable that it will be unable to collect all amounts due according to an asset's contractual terms. After that individual identification, it estimates credit losses on an individual basis. Collective assessment of credit losses is permitted, but not required, when impaired loans share common risk characteristics. For federal income tax purposes, when the allowance for loan losses (commonly 'specific reserves') is established on an individual loan basis, under certain circumstances, it can often be used to support a tax deduction even though the financial asset has not yet been written off under the entity's US GAAP writeoff policies. [310-10-35-10, 35-15, 35-16, 35-21, 35-22]

However, Subtopic 326-20 requires an entity to estimate expected credit losses on a collective basis when a financial asset shares similar risk characteristics with other financial assets. [326-20-30-2]

We expect that there will be circumstances in which loans that were considered impaired under legacy US GAAP will be individually assessed for credit losses under Subtopic 326-20 because they do not share similar risk characteristics with other financial assets. This may result in an allowance for expected credit losses that is similar to the specific reserves under legacy US GAAP, which may under certain circumstances be used to support some level of tax deduction.

22.2.20 AFS securities

Subtopic 326-30 requires credit losses to be recognized on an individual AFS debt security through an allowance for credit losses. In addition, when credit losses on an AFS debt security decrease, the Subtopic requires the allowance to be reversed through net income on an individual security basis. [326-30-35-2]

If a deferred tax asset has been recognized for an AFS debt security's allowance for credit losses, any subsequent reversals of credit losses recognized under Subtopic 326-30 for that AFS debt security when its expected cash flows or fair value floor increase will result in a need to adjust the deferred tax asset. However, there is a question about whether an allowance for credit losses on an AFS security creates a deferred tax asset (see Question 22.2.30).

Question 22.2.30

Will the allowance for credit losses established for an AFS debt security result in a deferred tax asset?

Interpretive response: It is not yet clear.

Many financial institutions have relied on informal guidance included in a 2014 IRS field directive for purposes of recognizing federal income tax deductions for OTTI recorded under legacy US GAAP (Subtopic 320-10). Under that directive, a bank (or subsidiary of a bank) can recognize a bad debt tax deduction under IRC Section 166 when the OTTI is recorded as a reduction of the amortized cost basis of the AFS debt security. [LB&I-04-1014-008]

Greater tax uncertainty arises under Subtopic 326-30, because credit losses are recorded through an allowance for credit losses and writeoffs reduce the allowance at a later date. The possibility of the Treasury Department promulgating new regulations under IRC Section 166 to address the deductibility of allowances established under Subtopic 326-30 has been raised in public forums, but nothing has emerged as of the date of this publication.

The allowance for credit losses would give rise to a deferred tax asset if it is not determined to be a current deduction for federal income tax purposes. The deferred tax asset would then be increased or decreased as the related allowance for credit losses changes.

If the allowance for credit losses can substantiate a current tax deduction under IRC Section 166, there will be no deferred tax asset.

Example 22.2.10

Tax implications arising from recognizing credit losses on AFS debt securities

In Year 1, Bank acquires a $1,000 par amount AFS debt security for $1,000. Therefore, the amortized cost basis is $1,000 for both book and tax purposes.

At the end of Year 1, the fair value has declined to $900 and Bank determines that the entire decline is due to credit risk and estimates credit losses of $100.

In Year 2, the fair value has declined further to $840 and Bank estimates that the credit losses have increased to $160. Bank therefore recognizes additional credit losses of $60 through the allowance account.

The security is redeemed for $840 in Year 3.

The following table summarizes the fact pattern.

	Year 1	Year 2	Year 3
Amortized cost	$1,000	$1,000	$1,000
Fair value	900	840	840
Credit loss	100	160	160

Bank's tax rate is 30%.

This example assumes that Bank does not establish a valuation allowance because it determines that it is more likely than not that it will realize its deferred tax assets in Years 1-3.

Scenario 1: The allowance for credit losses is not a deduction for federal income tax purposes

In Year 1, Bank establishes a deferred tax asset of $30 and records a deferred tax benefit of $30 as a result of recognizing an allowance for credit losses for book purposes.

	Debit	*Credit*
Credit loss expense	100	
Allowance for credit losses		100
To record allowance for credit losses.		
Deferred tax asset[1]	30	
Deferred income tax benefit		30
To record tax effect of allowance for which current tax deduction is not recognized.		

Note:
1. The allowance for credit losses of $100 × 30% tax rate.

In Year 2, Bank increases the deferred tax asset by $18 to $48 and records a deferred tax benefit of $18 as a result of the increase in the allowance for credit losses for book purposes.

	Debit	*Credit*
Credit loss expense	60	
Allowance for credit losses		60
To record increase in allowance for credit losses.		
Deferred tax asset[1]	18	
Deferred income tax benefit		18
To record tax effect of reduction in allowance.		

Note:
1. The increase in the allowance for credit losses of $60 × 30% tax rate.

When the security is redeemed for $840 in Year 3, Bank takes a current tax deduction of $160 and records a current tax benefit of $48. It also reduces its deferred tax asset by $48 and records a deferred tax expense of $48 (resulting in no net tax expense).

	Debit	*Credit*
Cash	840	
Allowance for credit losses	160	
AFS debt security		1,000
To record redemption of security and writeoff of allowance.		
Current tax receivable[1]	48	
Current income tax benefit		48
Deferred income tax expense[2]	48	
Deferred tax asset		48
To record tax effect of loss on redemption and writeoff of allowance.		

Notes:
1. The redemption loss of $160 × 30% tax rate.
2. Written off allowance for credit losses of $160 × 30% tax rate.

Scenario 2: The allowance for credit losses is a deduction for federal income tax purposes

In Year 1, Bank takes a current deduction of $100 and records a current tax benefit of $30 as a result of the deduction for the establishment of the allowance for credit losses. No deferred taxes are recorded.

	Debit	*Credit*
Credit loss expense	100	
Allowance for credit losses		100
To record loss allowance.		
Current tax receivable	30	
Current income tax benefit[1]		30
To record tax effect of allowance for which current tax deduction is recognized.		

Note:
1. The allowance for credit losses of $100 × 30% tax rate.

In Year 2, Bank takes a further current deduction of $60 and records a current tax benefit of $18 as a result of the reduction for the increase in the allowance for credit losses.

	Debit	Credit
Credit loss expense	60	
Allowance for credit losses		60
To record reduction in allowance for credit losses.		
Current tax receivable[1]	18	
Current income tax benefit		18
To record tax effect of increase in allowance for which current tax deduction is recognized.		

Note:
1. Increase in the allowance for credit losses of $60 × 30% tax rate.

In Year 3, Bank does not recognize taxable income or a deduction and does not record any financial statement income tax benefit or deduction. This is because its tax basis for federal income tax purposes equals the redemption amount of the security of $840.

	Debit	Credit
Cash	840	
Allowance for credit losses	160	
AFS debt security		1,000
To record redemption of security and writeoff of allowance.		

22.2.30 PCD financial assets

For PCD financial assets, Topic 326 requires the acquisition discount – i.e. the difference between the contractual par amount of a financial asset and the purchase price – to be separated into an allowance for credit losses and a non-credit premium or discount. Therefore, the net carrying amount in the financial statements comprises three elements: the contractual par amount, the allowance for credit losses, and the non-credit premium or discount. For further discussion of PCD assets, see chapter 12 and chapter 19 for PCD AFS debt securities. [326-20-30-13, 326-30-30-2]

However, for tax purposes, when a PCD asset is acquired at a discount in a taxable acquisition, the tax basis in the PCD asset is represented solely by the purchase price – i.e. the allowance for credit losses and the non-credit premium or discount are not recognized for tax purposes.

Although the net carrying amount of a PCD asset for financial statement purposes frequently equals the federal tax basis at acquisition in a taxable acquisition, offsetting temporary differences exist at acquisition that relate to the:

— allowance for credit losses;
— non-credit premium or discount recognized for book purposes; and

— difference between the face/contractual amount and the purchase price (tax market discount).

Although these temporary differences offset, they should be considered for separate presentation in the notes to the financial statements.

Comparison of book and tax basis in a taxable acquisition

Book vs tax basis on acquisition date

	Book basis	Tax basis
PCD asset	Face/contractual par amount	Purchase price
Allowance for credit losses	Day 1 allowance for credit losses	No tax basis
Non-credit premium or discount	Day 1 non-credit premium or discount	No tax basis

Question 22.2.40

Can temporary differences change after the acquisition date of a PCD asset due to changes in the allowance for credit losses?

Interpretive response: Yes, temporary differences can change through subsequent adjustments to the allowance for credit losses for PCD assets. As the allowance for credit losses is subsequently increased or decreased, the related deferred tax asset also changes. The treatment is generally consistent with the deferred tax effects of changes in the allowance for credit losses recognized for purchased credit impaired (PCI) assets under legacy US GAAP.

Question 22.2.50

Can temporary differences change after the acquisition date of a PCD asset due to the timing and amount of income recognized for book and tax purposes?

Interpretive response: Yes, temporary differences can change after the acquisition date of a PCD asset due to differences in the timing and amount of income recognized for book and tax purposes.

For financial statement purposes, the difference between the purchase price and the cash flows ultimately collected is recognized as income over the life of the PCD asset. This income is recognized as either interest income attributable to the non-credit premium/discount or credit loss expense/recovery attributable to the allowance for credit losses. [326-20-35-1, 326-30-30-2, 310-10-35-53B, 35-53C]

However, for federal income tax purposes, the entire difference between the face/contractual par amount of the asset and its acquisition price (the tax market discount) is generally recognized as taxable income over the life of the PCD asset as principal payments are received. When the PCD asset is sold, matures, or is otherwise settled or disposed of, the difference between the tax basis of the asset (i.e. the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected is generally recognized as an adjustment to taxable income.

If the entity ultimately collects less than the contractual amounts due, the maturity of a PCD asset often results in a bad debt deduction under IRC Section 166. The deduction arises because the acquisition price plus the accretion of the tax market discount typically exceeds the cumulative amounts collected from the borrower.

These temporary differences in the timing and amount of income recognition arise in a similar manner under legacy US GAAP. However, once an entity establishes a Day 1 allowance for credit losses for financial statement purposes, it will also need to consider the timing of the writeoff of that allowance and any remaining amortized cost of the PCD assets when recognizing the bad debt deduction under IRC Section 166.

Example 22.2.20
Book-tax differences for PCD assets

This example assumes the same facts as Examples 12.3.30 and 12.4.10 in chapter 12. Those examples have full details on how the financial statement amounts are determined.

Bank acquires a portfolio of PCD loans for $600,000 that have the following characteristics at the end of Year 1 of their five-year life.

Term:	Five years
Amortizable?	Yes
Prepayable?	No
Initial par amount:	$1,000,000
Coupon:	5%
Annual payments (contractual):	$230,975

After using a discounted cash flow method to determine the Day 1 allowance for credit losses, Bank records the following journal entry on the acquisition date.

	Debit	Credit
Loans	819,025	
Cash		600,000
Allowance for credit losses		165,464
Loans – non-credit discount		53,561
To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.		

Bank will subsequently recognize interest income for book purposes at the EIR of 7.97% (rounded) used to discount the expected credit losses.

The book-tax differences are determined on the acquisition date as follows.

Item	Financial statement basis DR/(CR)	Tax basis	Temporary deductible/ (taxable) difference
Loans	$819,025	$600,000	$(219,025)
Allowance for credit losses	(165,464)	0	165,464
Loans – non-credit discount	(53,561)	0	53,561
Total	**$600,000**	**$600,000**	**$ 0**

The following summarizes the activity for financial statement purposes in Years 2–5.

Year	Cash payments received (actual)	Ending loan balance[1]	Ending allowance for credit losses	Ending non-credit discount balance
2	$230,975	$629,001	$178,658	$33,476
3	161,682	429,476	123,611	17,440
4	161,682	219,975	64,175	6,059
5	161,681	0	0	0
Total	**$716,020**			

Note:

1. Equals the ending loan balance based on contractual amortization, after the effect of the cash payments received and amounts written off.

The following summarizes the activity for tax purposes in Years 2–5.

Year	Cash payments received (actual)	Ending tax basis – loan balance[1]	Tax deduction for writeoff[2]	Taxable income recognized[3]
2	$230,975	$487,933	$ 0	$118,908
3	161,682	422,950	0	96,699
4	161,682	334,349	0	73,081
5	161,681	0	217,007	44,339
Total	**$716,020**			

Notes:

1. The ending tax basis loan balance includes the application of borrower payments, and accrued interest income.
2. At the end of Year 5, management concludes that the remaining loan balances are worthless and the entity is entitled to a bad debt deduction under IRC Section 166. The deduction equals Bank's remaining tax basis in the loans; this is the difference between the cumulative amounts recognized for tax purposes (the initial tax basis of the loans plus the taxable income recognized) and the cumulative amounts collected from the borrowers.
3. Amounts include both the contractual stated interest on the loans – assuming no principal writeoffs – and recognition of the entire difference between the face value of the loans and the acquisition price (the tax market discount). This example assumes that the discount for each loan in the pool is (1) a tax market discount and (2) Bank has made the election under IRC Section 1276(b)(2) to accrue the tax market discount for each loan in the pool using constant yield principles.

The following summarizes the amortization of the tax market discount in Years 2–5.

Year	Beginning tax market discount[1]	Recognition of tax market discount as income[2]	Ending tax market discount
2	$219,025	$ 77,957	$141,068
3	141,068	65,249	75,819
4	75,819	48,614	27,205
5	27,205	27,205	0
Total		**$219,025**	

Notes:

1. The Day 1 tax market discount represents the difference between the purchase price and the outstanding principal balance on the acquisition date. This example assumes that the tax discount for each loan in the pool is (1) a tax market discount and (2) ABC has made the election under IRC Section 1276(b)(2) to accrue the tax market discount for each loan in the pool using constant yield principles.
2. Income recognition is based on the loans' contractual amortization.

The following summarizes the cumulative income recognized for book and tax purposes.

	Financial statement basis		Tax basis		
Year	Interest income[1]	Credit loss expense[2]	Interest income[3]	Tax deduction[4]	Change in temporary differences
Year 2	$ 61,037	$13,194	$118,908	$ 0	$ 71,065
Year 3	47,486	14,246	96,699	0	63,459
Year 4	32,855	9,857	73,081	0	50,083
Year 5	17,057	5,118	44,339	217,007	(184,607)
Cumulative	**$158,435**	**$42,415**	**$333,027**	**$217,007**	**$ 0**

Notes:

1. Represents interest income at the loans' EIR. For more information regarding the calculation of these amounts, see Example 12.4.10.
2. Represents the change in the present value of expected credit losses due to the passage of time. For more information regarding the calculation of these amounts, see Example 12.4.10.
3. Amounts include both the contractual interest on the loans – assuming no principal writeoffs – and recognition of the entire difference between the face value of the loans and the acquisition price (the tax market discount).
4. At the end of Year 5, management concludes that the remaining loan balances are worthless and Bank is entitled to a bad debt deduction under IRC Section 166. The deduction equals Bank's remaining tax basis in the loans; this is the difference between the cumulative amounts recognized for tax purposes (the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected from the borrowers.

The following summarizes the temporary differences in Years 2–5.

Loans	Financial statement basis DR/(CR)	Tax basis	Temporary deductible/ (taxable) difference
Acquisition date (Year 1)	$819,025	$600,000	$(219,025)
Year 2	629,001	487,933	(141,068)
Year 3	429,476	422,950	(6,526)
Year 4	219,975	334,349	114,374
Year 5	0	0	0

Allowance for credit losses	Financial statement basis DR/(CR)	Tax basis	Temporary deductible/ (taxable) difference
Acquisition date (Year 1)	$(165,464)	$ 0	$165,464
Year 2	(178,658)	0	178,658
Year 3	(123,611)	0	123,611
Year 4	(64,175)	0	64,175
Year 5	0	0	0

Non-credit discount	Financial statement basis DR/(CR)	Tax basis	Temporary deductible/ (taxable) difference
Acquisition date (Year 1)	$(53,561)	$ 0	$53,561
Year 2	(33,476)	0	33,476
Year 3	(17,440)	0	17,440
Year 4	(6,059)	0	6,059
Year 5	0	0	0

Total temporary differences related to PCD loans	Total financial statement basis	Total tax basis	Total temporary deductible/ (taxable) difference	Change in temporary differences
Acquisition date (Year 1)	$600,000	$600,000	$ 0	$ 0
Year 2	416,867	487,933	71,066	71,066
Year 3	288,425	422,950	134,525	63,459
Year 4	149,741	334,349	184,608	50,083
Year 5	0	0	0	(184,608)

Question 22.2.60

Do all PCD assets have a 'market discount' that subjects them to the tax treatment for assets acquired at a discount?

Interpretive response: No. Under Subtopic 326-20, it is possible that financial assets purchased at a premium could include a more-than-insignificant discount for deterioration in credit quality since origination and be accounted for as PCD assets. Similarly, under Subtopic 326-30, it is possible that an AFS debt security purchased at a premium could have indicators of credit losses and be accounted for as a PCD asset. PCD assets purchased at a premium are not subject to the same tax treatment as assets acquired at a discount.

For federal income tax purposes, when a financial asset is acquired at a discount, the discount is generally taken into taxable income as payments are received. When the asset is sold, matures or is otherwise settled or disposed of, the difference between the tax basis of the asset (i.e. the initial tax basis of the loans plus the taxable interest income recognized) and the cumulative amounts collected is generally recognized as an adjustment to taxable income.

If the entity ultimately collects less than the contractual amounts due, the maturity of a PCD asset often results in a bad debt deduction under IRC Section 166. The deduction arises because the acquisition price plus the accretion of the tax market discount typically exceeds the cumulative amounts collected from the borrower. PCI financial assets under legacy US GAAP generally qualify for this tax treatment because they typically are not considered PCI assets under Subtopic 310-30 unless they are purchased at a discount.

In contrast, for a taxable loan (i.e. a debt instrument in which the interest income is subject to tax) acquired at a premium, an entity can elect to either (1) amortize the entire premium as an offset to interest payments using constant yield principles or (2) take the premium into account when determining the amount of gain or loss when the loan is repaid or sold. Book-tax differences will arise due to the Day 1 allowance for credit losses and differences in the timing and amount of premium amortization depending on the tax elections made by the entity. Special rules under IRC Section 171 apply to tax-exempt loans acquired at a premium.

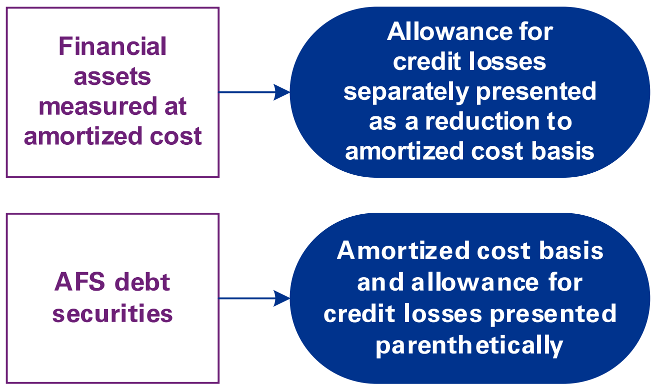
23. Presentation

Detailed contents

23.1 How the standard works

Topic 326 has different presentation requirements for:

- financial assets measured at amortized cost in the scope of the expected credit loss guidance (Subtopic 326-20); and
- AFS debt securities (Subtopic 326-30).



The amortized cost of a financial asset (including that of a debt security) includes the related accrued interest receivable. Topic 326 provides alternatives for how information related to accrued interest receivable is presented in the balance sheet and the income statement.

- **Balance sheet**: An entity may present accrued interest receivable and the related allowance for credit losses separately from the associated financial assets or net investments in leases.
- **Income statement:** An entity may present the writeoff of accrued interest receivable by reversing interest income, recognizing credit loss expense, or both.

The elections related to presentation of accrued interest receivable are available for AFS debt securities only if certain conditions are met.

23.2 Financial instruments in the scope of Subtopic 326-20

Excerpt from ASC 326-20

>> Off-Balance-Sheet Credit Exposures

30-11 In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer. At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic …

General

45-1 For **financial assets** measured at amortized cost within the scope of this Subtopic, an entity shall separately present on the statement of financial position, the allowance for credit losses that is deducted from the asset's **amortized cost basis**.

45-2 For off-balance-sheet credit exposures within the scope of this Subtopic, an entity shall present the estimate of expected credit losses on the statement of financial position as a liability. The liability for credit losses for off-balance-sheet financial instruments shall be reduced in the period in which the off-balance-sheet financial instruments expire, result in the recognition of a financial asset, or are otherwise settled. An estimate of expected credit losses on a financial instrument with off-balance-sheet risk shall be recorded separate from the allowance for credit losses related to a recognized financial instrument.

45-3 When a discounted cash flow approach is used to estimate expected credit losses, the change in present value from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. An entity that measures credit losses based on a discounted cash flow approach is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense). Alternatively, an entity may report the change in present value attributable to the passage of time as interest income. See paragraph 326-20-50-12 for a disclosure requirement applicable to entities that choose the latter alternative and report changes in present value attributable to the passage of time as interest income.

45-4 The **fair value** of the collateral of a collateral-dependent financial asset may change from one reporting period to the next. Changes in the fair value of the collateral shall be reported as credit loss expense or a reversal of credit loss expense when the guidance in paragraphs 326-20-35-4 through 35-6 is applied.

45-5 An entity may make an accounting policy election, at the class of financing receivable or major security-type level, to present separately on the statement of financial position or within another statement of financial position line item the accrued interest receivable balance, net of the allowance for credit losses (if any). An entity that presents the accrued interest receivable balance, net of the allowance for credit losses (if any), within another statement of financial position line item shall apply the disclosure requirements in paragraph 326-20-50-3A.

23.2.10 Balance sheet presentation

The following amounts are presented on the balance sheet separately:

- the allowance for credit losses related to assets measured at amortized cost – presented as a deduction from the assets' amortized cost basis. [326-20-45-1]
- the liability for off-balance sheet credit exposures – presented separately from the allowance for credit losses. This liability is reduced when the off-balance sheet credit exposure expires, results in the recognition of a financial asset or is otherwise settled. The liability is increased or reduced if an entity's expectation of the likelihood or magnitude of expected credit losses changes. For off-balance sheet credit exposure see chapter 13. [326-20-45-2]

Question 23.2.05

May accrued interest receivable be presented separately from the associated financial asset?

Interpretive response: Yes. An entity may make an accounting policy election to present accrued interest receivable, net of the related allowance for credit losses (if any), separately from the associated financial assets and/or net investments in leases.

In this situation, the net amount may be presented: [326-20-45-5]

- as a separate line item on the balance sheet; or
- in a line item together with other balances, with note disclosure of the amounts and the balance sheet line item in which they are included (see section 24.3.100).

The FASB created this election to provide relief from Subtopic 326-20's presentation requirements because stakeholders raised concerns about issues associated with accrued interest, including the operational burden and cost of tracking accrued interest at the individual loan level. [ASU 2019-04.BC12, BC14]

See also section 4.2.20 for guidance related to measuring the allowance for credit losses for accrued interest receivables.

23.2.20 Income statement presentation

Election regarding discounted cash flow method

If an entity uses a discounted cash flow method to estimate expected credit losses, it may present: [326-20-45-3, 50-12]

- the entire change in present value – including the change related to the passage of time – as credit loss expense or reversal of credit loss expense; or

— the change in present value related to the passage of time as interest income. If this alternative is elected, the entity is required to disclose the amount of interest income that represents the change in present value attributable to the passage of time.

Collateral-dependent financial assets

An entity estimates expected credit losses based on the fair value of collateral when (1) foreclosure is probable or (2) it applies the practical expedient for collateral-dependent financial assets or financial assets that meet the collateral maintenance provision requirements (see chapter 10).

In these instances, when changes in the fair value of collateral result in changes in expected credit losses, those changes in expected credit losses are presented in credit loss expense or reversal of credit loss expense. [326-20-35-4 – 35-6, 326-20-45-4]

Election regarding accrued interest receivable

An entity may elect to write off accrued interest receivable through reversing interest income, recognizing credit loss expense, or both. This election is made for each class of financing receivable or major security type (see Question 4.2.50). [326-20-35-8A]

Comparison to legacy US GAAP
Presentation of expected credit losses

The following table provides a summary comparison of the presentation requirements under Subtopic 326-20 and legacy US GAAP.

Legacy US GAAP	Topic 326
Balance sheet	
No specific presentation required; there is diversity in practice regarding whether and how an allowance for loan losses is presented on the balance sheet.	The allowance for credit losses for financial assets measured at amortized cost is separately presented as a deduction from (or addition to) the assets' amortized cost basis. An entity may make an accounting policy election to present accrued interest receivable, net of the related allowance for credit losses (if any), separately from the associated assets.
A liability is presented on the balance sheet for estimated losses related to off-balance sheet credit exposures; the liability is removed and an allowance for credit losses is recognized if the related amount is funded. [825-10-35-1]	Similar presentation to legacy US GAAP.
Income statement	
Loans and receivables Credit losses are reported as provision for loan losses (bad debt expense) in the income statement.	**Loans and receivables** Credit losses are presented as credit loss expense. However, an entity may elect to write off accrued interest receivable

Legacy US GAAP	Topic 326
The change in the present value of expected cash flows attributable to the passage of time may be presented as provision for loan losses – or reversal of provision for loan losses – or as interest income. [310-10-45-5 – 45-6]	through reversing interest income and/or recognizing credit loss expense. Similar to legacy US GAAP, the change in the present value of expected cash flows attributable to the passage of time may be presented as credit loss expense – or reversal of credit loss expense – or as interest income.
HTM debt securities Credit losses are presented in the income statement as impairment losses. The change in the present value of expected cash flows attributable to the passage of time is presented as interest income. [320-10-35-35, 45-8A, 45-9A]	**HTM debt securities** Credit losses are presented as credit loss expense. However, an entity may elect to write off accrued interest receivable through reversing interest income and/or recognizing credit loss expense. The change in the present value of expected cash flows attributable to the passage of time may be presented as credit loss expense – or reversal of credit loss expense – or as interest income.
Off-balance sheet credit exposures No specific presentation required for credit losses related to off-balance sheet credit exposure; there is diversity in practice.	**Off-balance sheet credit exposures** Topic 326 does not specify whether the credit loss expense for off-balance sheet credit exposure must be presented in the same line item as credit loss expense for other assets in its scope. As a result, there may be diversity in practice.

Question 23.2.10

Must an entity separately present the allowance for credit losses for financial assets with different measurement attributes?

Interpretive response: No. Topic 326 does not require each type of financial asset measured at amortized cost and the associated allowance for credit losses to be separately presented on the balance sheet.

Under legacy US GAAP, some entities combine AFS and HTM debt securities on the balance sheet, and then present them separately in the accompanying notes to the financial statements. [320-10-45-1, 320-10-50-1 – 50-5]

While this presentation alternative is not precluded under Topic 326, combining HTM debt securities and AFS debt securities on the balance sheet could be confusing because of the different presentation requirements applicable to each category.

For example:

— For HTM debt securities, an entity is required to separately present the allowance for credit losses, which is shown as a deduction from the amortized cost basis.

— For AFS debt securities, an entity is required to parenthetically present the amortized cost basis and the allowance for credit losses.

A separate presentation of HTM securities and AFS securities facilitates compliance with these presentation requirements. [320-10-45-1, 326-20-45-1, 326-30-45-1]

23.3 AFS debt securities

23.3.10 Overview

Excerpt from ASC 326-30

General

45-1 An entity shall present **available-for-sale debt securities** on the statement of financial position at **fair value**. In addition, an entity shall present parenthetically the **amortized cost basis** and the allowance for credit losses. If for the purposes of identifying and measuring an impairment the applicable accrued interest is excluded from both the fair value and the amortized cost basis of the available-for-sale debt security, an entity may present separately on the statement of financial position or within another statement of financial position line item the accrued interest receivable balance, net of the allowance for credit losses (if any). An entity that presents the accrued interest receivable balance, net of the allowance for credit losses (if any), within another statement of financial position line item shall apply the disclosure requirements in paragraph 326-30-50-3A.

45-2 An entity shall separately present, in the financial statement in which the components of accumulated other comprehensive income are reported, amounts reported therein related to available-for-sale debt securities for which an allowance for credit losses has been recorded.

45-3 When an entity applies the guidance in paragraph 326-30-35-7, the change in present value of cash flows expected to be collected from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. An entity is permitted to report the entire change in present value as a credit loss expense (or a reversal of credit loss expense). Alternatively, an entity may report the change in present value attributable to the passage of time as interest income. See paragraph 326-30-50-8 for a disclosure requirement applicable to creditors that choose the latter alternative and report changes in present value attributable to the passage of time as interest income.

Excerpt from ASC 320-10

> Other Comprehensive Income

45-9 Subsequent increases or decreases in the fair value of available-for-sale securities that do not result in recognition or reversal of an allowance for credit loss or write-down in accordance with Subtopic 326-30 on measuring credit losses on available-for-sale debt securities shall be included in other comprehensive income pursuant to paragraphs 320-10-35-1(b) and 320-10-45-8.

AFS debt securities are presented on the balance sheet at fair value with the amortized cost basis and allowance for credit losses presented parenthetically. [326-30-45-1]

Changes in fair value that do not result in recognition or reversal of an allowance for credit losses or a writedown of the security are included in other comprehensive income. In the financial statement in which the components of accumulated other comprehensive income are reported, an entity separately presents any amounts related to AFS debt securities for which an allowance for credit losses is reported. [320-10-45-9, 326-30-45-2]

Under Subtopic 326-30, an entity is required to use a discounted cash flow method when estimating credit losses for AFS debt securities, with the credit loss limited to the difference between the amortized cost basis and fair value of the debt security.

Election regarding discounted cash flow method

An entity may present: [326-30-45-3, 50-8]

— the entire change in present value, including the change related to the passage of time, as credit loss expense (or reversal of credit loss expense); or

— the change in present value related to the passage of time as interest income. If this alternative is elected, the entity is required to disclose the amount of interest income that represents the change in present value attributable to the passage of time.

Election regarding accrued interest receivable

An entity that excludes accrued interest receivable from both the fair value and amortized cost basis for purposes of identifying and measuring impairment may elect to write off accrued interest receivable through reversing interest income, recognizing credit loss expense, or both. This election is made for each major security type (see Questions 19.6.30 and 4.2.50). [326-30-35-13A]

Question 23.3.10

May accrued interest receivable be presented separately from the associated AFS debt security?

Interpretive response: Yes, provided the entity excludes accrued interest receivable from both the fair value and amortized cost basis of debt securities for purposes of identifying and measuring impairment. In this situation, the entity may elect to present accrued interest receivable, net of the related allowance for credit losses (if any), separately from the associated AFS debt security.

When an entity elects to separately present accrued interest receivable, it may present the net amount: [326-20-45-1]

— as a separate line item on the balance sheet; or

— in a line item together with other balances, with note disclosure of the amount of the accrued interest receivable and the balance sheet line item in which it is included (see section 24.3.100).

See also section 19.4.30 for guidance related to measuring the allowance for credit losses for accrued interest receivables.

Comparison to legacy US GAAP
Presentation of expected credit losses

The following table provides a summary comparison of the presentation requirements under Subtopic 326-30 and legacy US GAAP.

Legacy US GAAP	Topic 326
Balance sheet	
No specific presentation required. Only amortized cost of AFS securities is required to be disclosed in accompanying notes to the financial statements. [320-10-50-2]	The amortized cost and allowance for credit losses for AFS debt securities are parenthetically presented. [326-30-45-1] If an entity excludes accrued interest receivable from both the fair value and amortized cost basis for identifying and measuring impairment, it may elect to present accrued interest receivable, net of the related allowance for credit losses (if any), separately from the associated AFS debt securities. [326-20-45-1]
Income statement	
Credit losses for AFS securities are presented as impairment losses. [320-10-35-34D, 45-8A] The change in the present value of expected cash flows attributable to the passage of time is presented as interest income. [320-10-35-35]	Credit losses for AFS debt securities are presented as credit loss expense. However, if an entity excludes accrued interest receivable from both the fair value and amortized cost basis for identifying and measuring impairment, it may elect to write off accrued interest receivable through reversing interest income and/or recognizing credit loss expense. [326-30-35-13A] The change in the present value of expected cash flows attributable to the passage of time is presented as either credit loss expense (or reversal of credit loss expense) or as interest income. [326-30-45-3]

24. Disclosures

Detailed contents

Item significantly updated in this edition: #

24.1 How the standard works

Topic 326 requires disclosure of both qualitative and quantitative information about an entity's financial assets and the allowance for credit losses. The objective of these disclosures is to help financial statement users understand the credit risk inherent in an entity's portfolio of financial assets and how management monitors the portfolio's credit quality, management's estimate of expected credit losses and changes in the estimate of expected credit losses that have taken place during the period.

Some of the disclosure requirements are new and others were retained from legacy US GAAP. The retained disclosure requirements mostly relate to an entity's credit risk exposures and evaluation of the appropriateness of the allowance for credit losses. However, the financial assets to which the retained disclosures apply may be different under Topic 326 than under legacy US GAAP.

The following icons are used in this chapter.

☑ Represents retained disclosure requirements from legacy US GAAP that have not changed significantly.

▲ Represents retained disclosure requirements from legacy US GAAP that have been added to or modified in a manner we believe is significant.

+ Represents new disclosure requirements that do not exist under legacy US GAAP.

24.2 General disclosure considerations

24.2.10 Overview

Many of the Topic 326 disclosure requirements are legacy requirements from Section 310-10-50. Most of these retained disclosures relate to an entity's credit risk exposures and evaluation of the appropriateness of the allowance for credit losses.

However, the change from the Topic 310 incurred loss model to the Subtopic 326-20 expected credit loss model created the need for additional disclosures, including those about the inputs used to estimate expected credit losses. An example of a new disclosure that PBEs need to provide under Subtopic 326-20 is the amortized cost of financial assets by origination year (vintage). [326-20-50-6, 2016-13.BC108]

Elimination of some disclosure requirements

Some legacy US GAAP disclosure requirements were not retained. One set of these disclosure requirements is the impaired loan disclosures in paragraphs 310-10-50-14A to 50-20. These disclosures were not retained because the concept of an impaired loan does not exist in Subtopic 326-20.

Scope of retained disclosures has changed

Disclosures applicable to financial assets measured at amortized cost apply to HTM debt securities. As a result, many of the disclosure requirements retained from legacy US GAAP that are applicable under Subtopic 310-10 only to loans and receivables are also applicable to HTM debt securities under Subtopic 326-20. For example, disclosures about credit quality are required for HTM debt securities under Subtopic 326-20 while they are required only for certain loans and receivables under legacy US GAAP.

However, many of the disclosure requirements for securities retained from legacy US GAAP continue to be required for AFS debt securities but not for HTM debt securities. For example, disclosures about debt securities in unrealized loss positions without an allowance for credit losses are required for AFS debt securities but not for HTM debt securities. [326-20-50-10 – 50-13, 326-30-50-7 – 50-9]

Data gathering requirements and internal controls

Entities should assess whether their legacy systems and processes are capable of capturing, tracking, aggregating and reporting information to meet the new disclosure requirements of Topic 326. For many entities, this may require significant changes to their data-gathering processes, IT systems and internal controls. For example, PBEs have to gather information about the origination year of financial assets measured at amortized cost as part of the new disclosure requirements. In preparing that disclosure, current period originations include, among other things, financing receivables subject to modification that are accounted for as new receivables pursuant to Topic 310. [326-20-50-6, 326-30-50-7]

As part of their assessment, entities should consider the internal controls necessary to ensure the completeness and accuracy of the Topic 326 disclosures

– especially if the required data was not previously collected, or was collected for purposes other than financial reporting (e.g. financial planning and analysis).

24.2.20 Pre-adoption disclosures

Excerpt from ASC 250-10

>>> SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period

S99-5 The following is the text of SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period.

Facts: An accounting standard has been issued [FN5] that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

FN5 Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (e. g., exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. See also FRR 26.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue and concluded that registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission. [FN6] The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material. [FN7] MD&A [FN8] requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS [FN9] specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

FN6 FRR 6, Section 2.

FN7 In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

FN8 Item 303 of Regulation S-K.

FN9 See AU 9410.13-18.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.

A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.

A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.

Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

>> SEC Staff Announcement at Emerging Issues Task Force (EITF) Meetings

>>> SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M)

S99-6 The following is the text of SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M).

This announcement applies to Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*; ASU No. 2016-02, *Leases (Topic 842)*; and ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. [FN1]

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 [FN2] 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.

FN 1 This announcement also applies to any subsequent amendments to guidance in the ASUs that are issued prior to a registrant's adoption of the aforementioned ASUs.

FN 2 Topic 11.M provides SEC staff views on disclosures that registrants should consider in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may contain cross references to these disclosures that appear within the notes to the financial statements.

Question 24.2.10

What is an SEC registrant required to disclose related to the potential effects of Topic 326 before adoption?

Interpretive response: An SEC registrant is required to disclose the potential effects that recently issued accounting standards may have on the financial statements when the standards are adopted. [250-10-S99-5]

The objectives of the disclosure are to: [250-10-S99-5]

- notify financial statement users that a standard has been issued that the registrant will be required to adopt in the future; and
- assist those users in assessing the significance of the effect that the standard will have on the registrant's financial statements when adopted.

Therefore, for reporting periods before Topic 326 is adopted, a registrant is required to disclose the potential effects of the Topic on its financial statements. These disclosures should include the following: [250-10-S99-6]

- a brief description of the standard;

- the date that adoption is required and the date that the registrant plans to adopt, if earlier;
- a discussion of the method of adoption;
- a discussion of the effect that adoption of the standard is expected to have on the financial statements, unless not known or reasonably estimable. In that case, a statement to that effect may be made; and
- the potential effect of other significant matters that the registrant believes may result from the adoption of the standard is encouraged – e.g. technical violations of debt covenant agreements, planned or intended changes in business practices.

If a registrant is not able to reasonably estimate the effect Topic 326 will have on its financial statements, it should consider additional qualitative disclosures to assist financial statement users in determining the significance of the Topic's effect on its financial statements when adopted. The SEC staff expects these qualitative disclosures to include: [250-10-S99-6]

- a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison with the current accounting policies; and
- the registrant's progress in implementing the new standard and the significant implementation matters that it still needs to address.

The purpose of these disclosures is to ensure financial statement users understand the significance of the effect that Topic 326 is expected to have on the registrant's financial statements, as well as a clear timeline for the expected implementation of the standard. [250-10-S99-6]

The SEC staff expects SAB 74 disclosures for new standards to become more detailed as the effective date approaches. Therefore, even if a registrant provides only qualitative disclosures because it is not able to reasonably estimate the effect of Topic 326, it should augment its disclosures at each reporting date for any further relevant information. Additionally, it should continue to modify any quantitative disclosures as its estimates change and it receives more information.

The SEC staff's views on how SAB 74 disclosures should evolve were included in two speeches before the 2016 AICPA National Conference on Current SEC and PCAOB Developments. Although these speeches mention the revenue recognition standard (issued through ASU 2014-09), they provide important insights into the SEC staff's expectations regarding Topic 326 and other significant new accounting standards that have long periods between issuance and adoption.

Comments by Wesley R. Bricker, SEC Deputy Chief Accountant: [2016 AICPA Conf]

> The changes in standards will impact all companies, and even if the extent of change for a particular industry or company is slight, the disclosures necessary to explain the changes – and when implemented, to describe revenue streams – may not be. Investors and OCA staff will be looking for increased disclosures in 2016 filings and during 2017 about the significance of the impact – whether quantitative or qualitative – of revenue recognition, among the other new standards, when those standards are adopted in the future. In addition, companies may find it helpful to investors to incorporate a discussion of the

anticipated effects of the standard into their investor outreach activities to foster timely absorption of the information by market participants.

Timely implementation of the new standard is important…Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why and provide informative disclosures to investors about the status so that investors can assess the implications of the information. Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies.

Comments by Sylvia E. Alicea, Professional Accounting Fellow: [2016 AICPA Conf]

I'd like to offer a few additional points before moving on to my final topic. First, I believe a registrant should not be reluctant to disclose reasonably estimable quantitative information merely because the ultimate impact of adoption may differ, since that information may be relevant to investors even while lacking complete certainty. Second, I would encourage a registrant to disclose known or reasonably estimable quantitative information even if it's only for a subset of the registrant's arrangements – for example, one product category or revenue stream (accompanied by the appropriate disclosure, of course) – rather than waiting until all of the impacts are known. Third, these disclosures should be consistent with other information provided to the Audit Committee and investors, and they should be subject to effective internal control over financial reporting. As management completes portions of its implementation plan and develops an assessment of the anticipated impact, effective internal control should be designed and implemented to timely identify disclosure content and ensure that appropriately informative disclosure is made.

Question 24.2.20

Should SAB 74 (SAB Topic 11.M) disclosures be included in the notes to the financial statements?

Interpretive response: It depends. SAB 74 (SAB Topic 11.M) indicates that disclosure in the financial statements should be considered when recently issued accounting standards constitute a 'material matter'. If a recently issued accounting standard does not constitute a material matter, we believe the entity is not required to include the disclosures in the notes to the financial statements (although disclosure in Management's Discussion and Analysis of Financial Condition and Results of Operations may still be appropriate).

SAB 74 does not further define 'material matter'. An entity's determination of whether the adoption of ASU 2016-13 constitutes a material matter based on the guidance in SAB 74 is a judgment, for which the entity's analysis should be documented.

In making its determination of what constitutes a material matter, we believe an entity should consider both qualitative and quantitative factors. We believe these factors should include, but are not limited to, the following.

— The number and nature of inquiries from analysts and other investors about the impact of adopting ASU 2016-13.

- Whether adoption will affect compliance with regulatory requirements, including the entity's regulatory capital status – e.g. whether a bank would no longer be classified as 'well capitalized'.
- Whether adoption will affect compliance with debt covenants or other contractual requirements.
- The transition method. ASU 2016-13 is adopted using a combination of prospective and modified retrospective transition methods (see section 25.3). As a result, the amounts reported in the basic financial statements (i.e. balance sheet and statements of income, comprehensive income, shareholders' equity and cash flows) for periods before adoption will not be impacted by the adoption of ASU 2016-13.
- The amount of the cumulative effect of adoption in relation to various financial statement amounts as well as other metrics.

We expect that an entity will also consider other determinations of whether recently adopted and pending accounting standards constitute material matters. This is to evaluate whether its approach applied, and judgments used, in those cases is consistent with its determination in adopting ASU 2016-13.

In the past, some entities may have included SAB 74 disclosures in the notes to the financial statements without evaluating whether adoption of those accounting standards constituted material matters. In those circumstances, we do not believe an entity is required to continue including all future SAB 74 disclosures in the notes. Instead, we believe that entities may determine whether SAB 74 disclosure in the notes is appropriate based on their determination of whether adoption of each pending accounting standard (including ASU 2016-13) constitutes a material matter.

There may be circumstances in which an entity that has performed an analysis that considers relevant quantitative and qualitative factors will conclude that adoption of ASU 2016-13 is not a material matter – even when the cumulative effect of adoption is expected to exceed quantitative materiality for the financial statements as a whole in the year preceding adoption. Conversely, there may be circumstances in which an entity will conclude that adoption of ASU 2016-13 is a material matter when the cumulative effect adjustment is expected to be less than quantitative materiality for the financial statements as a whole in the year preceding adoption.

24.3 Financial instruments measured at amortized cost (Subtopic 326-20)

Excerpt from ASC 326-20

General

50-1 For instruments within the scope of this Subtopic, this Section provides the following disclosure guidance on credit risk and the measurement of expected credit losses:

a. Credit quality information
b. Allowance for credit losses
c. Past-due status

d. Nonaccrual status
e. **Purchased financial assets with credit deterioration**
f. Collateral-dependent **financial assets**
g. Off-balance-sheet credit exposures.

50-2 The disclosure guidance in this Section should enable a user of the financial statements to understand the following:

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

50-3 For **financing receivables**, the disclosure guidance in this Subtopic requires an entity to provide information by either **portfolio segment** or **class of financing receivable**. Net investment in leases are within the scope of this Subtopic, and the disclosure requirements for financing receivables shall be applied to net investment in leases (including the unguaranteed residual asset). For held-to-maturity **debt securities**, the disclosure guidance in this Subtopic requires an entity to provide information by major security type. Paragraphs 326-20-55-10 through 55-14 provide implementation guidance about the terms *portfolio segment* and class of *financing receivable*. When disclosing information, an entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements in this Section. An entity must strike a balance between not obscuring important information as a result of too much aggregation and not overburdening financial statements with excessive detail that may not assist a financial statement user in understanding the entity's financial assets and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial assets and associated risks.

>> Disclosure – Application of the Term *Portfolio Segment*

55-10 This implementation guidance addresses the meaning of the term *portfolio segment*. All of the following are examples of portfolio segments:

a. Type of **financing receivable**
b. Industry sector of the borrower
c. Risk rating.

>> Disclosure – Application of the Term *Class of Financing Receivable*

55-11 This implementation guidance addresses application of the term ***class of financing receivable***. An entity should base its principal determination of class of financing receivable by disaggregating to the level that the entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables. In its assessment, the entity should consider the risk characteristics of the financing receivables.

55-12 In determining the appropriate level of its internal reporting to use as a basis for disclosure, an entity should consider the level of detail needed by a user to understand the risks inherent in the entity's financing receivables. An entity could further disaggregate its financing receivables portfolio by considering numerous factors. Examples of factors that the entity should consider include any of the following:

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

55-13 An entity also may consider factors related to concentrations of credit risk as discussed in Section 825-10-55.

55-14 Classes of financing receivables generally are a disaggregation of a **portfolio segment**. For determining the appropriate classes of financing receivables that are related to a portfolio segment, the portfolio segment is the starting point with further disaggregation in accordance with the guidance in paragraphs 326-20-55-11 through 55-13. The determination of class for financing receivables that are not related to a portfolio segment (because there is no associated allowance) also should be based on the guidance in those paragraphs.

24.3.10 Overview

Financial statement disclosures about financial instruments measured at amortized cost are intended to provide information that is useful in analyzing an entity's exposures to credit risk and management's estimate of expected credit losses. To accomplish this, Subtopic 326-20 contains specific disclosure topics, each of which is detailed in a separate subsection below.

Each of these specific topics contains one or more objectives that are based on the overall disclosure objectives for Subtopic 326-20. The overall objectives are to provide disclosures that help financial statement users understand the following: [326-20-50-2, ASU 2016-13.BC106]

— credit risk inherent in a portfolio and how management monitors credit quality of the portfolio;

— management's estimate of expected credit losses; and

— changes in the estimate of expected credit losses that have taken place during the period.

Disaggregation considerations

An entity further needs to determine how to disaggregate its disclosed information under these specific topics. How disclosures are disaggregated depends on the type of financial asset.

Financing receivables and net investment in leases	HTM debt securities
Information provided by either portfolio segment or class of financing receivable, depending on the requirements for the specific disclosure topic. [326-20-50-3]	Information provided by major security type. [326-20-50-3]
A portfolio segment is the level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. [326-20 Glossary] Examples of portfolio segments include: [326-20-55-10] — type of financing receivable; — industry sector of the borrower; — risk rating.	Major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity considers all of the following: [320-10-50-1B] — shared activity or business sector; — vintage; — geographic concentration; — credit quality; — economic characteristic.
A class of financing receivable is a grouping based on both the risk characteristics of the financing receivable and the entity's method for monitoring and assessing credit risk. [326-20 Glossary] It is generally a disaggregation of a portfolio segment and may include consideration of factors such as: [326-20-55-11 – 55-14] — categorization of borrowers – e.g. commercial or consumer borrowers; — type of financing receivable – e.g. mortgage, credit card, or interest-only loans or finance leases; — industry sector – e.g. real estate, mining; — collateral type – e.g. residential or commercial property, government-guaranteed collateral, uncollateralized (unsecured); — geographic distribution – e.g. domestic, international; — concentrations of credit risk.	

Judgment is necessary to determine the appropriate level of detail to disclose based on an entity's particular facts and circumstances. However, there are two competing concerns involved in determining the appropriate level of aggregation or detail. [326-20-50-3]

— On one hand, the information should not be aggregated to such a degree that important information is obscured.

— On the other hand, the information should not be disaggregated to such a degree that the financial statement users are overburdened with excessive detail that is not decision useful.

Disclosure of accrued interest receivable

Due to stakeholder concerns, the FASB provided relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances.

Under the disclosure relief, an entity is permitted, as a practical expedient, to exclude accrued interest receivable included in an instrument's amortized cost from the disclosure requirements in paragraphs 326-20-50-4 to 50-22 (see sections 24.3.20 to 24.3.90). If an entity elects the practical expedient, it discloses the total amount of accrued interest excluded from the disclosed amortized cost basis (see section 24.3.100). [326-20-50-3B]

See section 24.3.100 for further information about disclosures related to accrued interest receivable.

24.3.20 Credit quality information#

Credit quality information is the first of the specific disclosure topics.

Objectives: The disclosures about credit quality information are designed to help financial statement users do both of the following: [326-20-50-4]

— understand how management monitors the credit quality of its financial assets; and

— assess the quantitative and qualitative risks arising from the credit quality of its financial assets.

☑ Disaggregation: An entity provides quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets in the scope of Subtopic 326-20, excluding off-balance sheet credit exposures and repurchase agreements and securities lending agreements in the scope of Topic 860. [326-20-50-5]

☑ This disclosure requires the following information about credit quality indicators and the amortized cost basis of financial assets: [326-20-50-5]

- a description of the credit quality indicator(s);
- the amortized cost basis, by credit quality indicator; and
- for each credit quality indicator, the date or range of dates in which the information was last updated for that credit quality indicator.

Related guidance on credit quality indicators
A credit quality indicator is a statistic about the credit quality of a financial asset. An entity applies judgment in determining the appropriate credit quality indicator for each class of financing receivable and major security type. As of the reporting date, the entity uses the most current information it has obtained for each credit quality indicator. [326-20 Glossary, 326-20-55-16]
Examples of credit quality indicators include: [326-20-55-15] — consumer credit risk scores;

Related guidance on credit quality indicators
— credit-rating-agency ratings; — an entity's internal credit risk grades; — debt-to-value ratios; — collateral; — collection experience; and — other internal metrics.
If an entity discloses internal risk ratings, it provides qualitative information on how those internal risk ratings relate to the likelihood of loss. [326-20-50-8]
The disclosures about credit quality indicators do not apply to receivables measured at the lower of amortized cost basis or fair value, or trade receivables due in one year or less (except for credit card receivables) that result from revenue transactions in the scope of Topic 606 (revenue from contracts with customers) or legacy Topic 605 (revenue recognition). [326-20-50-9]

When disclosing the credit quality indicators of financing receivables and net investment in leases, a PBE presents the amortized cost basis within each credit quality indicator and gross writeoffs recorded in the current year (on a current year-to-date basis) by year of origination – i.e. by vintage year. This requirement does not apply to reinsurance receivables nor to funded or unfunded amounts of line-of-credit arrangements, such as credit cards. A PBE provides, by class of financing receivable, separate columns for (1) revolving loans and (2) revolving loans that have been converted to term loans. [326-20-50-6 – 50-6A]

Before adopting ASU 2022-02, a PBE is not required to present gross writeoffs (see Question 24.3.20).

Related guidance for disclosing credit quality indicators by origination year
Guidance on year of origination (vintage year) [326-20-50-6]
For purchased financing receivables and net investment in leases, a PBE uses the initial date of issuance to determine the year of origination, not the date of acquisition.
For origination years before the fifth annual period, a PBE may present the amortized cost basis and gross writeoffs of financing receivables and net investments in leases in the aggregate.
For interim period disclosures, the current year-to-date originations in the current reporting period are considered to be the current period originations.
Guidance on line-of-credit conversions [326-20-50-6A]
A PBE presents the amortized cost basis of line-of-credit arrangements that were converted to term loans in a separate column within the entity's vintage disclosures. See FASB Example 15 in paragraph 326-20-55-79 (reproduced below).
A PBE discloses in each reporting period, by class of financing receivable, the amount of line-of-credit arrangements that were converted to term loans in each reporting period and the total of these financing receivables that were written off in the current reporting period.
Guidance on current period originations [326-20-50-7]
Except for line-of-credit arrangements that have been converted to term loans, a PBE uses the guidance in paragraphs 310-20-35-9 to 35-12 (receivables – nonrefundable fees and other costs – subsequent measurement – loan refinancing or restructuring) when determining whether a modification, extension

Related guidance for disclosing credit quality indicators by origination year
or renewal of a financing receivable should be presented as a current period origination.
An entity uses the guidance in paragraphs 842-10-25-8 to 25-9 (leases overall – recognition – lease modifications) when determining whether a lease modification should be presented as a current period origination.

Question 24.3.10

Are both public and nonpublic business entities required to provide credit quality disclosures by origination year (vintage year)?

Interpretive response: No, only PBEs are required to provide credit quality disclosures of the amortized cost basis for financing receivables and net investment in leases by vintage year of origination.

The FASB deemed the vintage-year information necessary so that financial statement users can understand the credit quality trends within a portfolio from period to period. Users can also combine the vintage year information with information disclosed in other areas in the financial statements and assumptions from public sources to derive their own roll-forward of the balances and related allowance for credit losses for each origination year. [ASU 2016-13.BC114]

The FASB believes this will provide useful information because it will help users develop estimates of: [ASU 2016-13.BC114]

- originations by period for each class of financing receivable;
- the initially expected credit losses and subsequent changes to the estimate; and
- the current-period provision attributable to originations and changes in expected credit losses on previously originated loans.

Only PBEs are required to make these disclosures because the FASB believes investors in private companies can generally obtain the information they need from management. [ASU 2016-13.BC114]

Additionally, PBEs that are not SEC filers may phase in the disclosures of credit quality indicators by year of origination. In the year of adoption, these entities are required to present only the three most recent origination years – including the first year of adoption. Additional information is added for the next two years so that a total of five origination years ultimately is presented. [326-10-65-1(h)]

Question 24.3.20#

Must a PBE disclose gross writeoffs and recoveries by vintage year before adopting ASU 2022-02?

Background: Before the amendments in ASU 2022-02, paragraph 326-20-50-6 required a PBE to disclose only the amortized cost basis of financial assets within each credit quality indicator by vintage year. In addition to the amortized cost basis, FASB Example 15 (beginning at paragraph 326-20-55-79) – which illustrated disclosure of credit quality information – included disclosure of gross writeoffs and recoveries within each credit quality indicator by vintage year.

Interpretive response: No. Before the amendments in ASU 2022-02, we believe a PBE is permitted – but not required – to disclose gross writeoffs and recoveries by vintage year. That is, the inclusion of this information in FASB Example 15 is for illustrative purposes and does not establish a requirement to disclose that information. After adopting ASU 2022-02, a PBE is required to disclose gross writeoffs by vintage year, but is not required to disclose gross recoveries.

Question 24.3.25

How are line-of-credit arrangements that have converted to term loans disclosed in the vintage disclosures?

Interpretive response: There are two disclosure requirements in the vintage disclosures for line-of-credit arrangements that have been converted to term loans. [326-20-50-6A]

— The amortized cost basis of line-of-credit arrangements that were converted to term loans is presented in a separate column. Therefore, an entity presents all currently outstanding term loans that were funded through a drawdown of line-of-credit arrangements in a separate column.

— The amount of line-of-credit arrangements that were converted to term loans in each reporting period is disclosed. We believe an entity may present this amount as a footnote to the amounts disclosed in the first requirement. We further believe an entity may develop other alternatives to present this amount.

Comparison to legacy US GAAP

Credit quality information

Under legacy US GAAP, an entity is required to disclose its recorded investment in financing receivables by credit quality indicator. In contrast, Subtopic 326-20 requires an entity to disclose its amortized cost basis by credit quality indicator. [310-10-50-29(b), 326-20-50-5(b)]

The amortized cost basis is defined as the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments. [326-20 Glossary]

The change in terminology from recorded investment to amortized cost may affect the amount an entity is required to disclose. However, Subtopic 326-20 permits an entity to elect to use a practical expedient related to accrued interest receivable for certain disclosure requirements (see section 24.3.10). [326-20-50-3B]

Excerpt from ASC 326-20

The Codification paragraphs in the excerpt below were amended by ASU 2022-02; therefore, they are relevant only before the ASU is adopted.

>> Example 15: Disclosing Credit Quality Indicators of Financing Receivables by Amortized Cost Basis

55-79 The following Example illustrates the presentation of credit quality disclosures for a financial institution with a narrow range of loan products offered to local customers—both consumer and commercial. Depending on the size and complexity of an entity's portfolio of financing receivables, the entity may present disclosures that are more or less detailed than the following Example. An entity may choose other methods of determining the class of financing receivable and may determine different credit quality indicators that reflect how credit risk is monitored. Some entities may have more than one credit quality indicator for certain classes of financing receivables.

	Term Loans Amortized Cost Basis by Origination Year								
As of December 31, 20X5	**20X5**	**20X4**	**20X3**	**20X2**	**20X1**	**Prior**	**Revolving Loans Amortized Cost Basis**	**Revolving Loans Converted to Term Loans Amortized Cost Basis**	**Total**
Residential mortgage:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total residential mortgage loans	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Residential mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Consumer:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total consumer	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Consumer loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Commercial business:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial business	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**

Commercial business loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**-**	**$ -**	**$ -**	**$ -**
Commercial mortgage									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial mortgage	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**-**	**$ -**	**$ -**	**$ -**
Commercial mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**-**	**$ -**	**$ -**	**$ -**

Excerpt from ASC 326-20

Pending Content

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

>> Example 15: Disclosing Credit Quality Indicators of Financing Receivables by Amortized Cost Basis

55-79 The following Example illustrates the presentation of credit quality disclosures for a financial institution with a narrow range of loan products offered to local customers—both consumer and commercial. Depending on the size and complexity of an entity's portfolio of financing receivables, the entity may present disclosures that are more or less detailed than the following Example. An entity may choose other methods of determining the class of financing receivable and may determine different credit quality indicators that reflect how credit risk is monitored. Some entities may have more than one credit quality indicator for certain classes of financing receivables.

	Term Loans Amortized Cost Basis by Origination Year								
As of December 31, 20X5	**20X5**	**20X4**	**20X3**	**20X2**	**20X1**	**Prior**	**Revolving Loans Amortized Cost Basis**	**Revolving Loans Converted to Term Loans Amortized Cost Basis**	**Total**
Residential mortgage:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total residential mortgage loans	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**

Residential mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~	-	-	-	-	-	-	-	-	-
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~
Consumer:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total consumer	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Consumer loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~	-	-	-	-	-	-	-	-	-
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~
Commercial business:									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial business	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Commercial business loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
~~Current-period recoveries~~	-	-	-	-	-	-	-	-	-
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~		~~$~~	~~$~~	~~$~~
Commercial mortgage									
Risk rating:									
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial mortgage	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**-**	**$ -**	**$ -**	**$ -**
Commercial mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	-	$ -	$ -	$ -
~~Current-period recoveries~~	-	-	-	-	-	-	-	-	-
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~		~~$~~	~~$~~	~~$~~

Example 24.3.10
Disclosing credit quality of HTM debt securities

The following table illustrates a credit quality disclosure for an entity that holds a portfolio of HTM debt securities.

Depending on the size and complexity of its portfolio, an entity may present disclosures that are more or less detailed than this example. For instance, this sample disclosure uses just one credit quality indicator (credit rating), but some entities may decide to present more than one credit quality indicator.

	Amortized cost of HTM debt securities by credit rating							
As of December 31, 20XX	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC – C**	**Total**
US Treasury and government agencies	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Obligations of US states and municipalities	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Corporate debt securities	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential MBS	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential MBS issued by US government-sponsored enterprises or US government agencies	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial MBS	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**

Question 24.3.30

If a PBE elects to maintain pools of loans or debt securities previously accounted for under Subtopic 310-30, how are they included in the vintage disclosures?

Interpretive response: We believe either of the following approaches, consistently applied, is acceptable.

— Include such loans or debt securities in the vintage disclosure table based on the vintage of each of the underlying loans.

— Exclude such loans or debt securities from the vintage disclosure table. Instead, place a note after the table indicating that the table does not include the loans or debt securities previously accounted for under Subtopic 310-30 that the entity elected to maintain as pools after adoption. This note should also include the vintage years of assets in the pools, the aggregate amortized cost basis and information about the credit quality of the assets in the pools.

Question 24.3.40

Must an entity provide credit quality disclosures for contract assets?

Excerpt from ASC 606-10

45-3 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a **contract asset**, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

45-4 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of **revenue** recognized shall be presented as a credit loss expense.

20 Glossary

Contract Asset – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Interpretive response: Yes. Credit losses of contracts assets are disclosed under Subtopic 326-20. Therefore, an entity must provide quantitative and qualitative information about the credit quality of contract assets. [606-10-45-3]

However, we believe contract assets are not subject to the credit quality disclosures by origination year (vintage disclosures) because such disclosures only apply to financing receivables and net investments in leases. A contract asset does not meet the definition of a financing receivable because the right to collect payment is conditioned on something other than the passage of time. [326-20-50-5 – 50-6, 606-10 Glossary, 606-10-45-3]

Contract asset subsequently becomes a receivable

Once a contract asset becomes a trade receivable (i.e. the related performance condition has been satisfied), the disclosures related to credit quality information, including vintage disclosures, do not apply if those trade receivables are due in one year or less. [326-20-50-9]

In contrast, such disclosures do apply if the contract asset becomes a financing receivable that is due after a year; however, the vintage disclosures only apply to PBEs. [326-20-50-9]

24.3.30 Allowance for credit losses

Information about the allowance for credit losses is the second of the specific disclosure topics.

Objectives: The disclosures about the allowance for credit losses are designed to help financial statement users understand: [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; and
- the circumstances that caused changes to the allowance for credit losses, thereby affecting the related credit loss expense (or reversal) reported for the period.

To meet these objectives, an entity discloses the following by portfolio segment and major security type: [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; and
  - 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 – e.g. 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 writeoffs, 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; and
- the amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period.

☑ When an entity estimates expected credit losses based on a discounted cash flow method, the change in present value from one reporting period to the next may result from the passage of time and a change in the estimate of future expected cash flows. An entity is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense). Alternatively, it may report the change in present value attributable to the passage of time as interest income. [326-20-45-3]

☑ An entity that chooses the latter alternative discloses the amount recorded to interest income that represents the change in present value attributable to the passage of time. [326-20-50-12]

Question 24.3.50

What information does an entity disclose about the reversion method?

Background: Subtopic 326-20 does not prescribe how an entity should revert to historical loss information. Instead, it indicates that an entity could revert immediately, on a straight-line basis, or using another rational and systematic basis. [326-20-30-9]

Interpretive response: An entity is required to include in its disclosures a discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period. [326-20-50-11(g)]

We believe an entity should disclose the specific method used to revert to historical loss information – i.e. immediately, on a straight-line basis, or another rational and systematic method. If another rational and systematic method is used, we believe an entity should describe the method to enable financial statement users to understand the qualitative impact on the allowance for credit losses.

Question 24.3.60

Does an entity disclose whether single or multiple economic scenarios are used to develop its economic forecast?

Background: An entity is required to include in its disclosures a description of how expected loss estimates are developed and 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: [326-20-50-11(a) – 50-11(b)]

— past events;
— current conditions; and
— reasonable and supportable forecasts about the future.

Interpretative response: We believe an entity should disclose whether it uses a single most likely or multiple forward-looking economic scenarios as part of its disclosures about the methodology for estimating the allowance for credit losses. In most circumstances, this information is important to enable financial statement users to understand the entity's methodology, how the entity developed its expected loss estimates, and the factors that influenced management's estimate.

Question 24.3.70

Does an entity disclose what the reasonable and supportable forecast period is?

Interpretive response: We believe an entity should disclose the reasonable and supportable forecast period as part of the disclosures about the methodology for estimating the allowance for credit losses. Such information is generally an important input to enable financial statement users to understand the methodology for estimating expected credit losses. [326-20-50-11(a) – 50-11(b)]

Comparison to legacy US GAAP

Allowance for credit losses

The disclosures about an entity's allowance for credit losses have been augmented to reflect the change from the incurred loss model to the expected credit loss model. Specifically, Subtopic 326-20 requires disclosure of the following additional items about the allowance for credit losses:

— factors that influenced management's current estimate of expected credit losses, including reasonable and supportable forecasts about the future, in addition to past events and current conditions;

— reasons for significant changes in the amount of writeoffs; and

— reversion method applied for periods beyond the reasonable and supportable forecast period.

24.3.40 Roll-forward of the allowance for credit losses

Information about the roll-forward of the allowance for credit losses is the third of the specific disclosure topics.

Objective: The disclosures about the roll-forward of the allowance for credit losses are designed to help financial statement users understand the activity in the allowance for credit losses for each period.

To meet this objective, an entity separately provides by portfolio segment and major security type the quantitative disclosures of the activity in the allowance for credit losses for financial assets in the scope of Subtopic 326-20. [326-20-50-13]

The disclosures include the following: [326-20-50-13]

- the beginning balance in the allowance for credit losses;
- the 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 beneficial interests that meet the criteria in paragraph 325-40-30-1A, if applicable;

- writeoffs charged against the allowance;
- recoveries collected; and
- the ending balance in the allowance for credit losses.

Comparison to legacy US GAAP
Roll-forward of the allowance for credit losses

Under legacy US GAAP, an entity does not establish a loan loss allowance at the initial acquisition of PCI financial assets. In contrast, under Subtopic 326-20 an entity establishes an allowance for credit losses through a gross-up entry at the initial acquisition of PCD financial assets. Therefore, Subtopic 326-20 requires that disclosure of the activity in the roll-forward of the allowance for credit losses include the initial allowance for credit losses recognized for PCD financial assets.

24.3.50 Past-due status

Information about the past-due status of financial assets is the fourth of the specific disclosure topics.

Objective: The disclosures about past-due status are designed to help financial statement users understand the extent of financial assets that are past due.

☑ To meet this objective, an entity provides 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. [326-20-50-14]

☑ An entity discloses when it considers a financial asset to be past due. [326-20-50-14]

Related guidance for past-due status disclosures [326-20-50-15]

The disclosures do not apply to receivables measured at the lower of amortized cost basis or fair value, or trade receivables due in one year or less (except for credit card receivables) that result from revenue transactions in the scope of Topic 606 (revenue from contracts with customers) or legacy Topic 605 (revenue recognition).

Excerpt from ASC 326-20

>> Example 16: Disclosing Past-Due Status

55-80 The following table illustrates certain of the disclosures in paragraph 326-20-50-14 by class of financing receivable.

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

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

	Age Analysis of Past-Due Financial Assets As of December 31, 20X5, and 20X4 Past Due						
20X4	**30-59 Days**	**60-89 Days**	**Greater Than 90 Days**	**Total**	**Current**	**Total**	**Amortized Cost > 90 Days and Accruing**
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate:							
Commercial real estate – construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer – credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential:							
Residential – prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases							
Total	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**

Example 24.3.20
Disclosing past-due status of HTM debt securities

The following table illustrates the presentation of past-due status for an entity that holds a portfolio of debt securities classified as HTM.

	Aging analysis of past-due HTM debt securities					
As of December 31, 20XX	**30-59 days**	**60-89 days**	**Greater than 90 days**	**Total**	**Current**	**Total**
US Treasury and government agencies	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Obligations of US states and municipalities	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Corporate debt securities	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential MBS	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential MBS issued by US government-sponsored enterprises or US government agencies	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial MBS	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**	**$XX,XXX**

24.3.60 Nonaccrual status

Information about financial assets in nonaccrual status is the fifth of the specific disclosure topics.

Objective: The disclosures about nonaccrual status are designed to help financial statement users understand the credit risk and interest income recognized on financial assets on nonaccrual status.

☑ To meet this objective, an entity discloses the following, disaggregated by class of financing receivable and major security type: [326-20-50-16]

- the amortized cost basis of financial assets on nonaccrual status as of the beginning 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; and
- 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.

☑ An entity's summary of significant accounting policies for financial assets in the scope of Subtopic 326-20 includes: [326-20-50-17]

- 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
- the policy for determining past-due or delinquency status; and

- the policy for recognizing writeoffs within the allowance for credit losses.

Related guidance for disclosing significant accounting policies [326-20-50-18]
The disclosures about nonaccrual status do not apply to receivables measured at the lower of amortized cost basis or fair value, or trade receivables due in one year or less (except for credit card receivables) that result from revenue transactions in the scope of Topic 606 (revenue from contracts with customers) or legacy Topic 605 (revenue recognition).

24.3.70 PCD financial assets

Information about purchased financial assets with credit deterioration (PCD) is the sixth of the specific disclosure topics.

To the extent that an entity acquired PCD financial assets during the current reporting period, it provides a reconciliation of the difference between the purchase price of the financial assets and the par value of the assets, including: [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; and
- the par value.

24.3.80 Collateral-dependent financial assets

Information about collateral-dependent financial assets is the last of the specific disclosure topics.

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 describes the type of collateral by class of financing receivable and major security type. [326-20-50-20]

An entity also qualitatively describes the following – by class of financing receivable and major security type: [326-20-50-20]

- the extent to which collateral secures its collateral-dependent financial assets; and
- significant changes in the extent to which collateral secures its collateral dependent financial assets, whether because of a general deterioration or some other reason.

24.3.90 Off-balance sheet credit exposures

Additional disclosure requirements exist for off-balance sheet credit exposures.

☑ In addition to disclosures required by other Topics, an entity discloses a description of the accounting policies and methodology it used to estimate its liability for off-balance sheet credit exposures and related charges for those credit exposures. The description identifies the factors that influenced management's judgment – e.g. historical losses, existing economic conditions, and reasonable and supportable forecasts – and a discussion of risk elements relevant to particular categories of financial instruments. [326-20-50-21]

Related guidance for disclosure about off-balance sheet credit exposures [326-20-50-22]
Off-balance sheet credit exposures refers to credit exposures on off-balance sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments, except for instruments in the scope of Topic 815.

24.3.100 Accrued interest receivable

Additional disclosures are required about an entity's elections related to the measurement, presentation and disclosure of accrued interest receivable.

⊞ An entity that makes an accounting policy election to present accrued interest receivable within another line item (see Question 23.2.05) discloses the amount of accrued interest, net of the allowance for credit losses (if any), and the line item in which that amount is presented. [326-20-50-3A]

⊞ An entity that elects the practical expedient to exclude the accrued interest receivable that is included in the amortized cost from the disclosure requirements in paragraphs 326-20-50-4 to 50-22 (see section 24.3.10) discloses the total amount of accrued interest excluded from the disclosed amortized cost basis. [326-20-50-3B]

⊞ An entity that elects to not measure an allowance for credit losses for accrued interest receivable (see section 4.2.20) discloses that accounting policy election, including information about what time periods are considered timely (at the class of financing receivable or major security-type level). [326-20-50-3C]

⊞ An entity discloses its accounting policy election to write off accrued interest receivable by reversing interest income, recognizing credit loss expense, or a combination of both (see Question 4.2.50). It also discloses the amount written off by reversing interest income, if applicable, by portfolio segment or major security type. [326-20-50-3D]

24.4 AFS debt securities (Subtopic 326-30)

Excerpt from ASC 326-30

General

50-1 For instruments within the scope of this Subtopic, this Section provides the following disclosure guidance related to credit risk and the measurement of credit losses:

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

50-2 The disclosure guidance in this Section should enable a user of the financial statements to understand the following:

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

50-3 An entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements in this Section and how it disaggregates information into major security types. 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 a financial statement user to understand an entity's securities and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of **financial assets** and associated risks.

24.4.10 Overview

Financial statement disclosures about AFS debt securities are intended to provide information that is useful in analyzing: [326-30-50-2]

— the credit risk inherent in AFS debt securities;
— management's estimate of credit losses; and
— changes in the estimate of credit losses that have taken place during the period.

Disaggregation considerations

An entity uses its judgment in determining the appropriate level of detail to provide and how it disaggregates information into major security types based on its particular facts and circumstances. However, there are two competing concerns involved in determining the appropriate level of aggregation and detail. [326-30-50-3]

— On one hand, the information should not be aggregated to such a degree that important information is obscured.

— On the other hand, the information should not be disaggregated to such a degree that the financial statement users are overburdened with excessive detail that is not decision useful.

Disclosure of accrued interest receivable

Due to stakeholder concerns, the FASB provided relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances when an entity excludes accrued interest receivable from both the fair value and amortized cost basis of AFS debt securities for purposes of identifying and measuring impairment.

Under the disclosure relief, an entity is permitted, as a practical expedient, to exclude accrued interest receivable included in an instrument's amortized cost from the disclosure requirements in paragraphs 326-30-50-4 to 50-10 (see sections 24.4.20 to 24.4.50). If an entity elects the practical expedient, it discloses the total amount of accrued interest excluded from the disclosed amortized cost basis (see section 24.4.60). [326-30-50-3B]

See section 24.4.50 for further information about disclosures related to accrued interest receivable.

24.4.20 AFS debt securities in unrealized loss positions without an allowance for credit losses

☑ For AFS debt securities in an unrealized loss position for which an allowance for credit losses has not been recorded, an entity discloses the following in its interim and annual financial statements: [326-30-50-4(a)]

- as of each date for which a balance sheet is presented, quantitative information in tabular format and aggregated by category of investment – i.e. each major security type that the entity discloses under Subtopic 326-30:
  - the aggregate related fair value of investments with unrealized losses; and
  - the aggregate amount of unrealized losses – i.e. the amount by which amortized cost basis exceeds fair value.

Related guidance on tabular disclosure of fair value and unrealized losses
AFS securities that are in the scope of Subtopic 325-40 (beneficial interests in securitized financial assets) are subject to these disclosures. [326-30-50-4]
These disclosures are disaggregated by those investments that have been in a continuous unrealized loss position for fewer than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer. [326-30-50-5]
The reference point for determining how long an investment has been in a continuous unrealized loss position is the reporting date of the period in which the impairment is identified. For entities that do not prepare interim financial information, the reference point is the reporting date of the annual period during which the impairment was identified. [326-30-50-6]
The continuous unrealized loss position ceases upon the investor becoming aware of a recovery of fair value up to (or beyond) the amortized cost basis of the investment during the period. [326-30-50-6]

☑ For AFS debt securities in an unrealized loss position for which an allowance for credit losses has not been recorded, an entity discloses the following in its interim and annual financial statements:

– as of the date of the most recent balance sheet, additional information (in narrative form) that provides sufficient information to allow financial statement users 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. [326-30-50-4(b)]

Related guidance on information considered when determining whether an allowance for credit losses is unnecessary
AFS securities that are in the scope of Subtopic 325-40 (beneficial interests in securitized financial assets) are subject to these disclosures. [326-30-50-4]
When disclosing why an allowance for credit losses is unnecessary, an entity may aggregate the information by investment category, but individually significant unrealized losses generally are not aggregated. Information relevant to the determination of whether an allowance for credit losses is unnecessary could include: [326-30-50-4(b)] — 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); and — other evidence considered by the investor in reaching its conclusion that an allowance for credit losses is not necessary, including, for example: – performance indicators of the underlying assets in the security, including default rates, delinquency rates, and 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; and – any other information that the investor considers relevant.

Excerpt from ASC 326-30

>> Example 2: Disclosures about Investments in Available-for-Sale Debt Securities in an Unrealized Loss Position with No Credit Losses Reported

55-8 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**

55-9 Following are illustrative narrative disclosures that would follow the illustrative table.

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.

Question 24.4.10

Do the disclosures for an AFS debt security in an unrealized loss position apply if an allowance for credit losses has been recognized for a portion of the loss?

Interpretive response: Yes. Consistent with legacy US GAAP, we believe disclosure of all unrealized loss amounts related to AFS debt securities is required. [320-10-50-6, 326-30-50-4]

The unrealized loss is the amount by which the amortized cost basis exceeds fair value. The amortized cost basis does not consider the allowance for credit losses. Therefore, we believe the disclosure applies when the unrealized loss on an AFS debt security includes both a credit portion (recognized by establishing an allowance for credit losses) and a non-credit portion (recognized in other comprehensive income). [326-20 Glossary]

24.4.30 Allowance for credit losses

☑ For interim and annual periods in which an allowance for credit losses of an AFS debt security is recorded, an entity discloses by major security type the methodology and significant inputs used to estimate the allowance, including its accounting policy for recognizing writeoffs of uncollectible AFS debt securities. [326-30-50-7]

☑ Examples of significant inputs include, but are not limited to: [326-30-50-7]

- performance indicators of the underlying assets in the security, including all of the following:
  - default rates;
  - delinquency rates; and
  - 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; and
- other market data that are relevant to the collectibility of the security.

The change in present value of cash flows that an entity expects to collect from one reporting period to the next may result from the passage of time and from changes in the estimate of expected future cash flows. An entity may report the entire change in the allowance for credit losses as credit loss expense or reversal of credit loss expense. Alternatively, it may report the change in present value attributable to the passage of time as interest income. [326-30-45-3]

An entity that chooses the latter alternative discloses the amount recorded to interest income that represents the change in present value attributable to the passage of time. [326-30-50-8]

24.4.40 Roll-forward of the allowance for credit losses

For each interim and annual reporting period presented, an entity discloses by major security type a tabular roll-forward of the allowance for credit losses. This includes, at a minimum: [326-30-50-9]

- the beginning balance of the allowance for credit losses on AFS 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 AFS debt securities accounted for as PCD financial assets, 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;
- writeoffs charged against the allowance;
- recoveries of amounts previously written off; and
- the ending balance of the allowance for credit losses related to debt securities held by the entity at the end of the period.

24.4.50 Purchased financial assets with credit deterioration

To the extent that an entity acquired PCD financial assets during the current reporting period, it provides a reconciliation of the difference between the purchase price of the assets and the par value of the AFS debt securities, including: [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; and
- the par value.

24.4.60 Accrued interest receivable

Additional disclosures are required about an entity's elections related to the measurement, presentation and disclosure of accrued interest receivable.

- An entity that makes an accounting policy election to present accrued interest receivable within another line item (see Question 23.3.10) discloses the amount of accrued interest, net of the allowance for credit losses (if any), and the line item in which that amount is presented. [326-30-50-3A]
- An entity that elects the practical expedient to exclude accrued interest receivable included in an instrument's amortized cost from the disclosure requirements in paragraphs 326-30-50-4 to 50-10 (see section 24.4.10) discloses the total amount of excluded accrued interest (net) excluded from the disclosed amortized cost basis. [326-30-50-3B]
- An entity that elects to not measure an allowance for credit losses for accrued interest receivable (see section 19.4.30) discloses that accounting policy election, including information about what time periods are considered timely (at the majority security-type level). [326-30-50-3C]
- An entity discloses its accounting policy election to write off accrued interest receivable by reversing interest income, recognizing credit loss expense, or a combination of both (see Question 19.6.30). It also discloses the amount written off by reversing interest income, if applicable, by major security type. [326-30-50-3D]

25. Effective dates and transition

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

25.1 How the standard works#

This chapter contains guidance for adopting ASU 2022-02 separately from the guidance for adopting 2016-13. An entity that adopts ASU 2016-13 in fiscal years beginning after December 15, 2022 must adopt ASU 2022-02 at the same time.

Effective dates and transition provisions for ASU 2016-13 (and related amendments other than those in ASU 2022-02)

	SEC filers[1] that are not eligible to be a smaller reporting company (SRC)[2]	All other entities
Effective date: [326-10-65-1(a)]	Annual and interim periods in fiscal years beginning after December 15, 2019	Annual and interim periods in fiscal years beginning after December 15, 2022
Early adoption: [326-10-65-1(b)]	Early adoption is permitted as of the beginning of a fiscal year for fiscal years beginning after December 31, 2018	
Transition requirements: [326-10-65-1(c) – 65-1(e)]	— Cumulative effect adjustment to retained earnings as of the beginning of the year of adoption. — Prospective application required for debt securities when OTTI was recognized before the adoption date. — Prospective application required for financial assets for which Subtopic 310-30 (loans and debt securities acquired with deteriorated credit quality) was previously applied. Accounting policy election to maintain pools of financial assets previously accounted for under Subtopic 310-30 on an ongoing basis. [TRG 6-17.3, TRG 6-17.6]	

Notes:

1. An SEC filer is an entity that is required to file or furnish its financial statements with either (1) the SEC or (2) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section. Financial statements for other non-SEC filers whose financial statements are included with another filer's SEC submission are not included in this definition. [326-10 Glossary]
2. An entity determines whether it is eligible to be a SRC based on its most recent SRC determination as of November 15, 2019. [326-10-65-1(a)(1)]

Effective dates and transition provisions for ASU 2022-02

	Transition provisions
Effective date: [326-10-65-5(a) - 65-5(b)]	Annual and interim periods in fiscal years beginning after December 15, 2022[1]
Early adoption: [326-10-65-5(b)]	Permitted for an entity that has adopted ASU 2016-13 (and other related amendments) in any interim period as of the beginning of the fiscal year that includes the interim period. An entity may elect to early adopt the amendments related to receivable modifications separately from the amendments related to vintage disclosures.

	Transition provisions
Transition requirements: [326-10-65-5(c)]	— Generally applied prospectively after the first day of the fiscal year of adoption. — However, related to the elimination of recognition and measurement of TDRs by creditors, an entity can elect to apply the ASU on a modified retrospective basis to recognize any change in the allowance for credit losses that had been recognized for receivables previously modified (or reasonably expected to be modified) in a TDR.

Note:

1. Entities that have not previously adopted ASU 2016-13 will adopt ASU 2022-02 at the same time that they adopt ASU 2016-13 (and other related amendments).

25.2 Effective dates for ASU 2016-13 (and related amendments other than those in ASU 2022-02)

25.2.10 Overview

Excerpt from ASC 326-10

> Transition Related to Accounting Standards Updates No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, No. 2019-04 Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

65-1 The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-10, Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*:

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

b. Early application of the pending content that links to this paragraph is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Note: See paragraph 250-10-S99-6 on disclosure of the impact that recently issued accounting standards will have on the financial statements of a registrant.

Question 25.2.10

May an entity early adopt Topic 326 at an interim date?

Interpretive response: No. We believe an entity is permitted to early adopt Topic 326 only as of the beginning of a fiscal year beginning after December 31, 2018. For example, a calendar year-end entity would be permitted to early adopt Topic 326 as of January 1 but not as of an interim date (such as April 1). [326-10-65-1(b)]

25.2.20 Determining the effective date

Excerpt from ASC 326-10

20 Glossary

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

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

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

ASU 2019-10 amended the effective dates that were originally required by ASU 2016-13 for certain entities. As a result, Topic 326 has different mandatory effective dates for SEC filers that are not eligible to be a SRC versus all other entities. [326-10-65-1(a)(1)]

— For SEC filers that are not eligible to be a SRC, it is effective for annual and interim periods in fiscal years beginning after December 15, 2019 – e.g. January 1, 2020 for calendar year-end entities.

— For all other entities, it is effective for annual and interim periods in fiscal years beginning after December 15, 2022 – e.g. January 1, 2023 for calendar year-end entities.

A SEC filer's determination of whether it is eligible to be a SRC is a one-time assessment as of November 15, 2019 based on its most recent determination of its eligibility under SEC rules. Under SEC rules, SEC filers determine their SRC eligibility annually on the last business day of the most recently completed second fiscal quarter. [Reg S-K 10(f)(1)]

For example, a calendar year-end entity will determine whether it is eligible for the deferred effective date based on its June 30, 2019 determination of SRC status, which is the most recent determination as of November 15, 2019.

The SEC defines a SRC based on the following initial qualification thresholds: [Reg S-K 10(f)(1)]

— public float of less than $250 million; or
— annual revenues less than $100 million as of the most recent fiscal year for which audited financial statements are available, and with a public float ranging from $0 to less than $700 million.

An entity that did not initially qualify as a SRC is subject to lower qualification thresholds for its ongoing assessments.

Question 25.2.20
Are all entities eligible to be a SRC?

Interpretive response: No. An entity must be an issuer to be eligible to be a SRC. In addition, the SEC's rule specifically excludes certain entities from being eligible to be SRCs. [Reg S-K 10(f)(1)]

Those entities specifically identified as not eligible for SRC status include investment companies and business development companies, asset-backed issuers, majority-owned subsidiaries of a parent that is not a SRC, and foreign companies that use special 'F' forms instead of domestic forms. In addition, broker-dealers that are not issuers are not eligible to be a SRC because an entity must be an issuer to be eligible to be a SRC.

As a result, some SEC filers that are similar in size to entities that are SRCs will not be eligible for the later effective date.

Question 25.2.25
Is SRC eligibility based on most recent filing status or most recent determination?

Interpretive response: An entity's SRC eligibility is based on its most recent determination. Specifically, an entity will determine its effective date based on its most recent determination of its SRC eligibility as of November 15, 2019. [326-10-65-1(a)(1)]

This means that there could be circumstances in which the entity's filing status differs from its most recent determination of SRC eligibility.

For example, Issuer has a calendar year-end and has been filing with the SEC as a SRC. Issuer determined at the end of its most recently completed second fiscal quarter (June 30, 2019) that it will no longer qualify as a SRC. However, as permitted by SEC rules, Issuer plans to continue to file as a SRC through the end of its current fiscal year (i.e. June 30 and September 30, 2019 Form 10-Qs). However, because the effective date is based on a one-time assessment as of November 15, 2019 that is based on the most recent determination of its SRC eligibility, Issuer would be subject to the effective date for SEC filers that are not eligible to be SRCs; this is even though its most recent filing was made as a SRC.

Question 25.2.30

How does an emerging growth company determine which effective date to apply?

Interpretive response: An emerging growth company that, under SEC rules, has elected to apply private entity adoption dates may continue to follow the effective dates for private entities. Therefore, the guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2022. [326-10-65-1(a)(1)]

An emerging growth company that, under SEC rules, has not elected to apply private entity adoption dates will need to evaluate whether it is eligible to be a SRC.

— If it is eligible to be a SRC based on its most recent determination of its SRC eligibility as of November 15, 2019, the guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2022.

— If it is not eligible to be a SRC, the guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019.

25.3 Transition for ASU 2016-13 (and related amendments other than those in ASU 2022-02)

Excerpt from ASC 326-10

> Transition Related to Accounting Standards Update No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, and No. 2019-04 *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief*, and No. 2019-11, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*

65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses,* and No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-05, Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief*: …

c. An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period in which the pending content that links to this paragraph is effective.
d. An entity shall apply prospectively the pending content that links to this paragraph for **purchased financial assets with credit deterioration** to **financial assets** for which Subtopic 310-30 was previously applied. The prospective application will result in an adjustment to the **amortized cost basis** of the financial asset to reflect the addition of the allowance for credit losses at the date of adoption. An entity shall not reassess whether recognized financial assets meet the criteria of a purchased financial asset with credit deterioration as of the date of adoption. An entity may elect to maintain pools of **loans** accounted for under Subtopic 310-30 at adoption. An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are **troubled debt restructurings** as of the date of adoption. The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the **effective interest rate** determined after the adjustment for credit losses at the adoption date. The same transition requirements should be applied to beneficial interests for which Subtopic 310-30 was applied previously or for which there is a significant difference between the contractual cash flows and expected cash flows at the date of recognition.
e. An entity shall apply prospectively the pending content that links to this paragraph to **debt securities** for which an other-than-temporary impairment had been recognized before the date of adoption, such that the amortized cost basis (including previous write-downs) of the debt security is unchanged. In addition, the effective interest rate on a security will remain unchanged as a result of the adoption of the pending content that links to this paragraph. Amounts previously recognized in accumulated other comprehensive income as of the adoption date that relate to improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. Recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption shall be recorded to income in the period received….
i. An entity may irrevocably elect the fair value option in accordance with Subtopic 825-10 for financial instruments within the scope of Subtopic 326-20, except for those financial assets in paragraph 326-20-15-2(a)(2), that are also eligible items in Subtopic 825-10.
j. An entity that adjusts the effective interest rate used to discount expected cash flows to consider the timing (and changes in timing) of expected cash flows resulting from expected prepayments in accordance with paragraphs 326-20-30-4 through 30-4A for troubled debt restructurings that exist as of the date of adoption may, as an accounting policy election, calculate the prepayment-adjusted effective interest rate using the original

contractual rate and the prepayment assumptions as of the date of adoption.

> Transition Related to Accounting Standards Update No. 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief:*

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

25.3.10 Overview

An entity records a cumulative effect adjustment in retained earnings in the balance sheet as of the beginning of the year of adoption of Topic 326 – e.g. January 1, 2020 for a calendar year-end PBE that is an SEC filer. [326-10-65-1(c)]

Although retrospective transition methods generally provide the most useful information, the FASB rejected those methods. The FASB "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." [ASU 2016-13.BC115]

Additional transition guidance applies to the following: [326-10-65-1(d) – 65-1(e), 65-1(i)]

— instruments in the scope of Subtopic 326-20 that are eligible for the fair value option under Subtopic 825-10, except for HTM debt securities (see section 25.3.15);

— assets previously accounted for as purchased credit-impaired (PCI) assets under Subtopic 310-30, including where an entity had applied that guidance by analogy (see section 25.3.20); and

— debt securities for which OTTI had been recognized before adoption of Topic 326 (see section 25.3.30).

25.3.15 Fair value option

An entity may irrevocably elect the fair value option for existing financial instruments at adoption of Topic 326. This election is made on an instrument-by-instrument basis for instruments that are eligible under Subtopic 825-10 and that are in the scope of Subtopic 326-20 – except for HTM debt securities. [326-10-65-1(i)]

The FASB provided this transition relief in response to financial statement preparers that have begun (or are planning) to elect the fair value option for *newly* originated or purchased financial assets that are in the scope of Subtopic 326-20. This transition relief allows an entity to use the same measurement basis for *previously* originated or purchased financial assets (other than HTM debt securities), resulting in a consistent measurement methodology for those financial assets and improving financial statement comparability for those entities. [ASU 2019-05.BC7]

When the fair value option is elected for a previously originated or purchased financial asset, the difference between the carrying amount and its fair value is recorded as a cumulative effect adjustment in retained earnings as of the beginning of the first reporting period of adoption of ASU 2019-05. Examples of differences between the carrying amount and fair value include: [326-10-65-3(d)]

— unamortized deferred costs, fees, premiums, and discounts;
— valuation allowances (allowance for loan losses); and
— accrued interest.

25.3.20 PCI assets

Subtopic 310-30 contains guidance on accounting for PCI assets. However, ASU 2016-13 has superseded Subtopic 310-30 in its entirety, and replaced it with purchased financial asset with credit deterioration (PCD) accounting. For more discussion of PCD assets as well as transitioning existing PCI pools, see chapter 12.

25.3.30 Debt securities with OTTI recognized before adoption

An entity prospectively applies Topic 326 to AFS and HTM debt securities when OTTI has been recognized before the adoption date. The effect of this approach is to maintain the same amortized cost basis before and after the adoption date. In addition, the EIR does not change as a result of the adoption of Topic 326, and amounts previously recorded in other comprehensive income that relate to improvements in cash flows before the effective date continue to be accreted to interest income. [326-10-65-1(e)]

Although the prospective approach is intended to simplify the accounting, the carryover of the amortized cost basis for these securities creates additional complexities when estimating the allowance for credit losses under Topic 326 and when accounting for improvements in expected cash flows for securities with OTTI before the adoption date. These complexities are unique to debt securities with OTTI before adoption and are further discussed in this section.

Allowance for credit losses at the date of adoption

Although the amortized cost of debt securities with OTTI recognized before adoption remains the same under the prospective transition approach, an allowance for credit losses may be necessary at adoption. This allowance reflects an entity's expected credit losses of the amortized cost basis – i.e. an entity may recognize an allowance for credit losses at adoption to the extent the amortized cost basis has not been previously reduced to reflect expected credit losses. [326-10-65-1(e), 326-20-30-4 – 30-5)

Question 25.3.10

How is the prospective transition guidance applied to debt securities with OTTI that was recognized before adoption?

Interpretive response: Under the prospective transition guidance, a debt security's amortized cost basis and EIR are unchanged as a result of adopting Topic 326. However, we believe that any allowance for credit losses recognized in connection with adopting Topic 326 is recognized as a cumulative effect adjustment to retained earnings as of the beginning of the fiscal year. [326-10-65-1(c)]

The FASB provided transition relief for debt securities with OTTI recognized before adoption because legacy US GAAP requires credit loss impairment on debt securities to be recognized as direct writedowns, which reduces the amortized cost basis. Therefore, the amortized cost basis would have been different if Topic 326 had been applied retrospectively. As a result of feedback from constituents, the FASB decided that the amortized cost should not be adjusted and Topic 326 should be applied prospectively. The FASB believes the prospective approach simplifies the subsequent accounting for preparers, and was favored by users because the yields on the securities are comparable from one reporting period to the next. [ASU 2016-13.BC116–BC117]

We believe the guidance for prospective application of Topic 326 relates solely to determining the amortized cost basis of such a debt security and its effective interest rate. We believe the guidance requiring a cumulative effect adjustment to retained earnings applies to any allowance recognized in connection with adoption. [326-10-65-1(c), 65-1(e)]

Question 25.3.20

When might an allowance for credit losses be recognized at adoption for a debt security with OTTI recognized before adoption?

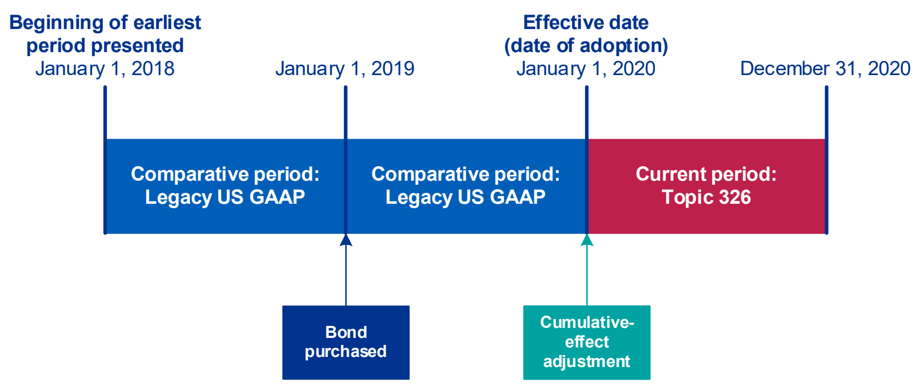
Interpretive response: An allowance for credit losses might be recognized at adoption because of differences in the allowance methods applied under Topic 326 as compared to legacy US GAAP, or differences in how those methods are applied.

For example, legacy US GAAP requires the use of a discounted cash flow method for estimating and recognizing credit loss impairment for HTM debt securities. In contrast, Subtopic 326-20 permits (but does not require) a discounted cash flow method when estimating expected credit losses for HTM debt securities. Further, an entity may estimate expected cash flows differently under Subtopic 326-20 than it did under legacy US GAAP – e.g. because Subtopic 326-20 does not require a loss to be probable. If there are expected credit losses of the amortized cost basis that were not reflected through previously recognized credit impairment, an allowance for credit losses may be recognized on transition because of these differences.

Example 25.3.10
Journal entries when entity uses a non-discounted cash flow method at adoption for a previously impaired HTM debt security

Investor is a calendar year-end PBE that is an SEC filer.

On January 1, 2019, Investor pays $275,000 to acquire a non-prepayable bond whose terms require a payment of $500,000 when it matures in five years with no other payments until that date (i.e. a zero-coupon bond). At acquisition, Investor classifies the bond as a HTM debt security and expects to receive all contractual cash flows. Investor calculates the EIR as 12.70% (rounded).



Accounting at December 31, 2019 (immediately before transition)

As of December 31, 2019, Investor's amortized cost basis in the bond is $309,928. The increase of $34,928 from the initial $275,000 amortized cost represents accretion for 2019 (i.e. one year) based on the EIR of 12.70% (rounded).

Assume that the fair value as of December 31, 2019 is $275,993, which reflects market assumptions at that date, including a market interest rate of 13%. Investor continues to have the ability to hold the security through maturity.

At the end of 2019, the bond is considered to be impaired because the fair value ($275,993) is less than the amortized cost ($309,928).

Investor considers the guidance in paragraphs 320-10-35-33D to 35-33I of legacy US GAAP to determine if a credit loss exists. Investor develops the following best estimate of cash flows.

	Year 2	Year 3	Year 4	Year 5	Total
Expected cash flows	$0	$0	$0	$450,000	$450,000
Present value of expected cash flows, discounted at EIR of 12.70% (rounded)					$278,935

Because the amortized cost of the bond ($309,928) is greater than the present value of expected cash flows ($278,935), Investor determines that a credit loss exists and records the following journal entries at December 31, 2019 under legacy US GAAP.

	Debit	*Credit*
Credit impairment loss (earnings)[1]	30,993	
Non-credit impairment loss (OCI)[2]	2,942	
HTM security		30,993
HTM security – valuation allowance (non-credit impairment)		2,942
To record OTTI and non-credit related loss.		

Notes:

1. The difference between amortized cost ($309,928) and the present value of expected cash flows ($278,935) discounted at the EIR.
2. The difference between fair value ($275,993) and the present value of expected cash flows ($278,935) discounted at the EIR.

The amortized cost basis of the bond as of December 31, 2019 is $278,935, which represents the purchase price ($275,000) as adjusted for accretion ($34,928) and OTTI recognized in net income ($30,993). The carrying amount of the bond is $275,993 (i.e. fair value).

Accounting at January 1, 2020 (transition)

At January 1, 2020, Investor adopts the guidance in Topic 326 and applies the provisions of Subtopic 326-20. Unlike legacy US GAAP (Subtopic 320-10), Subtopic 326-20 does not require the use of a discounted cash flow method for HTM securities and Investor elects to use a loss-rate method.

On adoption, the amortized cost basis of the bond is $278,935. Using a loss-rate method to estimate expected credit losses on the adoption date, Investor estimates that it will not receive $50,000 ($500,000 principal balance × 10% loss rate) of contractual cash flows.

Credit loss impairment was recognized through net income before adoption of Topic 326 and reduced the amortized cost basis. The $50,000 of contractual cash flows expected not to be collected is based on the $500,000 principal balance rather than the amortized cost basis. Because $30,993 of credit losses were recognized as a direct writedown of the amortized cost basis, expected credit losses of the amortized cost basis are $19,007.

Allowance for credit losses at 1/1/20 (transition)	
Contractual cash flows expected not to be collected as of Jan. 1, 2020	$50,000
Credit losses previously recognized	30,993
Allowance for credit losses as of Jan. 1, 2020 (transition) – represents expected credit losses of the amortized cost basis	$19,007

As of January 1, 2020, Investor records the following journal entry.

	Debit	*Credit*
Retained earnings	19,007	
Allowance for credit losses		19,007
To record cumulative effect adjustment of estimate of expected credit losses on HTM security.		

The allowance for credit losses in this example is the result of Investor electing to use a loss-rate method under Topic 326 (which is not a discounted cash flow method) while legacy US GAAP requires a discounted cash flow method.

Changes in cash flows subsequent to the date of adoption

Accounting for changes in cash flows subsequent to the date of adoption of Topic 326 depends on whether the change is an expected decrease or improvement in cash flows. Credit impairment of debt securities under legacy US GAAP is recognized as a direct writedown that reduces the amortized cost basis (rather than through a valuation allowance).

Because the FASB decided not to permit or require an entity to retrospectively apply Topic 326 to these securities, in many cases an allowance for credit losses will not be established at transition. As a result, the accounting for improvements in cash flows may differ between securities with credit impairment recognized before the effective date of Topic 326 and those for which credit losses are not recognized until after the effective date.

- For securities with credit impairment recognized before the effective date, improvements in cash flows (beyond any allowance for credit losses recognized at or subsequent to adoption) are treated as recoveries that are not recognized in the income statement until the period in which they are received.
- For securities with credit losses not recognized until after the effective date, improvements in cash flows are recognized through a reduction in the allowance for credit losses.

Nature of change in cash flow subsequent to adoption	How change is reflected in financial statements
Improvements in credit	— To the extent there is an allowance for credit losses, it is reduced for improvements in credit. — Additional improvements in credit that represent recoveries of amounts previously written off are recognized in the income statement in the period received.
Deterioration in credit	Allowance for credit losses is recorded based on the guidance in: — Subtopic 326-20 (HTM debt securities); or — Subtopic 326-30 (AFS debt securities).

Question 25.3.30

How are improvements in cash flows due to credit recognized for beneficial interests in the scope of Subtopic 325-40 with OTTI recognized before adoption?

Interpretive response: Under Subtopic 325-40, a beneficial interest's accretable yield ordinarily is adjusted on a prospective basis for improvements in expected cash flows once the allowance for credit losses has been reduced to zero (see section 20.4.20). However, Topic 326's transition provisions state that recoveries of amounts previously written off relating to improvements in expected cash flows after adoption are recorded in income when received.

The following approach is applied to improvements in expected cash flows for beneficial interests with OTTI recognized before adoption of Topic 326, based on the above guidance.

First	To the extent there is an allowance for credit losses, it is reduced for improvements in expected cash flows.
Second	Additional improvements that represent recoveries of amounts previously written off as OTTI before adoption are recognized in the income statement in the period received.
Third	The accretable yield is adjusted on a prospective basis. This may occur, for example, when expected cash flows at the reporting date exceed those that had been expected at the beneficial interest's initial recognition.

Effective interest rate

Because Topic 326 is prospectively applied to debt securities with OTTI before the adoption date, the EIR does not change as a result of the adoption of Topic 326. [326-10-65-1(e)]

25.3.40 Guarantees

An entity applies Topic 326 to guarantees and other instruments – other than those accounted for as either insurance or derivatives – that create off-balance sheet credit exposure for the guarantor (see chapter 14). Those items in the scope of Topic 326 represent a subset of guarantees in the scope of Topic 460 (guarantees). [326-20-15-2(c), 460-10-30-5]

The guarantor (issuer) of a guarantee recognizes a guarantee liability (the non-contingent aspect) at fair value under Topic 460. Under Subtopic 326-20, it also estimates and accounts for an allowance for credit losses (the contingent aspect) separately from the guarantee liability.

See chapter 14 for additional information on how guarantees in the scope of Topic 460 will be affected by the adoption of Subtopic 326-20.

25.3.50 Troubled debt restructurings

The guidance in this section applies before adoption of ASU 2022-02. See section 25.5 regarding adoption of ASU 2022-02.

As discussed in Question 4.4.70, when estimating expected credit losses using discounted cash flows for TDRs, entities can use either:

- the prepayment-adjusted EIR in effect immediately before the TDR; or
- the original EIR.

ASU 2019-11 provides transition relief for entities that elect to use a prepayment-adjusted EIR in a discounted cash flow approach to estimate credit losses on financial assets modified in a TDR before the adoption date. These entities may make an accounting policy election to calculate the prepayment-adjusted EIR based on the original contractual terms of the loan and prepayment assumptions as of the date of adoption – rather than using the prepayment assumptions in effect immediately before the restructuring date. [ASU 2019-11, 326-10-65-1j]

25.4 Transition disclosures for ASU 2016-13 (and related amendments other than those in ASU 2022-02)

Excerpt from ASC 326-10

> Transition Related to Accounting Standards Update No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*: …

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

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

h. In the year of initial application of the pending content that links to this paragraph, a public business entity that does not meet the definition of a

SEC filer may phase-in the disclosure of credit quality indicators by year of origination by only presenting the three most recent origination years (including the first year of adoption). In each subsequent fiscal year, the then-current origination year will be added in the periods after adoption until a total of five origination years are presented. Origination years before those that are presented separately shall be disclosed in the aggregate. For example, the phase-in approach would work as follows assuming a calendar year-end entity:

1. For the first annual reporting period ended December 31, 2X21, after the effective date of January 1, 2X21, an entity would disclose the end of period amortized cost basis of the current period originations within 2X21, as well as the two origination years of 2X20 and 2X19. The December 31, 2X21 end of period amortized cost balances for all prior originations would be presented separately in the aggregate.
2. For the second annual reporting period ended December 31, 2X22, after the effective date of January 1, 2X21, an entity would disclose the end of period amortized cost basis of the current period originations within 2X22, as well as the three origination years of 2X21, 2X20, and 2X19. The December 31, 2X22 ending amortized cost basis would be presented in the aggregate for all origination periods before the four years that are presented separately.
3. For the third annual reporting period ended December 31, 2X23, after the effective date of January 1, 2X21, an entity would disclose the end-of-period amortized cost basis of the current-period originations within 2X23, as well as the four origination years of 2X22, 2X21, 2X20, and 2X19. The December 31, 2X23 ending amortized cost basis would be presented in aggregate for all origination periods before the five years that are presented separately.
4. For interim-period disclosures within the years discussed above, the current year-to-date originations should be disclosed as the originations in the interim reporting period

25.4.10 Disclosures before adoption

SEC registrants are expected to provide certain disclosures in advance of adopting Topic 326. See further discussion in Question 24.2.10.

25.4.20 Disclosures about adoption

Entities are required to make certain disclosures in the period Topic 326 is adopted.

Nature of the change in accounting principle, including an explanation of the newly adopted accounting principle	**Method of applying the change**
Material effect of adoption on any line item on the balance sheet as of beginning of first period for which credit loss standard is effective	**Cumulative effect of change on retained earnings or other components of equity as of beginning of first period for which credit loss standard is effective**

Entities that issue interim financial statements are required to provide these disclosures in each interim financial statement of the year of adoption and also in the annual financial statements of the period of the adoption. [326-10-65-1(f) – 65-1(g)]

25.4.30 Disclosure of credit quality indicators by year of origination

As discussed in section 24.3.20, PBEs are required to present the amortized cost basis within each credit quality indicator by year of origination (vintage year). Topic 326 provides transition relief for this disclosure to PBEs that are not SEC filers. These entities are required to present the amortized cost basis within each credit quality indicator by year of origination, but may phase in the disclosure by only presenting the three most recent origination years in the year of adoption. In the second and third years after adoption, the current year's originations are added to the disclosure until a total of five years are presented. [326-10-65-1(h)]

25.5 Effective dates and transition for ASU 2022-02**

Excerpt from ASC 326-10

> Transition Related to Accounting Standards Update No. 2022-02, *Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*

65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2022-02, *Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*:

a. An entity that has not yet adopted the pending content that links to paragraph 326-10-65-1 shall apply the pending content that links to this paragraph when the entity first applies the pending content that links to paragraph 326-10-65-1.

b. An entity that has adopted the pending content that links to paragraph 326-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

    1. Early adoption, including adoption in any interim period as of the beginning of the fiscal year that includes that interim period, is permitted provided that an entity has adopted the pending content that links to paragraph 326-10-65-1 in financial statements of fiscal years or interim periods that have not been issued or made available for issuance. An entity may elect to early adopt the pending content that links to this paragraph individually for the pending content that links to this paragraph on vintage disclosures and troubled debt restructurings by creditors. For example, an entity may early adopt the pending content that links to this paragraph on vintage disclosures, and an entity m separately elect not to early adopt the pending content that links to this paragraph on troubled debt restructurings by creditors.

c. An entity shall apply the pending content that links to this paragraph prospectively from the beginning of the fiscal year of adoption, except as discussed in (c)(2).

    1. Disclosures required by the pending content in paragraphs 310-10-50-38 through 50-44 and 326-20-50-6 shall be provided for modifications and gross writeoffs made starting in the period of adoption. Information about modifications in periods before adoption need not be provided. That is, in disclosures that require information about modifications made in the previous 12 months, modifications made before the date of the adoption of the pending content that links to this paragraph do not need to be included.

    2. For the elimination of recognition and measurement guidance on troubled debt restructurings by creditors in Subtopic 310-40, an entity may elect to apply a modified retrospective transition by means of a cumulative-effect adjustment to the opening retained earnings as of the beginning of the fiscal year of adoption for any change in the allowance for credit losses that had been recorded for loans modified or reasonably expected to be modified in a troubled debt restructuring before the adoption of the pending content that links to this paragraph. If an entity elects a prospective approach, the guidance shall be applied to modifications occurring after the date of adoption of the pending content that links to this paragraph.

25.5.10 Effective dates

Question 25.5.10
When is an entity required to adopt ASU 2022-02?

Interpretive response: ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. This effective date is the same for all entities. Entities that have not previously adopted ASU 2016-13 (and other related amendments) will adopt ASU 2022-02 at the same time they adopt that ASU (see section 25.2.20). [326-10-65-5]

Question 25.5.20
Can an entity early adopt ASU 2022-02?

Interpretive response: Yes. Early adoption of ASU 2022-02 is permitted for an entity that has adopted ASU 2016-13 (and other related amendments). Further, an entity may elect to early adopt the ASU 2022-02 amendments related to receivable modifications separately from the amendments related to vintage disclosures. [326-10-65-5(b)]

Question 25.5.30
Can an entity early adopt ASU 2022-02's modified receivables guidance in an interim period other than the first interim period of its fiscal year?

Interpretive response: Yes. However, an entity is required to apply all of the ASU's modified receivables guidance beginning on the first day of its fiscal year, even if it does not early adopt in the year's initial interim period. This includes applying the guidance in its quarterly and year-to-date financial information for the interim period of adoption (and all subsequent periods). That is, the entity must restate its financial information for the interim periods in the fiscal year before adoption. [326-10-65-5(b)]

Example 25.5.10
Early adoption of ASU 2022-02 in an interim period other than the first interim period

Bank is a calendar year-end entity that has adopted ASU 2016-13 (and other related amendments) and elects to early adopt ASU 2022-02 in Q3 2022. Bank applies the ASU's guidance when determining the appropriate accounting and disclosures included in its quarterly and year-to-date financial statements for Q3 2022 (and subsequent periods). This means that Q1 and Q2 2022 results need to be restated to reflect the adoption of the ASU as of January 1, 2022, even though Bank did not early adopt until Q3 2022.

Restating these results includes taking the following steps.

— **Analyzing receivables modified in Q1 and Q2 2022.** Bank determines whether receivable modifications in Q1 and Q2 2022 that were TDRs under Subtopic 310-40 (TDRs by creditors) represent continuations of the existing receivables or new receivables under the ASU (i.e. based on the guidance in Subtopic 310-20). Bank then applies the corresponding recognition and measurement guidance for receivable modifications in its financial information for Q1 and Q2 2022 (and all subsequent periods). In most cases, this will result in a difference because the recognition and measurement guidance for a TDR differs from Subtopic 310-20's guidance for a modified receivable regardless of whether it is a continuation of the existing receivable or a new receivable. For example, the accounting guidance for a receivable modification that was a TDR under Subtopic 310-40 requires expensing costs related to the modification, while Subtopic 310-20 for continuations of existing receivables requires including those costs in the amortized cost basis of the modified receivable.

— **Estimating credit losses for receivables modified in Q1 and Q2 2022.** Bank also estimates expected credit losses as of March 31 and June 30, 2022 – and recognizes credit loss expense – based on the ASU's guidance for receivable modifications in Q1 and Q2 2022 that were TDRs under Subtopic 310-40. For example, if Bank uses a DCF method to estimate expected credit losses after adopting the ASU, it uses an EIR based on the post-modified contractual rate while under legacy US GAAP it used an EIR based on the original contractual rate. Similarly, if Bank uses a method other than a DCF method to estimate expected credit losses after adopting the ASU, it would use that method to estimate expected credit losses as of March 31 and June 30, 2022, as opposed to the DCF method that would have been applied before adoption of the ASU.

— **Electing a transition approach for estimating credit losses:** Bank determines which transition approach to apply to recognize any required changes in the estimated expected credit losses associated with TDRs (see Question 25.5.60).

  – If Bank elects the modified retrospective transition method of adoption, for any change in the estimated expected credit losses that had been recognized for receivables previously modified in a TDR, it recognizes a cumulative-effect adjustment to retained earnings as of January 1, 2022. Further, it calculates credit loss expense for 2022 using the restated allowance for expected credit losses balance as of January 1, 2022.
  – If Bank elects the prospective transition method, it continues to estimate expected credit losses in accordance with Subtopic 326-20's guidance measuring credit losses on TDRs (see section 11.3) for receivables modified in a TDR before adoption until the receivable is subsequently modified or settled. However, for any receivable modified after adoption (January 1, 2022), Bank estimates expected credit losses under the ASU's guidance.

See Questions 20 and 30 of KPMG Hot Topic, FAQs about FASB's ASU on modified receivables, for information about other impacts on accounting and disclosures, as well as on SEC filings, when an entity early adopts the ASU in an interim period other than its first period.

25.5.20 Transition provisions

Question 25.5.40
What are ASU 2022-02's transition provisions?

Interpretive response: The amendments in the ASU are generally applied prospectively after the first day of the fiscal year of adoption. However, a creditor can elect to recognize any required changes in the estimated expected credit losses associated with TDRs on a modified retrospective basis. This election would result in a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. [326-10-65-5(c)]

Question 25.5.50
Will adopting ASU 2022-02 generally result in a smaller or larger allowance for credit lossesis?

Interpretive response: ASU 2022-02 eliminates separate recognition and measurement guidance for TDRs, as well as the related guidance in Subtopic 326-20 for measuring credit losses on TDRs. Eliminating the guidance for measuring credit losses on TDRs will generally result in smaller allowances for credit losses for modifications identified as TDRs before adoption. The following table summarizes the guidance for measuring credit losses on TDRs before and after adoption.

Before adoption of ASU 2022-02	After adoption of ASU 2022-02
Topic 326-20 provides specific guidance on measuring credit losses for TDRs. The effective interest rate (EIR) used when a discounted cash flow (DCF) or reconcilable method is used to measure expected credit losses is based on the original contractual rate; see Question 4.4.30. A DCF (or reconcilable) method is required for measuring expected credit losses for some TDRs – e.g. interest rate concessions or more than insignificant delays in payment (i.e. term extensions or forbearances); see Question 11.3.40.	After adopting the ASU, an entity will no longer be required to use a DCF method for any receivables. If an entity continues to use a DCF method, it will use an EIR based on the post-modified contractual rate. These changes will generally result in smaller allowances for credit losses for modifications that previously would have been accounted for under the TDR guidance.

Question 25.5.60
Upon adopting the ASU, how does an entity estimate expected credit losses for receivables that were modified in a TDR before adoption?

Interpretive response: It depends on whether the entity elects to use a modified retrospective or prospective transition approach. [326-10-65-5(c)]

Transition approach	How expected credit losses are measured
Modified retrospective	The estimated expected credit losses for those receivables are measured based on the ASU's guidance, see Question 25.5.50. Further, the entity recognizes a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption for the difference between that amount and the estimated expected credit losses recorded before adoption for those receivables.
Prospective	The entity continues to estimate expected credit losses in accordance with legacy US GAAP for receivables modified in a TDR until the receivables are subsequently modified or settled, see Question 25.5.50. If a receivable is modified after adopting the ASU, the ASU's prospective transition provision no longer applies. Therefore, the entity estimates expected credit losses under the ASU's guidance and recognizes any resulting change to the allowance for expected credit losses in earnings as credit loss expense in the period of the modification.

25.5.30 Transition disclosures

Question 25.5.70

What disclosures are required before adoption of ASU 2022-02?

Interpretive response: When a new accounting standard has been issued, but has not yet been adopted, an SEC registrant discloses the items in the table below. These disclosures enable financial statement users to not only be aware of the impending change, but also to understand the expected significance of the change. We believe these disclosures are best practice for all entities. [SAB Topic 1M Q2]

Area	Disclosure
Background	Brief description of ASU
Timing	Required adoption date and registrant's expected adoption date (if earlier)
Method of adoption	Allowable methods of adoption and alternative registrant expects to use (if determined)
Effect of the ASU	— Effect that adoption is expected to have on registrant's financial statements, if known or reasonably estimable — If not known or reasonably estimable, further qualitative disclosures
Other consequential effects	Other significant matters registrant believes might result from adoption – e.g. technical violations of debt covenant agreements and planned or intended changes in business practices.

For further information, see section 6.3 of KPMG Handbook, Accounting changes and error corrections.

Question 25.5.80

Upon adopting the ASU, does an entity include the disclosures for accounting changes required by Topic 250?

Interpretive response: Yes. Since ASU 2022-02 does not include transition disclosure requirements, we believe Topic 250's disclosure requirements for changes in accounting principle apply. Those disclosures include: [250-10-50-1]

— the nature of and reason for the change in accounting principle;
— the method of applying the change, including the effect of the change on various financial statement line items; and
— indirect effects of the change in accounting principle, if any.

For further guidance including the required disclosures, see section 3.3.40 of KPMG Handbook, Accounting changes and error corrections.

A. Illustrative example

Detailed contents

Organization of the example

The example demonstrates one way that a hypothetical domestic regional bank, Lending Bank Corporation (the Bank), could apply the guidance for estimating expected credit losses for a pool of financial assets.

It illustrates how to estimate the allowance for credit losses for a pool of auto loans and is organized as follows.

- **Section A1:** Identifying loans having similar risk characteristics for collective assessment, including the requirement to continuously evaluate whether loans in the pool exhibit similar risk characteristics.
- **Section A2:** Developing and selecting a historical loss rate; in this example, the historical loss rate is determined based on exposure at default.
- **Section A3:** Adjusting historical loss information for:
  - asset-specific characteristics; and
  - current conditions, and reasonable and supportable forecasts of future economic conditions.
- **Section A4:** Applying the historical loss rate, as adjusted, to the estimated exposure at default (considering expected prepayments) to estimate expected credit losses.

Subtopic 326-20 does not prescribe the use of a particular methodology for estimating expected credit losses, but rather allows for various approaches to be used. As a result, estimating expected credit losses requires significant judgment at a number of points throughout the estimation process. This flexibility in methodology may lead to diversity in practice and ranges of acceptable estimates of expected credit losses for similar assets.

An entity should use estimation techniques that are practical and relevant in its circumstances and that faithfully estimate collectibility using the principles in Subtopic 326-20.

Observations and references

Explanatory notes are provided for decision points that reflect significant judgments applied in this example. Markers in the example indicate the relevant KPMG observation with commentary. For example, a indicates further discussion in KPMG observation (a).

Our commentary is referenced to:

- the FASB's Accounting Standards Codification® – e.g. 326-20-30-2 is paragraph 30-2 of ASC Subtopic 326-20; and
- other sections of this Handbook.

One possible approach

This example does not represent the only or all possible methods of applying the guidance in Subtopic 326-20. Many different methods and judgments may be appropriate and a more simplified approach for given facts and circumstances also may be appropriate.

We believe practices may develop whereby simplifying assumptions will be used in quantitative models, and then qualitative adjustments will be made to the allowance for credit losses to compensate for the effect of the simplifying assumptions. However, the benefit from simplifying the quantitative model may be offset by the complexity of developing and supporting the amount of the qualitative adjustments.

As with any estimate, each judgment is made in the context of the effect it has on the reasonableness of the overall estimate; not all inputs or assumptions will be significant to the estimate.

Also, this example does not include the disclosures required in the financial statements under US GAAP or SEC reporting requirements.

Further, this example focuses on the estimate of the year-end allowance for credit losses, but assumes that the Bank initially established an allowance for credit losses in intervening quarterly reporting periods.

A1. Identifying pools for collective assessment

A1.10 Overview

The Bank is a domestic regional bank that originates commercial and consumer loans. It identifies as portfolio segments Business Loans and Consumer Loans based on the level at which it develops and documents its systematic methodology for determining its allowance for credit losses. Within the Consumer Loans segment, the Bank has identified auto loans as a class of financing receivable.

For auto loans, management has determined that the primary drivers and/or indicators of credit losses are strength of underwriting standards, delinquency rates, used car prices, and unemployment rates. The Bank originates auto loans with contractual terms of 4, 5 or 6 years directly to borrowers collateralized by both new and used vehicles.

When it originates an auto loan, the Bank assigns an internal credit risk rating that considers factors such as the borrower's consumer credit score (e.g. FICO), the loan's level of collateralization (loan-to-value) and other borrower characteristics (e.g. length of employment history). The initial grade is not subsequently changed.

The Bank aggregates auto loans for purposes of estimating its allowance for credit losses based on its evaluation of those that have similar risk characteristics at origination. The fixed-term auto loans class of financing receivable is disaggregated by:

- internal credit risk rating (Superprime, Prime and Subprime);
- contractual term; and
- quarterly vintage (i.e. quarter of origination).

The Bank uses 'static pool' analysis to assess loan performance, as further explained in section A1.20. In the Bank's experience, loans sharing the above combination of characteristics (internal credit risk rating, contractual term and quarterly vintage) tend to experience similar credit losses. Therefore, loans sharing these characteristics are aggregated for estimating expected credit losses. Additionally, because contractual term and quarterly vintage are characteristics by which pools are formed, all loans in the pool have a similar remaining term to maturity. [a]

As of December 31, 2X10, the Bank identifies the following pools of auto loans that were originated in 2X10 (it has similar pools for prior origination years).

Superprime Loans	Prime Loans	Subprime Loans
Originated in Q1 2X10		
2X10-Q1 Super-Auto 4-yr	2X10-Q1 Prime-Auto 4-yr	2X10-Q1 Sub-Auto 4-yr
2X10-Q1 Super-Auto 5-yr	2X10-Q1 Prime-Auto 5-yr	**2X10-Q1 Sub-Auto 5-yr**
2X10-Q1 Super-Auto 6-yr	2X10-Q1 Prime-Auto 6-yr	2X10-Q1 Sub-Auto 6-yr

Example focuses on this pool

Superprime Loans	Prime Loans	Subprime Loans
Originated in Q2 2X10		
2X10-Q2 Super-Auto 4-yr	2X10-Q2 Prime-Auto 4-yr	2X10-Q2 Sub-Auto 4-yr
2X10-Q2 Super-Auto 5-yr	2X10-Q2 Prime-Auto 5-yr	2X10-Q2 Sub-Auto 5-yr
2X10-Q2 Super-Auto 6-yr	2X10-Q2 Prime-Auto 6-yr	2X10-Q2 Sub-Auto 6-yr
Originated in Q3 2X10		
2X10-Q3 Super-Auto 4-yr	2X10-Q3 Prime-Auto 4-yr	2X10-Q3 Sub-Auto 4-yr
2X10-Q3 Super-Auto 5-yr	2X10-Q3 Prime-Auto 5-yr	2X10-Q3 Sub-Auto 5-yr
2X10-Q3 Super-Auto 6-yr	2X10-Q3 Prime-Auto 6-yr	2X10-Q3 Sub-Auto 6-yr
Originated in Q4 2X10		
2X10-Q4 Super-Auto 4-yr	2X10-Q4 Prime-Auto 4-yr	2X10-Q4 Sub-Auto 4-yr
2X10-Q4 Super-Auto 5-yr	2X10-Q4 Prime-Auto 5-yr	2X10-Q4 Sub-Auto 5-yr
2X10-Q4 Super-Auto 6-yr	2X10-Q4 Prime-Auto 6-yr	2X10-Q4 Sub-Auto 6-yr

The remainder of this example focuses on estimation of the allowance for credit losses as of December 31, 2X10 for the 2X10-Q1 vintage of Subprime-classified auto loans having a 5-year contractual term (2X10-Q1 Sub-Auto 5-yr Loans), which had an original aggregate principal balance of $10 million. This example assumes that the Bank established an allowance for credit losses for this pool in Q1 2X10 and updated that estimate in Q2 and Q3 2X10 using a process similar to the one described in this example.

KPMG observation (a)

Collective assessment for similar risk characteristics

Expected credit losses must be estimated on a collective (pool) basis for financial assets sharing similar risk characteristics. Identifying the risk characteristic (or combination of risk characteristics) that form the basis for establishing a pool requires significant management judgment. [326-20-30-2, 55-5]

Although Subtopic 326-20 does not specifically require an entity to consider credit risk when aggregating financial assets, we would generally expect an entity to factor in some credit related characteristics. The number of pools into which management disaggregates its portfolio reflects the facts and circumstances of the portfolio.

The Bank aggregates pools of loans for collective estimation of expected credit losses based on the following risk characteristics:

- financial asset type (fixed-rate term loans);
- collateral type (automobiles);
- internal credit risk rating (based partly on external credit scores);
- contractual term; and
- vintage (quarterly).

When selecting a time period to include in a vintage, management considers that these loans are relatively short-term, that they are expected to have similar loss patterns and that the maximum difference in remaining term to maturity between individual loans in the pool is three months. Judgment is used in determining the time period to include in a pool when aggregating by vintage. Shorter – or longer – periods (e.g. a vintage may comprise loans originated in a month or in a year) may be appropriate depending on the characteristics of the loans being evaluated including loan term, degree of change in underwriting standards, historic and expected credit loss patterns, availability of historical data, and methodology used to estimate expected credit losses.

Other potential risk characteristics include size, EIR, geographic location, borrower industry, historical or expected credit loss patterns, and reasonable and supportable forecast periods. The Bank considers the identified risk characteristics to be appropriate because, in its experience, these characteristics result in similar credit losses and provide sufficient data points, in combination, to be useful in determining management's best estimate of expected credit losses for the loans in each pool. The Bank also believes that use of more risk characteristics would not significantly affect management's best estimate.

Read more: Section 5.2

A1.20 Static pool analysis [b]

The Bank uses 'static pool' analysis for estimating expected credit losses of its auto loans. For static pool analysis, statistical information about a pool of loans originated during a specified period is tracked over its life (e.g. losses, delinquencies and prepayments). Under this method, the integrity of the pool is maintained over its life (i.e. the same loans are included in the pool over its life).

The Bank determines that a static pool method is appropriate in these circumstances for the following reasons.

— Management considers delinquencies to be the primary indicator of credit performance after origination, and it monitors the level of delinquent loans (i.e. delinquency rates) in the pool. When the delinquency experience in a pool differs from the historical experience used to estimate expected credit losses, management makes adjustments to the loss rates. To make the adjustments, management develops and maintains statistical information about the relationship between credit loss amounts and delinquency levels.

— The other risk characteristics on which the Bank's pools are assembled (i.e. financial asset type, collateral type, contractual term, internal credit risk rating and vintage) do not change over time.

— Management estimates expected credit losses for collateral-dependent loans in the pool based on the guidance in Subtopic 326-20. That guidance requires that an entity estimate expected credit losses based on the fair value of the collateral when it determines that foreclosure (repossession) is probable. Under that guidance, the Bank estimates expected credit losses for loans for which foreclosure is probable as the amount by which the amortized cost exceeds the fair value of the underlying collateral (adjusted for any costs to sell).

KPMG observation (b)

Selecting a specific methodology used in estimating the allowance for credit losses and determining pools for collective assessment

Assumption made

For purposes of this example, it is assumed that a loan is written off at the same time foreclosure becomes probable. [326-20-35-4]

Judgment required

Judgment is necessary in selecting the specific methodology to be used. The Bank selects a static pool loss rate method because it is the method most consistent with its credit risk management practices and most readily accommodates management's process for determining adjustments for current conditions and reasonable and supportable forecasts.

Other methods that may be appropriate include discounted cash flow methods, roll-rate methods, probability of default and loss given default methods or methods that use an aging schedule. Alternative or simplified methods for given facts and circumstances also may be appropriate

As discussed in Question 4.2.10, the FASB permits an entity to estimate expected credit losses using various methods because the credit risks inherent in an entity's financial assets and how the entity manages those risks are unique to the entity. The FASB recognizes that different approaches may lead to diversity in practice and ranges of acceptable estimates of expected credit losses for similar assets. [326-20-30-3]

Read more: Section 4.2

Continuous evaluation

Subtopic 326-20 requires that an entity continuously evaluate whether the financial assets in a given pool continue to exhibit similar risk characteristics. Assets that cease to have similar risk characteristics (e.g. because credit risk for certain loans has changed) should be evaluated differently from other assets in the pool. [360-20-35-2]

In this example, because the Bank monitors delinquency experience and adjusts loss rates for changes in delinquency levels based on historical data, it reasonably expects that the credit loss amount estimated in this manner will be consistent with the amount that would have been estimated if delinquent loans had been placed into a separate pool.

Read more: Section 5.3

A2. Developing and selecting a historical loss rate

A2.10 Overview

As previously discussed, the Bank uses a static pool loss rate method for estimating expected credit losses. Historically, it has tracked monthly cumulative net losses (i.e. losses net of recoveries) on auto loans using a static pool approach by origination quarter based on internal credit risk rating and contractual term at origination.

A2.20 Selecting the historical loss period

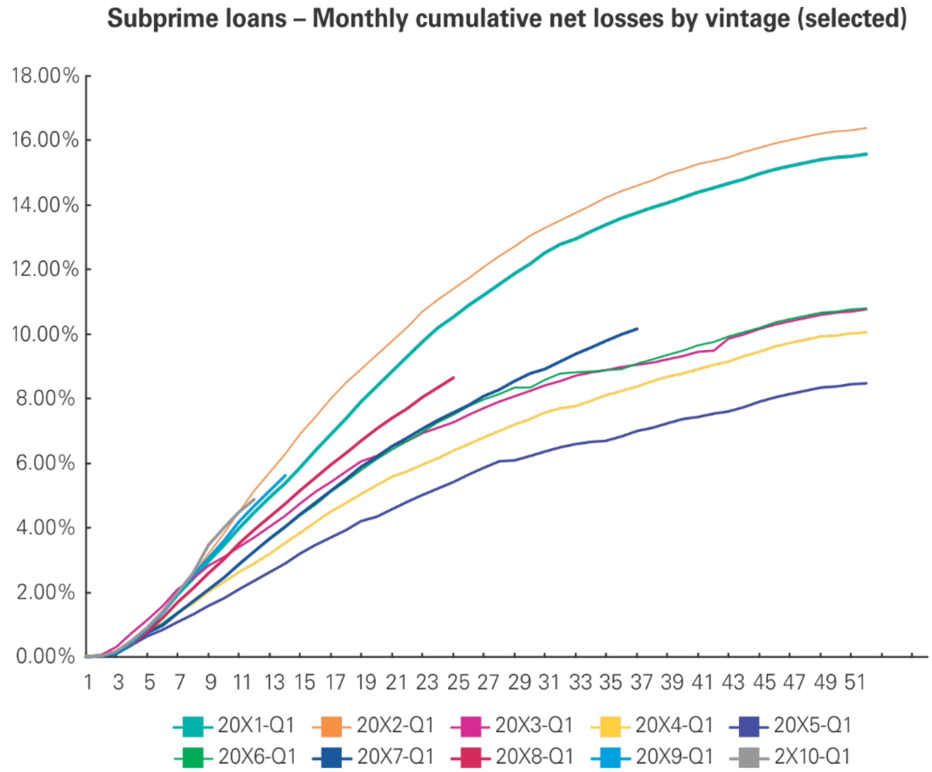
The Bank's approach for selecting the historical loss period is to select the period most consistent with its forward-looking expectations. Management believes this will decrease the number and/or magnitude of adjustments needed when adjusting for changes between the historical and current period, and between the current period and the reasonable and supportable forecast period. In making its selection, management considers the asset-specific risk characteristics and economic conditions that drive losses for its auto loans.

For purposes of selecting the historical period from which to use loss information when estimating the allowance for credit losses, the Bank compares the cumulative net loss (CNL) rate of each historical pool. CNL rates allow management to monitor cumulative losses over a pool's life and compare cumulative loss patterns against other vintages visually through the curve they depict.

The CNL rate comprises the following.

- **Numerator.** Cumulative net losses through the end of each corresponding period (month) in the historical vintage, which reflects the amortized cost basis that was written off, net of subsequent recoveries on those loans.
- **Denominator.** Pool's original unpaid principal balance (UPB).

The following chart summarizes monthly cumulative net losses as a percentage of the pool's original UPB (CNL rate) for subprime loans collateralized by autos for a sample of the quarterly vintages that management reviewed.



In selecting a loss curve to use for estimating expected credit losses of the 2X10-Q1 Sub-Auto 5-yr Loans, the Bank evaluates its historical loss curve information and makes several observations, including the following.

- Cumulative net losses for the quarterly vintages in the 20X1 and 20X2 origination years were significantly greater than those for the other completed years; loans originated in those years had looser underwriting standards and experienced the greatest effect from an economic downturn that occurred during that period. As underwriting standards improved and the economy improved, cumulative net losses decreased in each of the succeeding three years (20X3, 20X4 and 20X5).
- The lowest losses were realized for the quarterly vintages in the 20X5 origination year, with cumulative net losses increasing for each origination year thereafter.
- For incomplete origination years, losses experienced early in these pools were increasing sharply, with the losses in the early months of the 20X9 and 2X10 originations similar to those experienced for the 20X1 and 20X2 originations, respectively.

Management attributes the increasing loss trends observed in the more recent originations to a variety of factors, including increasing competition in the auto lending market, which has led to a loosening of underwriting standards to a degree not previously undertaken by the Bank.

Management also observed that, of the completed origination years analyzed, the earliest months of the 2X10 vintage loss pattern most closely resemble that of the earliest months of the 20X2-Q1 vintage. Management attributes this primarily to the degree that underwriting standards were loosened in both periods. Management observed that 20X2-Q1 experienced the loosest underwriting standards of the historical vintages, and that the underwriting standards in the 2X10 vintage were even looser than in the 20X2-Q1 vintage.

Management believes the 20X2-Q1 vintage is the vintage that is most consistent with its forward-looking expectations. In making this selection, management considered the similarity of the underwriting standards prevailing in 20X2-Q1 compared to early 2X10, as described above. Management also considered whether the effect of differences in expected economic conditions (e.g. used car prices, delinquency rates and/or unemployment rates) as compared to those experienced for the 20X2-Q1 vintage would result in other historical periods being more consistent with their forward-looking expectations. Nevertheless, management evaluated whether adjustments would be necessary for all factors (i.e. underwriting standards, used car prices, delinquency rates and/or unemployment rates). c

After making this consideration, the Bank concluded that the 20X2-Q1 vintage was the period most consistent with its forward-looking expectations and will minimize the number and/or magnitude of adjustments needed when adjusting for changes between the historical and current period, and between the current period and the reasonable and supportable forecast period.

KPMG observation (c)

Selecting the historical loss period(s)

Historical loss experience generally serves as the starting point for estimating expected credit losses. Subtopic 326-20 does not provide prescriptive guidance about what historical period(s) should be used for obtaining historical loss experience – e.g. a full credit cycle, recent experience or a historical period(s) that is representative of expected conditions in the future. We expect that, in many cases, entities may use multiple historical periods to develop the historical loss experience.

When multiple periods are selected, judgment is used in determining how to combine the periods, including whether different weights are given to each period. Once an entity has selected a historical period(s), it considers adjusting the historical loss information for current conditions and reasonable and supportable forecasts – as well as for asset-specific risk characteristics. [326-20-30-8, 55-3, 55-6 – 55-7]

Although the Bank selects the loss curve from the 20X2-Q1 vintage because it believes that loss data is most consistent with its forward-looking expectations, management considers differences in asset-specific risk characteristics and other conditions from the 20X2-Q1 vintage to the 2X10-Q1 Sub-Auto 5-yr Loans (see section A3). Further, each reporting period, management reevaluates its selection of the historical loss curve to use as its starting point for estimating expected credit losses along with adjustments to the historical loss information for current conditions and reasonable and supportable forecasts – as well as for asset-specific risk characteristics.

The Bank is permitted but not required to choose a historical period(s) that represents management's expectation of future credit losses. Additionally, management may incorporate external historical loss information when estimating expected credit losses. Regardless of the rationale used to select the period and information used, the Bank adjusts the historical loss information for current conditions and reasonable and supportable forecasts – as well as for asset-specific risk characteristics.

Read more: Section 7.2

A2.30 Selecting an approach for estimating the impact of accrued interest receivable, premiums and discounts

The Bank writes off accrued interest receivable by reversing interest income. It measures an allowance for credit losses on accrued interest receivable separately from the allowance for credit losses related to the unpaid principal balance and other components of the amortized cost basis. This example focuses on estimating the allowance for credit losses for components other than accrued interest receivable.

The Bank's historical loss information reflects the components of the amortized cost basis that was written off other than accrued interest receivable – i.e. the principal amount together with all premiums and discounts (including net deferred fees and costs, foreign exchange and fair value hedge accounting adjustments) on a combined basis. Differences between the principal balance and the amortized cost basis at the time of writeoff were due solely to net unamortized deferred fees and costs.

The Bank has not significantly changed amounts charged to auto loan borrowers (deferred fees) and has not experienced a significant change in the cost of originating these loans (deferred costs). Additionally, management does not expect a significant change in its prepayment experience nor in the timing or amount of credit losses for the 2X10-Q1 Sub-Auto 5-yr Loans as compared to the 20X2-Q1 vintage. Based on this information, the Bank develops its credit loss estimate using a combined approach. [d]

KPMG observation (d)
Effect of unamortized net deferred fees and costs

Because the Bank is not using a discounted cash flow method for estimating expected credit losses, it may estimate the effect of unamortized premiums and discounts using either: [326-20-30-3, 30-5]

— a combined approach – i.e. the principal amount together with accrued interest receivable, if applicable, and all premiums and discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments; or
— a separate approach.

The Bank develops its historical loss rate information using a combined approach for components of the amortized cost basis other than accrued interest receivable and estimates expected credit losses using that information. Because loans in the 20X2-Q1 vintage were originated with deferred fees or costs having similar magnitude in relation to the principal amount as the 2X10 vintage, and management does not expect significant changes in prepayment levels or in the amount or timing of credit losses, no adjustments are needed to the historical data to reflect changes in the level of unamortized premiums and discounts.

Read more: Section 4.2

A2.40 Calculating the historical loss rate

The Bank's methodology provides for adjustments to historical loss rates based on prepayment assumptions and certain other adjustments that are not the same in each future period (e.g. the adjustment for unemployment, which is discussed in section A3).

The Bank uses the CNL rate to select the historical period for its estimate of expected credit losses. However, for purposes of estimating expected credit losses, the Bank uses a historical net loss rate for each period based on exposure at default (i.e. the unpaid principal balance at the time of default). This periodic rate is calculated using the same numerator as the CNL rate (i.e. the losses that occurred in each period during the life of the 20X2-Q1 vintage), but a different denominator.

Periodic (monthly) historical net loss rates based on exposure at default comprise the following. e

- **Numerator.** Net losses experienced within the corresponding period (month) in the historical vintage, which reflects the amortized cost basis that was written off (excluding accrued interest receivable), net of amounts received as recoveries.
- **Denominator.** Exposure at default, which reflects the pool's UPB at the time of writeoff.

Management believes that using a periodic net loss rate based on exposure at default allows them to most easily incorporate changes in the principal balance's amortization (decline), including changes in expected prepayments.

KPMG observation (e)
Calculating the historical loss rate

Subtopic 326-20 requires the estimation of expected credit losses to be based on expected credit losses of the amortized cost basis, rather than of the principal balance. As described in Example 4.3.10, a historical loss rate may be calculated based on multiple bases – e.g. it may be calculated by dividing total losses by either the principal balance or the amortized cost. To estimate expected losses on the current pool, the calculated historical loss rate is applied to whichever base was used in the calculation of the historical loss rate. [326-20-30-5]

The Bank's historical loss rate is based on historical credit losses (the writeoffs of the amortized cost basis excluding accrued interest receivable) divided by the exposure at default (i.e. unpaid principal balance at the time of writeoff). For that reason, the estimate of the expected credit losses of the amortized cost basis for the 2X10-Q1 Sub-Auto 5-yr Loans is determined by applying the historical loss rate to the Bank's projection of the exposure at default.

Read more: Section 4.2

The following primary factors caused the 20X2-Q1 vintage pool's exposure at default to differ from its original UPB.

— **Contractual principal amortization.** Amortization (payments) of principal based on contractual terms of the auto loans underlying the pool.
— **Missed payments.** Payments not received when contractually due.
— **Prepayments.** Payments received in advance of their contractual due date.
— **Credit losses.** Credit losses experienced.

The following table illustrates the following.

— The missed payment and prepayment rates for the 20X2-Q1 vintage.
— The periodic net loss rate based on the pool's original UPB for the 20X2-Q1 vintage.
— The periodic net loss rate based on exposure at default. The periodic net loss rate based on exposure at default is based on the declining principal balance and, as a result, is higher than that based on the pool's original UPB. The periodic loss rate based on exposure at default is the base assumption used for historical losses in estimating expected credit losses for the 2X10-Q1 Sub-Auto 5-yr Loans.

	Missed payment rate[1]	Prepayment rate[2]	Periodic net loss rate based on pool's original UPB[3]	Periodic net loss rate based on exposure at default[4]
Year 1	19.62%	1.05%	5.16%	5.16%
Year 2	19.23%	1.88%	5.92%	7.39%
Year 3	18.85%	2.78%	3.34%	5.71%
Year 4	18.47%	3.00%	1.71%	4.45%
Year 5	18.10%	3.20%	0.25%	1.32%
Total			**16.38%**	

Notes:
1. The missed payment rate is expressed as a percentage of contractual principal amortization.
2. The prepayment rate is expressed as a percentage of contractual principal amortization.
3. The periodic net loss rate based on the pool's original UPB is calculated as the CNL rate for the current period less the CNL rate for the immediately preceding period. It can also be calculated based on the net losses experienced in the current period as a percentage of the original pool UPB.
4. The periodic net loss rate based on exposure at default is calculated as the net losses experienced in the current period as a percentage of the exposure at default. Exposure at default is the pool's unpaid principal balance at the time of writeoff.

The effect in Years 2 to 5 of the missed payment rate, prepayment rate and periodic net loss rate based on exposure at default on the allowance for credit losses is further demonstrated in section A4.

Estimating exposure at default

The primary factors causing exposure at default to differ from a pool's original UPB are contractual principal amortization, missed payments, prepayments and expected credit losses. This table summarizes management's estimate of these factors for purposes of determining exposure at default for the 2X10-Q1 Sub-Auto 5-yr Loans. f

Factor	Management's estimate
Contractual principal amortization	Based on the contractual terms of the auto loans underlying the pool.
Missed payment rate	Management expects the missed payment rate to be approximately the same as that for the 20X2-Q1 vintage.
Prepayment rate	Management expects the prepayment rate to be approximately the same as that for the 20X2-Q1 vintage.
Expected credit losses	Management's estimate of writeoffs, net of recoveries, (expected credit losses) in each period over the remaining life of the 2X10-Q1 Sub-Auto 5-yr Loans.

See section A4, which includes a roll-forward (by year) of expected exposure at default for the 2X10-Q1 Sub-Auto 5-yr Loans.

KPMG observation (f)
Exposure at default

Subtopic 326-20 requires an entity to consider the effect of prepayments when estimating the allowance for credit losses. Further, for periods beyond the reasonable and supportable forecast period, it requires an entity revert to using historical credit loss information, adjusted for asset-specific risk characteristics, but without adjustments for future economic conditions. To accommodate these and other considerations, the Bank estimates its exposure at default over the duration of 2X10-Q1 Sub-Auto 5-yr Loans, which are prepayable, amortizing loans. [326-20-30-6, 30-8, 30-9, 55-4]

The method used by the Bank adjusts the basis to which loss rates are applied by estimating the unpaid principal balance at the time losses are expected to occur. Other methods, such as those that adjust the loss rate rather than the basis, may also be appropriate for reflecting these considerations, some of which may be simpler. Regardless of the method used, the purpose is to reflect the effect that a different pattern of amortization (i.e. declining principal balance) will have on expected credit losses.

Read more: Section 6.2.40 and Section 7.3

A3. Adjustments to historical loss information

A3.10 Overview

The Bank selects the loss curve for the 20X2-Q1 vintage as its historical loss information because it is most consistent with management's forward-looking expectations, and results in management's best estimate of the allowance for credit losses. Next, management considers whether adjustments to this historical loss information are needed for differences in asset-specific risk characteristics, including when the historical loss information is not reflective of the contractual term of the pool. It also considers whether adjustments are needed to reflect the extent to which it expects current conditions and reasonable and supportable forecast of economic conditions to differ from the conditions that existed during the selected historical period.

A3.20 Asset-specific risk characteristics – differences in underwriting standards

Management considers whether asset-specific risk characteristics are expected to cause expected credit losses for the loan pool to differ in extent and/or to develop in a different pattern as compared to the historical loss period. Unlike adjustments made to reflect differences in economic conditions, adjustments for differences in asset-specific characteristics (e.g. underwriting standards or loan terms) are made for the entire contractual term of the loan (or pool of loans). Management identifies differences in underwriting standards as such a characteristic.

Underwriting standards have loosened since 20X5, which was the origination year with the lowest cumulative net losses. Underwriting standards were most stringent in 20X4–20X5, because they had been significantly strengthened as a result of experiencing a recession. However, as the economy improved, competition for auto loans began increasing due to new lenders entering the market, which led lenders to loosen their lending criteria. Management estimates that the underwriting standards were less stringent (looser) in the 2X10-Q1 Sub-Auto 5-yr Loans as compared to 20X2-Q1 originations.

To determine the extent of the adjustment to historical loss information needed, g management performs a statistical analysis of underwriting characteristics for different vintages, using consumer credit scores as an indicator of the stringency of underwriting standards. In its analysis, management uses all historical vintages and computes the historical correlation of consumer credit scores with losses. Further, management isolates the effect of changes in underwriting standards for those periods. Through this analysis, it determines that there was a strong correlation.[1]

[1] This was performed using Microsoft® Excel.

Management next estimates the extent to which a change in consumer credit scores resulted in a change in losses.[2] In making that estimate, management isolates the effect that changes in underwriting standards had on historical periods. It estimates the effect of the difference between the 2X10-Q1 Sub-Auto 5-yr Loans average consumer credit score and that of the 20X2-Q1 vintage to be a 6% greater loss rate in the 2X10-Q1 Sub Auto 5-year Loans pool. Management's experience is that the underwriting changes have an incremental credit loss effect throughout the pool's life. This means the timing of losses does not change, but rather the overall loss rate is different by a proportionate amount in each period, which shifts the entire loss curve as compared to the historical vintages. As a result, management applies a 6% adjustment to all points in the 20X2-Q1 curve to adjust for differences in underwriting standards.

The following table reflects adjustments to the historical credit loss experience for less stringent (or loosened) underwriting standards.

	Periodic historical loss rate (based on original pool balance)	Adjustment to historical experience for less stringent underwriting standards (rounded)[1]
Increased losses to be recognized over remaining term to maturity:		
Year 2 (2X11)	5.92%	0.36%
Year 3 (2X12)	3.34%	0.20%
Year 4 (2X13)	1.71%	0.10%
Year 5 (2X14)	0.25%	0.02%

Note:

1. Periodic historical loss rate × 0.06.

The effect of the adjustment to historical experience for less stringent underwriting standards on the allowance for credit losses is further demonstrated in section A4.

KPMG observation (g)

Methods for determining the extent of adjustments to historical loss information

Subtopic 326-20 does not provide specific guidance on the methods that must be used to estimate expected credit losses or the extent of any necessary adjustments to historical loss information. Instead, management needs to exercise significant judgment when selecting the methods it uses to determine any adjustments necessary to reflect changes in relevant data. Examples of such changes are changes in unemployment rates, property values, commodity values, delinquency or other factors that are associated with credit losses on the financial asset or in the group of financial assets. [326-20-30-9]

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[2] This was performed using Microsoft® Excel.

We believe there are several methods available for determining the extent of adjustments to historical loss information, including statistical analysis and simplified methods. Further, an entity may use a quantitative model to capture the effects of some of those changes and adjust the output of that model to the extent needed for its allowance for credit losses to reflect its best estimate of expected credit losses. Such an adjustment to an entity's quantitative model is referred to as a 'qualitative adjustment'.

Regardless of the approach(es) used, adjustments to the historical loss information used may be positive or negative.

Read more: Section 7.3.

Statistical analysis

Statistical analysis refers to analyzing and interpreting data to determine patterns, relationships, and trends. One useful tool is correlation analysis, which determines the strength of association between two variables; the stronger the correlation between two variables, the better one variable is as a predictor of the other. A frequently used method of performing statistical analysis is regression analysis, which is a method for estimating the extent to which a change in one variable (referred to as an 'independent' variable, such as the consumer credit score when evaluating the effect of changes in underwriting standards) causes a change in another variable (referred to as the 'dependent' variable, such as credit losses).

While statistical analysis can be performed using specialized software packages or common spreadsheet software, its use can be complex or misunderstood. For example, correlation may not identify a nonlinear relationship between variables. When using statistical analysis, an entity considers its validity before relying on its results. For example, when using regression, it may be useful to consider the coefficient of determination (R-squared), the slope coefficient, and the t- or F-statistic.

Anchoring analysis

Anchoring analysis is an approach that may be used to estimate qualitative adjustments in some circumstances. The principal benefit of anchoring analysis is to identify logical boundaries for the highest and lowest loss estimate that might be reasonable in determining the best estimate of credit losses. This approach requires management to identify (1) reference periods from the entity's loss history and (2) the asset-specific characteristics and economic conditions that drove losses (referred to as 'loss factors') present during those reference periods. The reference periods and loss factors serve as logical boundaries (or 'anchors') for determining the extent of qualitative adjustment(s) needed.

As discussed in Question 7.3.80, when an entity makes a qualitative adjustment, it should be careful to avoid capturing in the qualitative adjustment the effects of:

- factors already contemplated in the quantitative model – i.e. to avoid double counting; and
- factors for which recognizing estimated credit losses is not permitted – e.g. the effects of economic conditions beyond the reasonable and supportable forecast period, other than the effects of reversion.

There are additional considerations for different types of adjustments.

— **Asset-specific risk characteristics.** The adjustment should relate solely to asset-specific risk factors and should not include the effects of differences in economic conditions.

— **Economic conditions.** Adjustments for economic conditions should relate solely to the reasonable and supportable forecast period; see also Questions 7.3.10 and 7.3.16.

An anchoring analysis may not be appropriate in all circumstances. For example, it may not be appropriate in situations where there are no historical periods or vintages with characteristics or conditions similar to the current pools.

A3.30 Current conditions and reasonable and supportable forecasts

In addition to making adjustments to the 20X2-Q1 loss curve for asset-specific characteristics, the Bank considers the need to adjust the historical loss information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts of economic conditions to cause expected credit losses for the loan pool to:

— differ in extent; and/or
— develop in a different pattern as compared to the historical period.

Based on the nature of financial assets in the 2X10-Q1 Sub-Auto 5-yr Loans, management identifies changes in used car prices (collateral value), delinquency rates and unemployment rates as the primary conditions that may cause expected credit losses to differ from those experienced in the historical period.

— **Used car prices (collateral value).** Since auto loans are secured by the underlying vehicles, collateral values affect the severity of losses in the event of default. Management considers the following overall factors that can affect the collateral values.

  – **General economy.** The effect of the general economy on collateral values (and, accordingly, loss severity) is addressed by considering unemployment rates as a separate condition.

  – **Used vehicle market.** The used vehicle market is driven by changes in the supply and demand for used vehicles, which is assessed based on management's industry expertise as well as industry reports on market outlook. Based on management's evaluation, which includes consideration of the Manheim Index (an indicator of pricing trends in the used vehicle market), management concludes that no adjustment is necessary for forecasted changes in the levels of used car prices as compared to the historical period. h

— **Delinquency rates.** Within each internal credit rating (Superprime, Prime and Subprime), management considers the main indicator of credit risk for auto loans to be their delinquency status. For auto loans, delinquency is typically the first indicator of an increase in credit risk, because the Bank does not refresh internal credit ratings subsequent to origination. Although many delinquent loans cure (i.e. return to 'current' status), differences in delinquency rates may signal differences in the timing and/or amount of expected credit losses over the life of the loans in the 2X10-Q1 Sub-Auto vintage.

— Management compares delinquency rates for the 2X10-Q1 Sub-Auto vintage with those in the selected historical vintage (20X2-Q1 Sub-Auto) and observes that they are substantially consistent. Further, management expects the delinquency trends (including the timing of delinquencies) of the 2X10-Q1 Sub-Auto vintage to continue to be consistent with those experienced during the 20X2-Q1 Sub-Auto vintage. As a result, management concludes that no adjustment is necessary for expected differences and/or expected changes in delinquency rates. h

— **Unemployment rates.** Unlike used vehicle prices, management believes that changes in unemployment over the pool life will differ from the historical period and therefore adjustment is needed for this economic condition. The remaining discussion in this section focuses on the effect of forecasted changes in unemployment rates on expected credit losses.

KPMG observation (h)

Methods for determining the extent of adjustments to historical loss information

The Bank concludes that no adjustment is necessary for used car prices (collateral value) or delinquency rates because these conditions for the 2X10-Q1 Sub-Auto vintage have been substantially consistent – and management expects them to continue to be substantially consistent – with those in the 20X2-Q1 vintage. In future periods, if management concludes that an adjustment *is* necessary, it will need to determine the extent of that adjustment.

As discussed in KPMG observation (g), Subtopic 326-20 does not provide specific guidance for determining the extent of adjustments to make to historical loss information. Selecting the appropriate method for estimating the extent to which historical loss experience should be adjusted requires management to exercise significant judgment. We believe there are several methods available for estimating the extent of adjustment(s) to be made, some of which may be simpler for given facts and circumstances.

For example, with regard to delinquency rates, the anchoring approach may include consideration of how losses historically developed as loans migrated through aging categories with appropriate adjustment over the remaining term to maturity for that migration.

Also, as discussed in KPMG observation (g), an entity making a qualitative adjustment should take care to avoid double counting. For example, an entity making a qualitative adjustment to reflect changes in used car prices (collateral value) should be careful to avoid including in that adjustment the effect of unemployment on credit losses.

Reasonable and supportable forecast period

As noted above, management has identified changes in used car prices (collateral value), delinquency rates and unemployment rates as the primary conditions that may cause expected credit losses to differ from those experienced in the historical period. Management concluded that no adjustment is necessary for changes in used car prices (collateral value) and delinquency rates; the remaining discussion in this section pertains solely to changes in unemployment rates.

Now that management has identified the conditions for which adjustments to the historical period are needed, it next determines the extent of the adjustment needed and the length of the period for which it can make a reasonable and supportable forecast of the unemployment rate.

To determine the period over which it can make a reasonable and supportable forecast of the unemployment rate, management has made the following observations.

— The Bank does not employ an economist or quantitative statisticians. Rather, management relies primarily on available external information and projections to identify its reasonable and supportable forecast period.

— The Bank does not project unemployment rates other than for its estimate of expected credit losses.

— The 2X10-Q1 Sub-Auto 5-yr Loans are not concentrated in any particular geography nor to borrowers employed in any particular industry. Rather, they are fairly well-diversified in terms of sources of underlying borrower income (i.e. repayment source) and are spread across the region in which the Bank operates. Management determines that the unemployment rate in the region in which it operates has historically been consistent with the national unemployment rate and expects that to continue. Therefore, management concludes that it would be appropriate to consider a national economic forecast when determining the appropriate adjustment (if any) to be made to historical loss information.

External economists forecast unemployment data for extended periods (e.g. 10 years), but acknowledge that their forecasts are increasingly less reliable with successive future periods. The FRB provides quarterly projections of various market information (including projections of unemployment) that are made by FRB Board members and FRB Bank Presidents. It includes projections through the current year and each of the two subsequent years, as well as a nonspecific 'longer term' projection. This information is expected to be consistently developed and published.

Management believes that three years is the reasonable and supportable period for forecasting unemployment, which is the period for which projections are published by the FRB. Management uses as its forecasted unemployment rate the midpoint of the FRB's projected range, because it does not believe any point within the range better reflects its expectations about future unemployment rates.

The following table reflects actual unemployment rates during the 20X2-Q1 vintage and management's forecasted unemployment rates during the reasonable and supportable forecast period.

	Actual unemployment rate during corresponding year in 20X2-Q1 vintage	Forecasted unemployment rate during reasonable and supportable forecast period[1]
Year 1 (actual)	5.10%	4.95%
Year 2	**5.50%**	**4.80%**
Year 3	**5.10%**	**4.75%**
Year 4	**5.10%**	**4.75%**
Year 5	**5.25%**	**N/A**

Note:

1. Represents the midpoint of the range of unemployment projections made by FRB Board members and FRB Bank Presidents.

KPMG observation (i)

Determining the reasonable and supportable forecast period

When adjusting historical loss information for current conditions and reasonable and supportable forecasts, management considers its ability to forecast external economic conditions. In assessing its forecasting ability, management considers the availability of relevant and reliable external information that can be obtained without undue cost and effort.

Subtopic 326-20 does not provide guidance on determining whether a forecast is reasonable and supportable. We believe there are no bright lines in making this determination and significant judgment may be required.

Read more: Section 7.3.20

Extent of adjustment needed j

To estimate the extent of the adjustment needed for the forecasted unemployment rates for the 2X10-Q1 Sub-Auto 5-yr Loans, management considers the effect of changes in unemployment during the years reflected in the 20X2-Q1 vintage's loss experience.

Management performs a statistical analysis of the correlation between changes in unemployment rates and changes in loss rates.[3] In its analysis, management uses all historical vintages and computes the historical correlation of month-over-month changes in loss rates to unemployment rates using different lags (3, 6, 9 and 12 months). Further, management isolates the effect of changes in underwriting standards for those periods. Management finds that the unemployment rate lagged 6 months shows the highest (strongest) positive correlation with loss rates. The results of the analysis also show that every 10 basis

3 This was performed using Microsoft® Excel.

point increase in unemployment rate resulted in a 2 basis point increase to the loss rates with a 6 month lag.

Based on the results of this analysis, management calculates the effect on expected credit losses over the next three years by comparing (1) changes in the unemployment rates experienced during the 20X2 Q1 vintage; and (2) the forecasted changes in the unemployment rate Years 2, 3 and 4 for the 2X10-Q1 Sub-Auto 5-yr Loans using the FRB projections. In making that estimate, management isolates the effect of changes in underwriting standards for those historical periods. The results of this equation are used to adjust the 20X2 Q1 vintage historical loss rates for the expected changes in unemployment over the reasonable and supportable forecast period of the 2X10-Q1 Sub-Auto 5-yr Loans.

As a result of this analysis, the adjustments to the historical credit loss experience for the effects of unemployment during the reasonable and supportable period are estimated as follows.

Adjustments to historical experience for forecasted unemployment	
Decreased losses to be recognized over remaining term to maturity:	
Year 2 (2X11)	-0.10%
Year 3 (2X12)	-0.07%
Year 4 (2X13)	-0.07%

The effect of the adjustment to historical experience for forecasted unemployment on the allowance for credit losses is further demonstrated in section A4.

KPMG observation (j)
Extent of adjustment needed

As discussed in KPMG observation (g), Subtopic 326-20 does not provide specific guidance for determining the extent of adjustments to make to historical loss information. Estimating the appropriate method for reflecting the extent to which historical loss experience should be adjusted requires management to exercise significant judgment. We believe there are several methods available for estimating the extent of adjustment(s) to be made.

Reversion method[k]

Management determines that the straight-line reversion approach is appropriate for reverting to historical loss information, which it applies by amortizing the adjustment that was made to the historical loss rates for differences in economic conditions (unemployment) from the end of the reasonable and supportable forecast period to the end of the contractual term of the pool. That is, management will reflect adjustments for differences in unemployment for three years (2X11, 2X12, 2X13) and will amortize the adjustment for 2X13 (-0.07%) for the last year in the remaining term to maturity (2X14).

Management selects this reversion method because, while it cannot obtain a reasonable and supportable forecast beyond 2X13, it expects the economy to continue to move steadily toward longer-term historical average economic conditions. Additionally, management does not believe that there are any scenarios that reflect a more likely outcome than the conditions estimated using straight-line reversion through the contractual maturity of the pool.

Reversion of adjustments to historical experience for forecasted unemployment	
Year 5 (2X14)	-0.035%[1]

Note:

1. The adjustment for 2X13 (-0.07) divided by 2. This reduces the full adjustment of -0.07% evenly over the final year (i.e. -0.07% at the beginning of the year to 0.00% at the end of the year) resulting in an average adjustment in 2X14 of -0.035).

The effect of the reversion adjustment to historical experience for forecasted unemployment on the allowance for credit losses is further demonstrated in section A4.

KPMG observation (k)
Reversion method

The reversion method selected by an entity is an assumption in its overall estimate of expected credit losses and should – in combination with other assumptions and adjustments – result in an allowance that represents management's best estimate of expected credit losses.

Read more: Section 7.3.30

A4. Estimate of expected credit losses

The Bank established an allowance for credit losses in Q1 2X10 and updated that estimate in Q2 and Q3 2X10. The following table summarizes management's update to the estimate of expected credit losses for the 2X10-Q1 Sub-Auto 5-yr Loans as of December 31, 2X10.

	Remaining term to maturity			
	Year 2	**Year 3**	**Year 4**	**Year 5**
Periodic net loss rate based on exposure at default (section A2.20)	7.39%	5.71%	4.45%	1.32%
Adjustments for asset-specific characteristics (section A3.20):				
Less stringent underwriting (rounded)	0.36%	0.20%	0.10%	0.02%
Adjustments for other conditions (section A3.30):				
Lower unemployment	-0.10%	-0.07%	-0.07%	
Straight-line reversion for unemployment				-0.035%
Used car prices	0.00%	0.00%	0.00%	0.00%
Delinquencies	0.00%	0.00%	0.00%	0.00%
Expected credit loss rate (rounded)	**7.64%**	**5.84%**	**4.48%**	**1.30%**
Expected exposure at default – section A2.40 **Beginning principal balance**	**8,045,755**	**5,862,232**	**3,845,557**	**1,900,562**
Contractual principal amortization	1,897,928	1,995,030	2,097,099	2,204,391
Expected missed payment rate[1]	19.23%	18.85%	18.47%	18.10%
Expected effect of missed payments[2]	364,980	375,979	387,311	398,985
Expected prepayment rate[3]	1.88%	2.78%	3.00%	3.20%
Expected prepayments[4]	35,681	55,462	62,913	70,541
Expected credit losses[5]	614,894	342,162	172,294	24,615
Ending balance[6]	5,862,232	3,845, 557	1,900,562	0
Expected credit losses[5]	**614,894**	**342,162**	**172,294**	**24,615**
Total expected credit losses – Allowance for credit losses				**1,153,965**

Notes:

1. Expected missed payment rate is expressed as a percentage of contractual principal amortization. Management observes that the delinquency (missed payment) rates in the 2X10-Q1 vintage were substantially the same as during the 20X2-Q1 vintage selected. Management expects those rates to be consistent in the future.
2. Expected effect of missed payments rate is calculated as contractual principal amortization × expected missed payment rate.
3. Expected prepayment rate is expressed as a percentage of contractual principal amortization. Management observes that the prepayment rates in the 2X10-Q1 vintage

were substantially the same as during the 20X2-Q1 vintage selected. Management expects those rates to be consistent in the future.

4. Expected prepayments is calculated as contractual principal amortization × expected prepayment rate.
5. Expected credit losses is calculated as expected credit loss rate (rounded) × exposure at default. For simplicity of this example, it is based on the annual beginning balance of the exposure at default. In practice, an entity would consider whether other methods more precisely estimate the exposure at default to which the expected credit loss rate should be applied. For example, an entity might consider calculations that project exposure at default for shorter periods (e.g. monthly or quarterly), average balances within a period, and/or based on estimates of when defaults and prepayments will occur within a period.
6. Ending balance is calculated as beginning balance (exposure at default) – contractual principal amortization + expected effect of missed payments – expected prepayments – expected credit losses.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New sections, Questions and Examples added in this edition are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #. In addition, Questions and Examples that have been moved in this edition without being significantly updated are marked with ●.

24. **Disclosures**

24.3 **Financial instruments measured at amortized cost (Subtopic 326-20)**

24.3.20 **Credit quality information #**

Questions

24.3.20 Must a PBE disclose gross writeoffs and recoveries by vintage year before adoptiong ASU 2022-02? #

25. **Effective dates and transition**

25.1 **How the standard works #**

25.5 **Effective dates and transition for ASU 2022-02 ****

Entire section is new in this edition.

Moved guidance

Question / Example	Old location	New location●
Evaluating whether the debtor is experiencing financial difficulties	Example 11.2.10	Example 10.2.05
Must an entity evaluate whether financial asset modifications made to PCD assets are TDRs?	Question 11.3.50	Question 11.2.05

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- Debt and equity financing
- Derivatives and hedging
- Discontinued operations and held-for-sale disposal groups
- Earnings per share
- Employee benefits
- Equity method of accounting
- Fair value measurement
- Financial statement presentation
- Foreign currency
- Going concern
- IFRS compared to US GAAP
- Impairment of nonfinancial assets
- Income taxes
- Leases
- Leases: Real estate lessors
- Long-duration contracts
- Reference rate reform
- Research and development
- Revenue recognition
- Revenue: Real estate
- Revenue: Software and SaaS
- Segment reporting
- Service concession arrangements
- Share-based payment
- Statement of cash flows
- Transfers and servicing of financial assets

Acknowledgments

This Handbook has been produced by the Department of Professional Practice of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this publication:

Lisa Blackburn

Danielle Imperiale

Mahesh Narayanasami

Mark Northan

Jennifer Stemple

We would also like to acknowledge the significant contributions to this edition of the following: Jennifer Austin, Kimber Bascom, Joon Byun, Darcie Garza, Alan Goad, Michael Hall, Kayreen Handley, Erik Hiller, Daniel Jones, Jafet Malave, Matthew Mosby, Jennifer Murphy, Scott Muir, Jack Pohlman, Joan Rood, Julie Santoro, Angie Storm, Ryan Swedalla and Todd Voss.

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