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## Subtopic 326-30

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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 marks a significant change – requiring the immediate recognition of estimated credit losses expected to occur over the remaining life of many financial assets.

The significance of the accounting change cannot be overstated, particularly for 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.

In developing your approach, there is a path to follow … It starts with understanding the standard, and continues with evaluating which alternatives for applying the guidance are the best fit for your company. This includes considering the practicality of each alternative, because there will be differing impacts to systems, processes and internal controls.

Some are just beginning implementation, others are further along. Our purpose with this book is to help you gain a thorough understanding of the new standard – information that is useful no matter where you are on the path.

We intend to continue the dialogue – updating our guidance as discussions continue, and sorting through the practical alternatives. We understand that there is no one-size-fits-all solution, and we want to help you discover yours.

Kimber Bascom and Mark Northan
*Department of Professional Practice, KPMG LLP*
About this publication

The purpose of this Handbook is to assist you in understanding the new 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

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.
— 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.
Future developments

In November 2018, the FASB issued a proposed ASU, Codification Improvements—Financial Instruments. The proposed amendments are incorporated into this edition of our Handbook as follows.

— In some cases, aspects of the proposals correspond directly to a Question that was already included in this Handbook. In that case, our interpretive response has been updated to incorporate the proposals.
— In other cases, the proposals are included as ‘Future developments’ in the relevant sections.

In February 2019, the FASB issued a proposed ASU, Targeted Transition Relief for Topic 326, Financial Instruments—Credit Losses. The proposed amendments are included as ‘Future developments’ in chapter 25 (effective dates and transition).

In addition, 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.

March 2019 edition

This version of our Handbook includes new and updated interpretations based on our experience with companies implementing Topic 326, as well as discussions with the FASB and the SEC staff. It also includes significant updates and new material addressing the amendments to Topic 326 in ASU 2018-19, 2018-10 and the proposed ASUs.

New Questions and Examples are identified with ** and items that have been significantly updated or revised are identified with #.

Abbreviations

We use the following abbreviations in this Handbook.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS</td>
<td>Available-for-sale</td>
</tr>
<tr>
<td>EIR</td>
<td>Effective interest rate</td>
</tr>
<tr>
<td>DIEP</td>
<td>AICPA’s Depository Institutions Expert Panel</td>
</tr>
<tr>
<td>HTM</td>
<td>Held-to-maturity</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>OTTI</td>
<td>Other-than-temporary impairment</td>
</tr>
<tr>
<td>PBE</td>
<td>Public business entity</td>
</tr>
<tr>
<td>PCD</td>
<td>Purchased financial assets with credit deterioration</td>
</tr>
<tr>
<td>PCI</td>
<td>Purchased credit impaired loans accounted for under ASC 310-30</td>
</tr>
<tr>
<td>TDR</td>
<td>Troubled debt restructuring</td>
</tr>
<tr>
<td>TRG</td>
<td>FASB’s Transition Resource Group for Credit Losses</td>
</tr>
</tbody>
</table>
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

Public business entities (PBEs) that are SEC filers apply Topic 326 for interim and annual periods in fiscal years beginning after December 15, 2019.

PBEs that are not SEC filers apply Topic 326 for interim and annual periods in fiscal years beginning after December 15, 2020.

All other entities apply Topic 326 for interim and annual periods in fiscal years beginning after December 15, 2021.

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:
- Financial assets measured at amortized cost
- Net investments in leases
- Off-balance sheet credit exposures not accounted for as insurance

Subtopic 326-30 applies to:
- AFS debt securities

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.

<table>
<thead>
<tr>
<th>Method</th>
<th>Allowance calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discounted cash flow method</td>
<td>The allowance for credit losses reflects the difference between:</td>
</tr>
<tr>
<td></td>
<td>— the amortized cost basis; and</td>
</tr>
<tr>
<td></td>
<td>— the present value of the principal and interest cash flows expected to be collected.</td>
</tr>
<tr>
<td>Other methods</td>
<td>The allowance for credit losses reflects the entity’s expected credit losses of the amortized cost basis.</td>
</tr>
</tbody>
</table>
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).

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
— differences in 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.

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.

<table>
<thead>
<tr>
<th>Collateral-dependent financial asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreclosure probable</td>
</tr>
<tr>
<td>Expected credit loss required to be based on collateral’s fair value.</td>
</tr>
<tr>
<td>Foreclosure not probable</td>
</tr>
<tr>
<td>Practical expedient allows expected credit loss based on collateral’s fair value.</td>
</tr>
</tbody>
</table>

**Troubled debt restructurings**

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 method is required when it is the only method that can capture the effects of the TDR.

**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.

<table>
<thead>
<tr>
<th>Portion</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funded portion</td>
<td>— 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.</td>
</tr>
<tr>
<td></td>
<td>— The expected credit losses for funded portions are reported in an allowance for credit losses.</td>
</tr>
</tbody>
</table>
### Credit impairment

#### 1. Executive summary

<table>
<thead>
<tr>
<th>Portion</th>
<th>Accounting</th>
</tr>
</thead>
</table>
| **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. |

### Financial guarantees can have expected credit losses

Financial 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 financial guarantee liability (non-contingent aspect) accounted for under Topic 460. Subtopic 326-20’s expected credit loss model is applied to the contingent aspect.

- **Guarantor initially separately recognizes both:**  
  - guarantee liability at fair value for non-contingent aspect  
  - expected credit loss liability for the contingent aspect

- **Guarantor initially recognizes the greater of:**  
  - guarantee liability at fair value for non-contingent aspect  
  - contingent liability if probable and reasonably estimable

#### Note:

1. Financial 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.

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

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.

<table>
<thead>
<tr>
<th>Beneficial interests classification</th>
<th>Accounting for PCD assets is applied</th>
<th>Accounting for PCD assets is not applied</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Held-to-maturity</strong></td>
<td>Initial estimate of expected</td>
<td>No allowance is recognized at initial</td>
</tr>
<tr>
<td></td>
<td>credit losses is recognized as</td>
<td>recognition.</td>
</tr>
<tr>
<td></td>
<td>an allowance through a gross-up</td>
<td>Subsequent favorable or adverse changes</td>
</tr>
<tr>
<td></td>
<td>that increases the amortized</td>
<td>in expected cash flows first decrease or</td>
</tr>
<tr>
<td></td>
<td>cost basis of the asset with no</td>
<td>increase the allowance for credit losses.</td>
</tr>
<tr>
<td></td>
<td>effect on net income at initial</td>
<td>If the change in expected cash flows has</td>
</tr>
<tr>
<td></td>
<td>recognition.</td>
<td>reduced the allowance to zero,</td>
</tr>
<tr>
<td></td>
<td>Subsequent favorable or adverse</td>
<td>the acrétable yield is adjusted on a</td>
</tr>
<tr>
<td></td>
<td>changes in expected cash flows</td>
<td>prospective basis.</td>
</tr>
<tr>
<td></td>
<td>first decrease or increase the</td>
<td></td>
</tr>
<tr>
<td></td>
<td>allowance for credit losses.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the change in expected cash flows</td>
<td></td>
</tr>
<tr>
<td></td>
<td>has reduced the allowance to zero,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>the acrétable yield is adjusted on</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a prospective basis.</td>
<td></td>
</tr>
</tbody>
</table>

| **Available-for-sale**            | Initial estimate of expected       | No allowance is recognized at initial    |
|                                   | credit losses is recognized as      | recognition.                             |
|                                   | an allowance through a gross-up     | Subsequent favorable or adverse changes  |
|                                   | that increases the amortized        | in expected cash flows first decrease or  |
|                                   | cost basis of the asset with no    | increase the allowance for credit losses.|
|                                   | effect on net income at initial     | If the allowance has been reduced to zero|
|                                   | recognition.                        | (due to favorable changes) or has met    |
|                                   | Subsequent favorable or adverse     | the fair value floor (due to adverse     |
|                                   | changes in expected cash flows      | changes), the acrétable yield is adjusted|
|                                   | first decrease or increase the      | on a prospective basis.                  |
|                                   | 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 |                                          |
|                                   | acrétable 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, similar to legacy US GAAP, there will be no net book-tax basis difference on the acquisition date. However, 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.

- Financial assets measured at amortized cost: Allowance for credit losses separately presented as a reduction to amortized cost basis.
- AFS debt securities: Amortized cost basis and allowance for credit losses presented parenthetically.

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.

A modified retrospective transition approach

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.
2. Scope of Subtopic 326-20

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

2.1 How the standard works

2.2 Instruments in scope

2.2.10 Overview

Questions

2.2.10 Are cash equivalents in the scope of Subtopic 326-20?
2.2.20 Is preferred stock in the scope of Topic 326?
2.2.30 Are perpetual preferred securities in the scope of Subtopic 326-20?
2.2.40 Are held-for-sale loans in the scope of Subtopic 326-20? #
2.2.50 Are investments in bank-owned or corporate-owned life insurance policies in the scope of Subtopic 326-20? **

2.3 Explicit scope exclusions

2.3.10 Overview #

Questions

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?
2.3.20 When does the scope exclusion for loans and receivables between entities under common control apply?
2.3.30 Are assets that arise from recognizing lease income on a straight-line basis in the scope of Subtopic 326-20? **

2.4 Interaction with other recently issued standards

2.4.10 Overview #
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.

| 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 applies¹ |
| 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. Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance
   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

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:
2. Scope of Subtopic 326-20

- Loans
- Trade accounts receivable
- Notes receivable
- Credit cards
- 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)...
- **Lease receivables** arising from **sales-type leases** or **direct financing leases**.

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

- **Debt securities** within the scope of Topic 320 (see the guidance beginning in paragraph 320-10-15-5)
- 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
- 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, deposits with other financial institutions, balances with the Federal Reserve Banks and the Federal Home Loan Banks, federal funds sold and cash and cash equivalents on hand.

Cash equivalents that are financial assets measured at amortized cost (such as financing receivables) are in the scope of Subtopic 326-20. Nevertheless, if certain conditions are met, an entity may not be required to estimate expected credit losses for these instruments. For a discussion of these conditions, see chapter 8.
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 are 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:

— 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.

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.

<table>
<thead>
<tr>
<th>Preferred share redemption option</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption option is currently exercisable by the investor</td>
<td>Debt security (in scope of Topic 326)</td>
</tr>
<tr>
<td>Redemption option is time-based – i.e. it will become exercisable by the investor following the passage of time</td>
<td>Debt security (in scope of Topic 326)</td>
</tr>
<tr>
<td>Redemption option will become exercisable by the investor on the occurrence of a contingent event outside the investor’s control</td>
<td>Equity security (outside scope of Topic 326)</td>
</tr>
</tbody>
</table>
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’s Q&A, Financial Instruments: Recognition and measurement of financial assets and financial liabilities, [321-10-35-1 – 35-4].

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. 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]

When a loan is transferred from held-for-sale to held-for-investment, it is recorded at the lower of amortized cost or fair value on the transfer date, which establishes a new cost basis for the loan. The transferred loan then becomes subject to Subtopic 326-20. [948-310-30-4]

See also the following future developments.

— Initial recognition of transfers from loans held-for-sale to held-for-investment, or debt securities from AFS to HTM, in section 3.2.10.
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.

Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2021 | Transition Guidance: 326-10-65-1

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]

<table>
<thead>
<tr>
<th>Scope exclusions</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets measured at fair value through net income</td>
<td>The exclusion of financial assets measured at fair value through net income is consistent with legacy US GAAP.</td>
</tr>
<tr>
<td>AFS debt securities</td>
<td>AFS debt securities are accounted for under Subtopic 326-30 rather than Subtopic 326-20. Subtopic 326-30 contains targeted changes to the legacy impairment guidance for AFS debt securities (see chapter 19).</td>
</tr>
<tr>
<td>Loans made to participants by defined contribution employee benefit plans</td>
<td>Subtopic 962-310 provides industry-specific guidance for these loans.</td>
</tr>
<tr>
<td>Policy loan receivables of an insurance entity</td>
<td>Topic 944 provides industry-specific guidance for insurance entities.</td>
</tr>
<tr>
<td>Pledge receivables of a not-for-profit entity</td>
<td>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.</td>
</tr>
<tr>
<td>Loans and receivables between entities under common control</td>
<td>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.</td>
</tr>
<tr>
<td>Receivables arising from operating leases</td>
<td>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]</td>
</tr>
</tbody>
</table>

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.
2.4 Interaction with other recently issued standards

2.4.10 Overview #

<table>
<thead>
<tr>
<th>Topic</th>
<th>Interaction with credit loss standard (ASU 2016-13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from contracts with customers (Topic 606)</td>
<td>The scope of Subtopic 326-20 specifically includes receivables that result from revenue transactions in the scope of Topic 606.</td>
</tr>
<tr>
<td></td>
<td>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]</td>
</tr>
<tr>
<td></td>
<td>— Receivables are unconditional rights to consideration. A right is unconditional if only the passage of time is required before payment becomes due.</td>
</tr>
<tr>
<td></td>
<td>— 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.</td>
</tr>
<tr>
<td></td>
<td>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]</td>
</tr>
<tr>
<td></td>
<td>For further discussion of the impairment of trade receivables, see chapter 18.</td>
</tr>
<tr>
<td></td>
<td>For further discussion of the new revenue standard, see KPMG’s Handbook, Revenue recognition.</td>
</tr>
</tbody>
</table>

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.
<table>
<thead>
<tr>
<th>Topic</th>
<th>Interaction with credit loss standard (ASU 2016-13)</th>
</tr>
</thead>
</table>
| **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’s Handbook, *Leases*. |
| **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’s Q&A, *Financial Instruments: Recognition and measurement of financial assets and financial liabilities*. |
3. Recognition of expected credit losses

Detailed contents

New item added to this chapter: **

3.1 How the standard works

3.2 Recognition

3.2.10 Overview

Future developments

Initial recognition of transfers from loans held-for-sale to held-for-investment or debt securities from AFS to HTM **

Questions

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

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

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

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. 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.

Nevertheless, the allowance for credit losses is generally expected to increase on adoption of Subtopic 326-20. The amount of the increase 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. We expect the amount of expected credit losses immediately recognized through net income may be significantly greater for longer duration loan portfolios. In addition, the immediate recognition of expected credit losses for HTM debt securities will be a change for all entities.

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. 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]

The Basel Committee on Banking Supervision published a paper on interim regulatory treatment of accounting provisions and standards for transitional arrangements under the Basel III capital framework. [Basel paper, 03/2017]

The Basel Committee indicated its support for using an expected loss approach and acknowledged that the accounting changes will affect bank regulatory capital. The Basel paper acknowledges that some jurisdictions will choose to adopt transitional arrangements to smooth any potential significant negative effect on regulatory capital arising from the new credit loss guidance over a number of periods. The paper provides a number of high-level requirements for those transitional arrangements.

The Agencies will monitor changes in entities’ regulatory capital due to the adoption of Subtopic 326-20. However, it remains to be seen what actions, if any, banking and insurance regulators will take with respect to regulatory capital rules in the United States.

**Future developments**

**Initial recognition of transfers from loans held-for-sale to held-for-investment or debt securities from AFS to HTM**

Stakeholders raised concerns about an entity double counting credit losses if it transfers a loan from held-for-sale to held-for-investment or a debt security from AFS to HTM. The following table summarizes the reasons for these concerns.

| Loans transferred from held-for-sale to held-for-investment | US GAAP requires a loan to be recorded at the lower of amortized cost or fair value on the transfer date when it is transferred from held-for-sale to held-for-investment (see Question 2.2.40).
However, subsequent to the transfer, the transferred loan is subject to Subtopic 326-20 and the entity is required to record an allowance for credit losses based on expected credit losses of the amortized cost basis; this is notwithstanding that credit deterioration may have already been recognized in earnings. |
| Debt security transferred from AFS to HTM | Subtopic 326-30 requires an entity to record an allowance for credit losses if the debt security is impaired (i.e. the security’s fair value is less than amortized cost) and a credit loss exists. The allowance is limited to the difference between amortized cost and fair value. When a security is transferred from AFS to HTM, it is recorded in HTM at fair value on the transfer date, which establishes a new cost basis. Subsequent to transfer, the HTM debt security is subject to Subtopic 326-20 and the entity is required to record an allowance for lifetime expected credit losses of the amortized cost basis; this is notwithstanding that credit losses may have already been recognized in earnings. |
The FASB’s recently proposed amendments to the above guidance would require an entity to: 

- reverse in earnings the existing valuation allowance related to a loan transferred from held-for-sale (to held-for-investment), or the allowance for credit losses related to a debt security transferred from AFS (to HTM);
- record the transferred loan at its amortized cost basis. For a transfer of a debt security from AFS to HTM, the amount of any remaining unrealized holding gain or loss reported in AOCI would also be included in the amount recorded;
- recognize a new allowance for credit losses based on the guidance in Subtopic 326-20; and
- present the effects of the transfer on a gross basis in the income statement or in the notes to the financial statements.
4. Methods to estimate expected credit losses

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

4.1 How the standard works

4.2 Estimating expected credit losses

4.2.10 Overview

Future developments

Consideration of expected recoveries **
Accrued interest receivable **

Questions

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

4.2.20 Can an entity leverage its existing allowance method to meet the requirements of Subtopic 326-20?

4.2.30 Can 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?

4.2.35 Is an entity permitted to discount some, but not all, cash flows when applying a method other than a discounted cash flow method? **

4.2.36 Is an entity permitted to discount cash flows or inputs to a date other than the reporting date? **

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

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

4.2.60 Does an entity have to accumulate new data if it measures the components of the amortized cost separately?

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

4.2.80 Should anticipated expenses and losses on foreclosed assets (other than costs to sell) be included in the estimate of expected credit losses? **
4.2.90 When a discounted cash flow method is used, at what date are amounts from expected foreclosed assets included? **

**Examples**

4.2.10 Applying the combined approach
4.2.20 Applying the separate approach

### 4.3 Discounted cash flow method – Calculating the EIR

4.3.10 Overview #
4.3.20 Consideration of prepayments in the EIR

**Future developments**

EIR for variable rate loans **

**Questions**

4.3.10 How is the EIR calculated under Subtopic 326-20?
4.3.20 Is the EIR calculated under Subtopic 326-20 also used to recognize interest income under Subtopic 310-20?
4.3.30 How is the EIR calculated under Subtopic 326-20 for a variable rate loan? #
4.3.40 Should the EIR be adjusted when a loan is transferred from held-for-sale to held-for-investment? #
4.3.50 When estimating expected credit losses, can an entity use a prepayment-adjusted EIR to discount cash flows? #
4.3.60 How is the prepayment-adjusted EIR determined? #
4.3.70 When discounted cash flows are used to estimate credit losses, can the EIR change over the life of the financial asset?

**Examples**

4.3.10 EIR used to calculate the allowance for credit losses – variable rate loan
4.3.20 Isolating the effect of different EIR approaches
4.3.30 Discounted cash flow method – changes in EIR due to additional costs
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.

<table>
<thead>
<tr>
<th>Method</th>
<th>Allowance calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discounted cash flow method</td>
<td>The allowance for credit losses reflects the difference between:</td>
</tr>
<tr>
<td></td>
<td>— the amortized cost basis; and</td>
</tr>
<tr>
<td></td>
<td>— the present value of the principal and interest cash flows expected to be collected.</td>
</tr>
<tr>
<td>Other methods</td>
<td>The allowance for credit losses reflects the entity’s expected credit losses of the amortized cost basis.</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generally considers past loss experience and current conditions. [310-10-35-4]</td>
<td>Considers past loss experience, current conditions, and reasonable and supportable forecasts of future conditions.</td>
</tr>
<tr>
<td>Incurred credit losses on loans considers a loss-emergence period. [310-10-35]</td>
<td>Considers lifetime expected losses.</td>
</tr>
</tbody>
</table>
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.

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. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

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

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

b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments.
4. Methods to estimate expected credit losses

Developing an Estimate of Expected Credit Losses

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.

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.

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

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

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

After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A’s
historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information 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.

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

Subtopic 326-20 distinguishes between a discounted cash flow method and other methods. An estimate of expected credit losses that discounts projected future principal and interest cash flows is a discounted cash flow method.

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 4.2.20) or on a combined basis (see Example 4.2.10). [326-20-30-4 – 30-5]

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. [326-20 Glossary]

**Future developments**

**Consideration of expected recoveries**

**Excerpt from ASC 326-20**

> **Writeoffs and Recoveries 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. Recoveries of financial assets and trade receivables previously written off shall be recorded when received.

The FASB’s recently proposed amendments to the existing guidance in Subtopic 326-20 (existing guidance reproduced above) would require an entity to consider expected recoveries of previously charged-off financial assets when estimating expected credit losses. [Proposed ASU]

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 proposed amendments would not permit the negative allowance for credit losses to exceed amounts previously written off (or expected to be written off). [Proposed ASU]
Stakeholders raised concerns about issues associated with accrued interest, including the operational burden and cost of tracking accrued interest at the individual loan level. Additionally, some stakeholders were concerned about changing their current nonaccrual practice of reversing accrued interest receivable through interest income. As a result, the FASB’s recently proposed amendments to Subtopic 326-20 would provide relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances. [Proposed ASU]

**Measurement**

The proposed amendments would permit an entity to elect to exclude accrued interest receivable when estimating expected credit losses in certain situations, as shown in the following flowchart. [Proposed ASU]

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In addition, the proposed amendments would permit an entity to 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 and major security type: [Proposed ASU]

- reversing interest income;
- recognizing credit loss expense; or
- a combination of both.
Presentation
See section 23.2.10 for future developments (accrued interest receivable) related to the presentation of accrued interest receivable balances and the related allowance for credit losses.

Disclosure
See section 24.3.10 for future developments (accrued interest receivable) related to a practical expedient for accrued interest receivable for certain disclosures.

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

Can an entity leverage its existing allowance method to meet the requirements of 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 4.2.30

Can 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 4.2.35**

Is an entity permitted to discount some, but not all, cash flows when applying a method other than a discounted cash flow method?

**Interpretive response:** No. The FASB and TRG discussed this issue at meetings in November 2018. They 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 meeting 11-18, TRG 11-18.14]

When an entity incorporates discounting in its measurement methodology, we believe the entity should discount all cash flows. Additionally, we believe the entity should apply Subtopic 326-20’s guidance for calculating the EIR (see section 4.3) and that the cash flows should be discounted to the reporting date (see Question 7.2.50).

**Question 4.2.36**

Is an entity permitted to discount cash flows or inputs to a date other than the reporting date?

**Interpretive response:** No. The FASB and TRG discussed this issue at meetings in November 2018. They indicated that an entity is not permitted to discount cash flows or inputs to a date other than the reporting date. [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 may not be applied when estimating expected credit losses.

**Question 4.2.40**

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.
Question 4.2.50

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:

— the expected loss of principal; and
— the effect of unamortized premiums and discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments.

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 prepayment expectations 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 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 4.2.10

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 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. Additionally, 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unpaid principal balance of the loan portfolio [a]</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Loan origination transaction costs pertaining to the loan portfolio [b]</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Amortized cost [c = a + b]</strong></td>
<td><strong>$102,000,000</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unpaid principal balance of the defaulted loans – 10% of $100,000,000 [a]</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Unamortized costs pertaining to the defaulted loans at the time of writeoff [b]</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Amortized cost at the time of writeoff [c = a + b]</strong></td>
<td><strong>10,080,000</strong></td>
</tr>
<tr>
<td>Cash received as final settlement of the loans [d]</td>
<td>9,000,000</td>
</tr>
<tr>
<td><strong>Writeoff of amortized cost basis [e = c - d]</strong></td>
<td><strong>$ 1,080,000</strong></td>
</tr>
</tbody>
</table>

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 x 1.08% = $216,000.

Question 4.2.60

Does an entity have to 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 unamortized premiums and discounts (including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments) have on the expected credit loss estimate – e.g. 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 4.2.20

Applying the separate approach

ABC Corp. estimates its allowance for credit losses using a probability of default/loss given default (PD/LGD) method.

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.

ABC considers the current conditions and its reasonable and supportable forecasts of future conditions. It 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Principal amount of loans multiplied by PD</td>
<td>30,000</td>
</tr>
<tr>
<td>Expected loss on principal amount</td>
<td>12,000</td>
</tr>
<tr>
<td>Less: Unaccreted deferred fees included in expected credit loss of amortized cost basis</td>
<td>(420)</td>
</tr>
<tr>
<td><strong>Allowance for credit losses</strong></td>
<td><strong>$11,580</strong></td>
</tr>
</tbody>
</table>

**Note:**

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net deferred fees at origination</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: Amount expected to be accreted at the time credit losses are expected to occur</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Unaccreted amount expected at the time credit losses are expected to occur</td>
<td>14,000</td>
</tr>
<tr>
<td><strong>Unaccreted amount included in expected credit loss of amortized cost basis</strong></td>
<td><strong>(420)</strong></td>
</tr>
</tbody>
</table>

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 4.2.10 and 4.2.20, 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.
Question 4.2.70**
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 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 4.2.90.

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.

As discussed in the future developments in section 4.2.10 (consideration of expected recoveries), the FASB’s recently proposed amendments to Subtopic 326-20 would require an entity to consider expected recoveries when estimating credit losses. [Proposed ASU]

Question 4.2.80**
Should anticipated expenses and losses on foreclosed assets (other than costs to sell) be included in the estimate of expected credit losses?

**Background:** When an entity forecloses on collateral underlying its financial assets, a foreclosed asset that is a long-lived asset is initially recognized at its fair value less estimated costs to sell. That amount becomes the initial cost basis of the long-lived asset. [310-40-40-2 – 40-3]

An entity may anticipate that it will incur incremental expenses and/or losses after foreclosure. For example, the entity may anticipate the following before the expected sale:

- expenses associated with owning and operating the asset; and/or
- a decrease in the asset’s fair value.

**Interpretive response:** No. An entity accounts for assets after foreclosure as if those assets had been acquired for cash. Anticipated expenses and losses on foreclosed assets are associated with the period that the entity owns the asset, rather than the period that it holds the loan. [310-40-40-5]
As a result, an entity should not include expenses and losses that it anticipates will occur after foreclosure when estimating the allowance for credit losses of the loan before foreclosure. Additionally, these amounts should not be charged-off against the allowance for credit losses when they are incurred.

**Question 4.2.90**
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.

As discussed in Question 4.2.80, when an entity forecloses on a long-lived asset, the asset is initially recognized at fair value less estimated costs to sell. 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.

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.

### 4.3 Discounted cash flow method – Calculating the EIR

#### 4.3.10 Overview

**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. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

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.

The EIR is used primarily to:

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

However, as discussed in this section, the EIR under Topic 326 may not be the same as the rate used to recognize interest income under Topic 310.

ASU 2016-13 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. The focus of the discussion in this section is the EIR used in a discounted cash flow method when determining the allowance for credit losses under Subtopic 326-20.

Subtopic 326-20 permits, but does not require, an entity to use a discounted cash flow method to determine the allowance for credit losses. If a discounted cash flow method is used, the expected cash flows are discounted at the financial asset’s EIR. [326-20-30-3 – 30-4]

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 4.3.10
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. 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 (see Question 4.3.50). [326-20 Glossary, 310-40-35-12]

When an entity uses discounted cash flows to estimate expected credit losses, Subtopic 326-20 requires it to adjust the expected contractual cash flows for prepayment assumptions.

As explained more thoroughly in the future developments in section 4.3.20, the FASB’s recently proposed amendments to the guidance in Subtopic 326-20 would permit an entity 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. [Proposed ASU]

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 4.3.20
Is the EIR calculated under Subtopic 326-20 also used to recognize interest income under Subtopic 310-20?

Interpretive response: It depends. As explained in Question 4.3.50, when determining expected credit losses under Subtopic 326-20 for a financial asset that is prepayable, an entity is permitted to consider estimated prepayments in calculating the asset’s EIR.

In contrast, when recognizing income on the same asset, the entity might not be permitted to use prepayment assumptions. Prepayment assumptions are permitted (but not required) only for large numbers of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. [310-20-35-26]

For those financial assets that are not prepayable, the same EIR (based on the contractual term) is used for both recognizing interest income and determining the allowance for credit losses.
**Question 4.3.30#**

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

**Interpretive response:** 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 is 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 an entity should use the current market rate at the reporting date and should 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.

**Example 4.3.10**

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

Bank makes a loan to Borrower with the following attributes.

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unpaid principal balance (UPB)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Stated interest rate</td>
<td>Prime on Jan. 1 + 100 bps</td>
</tr>
<tr>
<td>Contractual term</td>
<td>10 years</td>
</tr>
<tr>
<td>Payment terms</td>
<td>Annual payments</td>
</tr>
</tbody>
</table>

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 at the end of Year 4, Bank applies the guidance in Subtopic 326-20 and assumes that the rate will remain unchanged in future periods.

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.
At the end of Year 4, Bank expects full prepayment at the end of Year 7

Bank elects to use the prepayment-adjusted EIR when measuring the allowance for credit losses. The prepayment-adjusted EIR is 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).

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).

Future developments

The FASB’s recently proposed amendments to the guidance in Subtopic 326-20 would allow an entity to use its projections of future interest rates in estimating expected future cash flows on variable rate financial assets when using a discounted cash flow approach. If the entity makes such projections, the same
projections would be used in determining the EIR that is used to discount those cash flows for purposes of estimating expected credit losses. [Proposed ASU]

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. The proposed amendments to the guidance in Subtopic 326-20 are included in the table; requirements referenced to Subtopic 310-20 would not change under the proposals.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>EIR used to recognize interest income</th>
<th>EIR used to discounted expected cash flow for determining the allowance for credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prepayable fixed rate financial assets</strong></td>
<td>General requirement</td>
<td>Policy election (for each class of financing receivable or major security type) to calculate the EIR based on: [Proposed ASU]</td>
</tr>
<tr>
<td></td>
<td>EIR is based on contractual terms.</td>
<td>— contractual cash flows; or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— prepayment-adjusted EIR.</td>
</tr>
<tr>
<td></td>
<td><strong>Exception</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>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]</td>
<td></td>
</tr>
<tr>
<td></td>
<td>— contractual cash flows; or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>— prepayment-adjusted EIR.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>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></td>
</tr>
<tr>
<td><strong>Non-prepayable fixed rate financial assets</strong></td>
<td>EIR is based on contractual terms.</td>
<td>EIR is based on contractual terms.</td>
</tr>
<tr>
<td><strong>Variable rate financial assets</strong></td>
<td>EIR is calculated based on: [310-20-35-18(c), 35-20]</td>
<td>Loans and HTM debt securities</td>
</tr>
<tr>
<td></td>
<td>— the factor as it changes over the life of the asset; or</td>
<td>— EIR is calculated based on the independent factor as it changes over the life of the financial asset. [326-20-30-4]</td>
</tr>
<tr>
<td></td>
<td>— fixed at the rate in effect at inception of the asset.</td>
<td>AFS debt securities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— EIR is calculated based on: [326-30-35-11]</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— the factor as it changes over the life of the AFS debt security; or</td>
</tr>
</tbody>
</table>
4. Methods to estimate expected credit losses

<table>
<thead>
<tr>
<th>Instrument</th>
<th>EIR used to recognize interest income</th>
<th>EIR used to discounted expected cash flow for determining the allowance for credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>fixed at the rate in effect at the time of the most recent credit loss.</td>
</tr>
</tbody>
</table>

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]

**All financial assets**

Projections of changes in the factor would not be required when estimating expected future cash flows for determining the allowance for credit losses. However, if such projections are made, the same projections would be used in calculating the EIR used for discounting those expected future cash flows. [Proposed ASU]

---

**Question 4.3.40#**

Should the EIR be adjusted when a loan is transferred from held-for-sale to held-for-investment?

**Interpretive response:** Yes. When a loan is reclassified from held-for-sale to held-for-investment, it is transferred at the lower of amortized cost or fair value on the transfer date. Any previously existing valuation allowance or additional valuation allowance needed because amortized cost exceeds fair value is applied against the amortized cost basis of the loan, similar to an origination discount or writeoff. [948-310-30-4]

If the basis of a loan reclassified as held-for-investment was adjusted from the application of hedge accounting while it was classified as held-for-sale, the amortized cost basis used at the date of the transfer should consider those hedge accounting adjustments. [948-310-35-1]

Any difference between the amortized cost balance at the date of transfer (the carrying amount) of the loan and the outstanding principal balance should be recognized as an adjustment to the loan’s yield using the interest method as discussed in Subtopic 310-20. [948-310-35-4]

To implement this guidance in Subtopic 948-310, an entity should calculate a revised EIR at the date of transfer that would accrete the carrying amount of the loan to the outstanding principal balance.
Additionally, when the loan is reclassified as held-for-investment, the entity should calculate an allowance for credit losses consistent with other held-for-investment financial assets based on the new amortized cost basis of the asset on the transfer to held-for-investment.

See also section 3.2.10 for future developments related to the initial recognition of transfers from loans held-for-sale to held-for-investment or debt securities from AFS to HTM. The FASB’s recently proposed amendments would require an entity to reverse in earnings the existing allowance for credit losses, record the transferred loan at its amortized cost basis, and recognize a new allowance for credit losses based on the guidance in Subtopic 326-20.

### 4.3.20 Consideration of prepayments in the EIR

#### Excerpt from ASC 310-20

**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.

#### 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 it has a reasonable expectation at the reporting date that it will execute a **troubled debt restructuring** with the borrower.

>> **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.

---

**Excerpt from ASC 326-20**

**20 Glossary**

**Class of Financing Receivable** – A group of financing receivables determined on the basis of both of the following:

1. Risk characteristics of the financing receivable
2. An entity’s method for monitoring and assessing credit risk.

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

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), as required; 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 4.3.10). [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 that do not represent expected credit losses. Rather, the difference 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. The FASB recently proposed amendments that would allow an entity to elect to use a prepayment-adjusted EIR (see Question 4.3.50). [310-20-35-26, 30-6]
Question 4.3.50#
When estimating expected credit losses, can an entity use a prepayment-adjusted EIR to discount cash flows?

Interpretive response: Yes, if an entity has applied the option to consider prepayments provided by paragraph 310-20-35-26 or makes a policy election.

As discussed in Question 4.3.20, an entity is permitted (but not required) to consider prepayment assumptions when determining its EIR for interest income recognition only for large numbers of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. [310-20-35-26]

However, discounting projected cash flows that include prepayment expectations while using an EIR that has not been adjusted for prepayment expectations will always increase the allowance for credit losses for financial assets held at a premium. Additionally, it will always offset the allowance for credit losses for financial assets held at a discount. See Example 4.3.20 for an illustration of the effect.

The FASB’s recently proposed amendments to the guidance in Subtopics 326-20 and 326-30 would clarify that an entity may make an accounting policy election to adjust the EIR used to discount expected cash flows to consider the timing (and changes in expected timing) of expected cash flows from expected prepayments. An entity would apply the policy election consistently for financing receivables at the class of financing receivable level and for debt securities at the major security type level. [Proposed ASU]

However, an entity may only use a prepayment-adjusted EIR to recognize interest income if certain conditions in paragraph 310-20-35-26 are met. As a result, an entity may not be permitted to use a prepayment-adjusted EIR to recognize interest income even though the entity elects to use a prepayment-adjusted EIR to estimate credit losses. See also Question 4.3.20. [310-20-35-26]

Further, 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]

In a December 2017 meeting, the FASB provided 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 provided, see section 25.3.50.
Question 4.3.60#

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]

Example 4.3.20

Isolating the effect of different EIR approaches

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning principal balance</th>
<th>Scheduled payment</th>
<th>Ending principal balance</th>
<th>Ending premium balance</th>
<th>Ending amortized cost</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Principal</td>
<td>Interest</td>
<td>Principal</td>
<td>Interest</td>
<td>Principal</td>
</tr>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$79,505</td>
<td>$50,000</td>
<td>920,495</td>
<td>20,650</td>
</tr>
<tr>
<td>2</td>
<td>920,495</td>
<td>83,480</td>
<td>46,025</td>
<td>837,015</td>
<td>17,020</td>
</tr>
</tbody>
</table>
Credit impairment

4. Methods to estimate expected credit losses

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$129,505</td>
</tr>
<tr>
<td>2</td>
<td>129,505</td>
</tr>
<tr>
<td>3</td>
<td>129,505</td>
</tr>
<tr>
<td>4</td>
<td>129,505</td>
</tr>
<tr>
<td>5’</td>
<td>690,190</td>
</tr>
</tbody>
</table>

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

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortized cost basis</th>
<th>Present value of cash flows</th>
<th>Allowance for credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origination</td>
<td>$1,024,500</td>
<td>$1,018,275</td>
<td>$6,225</td>
</tr>
<tr>
<td>1</td>
<td>941,145</td>
<td>934,639</td>
<td>6,506</td>
</tr>
<tr>
<td>2</td>
<td>854,035</td>
<td>847,236</td>
<td>6,799</td>
</tr>
<tr>
<td>3</td>
<td>763,002</td>
<td>755,896</td>
<td>7,106</td>
</tr>
</tbody>
</table>
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 prepay 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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning principal balance</th>
<th>Expected payment</th>
<th>Ending principal balance</th>
<th>Ending premium balance</th>
<th>Ending amortized cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$79,505</td>
<td>920,495</td>
<td>18,950</td>
<td>939,445</td>
</tr>
<tr>
<td>2</td>
<td>920,495</td>
<td>83,480</td>
<td>837,015</td>
<td>13,685</td>
<td>850,700</td>
</tr>
<tr>
<td>3</td>
<td>837,015</td>
<td>87,654</td>
<td>749,361</td>
<td>8,743</td>
<td>758,104</td>
</tr>
<tr>
<td>4</td>
<td>749,361</td>
<td>92,037</td>
<td>657,324</td>
<td>4,167</td>
<td>661,491</td>
</tr>
<tr>
<td>5</td>
<td>661,491</td>
<td>32,866</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortized cost basis</th>
<th>Present value of cash flows</th>
<th>Allowance for credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origination</td>
<td>$1,024,500</td>
<td>$1,024,500</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
<td>939,445</td>
<td>939,445</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>850,700</td>
<td>850,700</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>758,104</td>
<td>758,104</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>661,491</td>
<td>661,491</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

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

**Question 4.3.70**

When discounted cash flows are used to estimate credit losses, can the EIR change over the life of the financial asset?

**Interpretive response:** Yes. An entity uses the EIR based on the contractual cash flows (over the contractual term) unless it:

- qualifies for and elects to estimate prepayments for interest income recognition when it has a large number of similar loans for which prepayments are probable and the timing and amount can be reasonably estimated; or [326-20-35-26]

- has made the policy election to use a prepayment-adjusted EIR as discussed in section 4.3.20. [TRG 06-17.1, TRG 06-17.6]

When the EIR based on the contractual cash flows (over the contractual term) is used to estimate credit losses, Subtopic 310-20 addresses situations when that rate should be adjusted throughout the life of a financial asset. Those situations include transactions in which additional fees are collected; costs are incurred or prepayment penalties are charged in conjunction with a loan modification that is not a TDR and should not be accounted for as a new loan; or fees are received by the lender unrelated to the origination of the loan. 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]

When a prepayment-adjusted EIR is used to estimate credit losses, that rate is adjusted for changes required to the EIR based on the contractual cash flows (over the contractual term) under Subtopic 310-20 discussed in the preceding paragraph, as well as changes in prepayment expectations.

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, assuming that the amortized cost basis does not include unpaid accrued interest. If differences arise between the expected prepayments and actual prepayments received, an entity uses the updated amortized cost of the financial asset (which includes actual prepayments) and calculates an updated effective yield that reflects anticipated future payments, including expected prepayments. Similarly, if an entity changes its future expectations regarding prepayments, the EIR should be updated for those changes in expectations. As discussed in Question 4.3.50, an entity should not update the EIR for TDRs for changes in future prepayment expectations. [TRG 06-17.1, TRG 06-17.6]

In addition to prepayment expectations, there are other items considered in determining the EIR. When the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the EIR is adjusted from the EIR based on the contractual cash flows (over the contractual term) to the rate that equates the present value of the loan’s future cash flows with the adjusted amortized cost basis. [326-20-55-9]
Example 4.3.30

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning principal balance</th>
<th>Scheduled payment</th>
<th>Ending principal balance</th>
<th>Ending premium balance</th>
<th>Ending amortized cost</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Principal</td>
<td>Interest</td>
<td>$1,000,000</td>
<td>$24,500</td>
</tr>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$79,505</td>
<td>$50,000</td>
<td>920,495</td>
<td>20,650</td>
</tr>
<tr>
<td>2</td>
<td>920,495</td>
<td>83,480</td>
<td>46,025</td>
<td>837,015</td>
<td>17,020</td>
</tr>
<tr>
<td>3</td>
<td>837,015</td>
<td>87,654</td>
<td>41,851</td>
<td>749,361</td>
<td>13,641</td>
</tr>
<tr>
<td>4</td>
<td>749,361</td>
<td>92,037</td>
<td>37,468</td>
<td>657,324</td>
<td>10,543</td>
</tr>
<tr>
<td>5</td>
<td>657,324</td>
<td>96,639</td>
<td>32,851</td>
<td>560,685</td>
<td>7,762</td>
</tr>
<tr>
<td>6</td>
<td>560,685</td>
<td>101,470</td>
<td>28,035</td>
<td>459,215</td>
<td>5,334</td>
</tr>
<tr>
<td>7</td>
<td>459,215</td>
<td>106,544</td>
<td>22,961</td>
<td>352,671</td>
<td>3,299</td>
</tr>
<tr>
<td>8</td>
<td>352,671</td>
<td>111,871</td>
<td>17,634</td>
<td>240,800</td>
<td>1,701</td>
</tr>
<tr>
<td>9</td>
<td>240,800</td>
<td>117,465</td>
<td>12,040</td>
<td>123,335</td>
<td>585</td>
</tr>
<tr>
<td>10</td>
<td>123,335</td>
<td>123,335</td>
<td>6,170</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

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.

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

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>$129,505</td>
</tr>
<tr>
<td>7</td>
<td>129,505</td>
</tr>
<tr>
<td>8</td>
<td>129,505</td>
</tr>
<tr>
<td>9</td>
<td>129,505</td>
</tr>
<tr>
<td>10</td>
<td>129,505</td>
</tr>
</tbody>
</table>

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.
5. Collective assessment

Detailed contents

5.1 How the standard works

5.2 Identifying pools
   5.2.10 Overview
   Questions
   5.2.10 Is an entity required to pool assets based on similar risk characteristics?
   5.2.20 Is an entity required to revise pools of financial assets if risk characteristics change?
   5.2.30 Are an entity’s segmentation practices under the incurred loss model permitted under Subtopic 326-20?
   5.2.40 Should the collective assessment guidance be applied to off-balance sheet credit exposures?

5.3 Changes to pools
   5.3.10 Overview
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.
Credit impairment

5. Collective assessment

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**

Is an entity required to 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]

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]
Is an entity required to 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.

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

Should the collective assessment guidance be 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]
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.
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

Item significantly updated in this chapter: #

6.1 How the standard works

6.2 Determining the contractual term
   6.2.10 Intention to renew
   6.2.20 Options to extend the contractual term
   6.2.30 Call options
   6.2.40 Expected prepayments

Questions
   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?
   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?
   6.2.30 What is the effect on the contractual term of a call option held by the lender?
   6.2.40 Can the weighted-average remaining life be used as the contractual term for a portfolio of loans? #
   6.2.50 Is a lender required to use the loan modification guidance to determine whether a refinancing should be considered a prepayment? #

Examples
   6.2.10 Loan with no lender contractual obligation to renew
   6.2.20 Effect of extensions on the contractual term
   6.2.30 Loan with borrower conditional option to extend
   6.2.40 Callable loan
   6.2.50 Weighted-average remaining life

6.3 TDRs that are reasonably expected
   6.3.10 Overview

6.4 Estimating the life of credit card receivables
   6.4.10 Overview
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 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 it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

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 it 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. [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 borrower-controlled extension or renewal options. 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 extended 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 extended the maturity date could be unilateral (i.e. unconditional), or alternatively 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, we believe the lender should adjust the contractual term of a funded loan if the borrower has an option – either conditional or unconditional – to extend the maturity date. Because the option is similar to a loan commitment, we believe that the lender should factor in the likelihood that the contractual option will be exercised by the borrower when estimating expected credit losses. However, it is not yet clear if the exposure associated with the extended term should be part of the allowance for credit losses (i.e. a contra-asset on the balance sheet) or a liability for off-balance sheet credit exposure (similar to a loan commitment), or whether either approach would be acceptable. Revisions to this interpretive response may be provided in a future edition.

**Borrower option within lender’s control**

If the borrower’s ability to exercise the term-extension option is within the lender’s control, we believe 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.

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**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 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 estimate of credit losses as $1,000 × 2% × 65% × 50% = $6.50. As noted in Question 6.2.10, it is not yet clear if the exposure associated with the extended term would be included in the allowance for credit losses or as a liability for off-balance sheet credit exposure.
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.

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 would be 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.

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.

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 is adjusted for expected prepayments. [326-20-30-6]

Question 6.2.40#
Can 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
Credit impairment

6. Contractual term

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

<table>
<thead>
<tr>
<th>Loan</th>
<th>Amortized cost</th>
<th>Prepayment expected after ___ years</th>
<th>Cumulative loss rate</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$2,000,000</td>
<td>1</td>
<td>2.50%</td>
<td>$50,000</td>
</tr>
<tr>
<td>2</td>
<td>2,000,000</td>
<td>3</td>
<td>4.50%</td>
<td>90,000</td>
</tr>
<tr>
<td>3</td>
<td>2,000,000</td>
<td>5</td>
<td>5.00%</td>
<td>100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$6,000,000</td>
<td></td>
<td>4.00%</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Loan</th>
<th>Amortized cost</th>
<th>Prepayment expected after ___ years</th>
<th>Cumulative loss rate</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pool</td>
<td>$6,000,000</td>
<td>3</td>
<td>4.50%</td>
<td>$270,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Calculated based on:</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using the contractual term and loss rates determined for each loan</td>
<td>$240,000</td>
</tr>
<tr>
<td>Using weighted-average life as the remaining term for all loans in the portfolio</td>
<td>270,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$30,000</td>
</tr>
</tbody>
</table>
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#

Is a lender required to 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 that is not a TDR results in recognition of a new loan or a continuation of the existing loan (i.e. a loan modification).

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.

6.3 TDRs that are reasonably expected

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.

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

New item added to this chapter: **

7.1 How the standard works

7.2 Historical loss experience

7.2.10 Overview
7.2.20 Source(s) of historical information
7.2.30 Selecting historical period(s)

Questions

7.2.10 Under what circumstances may an entity use external data?
7.2.20 Is an entity required to select a historical period that represents its expectation for future periods?
7.2.30 Can an entity base its selection of a historical loss period on an economic outlook that extends further than its reasonable and supportable forecast period?
7.2.40 [Not used]

7.3 Adjusting historical loss information

7.3.10 Overview
7.3.20 Determining the reasonable and supportable forecast period
7.3.30 Reversion to historical loss information

Questions

7.3.10 What types of adjustments are required or precluded during and after the reasonable and supportable forecast period?
7.3.15 Is an entity required to consider multiple economic scenarios when developing its economic forecast? **
7.3.20 May an entity assert that it cannot develop any economic forecasts and rely solely on historical losses?
7.3.30 Can the length of the reasonable and supportable forecast period differ for different economic assumptions?
7.3.40 Is a statistical confidence level required to support the length of the reasonable and supportable forecast period?
7.3.50 Is ‘backtesting’ the historical accuracy of the forecasting process required to substantiate whether a current period forecast is reasonable and supportable?
7.3.60 Is an entity required to reevaluate the reasonable and supportable forecast period?

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

7.3.80 How is the reasonable and supportable forecast period determined when reversion is based on the entire estimate?

7.3.90 Is the reversion method a practical expedient?

7.3.100 Can an entity revert to historical loss experience over a period shorter than the remaining contractual term of the financial assets?

Examples

7.3.05 Multiple scenarios vs. single best estimate for economic forecasts **

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

7.3.20 Reversion at input level

7.3.30 Reversion based on the entire estimate

7.3.40 Applying immediate and straight-line reversion

7.4 FASB examples
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 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**

*Is an entity required to 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

Can 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
Credit impairment

7. Historical loss experience, forecasts and reversion

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]

<table>
<thead>
<tr>
<th>Type of adjustment</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>For current asset-specific risk characteristics</td>
<td>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]</td>
</tr>
<tr>
<td>For current conditions</td>
<td>Adjustments for external economic factors at the reporting date that did not exist over the period from which historical experience was used.</td>
</tr>
<tr>
<td>For reasonable and supportable forecasts</td>
<td>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.</td>
</tr>
</tbody>
</table>

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 asset-specific risk characteristics and economic conditions are required to be made – or are precluded from being made – depends on the nature of the difference and
whether an entity is able to make or obtain reasonable and supportable forecasts of expected credit losses. [326-20-30-8 – 30-9]

<table>
<thead>
<tr>
<th>Nature of differences between historical loss information</th>
<th>Periods that an entity can reasonably and supportably forecast</th>
<th>Periods that an entity cannot reasonably and supportably forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Differences in asset-specific risk characteristics, e.g. underwriting or loan terms</td>
<td>Adjustment required</td>
<td>Adjustment required</td>
</tr>
<tr>
<td>Differences in economic conditions, both current conditions and expectations for future conditions</td>
<td>Adjustment required</td>
<td>Adjustment prohibited</td>
</tr>
</tbody>
</table>

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 periods for the asset-specific risk characteristics, we believe it should adjust the historical loss information based on an assumption that the asset-specific risk characteristics existed over the period used for the historical loss experience. This assumption avoids indirectly adjusting historical loss experience for current economic conditions and forecasts of future economic forecasts for periods beyond the reasonable and supportable forecast period (which is prohibited by Subtopic 326-20). [326-20-30-8 – 30-9]

**Question 7.3.15**

Is an entity required to 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: [ASU0216-13.BC67–BC68]

— whether a single best estimate or multiple forward-looking economic scenarios should be used; and
— how to incorporate multiple forward-looking economic scenarios.

Therefore, an entity may use either a single best estimate 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.

When an entity uses multiple forward-looking economic scenarios, we believe the allowance for credit losses should reflect the possibility that credit losses
may be worse (or better) than the best estimate scenario. An entity may reflect these possibilities through at least one scenario that is more favorable and at least one that is less favorable than the best estimate scenario in the model.

Example 7.3.05**  
**Multiple scenarios vs. single best estimate for economic forecasts**

Bank determines that 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.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Forecast unemployment rate</th>
<th>Expected credit losses</th>
<th>Likelihood of scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Favorable</td>
<td>4%</td>
<td>$ 30</td>
<td>20%</td>
</tr>
<tr>
<td>2 Most likely</td>
<td>5%</td>
<td>70</td>
<td>50%</td>
</tr>
<tr>
<td>3 Recession</td>
<td>8%</td>
<td>170</td>
<td>30%</td>
</tr>
</tbody>
</table>

**Scenario: Multiple scenario approach**

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

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Forecast unemployment rate</th>
<th>Expected credit losses</th>
<th>Likelihood of scenario</th>
<th>Probability-weighted expected credit losses′</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Favorable</td>
<td>4%</td>
<td>$ 30</td>
<td>20%</td>
<td>$ 6</td>
</tr>
<tr>
<td>2 Most likely</td>
<td>5%</td>
<td>70</td>
<td>50%</td>
<td>35</td>
</tr>
<tr>
<td>3 Recession</td>
<td>8%</td>
<td>170</td>
<td>30%</td>
<td>51</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$92</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. Expected credit losses × likelihood of scenario.

**Scenario: Single best estimate 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.
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.

<table>
<thead>
<tr>
<th>Steps</th>
<th>Comments</th>
</tr>
</thead>
</table>
| 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 7.3.30**

**Can 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

Is an entity required to 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).
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]
Credit impairment

7. Historical loss experience, forecasts and reversion

**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. 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 instance, if the forecasted economic conditions immediately preceding the period covered by the reversion method are expected to be significantly better or worse than average, an entity should consider that fact when determining both the period it will use to determine the historical credit loss experience that it will revert to and the method that it will use to revert.

The SEC staff provides guidance for public companies in SEC Staff Accounting Bulletin No. 102. 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
Can 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.

Assumptions

The historical information shows that the annual loss rates that make up the cumulative lifetime loss rate are broken down as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.0%</td>
</tr>
<tr>
<td>2</td>
<td>2.0%</td>
</tr>
<tr>
<td>3</td>
<td>1.0%</td>
</tr>
<tr>
<td>4</td>
<td>1.0%</td>
</tr>
<tr>
<td>Cumulative lifetime loss rate</td>
<td>7.0%</td>
</tr>
</tbody>
</table>

ABC has determined that no adjustments are needed for asset-specific risk characteristics. Also, ABC has determined that it can develop a reasonable and supportable forecast for economic conditions for one year, and that an adjustment of 0.8% for economic conditions is appropriate during that period.
Scenario 1 – Immediate reversion method
If ABC applies the immediate reversion method, the cumulative loss rate is 7.8%.

<table>
<thead>
<tr>
<th>Year</th>
<th>Unadjusted historical loss rates</th>
<th>Adjustment for differences in</th>
<th>Annual loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Asset-specific risk charact. (i.e. underwrite.)</td>
<td>Economic conditions</td>
</tr>
<tr>
<td>1</td>
<td>3.0%</td>
<td>0%</td>
<td>0.8%</td>
</tr>
<tr>
<td>2</td>
<td>2.0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>1.0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>1.0%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

Expected cumulative lifetime loss rate 7.8%

Scenario 2 – Straight-line reversion method
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%.

<table>
<thead>
<tr>
<th>Year</th>
<th>Unadjusted historical loss rates</th>
<th>Adjustment for differences in</th>
<th>Annual loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Asset-specific risk charact. (i.e. underwrite.)</td>
<td>Economic conditions</td>
</tr>
<tr>
<td>1</td>
<td>3.0%</td>
<td>0%</td>
<td>0.8%</td>
</tr>
<tr>
<td>2</td>
<td>2.0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>1.0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>1.0%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

Expected cumulative lifetime loss rate 9.0%

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.

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.
 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

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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.

<table>
<thead>
<tr>
<th>Year of Origination</th>
<th>Loss Experience in Years Following Origination</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>20X1</td>
<td>$ 50</td>
</tr>
<tr>
<td>20X2</td>
<td>$ 40</td>
</tr>
<tr>
<td>20X3</td>
<td>$ 40</td>
</tr>
<tr>
<td>20X4</td>
<td>$ 60</td>
</tr>
<tr>
<td>20X5</td>
<td>$ 50</td>
</tr>
<tr>
<td>20X6</td>
<td>$ 70</td>
</tr>
<tr>
<td>20X7</td>
<td>$ 80</td>
</tr>
<tr>
<td>20X8</td>
<td>$ 70</td>
</tr>
<tr>
<td>20X9</td>
<td>$ 70</td>
</tr>
</tbody>
</table>

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.

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

<table>
<thead>
<tr>
<th>Past-Due Status</th>
<th>Amortized Cost Basis</th>
<th>Credit Loss Rate</th>
<th>Expected Credit Loss Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$5,984,698</td>
<td>0.27%</td>
<td>$16,159</td>
</tr>
<tr>
<td>1-30 days past due</td>
<td>8,272</td>
<td>7.2%</td>
<td>596</td>
</tr>
<tr>
<td>31-60 days past due</td>
<td>2,882</td>
<td>23.4%</td>
<td>674</td>
</tr>
<tr>
<td>61-90 days past due</td>
<td>842</td>
<td>52.2%</td>
<td>440</td>
</tr>
<tr>
<td>More than 90 days past due</td>
<td>1,100</td>
<td>73.8%</td>
<td>812</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,997,794</strong></td>
<td></td>
<td><strong>$18,681</strong></td>
</tr>
</tbody>
</table>
8. No allowance for credit losses

Detailed contents

8.1 How the standard works

8.2 Zero loss expectation exception
   8.2.10 Overview

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   8.2.10 What financial assets are eligible for the zero loss expectation exception?
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   8.3.30 Financial assets that are fully guaranteed by Fannie Mae or Freddie Mac
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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 8.4) or the financial asset is collateral dependent (see chapter 10). [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 should 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 \times 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.

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

9.1 How the standard works

9.2 Determining whether a credit enhancement is freestanding

9.2.10 Overview

Questions

9.2.10 When is a credit enhancement entered into separate and apart from other transactions?
9.2.20 When is a credit enhancement entered into in conjunction with a financial asset?
9.2.30 When is a credit enhancement legally detachable?
9.2.40 When is a credit enhancement separately exercisable?

Examples

9.2.10 Credit insurance
9.2.20 Insurance-wrapped debt security
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.

<table>
<thead>
<tr>
<th>Counterparties</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate, unrelated counterparties</td>
<td>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.</td>
</tr>
</tbody>
</table>
| 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: For a credit enhancement to be considered as entered into in conjunction with a financial asset, it should be entered into in 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?

Interpretive response: Legally detachable generally means the credit enhancement and the financial asset can be legally 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. 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.

Question 9.2.40
When is a credit enhancement separately exercisable?

Interpretive response: Separately exercisable generally means one instrument can be exercised without terminating the other instrument – e.g. through redemption, simultaneous exercise or expiration.

We believe a financial instrument can be exercised separately from other financial instruments or transactions in a number of ways. One important factor to consider 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 separately exercisable.

**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]

<table>
<thead>
<tr>
<th>Description</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nature of coverage</strong></td>
<td>Lender requires Borrower to take insurance coverage for specific loans – e.g. when the loan-to-value ratio exceeds a 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).</td>
<td>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 subsequent purchaser if the loans are subsequently sold.</td>
</tr>
<tr>
<td><strong>Premiums</strong></td>
<td>Typically paid by Borrower.</td>
<td>Typically paid by Lender.</td>
</tr>
<tr>
<td><strong>Is the insurance contract (i.e. the credit enhancement) entered into separate and apart from, or in conjunction with the mortgage loan?</strong></td>
<td>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</td>
<td>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</td>
</tr>
</tbody>
</table>
### Credit impairment

9. Credit enhancements

<table>
<thead>
<tr>
<th>Description</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>between Lender and Borrower and, as a result, the PMI is not contractually distinct. Instead, it was obtained in conjunction with the mortgage loan.</td>
<td>considered a freestanding contract.</td>
<td></td>
</tr>
<tr>
<td><strong>Is the contract legally detachable?</strong></td>
<td>No, the insurance contract is not legally detachable from the loan. If the loan is sold, the insurance contract transfers with the loan and the new owner of the loan will be the beneficiary.</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>No, the insurance contract is not legally detachable from the loan. If the loan is sold, the insurance contract transfers with the loan and the new owner of the loan will be the beneficiary.</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>No, the insurance contract is not separately exercisable. If Borrower defaults and the PMI is exercised, Lender has no remaining claim against the loan to Borrower.</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>No, the insurance contract is not separately exercisable. If Borrower defaults and the PMI is exercised, Lender has no remaining claim against the loan to Borrower.</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>No, the insurance contract is not freestanding.</td>
<td>Yes, the insurance contract is freestanding.</td>
</tr>
<tr>
<td></td>
<td>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.</td>
<td>Should not be considered in estimating expected credit losses because the credit enhancement is a freestanding contract.</td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Municipal bond with an insurance wrapper</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the financial guaranty insurance contract (i.e., the credit enhancement) entered into separate and apart from, or in conjunction with the municipal bond?</td>
<td>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.</td>
</tr>
<tr>
<td>Is the contract legally detachable?</td>
<td>No, the insurance contract is not legally detachable from the municipal bond. 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.</td>
</tr>
<tr>
<td>Is the contract separately exercisable?</td>
<td>No, the insurance contract is not separately exercisable. 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.</td>
</tr>
<tr>
<td>Is the insurance contract freestanding?</td>
<td>No, the insurance contract is not freestanding.</td>
</tr>
<tr>
<td>Consideration of credit enhancement (insurance) in estimating expected credit losses</td>
<td>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.</td>
</tr>
</tbody>
</table>
10. Practical expedients

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10.2 Collateral-dependent financial assets

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10.2.20 Estimating expected credit losses when foreclosure is probable
10.2.30 Estimating expected credit losses when foreclosure is not probable

Questions

10.2.10 Do expected selling costs reduce the fair value of collateral when foreclosure is probable?
10.2.20 How should an entity determine the present value of estimated selling costs?
10.2.30 What types of costs should be considered in estimated selling costs?
10.2.40 Should an entity consider credit enhancements when estimating expected credit losses when foreclosure is probable?
10.2.50 How should an entity determine if the debtor is experiencing financial difficulty?
10.2.60 Does an entity continue to apply the practical expedient once the borrower is no longer experiencing financial difficulty?
10.2.70 Should the practical expedient be applied at the individual financial asset level?
10.2.80 Should an entity consider credit enhancements when estimating expected credit losses when applying the practical expedient?
10.2.90 When a loan is considered collateral-dependent, is an entity required to use the fair value of collateral to estimate expected credit losses for bank regulatory reporting purposes?

Example

10.2.10 Application of the practical expedient when the debtor operates the property
10.3 Collateral maintenance provisions

Questions

10.3.10 To apply the practical expedient, does an entity need to assess whether the borrower will be able to replenish collateral?

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?

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?

Example

10.3.10 Repurchase agreement
10.1 How the standard works

Subtopic 326-20 provides two practical expedients – for collateral-dependent assets and assets with collateral maintenance provisions.

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.

For guidance on how to estimate expected credit losses when a financial asset is not collateral-dependent, see chapters 4 to 8.

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 that effectively caps the estimate of expected credit losses at the amount (if any) that the amortized cost exceeds the current fair value of the collateral.
10.2 Collateral-dependent financial assets

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]

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. However, if it determines that the asset is collateral-dependent but foreclosure is not probable, it can elect to apply the practical expedient to use the collateral’s fair value to estimate the asset’s expected credit loss. If it chooses not to elect the practical expedient or the practical expedient does not apply, an entity uses the general measurement principles in Subtopic 326-20 to estimate the allowance for credit losses. Regardless of whether foreclosure is probable or an entity applies the practical expedient, credit enhancements that are not freestanding are also considered in the estimate of expected credit losses. For further discussion regarding the consideration of credit enhancements, see chapter 9. [326-20-35-4 – 35-5]

How expected credit losses are calculated depends on whether repayment of the financial asset is expected to be from the sale or the operation of the collateral. The following table summarizes how an allowance for credit losses is calculated based on the expected source of repayment regardless of the reason why fair value of the collateral is the basis for estimating expected credit losses, i.e. because: [326-20-35-4, 35-5]

— foreclosure is probable and therefore it is required; or
— foreclosure is not probable, but the fair value of the collateral is being used as a practical expedient when (1) repayment is expected to be provided substantially by the collateral and (2) the borrower is experiencing financial difficulty.

<table>
<thead>
<tr>
<th>How an entity considers the fair value of the collateral when estimating expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repayment depends on sale of the collateral</td>
</tr>
<tr>
<td>Allowance calculated as: amortized cost basis - fair value of collateral + present value of estimated costs to sell. If the fair value less present value of estimated costs to sell is equal to or greater than the amortized cost, no allowance is recorded. The effect of credit enhancements that are not freestanding should also be incorporated into the measurement.</td>
</tr>
</tbody>
</table>

For additional guidance on how to calculate expected credit losses when foreclosure is probable and when it is not probable, see sections 10.2.20 and 10.2.30, respectively.
### Comparison to legacy US GAAP

#### Collateral-dependent measurement approach

<table>
<thead>
<tr>
<th></th>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope</strong></td>
<td>Limited to loans. [310-10-35-22]</td>
<td>Applicable to all financial assets.</td>
</tr>
<tr>
<td><strong>Applicability</strong></td>
<td>Required when foreclosure is probable. [310-10-35-32]</td>
<td>Required when foreclosure is probable. Permitted as a practical expedient when:</td>
</tr>
<tr>
<td></td>
<td>Permitted as a practical expedient only when a loan is impaired. [310-10-35-22]</td>
<td>— repayment is expected to be provided substantially by the sale or operation of the collateral; and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— the borrower is experiencing financial difficulty.</td>
</tr>
<tr>
<td><strong>Definition of collateral-dependent financial asset</strong></td>
<td>A loan for which repayment is expected to be provided <em>solely</em> by the underlying collateral. [310 Glossary]</td>
<td>A financial asset for which repayment is expected to be provided <em>substantially</em> through the operation or sale of the collateral when the borrower is experiencing financial difficulty.</td>
</tr>
<tr>
<td><strong>Requirement to consider borrower’s financial condition</strong></td>
<td>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]</td>
<td>Borrower’s financial condition is explicitly considered when foreclosure is not probable.</td>
</tr>
</tbody>
</table>

As demonstrated in the table, 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.
10.2.20 Estimating expected credit losses when foreclosure is probable

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 when the entity determines that foreclosure is probable. When an entity determines that foreclosure is probable, the entity shall remeasure the financial asset at the fair value of the collateral so that the reporting of a credit loss is not delayed until actual foreclosure. 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.

If on the reporting date an entity determines that foreclosure of a collateral-dependent financial asset is probable, it estimates the asset’s expected credit losses based on the fair value of the collateral and records any resulting credit losses at the time. This requirement prevents the entity from delaying recognition of the credit losses until foreclosure occurs. [326-20-35-4]

If the fair value of the underlying collateral – adjusted for the present value of costs to sell when applicable – is less than the amortized cost of the financial asset, the resulting difference is the allowance for credit losses. Additionally, an entity considers credit enhancements that are not freestanding when estimating expected credit losses. For further discussion regarding the consideration of credit enhancements, see chapter 9. [326-20-35-4]

Question 10.2.10

Do expected selling costs reduce the fair value of collateral when foreclosure is probable?

Interpretive response: Yes, we believe that expected selling costs should reduce the fair value of the collateral when foreclosure is probable and repayment is expected to come from the sale of the collateral.

Paragraph 326-20-35-4 – which explains how to estimate expected credit losses when foreclosure is probable – is silent on whether to reduce the collateral’s fair value by estimated selling costs. However, paragraph 326-20-35-5 – which contains a practical expedient allowing an entity to use the collateral’s fair value to measure a collateral-dependent financial asset when foreclosure is not probable – states that the collateral’s fair value is reduced by the present value of estimated costs to sell.

We believe the guidance regarding costs to sell also applies when foreclosure is probable. For further guidance on paragraph 326-20-35-5, see section 10.2.30. As a reminder, estimated selling costs are not considered when repayment is expected to come from the operation of the collateral. [326-20-35-5]
**Question 10.2.20**

How should an entity determine the present value of estimated selling costs?

**Interpretive response:** Judgment is necessary to estimate both selling costs and the timing of the foreclosure/sale of the underlying collateral.

After estimating selling costs and the timing of the foreclosure/sale of the underlying collateral, those selling costs are discounted at the EIR of the related financial asset. [326-20-35-5]

**Question 10.2.30**

What types of costs should be 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 incurred to transfer legal title were incurred solely because the asset was sold.

**Question 10.2.40**

Should an entity consider credit enhancements when estimating expected credit losses when foreclosure is probable?

**Interpretive response:** Yes, when foreclosure is probable an entity considers credit enhancements that are not freestanding when estimating expected credit losses. [326-20-35-4]

For further discussion regarding the consideration of credit enhancements when estimating expected credit losses, see chapter 9.

### 10.2.30 Estimating expected credit losses when foreclosure is not probable

**Excerpt from ASC 326-20**

**>> Collateral-Dependent Financial Assets**

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 (on a discounted basis). 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. For a collateral-dependent financial asset, an entity may expect credit losses of zero when the fair value (less costs to sell, if applicable) of the collateral at the reporting date is equal to or exceeds the amortized cost basis of the financial asset. 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 360-20

>> 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
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.

When foreclosure is not probable, an entity can elect the practical expedient if:

— 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. [326-20-35-5]

If an entity elects to use the practical expedient and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral is adjusted for the present value of estimated costs to sell. In contrast, when repayment or satisfaction of the financial asset depends only on the operation of the collateral, the entity does not include the estimated selling costs. [326-20-35-5]

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) is operating the property. [326-20-35-5]

Additionally, an entity considers credit enhancements that are not freestanding when estimating expected credit losses. For further discussion regarding the consideration of credit enhancements, see chapter 9. [326-20-35-5]

**Example 10.2.10**

**Application of the practical expedient when the debtor operates the property**

Bank has a $20 million loan to ABC Corp. that was originated on January 1, Year 1. The loan is secured by commercial real estate that had a fair value at origination of $25 million. The primary source of repayment of the loan is rent collected from the property’s tenants.

ABC recently informed Bank that it had lost the anchor tenant and current rent projections do not support the loan payments. ABC has made no payments for two months and Bank 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.
Bank uses the practical expedient and estimates that the allowance for credit losses is $4 million at June 30, Year 4: fair value of the collateral of $15 million (which does not consider costs to sell) less $19 million (loan’s remaining amortized cost).

Question 10.2.50

How should an entity determine if the debtor is experiencing financial difficulty?

Interpretive response: Subtopic 310-40 provides indicators for determining whether a borrower is experiencing financial difficulty when evaluating whether a loan modification is a TDR. We believe those indicators may be applied by analogy when considering whether the practical expedient for collateral-dependent financial assets could be applied. [310-40-15-20]

For guidance on indicators to consider in determining whether a borrower is experiencing financial difficulty, see section 11.2.20.

Question 10.2.60

Does an entity continue to apply the practical expedient once the borrower is no longer experiencing financial difficulty?

Interpretive response: No. We believe for the practical expedient to be applied, the borrower should be experiencing financial difficulty and repayment is expected to be provided substantially through the sale or operation of the collateral. If the borrower is no longer experiencing financial difficulty, another acceptable method should be used to estimate expected credit losses.

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.

Similarly, if repayment is no longer expected to be provided substantially through the sale or operation of the collateral, an entity is not permitted to continue applying the practical expedient. [326-20-35-4, 35-5]

Question 10.2.70

Should the practical expedient be 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**

Should an entity consider credit enhancements when estimating expected credit losses when applying the practical expedient?

**Interpretive response:** Yes, when applying the practical expedient an entity considers credit enhancements that are not freestanding when estimating expected credit losses. [326-20-35-5]

For further discussion regarding the consideration of credit enhancements when estimating expected credit losses, see chapter 9.

**Question 10.2.90**

When a loan is considered collateral-dependent, is an entity required to 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]

Subtopic 326-20 provides an option in the form of a practical expedient, but not a requirement, to estimate expected credit losses for a collateral-dependent financial asset using the fair value of the collateral when foreclosure is not probable. It also allows an entity to use the general guidance on estimating credit losses when foreclosure is not probable. The Bank regulatory guidance may effectively prohibit the use of the general guidance in Subtopic 326-20 in these circumstances. [326-20-35-4 – 35-5, Agency FAQs #37]

If an entity does not elect to apply the practical expedient to collateral-dependent loans held-for-investment for US GAAP financial reporting, differences could result between bank regulatory and US GAAP reporting.

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]
10.3 Collateral maintenance provisions

> Excerpt from ASC 326-20


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.


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 that effectively caps the estimate of expected credit losses at the amount (if any) that the amortized cost exceeds the current fair value of the collateral. [326-20-35-6]

**Question 10.3.10**

To apply the practical expedient, does an entity need to assess whether the borrower will be able to replenish collateral?

**Interpretive response:** Yes. To apply the practical expedient, an entity needs to assess whether the borrower will be able to replenish collateral. However, we believe the entity only needs to assess whether it has a reasonable expectation that the borrower will be able to replenish collateral, if necessary. We do not believe the entity would need to either:

- 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 10.3.20**

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. Additionally, we believe the entity does not need to consider the possibility of the collateral declining in value after the reporting date.
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, we believe 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.

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**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 has a reasonable expectation that ABC will be able to replenish collateral as needed.

XYZ elects to apply the practical expedient, 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 to this chapter: **

11.1 How the standard works

11.2 Identifying a TDR

11.2.10 Overview
11.2.20 Determining whether the debtor is experiencing financial difficulties
11.2.30 Determining whether a creditor has granted a concession
11.2.40 Timing of TDR identification

Questions

11.2.10 Should an entity include an estimate of future TDRs in its estimate of expected credit losses?
11.2.20 What is a ‘reasonably expected’ TDR?
11.2.30 May modifications be evaluated on a program basis to identify TDRs?

Examples

11.2.10 Evaluating whether the debtor is experiencing financial difficulties
11.2.20 Evaluating whether a concession was granted

11.3 Accounting for a TDR

11.3.10 Overview

Questions

11.3.10 Should TDRs be assessed for expected credit losses on a collective basis?
11.3.20 Should TDRs be pooled separately from non-TDRs when estimating expected credit losses?
11.3.30 Is an entity required to consider interest rate concessions and more than insignificant delays in payments when estimating expected credit losses?
11.3.40 Is a specific method prescribed to estimate expected credit losses for TDRs?
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? **
11.3.50 Does an entity need to evaluate whether financial asset modifications made to PCD assets are TDRs?

11.3.60 Can a TDR financial asset be placed on nonaccrual status at the time of or subsequent to modification?
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.

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 it is required to use a discounted cash flow method when that is the only method that will capture the effects of the TDR.
11.2 Identifying a TDR

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.

Is the modification a TDR?

1. Is the debtor experiencing financial difficulties? (section 11.2.20)
   - Yes
   - No

2. Has the creditor granted a concession? (section 11.2.30)
   - Yes
   - No

The modification is not a TDR

The 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.

### Comparison to legacy US GAAP

**Identification of TDRs**

The following table compares the identification of TDRs under legacy US GAAP to Subtopic 326-20. The differences included in this table are discussed in further detail throughout this section.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>TDRs are included within the allowance for loan losses when the individual loan is impaired – i.e. it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the original loan agreement or modified as a TDR. A loan may be identified as impaired before a TDR is executed. [310-40-35-8, 35-9]</td>
<td>TDRs included in historical losses remain in the historical loss experience. Historical losses are adjusted for the expectation of future TDRs and the effect that those TDRs will have on credit loss amounts. TDRs not included in historical losses are included within estimate of expected credit losses when they are reasonably expected at the individual asset level.</td>
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### 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.

Example 11.2.10

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.

— 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.
— Developer’s repayment capacity is uncertain and it has weak financial support.
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]

>> 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
Example 11.2.20

Evaluating whether a concession was granted

Assume the same facts as in Example 11.2.10.

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.

Timing of TDR identification

Excerpt from ASC 326-20

30-6 An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

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
Should 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 Accounting 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.
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

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 4.3.50 for further information regarding the EIR for TDRs. [310-40-35-10, 35-12]

Comparison to legacy US GAAP

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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collective assessment is permitted, but not required, when impaired loans, including TDRs, share common risk characteristics [310-10-35-21]</td>
<td>Collective assessment is required when the financial assets share similar risk characteristics.</td>
</tr>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
</tbody>
</table>
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]

In contrast, under legacy US GAAP, entities are permitted, but not required, to measure the impairment of TDRs on a collective basis if the TDRs share common risk characteristics. [310-10-35-21]

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]

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]

However, for loan modifications that are TDRs, an entity will continue to disclose – for each period that an income statement is presented – certain qualitative and quantitative information about TDRs that occurred during the period. See chapter 24 for more information regarding required disclosures. [310-10-50-33 – 50-34]

**Question 11.3.30**

*Is an entity required to consider interest rate concessions and more than insignificant delays in payments when estimating expected credit losses?*

**Interpretive response:** Yes. Consistent with legacy US GAAP, the FASB decided to retain the concept of a TDR. As a result, 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) 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 within 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 dependant. 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 chapter 10 on identifying and accounting for collateral-dependent financial assets.
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, 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).

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 effect of certain types of TDRs – mainly interest rate concessions that can only be captured using a discounted cash flow (or a reconcilable) method.

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.

Additionally, 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 other effects of the previous TDR – e.g. the impact of a concession that reduced the contractual interest rate.

Question 11.3.50

Does an entity need to 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]

Question 11.3.60
Can 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

New item added to this chapter: **
Item significantly updated in this chapter: #

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12.2 Definition and scope

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12.2.12 What should an entity evaluate to determine whether PCD accounting should be applied to an HTM debt security? **

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12.3.30 [Not used]

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12.3.20 [Not used]
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Example

12.6.10 Journal entries on adoption for loans measured at amortized cost and PCI loans
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 ASC 326-20.

<table>
<thead>
<tr>
<th>Comparison to legacy US GAAP</th>
<th>Accounting for PCI and PCD assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legacy US GAAP</strong></td>
<td><strong>Subtopic 326-20</strong></td>
</tr>
<tr>
<td>No allowance recognized at acquisition. [310-30-30-1]</td>
<td>Allowance recognized on acquisition through a gross-up that increases the amortized cost basis of the asset with no effect on net income.</td>
</tr>
<tr>
<td>Discounted cash flow method required for estimating credit losses. [310-30-30-1]</td>
<td>No specific method required for estimating expected credit losses.</td>
</tr>
<tr>
<td>Effective yield increased when subsequent changes in expected cash flows are both probable and significantly favorable. [310-30-35-10]</td>
<td>Subsequent changes (favorable and unfavorable) in expected cash flows are recognized immediately in net income by adjusting the allowance.</td>
</tr>
<tr>
<td>Allowance recognized immediately through net income when there is a subsequent decrease in expected cash flows. [310-30-35-10]</td>
<td>PCD accounting for non-PCD assets not permitted to be applied by analogy. [AICPA DIEP 12-09]</td>
</tr>
</tbody>
</table>
12.2 Definition and scope

12.2.10 Overview

Excerpt from ASC 326-20

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.

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 should 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 12.2.15**

Should 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. The FASB concluded that purchased assets and originated assets should follow the same model, to the extent possible. [ASU 2016-13.BC85–BC86]

Additionally, Topic 326 and the basis for conclusions do not indicate that net investments in leases are excluded from the scope of PCD accounting.

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).

<table>
<thead>
<tr>
<th>PCI assets under legacy US GAAP</th>
<th>PCD assets under Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
</tbody>
</table>
12. Purchased financial assets with credit deterioration

<table>
<thead>
<tr>
<th>PCI assets under legacy US GAAP</th>
<th>PCD assets under Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>PCI accounting under Subtopic 310-30 may be applied by analogy to other assets that do not meet the PCI definition. [AICPA DIEP 12-09]</td>
<td>PCD accounting under Subtopic 326-20 cannot be applied by analogy to assets that do not meet the PCD definition.</td>
</tr>
</tbody>
</table>

Question 12.2.20

Should an entity apply the PCD definition at the individual asset level or at a 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.BC99]

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 12.6.2).
## 12. Purchased financial assets with credit deterioration

<table>
<thead>
<tr>
<th>PCI assets under legacy US GAAP</th>
<th>PCD assets under Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
<tr>
<td>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 origination, term and geographic location. [310-30-15-6]</td>
<td>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, 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.</td>
</tr>
</tbody>
</table>

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 12.2.40

Can 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]

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

30-14 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]

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) [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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total contractual principal cash flows that it expects to collect:</td>
<td>$800,000</td>
</tr>
<tr>
<td>Allowance for credit losses based on unpaid principal balance (par):</td>
<td>$200,000</td>
</tr>
<tr>
<td>Non-credit discount:</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
ABC records the following journal entry to account for the acquisition of these loans.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>700,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>200,000</td>
</tr>
<tr>
<td>Loans – non-credit discount</td>
<td>100,000</td>
</tr>
</tbody>
</table>

*To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.*

---

**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.

---

**Question 12.3.20**

Does the gross-up method apply to PCD assets acquired in a business combination?

**Interpretive response:** Yes. PCD accounting applies to PCD assets acquired in a business combination – i.e. 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]

The estimate of expected credit losses for non-PCD assets acquired in a business combination is recorded in net income on the acquisition date and not as an acquisition accounting adjustment impacting goodwill. [805-20-30-4A]
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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Topic 326 and Subtopic 325-40 (as amended)</th>
</tr>
</thead>
<tbody>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
</tbody>
</table>

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

Can 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 should 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.

<table>
<thead>
<tr>
<th>Term:</th>
<th>Five years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortizable?</td>
<td>Yes</td>
</tr>
<tr>
<td>Prepayable?</td>
<td>No</td>
</tr>
<tr>
<td>Initial par amount:</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Coupon:</td>
<td>5%</td>
</tr>
<tr>
<td>Annual payments:</td>
<td>$230,975</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning balance</th>
<th>Payments</th>
<th>Interest</th>
<th>Principal</th>
<th>Ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$230,975</td>
<td>$50,000</td>
<td>$180,975</td>
<td>$819,025</td>
</tr>
<tr>
<td>2</td>
<td>819,025</td>
<td>230,975</td>
<td>40,951</td>
<td>190,024</td>
<td>629,001</td>
</tr>
<tr>
<td>3</td>
<td>629,001</td>
<td>230,975</td>
<td>31,450</td>
<td>199,525</td>
<td>429,476</td>
</tr>
<tr>
<td>4</td>
<td>429,476</td>
<td>230,975</td>
<td>21,474</td>
<td>209,501</td>
<td>219,975</td>
</tr>
<tr>
<td>5</td>
<td>219,975</td>
<td>230,975</td>
<td>11,000</td>
<td>219,975</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$1,154,875</td>
<td>$154,875</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flows</th>
<th>Expected credit losses</th>
<th>Present value of expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$230,975</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>3</td>
<td>161,682</td>
<td>69,293</td>
<td>59,436</td>
</tr>
<tr>
<td>4</td>
<td>161,682</td>
<td>69,293</td>
<td>55,047</td>
</tr>
<tr>
<td>5</td>
<td>161,681</td>
<td>69,293</td>
<td>50,981</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$165,464</td>
</tr>
</tbody>
</table>

ABC records the following journal entry at the date of acquisition.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>819,025</td>
</tr>
<tr>
<td>Cash</td>
<td>600,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>165,464</td>
</tr>
<tr>
<td>Loans – non-credit discount</td>
<td>53,561</td>
</tr>
</tbody>
</table>

*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.
### 12. Purchased financial assets with credit deterioration

#### 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...
Credit impairment

12. Purchased financial assets with credit deterioration

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:

\[
\text{Amortized cost basis} = \text{Purchase price} + \text{Day 1 allowance for credit losses} + \text{Subsequent adjustments} - \text{e.g. accretion, amortization}
\]

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.
## Credit impairment

### 12. Purchased financial assets with credit deterioration

<table>
<thead>
<tr>
<th>Year</th>
<th>Amort. cost beg. bal.</th>
<th>Cash pmts rec’d</th>
<th>Interest income</th>
<th>Interest rec’d</th>
<th>Principal rec’d</th>
<th>Writeoffs</th>
<th>Amort. cost end. bal.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$765,4641</td>
<td>$230,975</td>
<td>$61,037</td>
<td>$40,951</td>
<td>$190,024</td>
<td>$0</td>
<td>$595,526</td>
</tr>
<tr>
<td>3</td>
<td>595,526</td>
<td>161,682</td>
<td>47,486</td>
<td>22,015</td>
<td>139,667</td>
<td>69,293</td>
<td>412,037</td>
</tr>
<tr>
<td>4</td>
<td>412,037</td>
<td>161,682</td>
<td>32,855</td>
<td>15,031</td>
<td>146,651</td>
<td>69,293</td>
<td>213,917</td>
</tr>
<tr>
<td>5</td>
<td>213,917</td>
<td>161,681</td>
<td>17,057</td>
<td>7,699</td>
<td>153,982</td>
<td>69,293</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$716,020</td>
<td>$158,435</td>
<td>$85,696</td>
<td>$630,324</td>
<td>$207,879</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans – accrued interest1</td>
<td>31,450</td>
</tr>
<tr>
<td>Loans – non-credit discount2</td>
<td>16,036</td>
</tr>
<tr>
<td>Interest income</td>
<td>47,486</td>
</tr>
<tr>
<td><strong>To record interest income at EIR.</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>161,682</td>
</tr>
<tr>
<td>Loans</td>
<td>139,667</td>
</tr>
<tr>
<td>Loans – accrued interest</td>
<td>22,015</td>
</tr>
<tr>
<td><strong>To record receipt of cash (principal and interest) at 70% of contractual amounts due.</strong></td>
<td></td>
</tr>
<tr>
<td>Credit loss expense3</td>
<td>14,246</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>14,246</td>
</tr>
<tr>
<td><strong>To record change in present value of expected credit losses due to passage of time.</strong></td>
<td></td>
</tr>
</tbody>
</table>

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12. Purchased financial assets with credit deterioration

| 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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning balance</th>
<th>Change in present value due to passage of time</th>
<th>Writeoffs</th>
<th>Ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$165,464</td>
<td>$13,194</td>
<td>$0</td>
<td>$178,658</td>
</tr>
<tr>
<td>3</td>
<td>178,658</td>
<td>14,246</td>
<td>69,293</td>
<td>123,611</td>
</tr>
<tr>
<td>4</td>
<td>123,611</td>
<td>9,857</td>
<td>69,293</td>
<td>64,175</td>
</tr>
<tr>
<td>5</td>
<td>$ 64,175</td>
<td>$ 5,118</td>
<td>$69,293</td>
<td>0</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amort. cost beg. bal.</th>
<th>Cash pmts rec’d</th>
<th>Interest income</th>
<th>Interest rec’d</th>
<th>Principal rec’d</th>
<th>Writeoffs</th>
<th>Amort. cost end. bal.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$788,700</td>
<td>$230,975</td>
<td>$52,396</td>
<td>$40,951</td>
<td>$10,404</td>
<td>0</td>
<td>$610,121</td>
</tr>
<tr>
<td>3</td>
<td>610,121</td>
<td>161,682</td>
<td>22,015</td>
<td>139,667</td>
<td>69,293</td>
<td>419,679</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>419,679</td>
<td>161,682</td>
<td>15,031</td>
<td>146,651</td>
<td>69,293</td>
<td>216,585</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>216,585</td>
<td>161,681</td>
<td>14,389</td>
<td>153,982</td>
<td>69,293</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>$716,020</strong></td>
<td><strong>$135,199</strong></td>
<td><strong>$85,696</strong></td>
<td><strong>$630,324</strong></td>
<td><strong>$207,879</strong></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans – accrued interest¹</td>
<td>31,450</td>
</tr>
<tr>
<td>Loans – non-credit discount²</td>
<td>9,083</td>
</tr>
<tr>
<td>Interest income</td>
<td>40,533</td>
</tr>
</tbody>
</table>

*To record interest income at EIR.*
### Credit impairment

12. Purchased financial assets with credit deterioration

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>161,682</td>
</tr>
<tr>
<td>Loans</td>
<td>139,667</td>
</tr>
<tr>
<td>Loan – accrued interest</td>
<td>22,015</td>
</tr>
</tbody>
</table>

*To record receipt of cash (principal and interest) at 70% of contractual amounts due.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>9,436</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>9,436</td>
</tr>
</tbody>
</table>

*To record credit losses for accrued interest not expected to be collected.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>69,293</td>
</tr>
<tr>
<td>Loans</td>
<td>59,857</td>
</tr>
<tr>
<td>Loans – accrued interest</td>
<td>9,436</td>
</tr>
</tbody>
</table>

*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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning balance</th>
<th>Credit loss expense</th>
<th>Writeoffs of principal and interest</th>
<th>Ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$188,700</td>
<td>$0</td>
<td>$0</td>
<td>$188,700</td>
</tr>
<tr>
<td>3</td>
<td>188,700</td>
<td>9,436</td>
<td>69,293</td>
<td>128,843</td>
</tr>
<tr>
<td>4</td>
<td>128,843</td>
<td>6,443</td>
<td>69,293</td>
<td>65,993</td>
</tr>
<tr>
<td>5</td>
<td>65,993</td>
<td>3,300</td>
<td>69,293</td>
<td>0</td>
</tr>
</tbody>
</table>

**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
Is an entity required to 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.
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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
<tr>
<td>No specific guidance for accounting for writeoffs.</td>
<td>Writeoffs are determined at the individual asset level.</td>
</tr>
<tr>
<td>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]</td>
<td>Modification to an individual PCD asset is assessed to determine if it is a TDR.</td>
</tr>
</tbody>
</table>

### 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
Can 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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
</tbody>
</table>

Question 12.5.20#

Can 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 an entity does not evaluate any existing assets to determine whether they meet the PCD definition. Rather, 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]

**Current US GAAP**
- PCI asset previously accounted for under Subtopic 310-30
- Asset previously accounted for under Subtopic 310-30 by analogy
- Other purchased asset

**At adoption**
- PCD asset at the adoption date
- Not PCD asset at the adoption date

### 12.6.20 Accounting for PCI assets 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 nonaccretion 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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20 – other than legacy GAAP pools maintained after adoption</th>
<th>Subtopic 326-20 – for legacy GAAP pools maintained after adoption</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the acquisition date, PCI loans are recorded at an initial carrying amount</td>
<td>Allowance recognized on adoption through a gross-up that increases the</td>
<td>Allowance recognized on adoption through a gross-up that increases the</td>
</tr>
<tr>
<td>without establishing an allowance for loan losses. [310-30-30-1]</td>
<td>amortized cost basis of the asset. [326-10-65-1(d)]</td>
<td>amortized cost basis of the asset. [326-10-65-1(d)]</td>
</tr>
<tr>
<td></td>
<td>The effect of any non-credit discount or premium is allocated to or</td>
<td>The effect of any non-credit discount or premium is recognized at</td>
</tr>
<tr>
<td></td>
<td>recognized at the individual asset level. [326-20-30-13]</td>
<td>the pool level.</td>
</tr>
<tr>
<td>After acquisition, allowance is recognized at the present value of all cash</td>
<td>Allowance for lifetime expected credit losses is recognized using either</td>
<td>Allowance for lifetime expected credit losses is generally expected</td>
</tr>
<tr>
<td>flows expected at acquisition that are not expected to be received (discounted</td>
<td>a discounted or undiscounted approach. [326-20-30-3]</td>
<td>to be recognized using a discounted approach to leverage systems</td>
</tr>
<tr>
<td>approach). [310-30-35-8]</td>
<td></td>
<td>and processes developed under legacy GAAP.</td>
</tr>
<tr>
<td>Decreases in expected cash flows recognized immediately in net income as a</td>
<td>Subsequent changes (favorable and unfavorable) in expected cash flows</td>
<td>Consistent with Subtopic 326-20 when legacy pools are not</td>
</tr>
<tr>
<td>provision for credit losses. [310-30-35-10]</td>
<td>are recognized immediately in net income by adjusting the allowance.</td>
<td>maintained.</td>
</tr>
<tr>
<td>If it is probable that there is a significant increase in cash flows</td>
<td>[326-20-35-1]</td>
<td></td>
</tr>
</tbody>
</table>
### Legacy US GAAP | Subtopic 326-20 – other than legacy GAAP pools maintained after adoption | Subtopic 326-20 – for legacy GAAP pools maintained after adoption
--- | --- | ---
remaining allowance previously established – prospectively as interest income by adjusting the accretable yield. [310-30-35-10] |  | Consistent with legacy US GAAP.
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] | 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.
No specific guidance for accounting for writeoffs. | Writeoff determined at the individual asset level. [326-20-35-8] | 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.
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 assessed to determine if it is a TDR (or reasonably expected TDR). |
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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>5,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>5,000</td>
</tr>
<tr>
<td>To record cumulative effect adjustment of estimate of expected credit losses on loans measured at amortized cost.</td>
<td></td>
</tr>
</tbody>
</table>

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.
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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans – non-credit discount</td>
<td>200</td>
</tr>
<tr>
<td>Interest income</td>
<td>200</td>
</tr>
</tbody>
</table>

To record quarterly accretion of interest income after adoption.

**Question 12.6.20**

Should an entity capture the effects of previous interest rate concessions for PCI assets when estimating expected credit losses on adoption?

**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, 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. [326-10-65-1(d)]
Question 12.6.30**
If an entity uses a method other than a discounted cash flow method, should 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 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.
13. Off-balance sheet credit exposures

Detailed contents

13.1 How the standard works

13.2 Scope
  13.2.10 Overview

13.3 Measurement
  13.3.10 Overview

Questions
  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?
  13.3.20 What is the contractual term used for estimating expected credit losses for loan commitments?

Examples
  13.3.10 Contractual term
  13.3.20 Irrevocable loan commitment
  13.3.30 Revocable loan commitment
### 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.

<table>
<thead>
<tr>
<th>Portion</th>
<th>Accounting</th>
</tr>
</thead>
</table>
| **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 due to credit risk and not due to other risks, such as risks related to breach of representations and warranties. [326-20-15-2(c), 326-20-55-81 – 55-82]

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.

---

**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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>320</td>
</tr>
<tr>
<td>Allowance for credit losses¹</td>
<td>240</td>
</tr>
<tr>
<td>Liability for off-balance sheet credit losses²</td>
<td>80</td>
</tr>
</tbody>
</table>

*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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
</tr>
<tr>
<td>Loans</td>
<td>$60,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>$(240)</td>
</tr>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Liability for off-balance sheet credit losses</td>
<td>$80</td>
</tr>
</tbody>
</table>
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.

### Account | Amount
--- | ---
**Income statement** |  
Credit loss expense | $320

| Debit | Credit |
--- | --- |
Credit loss expense¹ | 80 |
Liability for off-balance sheet credit losses² | 80 |
Allowance for credit losses³ | 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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>240</td>
</tr>
<tr>
<td>Allowance for credit losses*</td>
<td>240</td>
</tr>
</tbody>
</table>

*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.
14. Financial guarantees

Detailed contents

14.1 How the standard works

14.2 Guarantees subject to Subtopic 326-20
   14.2.10 Overview

14.3 Initial recognition and measurement
   14.3.10 Overview
   Examples
   14.3.10 Financial standby letter of credit: up-front cash premium
   14.3.20 Financial standby letter of credit: premium receivable

14.4 Subsequent measurement
   14.4.10 Overview
   14.4.20 Non-contingent aspect (stand-ready obligation)
   14.4.30 Contingent aspect

14.5 Effect of adoption of Subtopic 326-20
   14.5.10 Overview
   Example
   14.5.10 Journal entries on adoption for a financial guarantee
14.1 How the standard works

Financial 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 financial guarantee liability (non-contingent aspect) accounted for under Topic 460. Subtopic 326-20’s expected credit loss model is applied to the contingent aspect.

Guarantor initially separately recognizes both:
- Guarantee liability at fair value for non-contingent aspect
- Expected credit loss liability for the contingent aspect

Guarantor initially recognizes the greater of:
- Guarantee liability at fair value for non-contingent aspect
- Contingent liability if probable and reasonably estimable

Note:
1. Financial 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 financial guarantees in the scope of Topic 460 that are also in the scope of Subtopic 326-20.

<table>
<thead>
<tr>
<th>Initial measurement</th>
<th>Subsequent measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-contingent component</strong></td>
<td>Typically the liability is reduced through net income as the guarantor is released of its obligation. Three methods are used in practice to recognize the liability in net income:</td>
</tr>
<tr>
<td>Fair value is recognized as a liability.</td>
<td>— in full upon either expiration or settlement of the guarantee;</td>
</tr>
<tr>
<td></td>
<td>— systematic and rational amortization method; or</td>
</tr>
<tr>
<td></td>
<td>— through changes in the fair value of the guarantee.</td>
</tr>
<tr>
<td>Initial measurement</td>
<td>Subsequent measurement</td>
</tr>
<tr>
<td>---------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td><strong>Contingent component</strong></td>
<td><strong>Subsequent measurement</strong></td>
</tr>
<tr>
<td>Expected credit losses are estimated under Subtopic 326-20 and are recognized as a separate liability.</td>
<td>At each reporting date, expected credit losses are estimated and related adjustments to the liability are made through net income.</td>
</tr>
</tbody>
</table>

### 14.2 Guarantees subject to Subtopic 326-20

#### 14.2.10 Overview

Topic 460 applies to many types of guarantees, including financial guarantees, performance guarantees, indemnifications and indirect guarantees of the indebtedness of others. The guidance in Subtopic 326-20 applies to a subset of the guarantees that are in the scope of Topic 460. Only financial guarantees that create off-balance sheet credit exposure for the guarantor are in the scope of Subtopic 326-20. Examples of financial 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)]

### 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 financial 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 obligation**

A liability for the non-contingent obligation of a financial guarantee is recognized under Topic 460 at fair value at inception. The fair value of a financial 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 financial 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.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantor initially recognizes the greater of:</td>
<td>Guarantor initially separately recognizes both:</td>
</tr>
<tr>
<td>— guarantee liability at fair value for non-contingent aspect; or</td>
<td>— guarantee liability at fair value for non-contingent aspect; and</td>
</tr>
</tbody>
</table>

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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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>30,000</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>5,000</td>
</tr>
<tr>
<td>Financial guarantee liability – non-contingent</td>
<td>30,000</td>
</tr>
<tr>
<td>Liability for off-balance sheet credit losses – contingent</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>To record fair value of financial guarantee (non-contingent aspect) and associated liability for off-balance sheet credit losses (contingent aspect).</strong></td>
<td></td>
</tr>
</tbody>
</table>

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 losses for the premium receivable to be $1,000.
It records the following journal entry to account for the guarantee at inception.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium receivable</td>
<td>30,000</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>6,000</td>
</tr>
<tr>
<td>Financial guarantee liability – non-contingent</td>
<td>30,000</td>
</tr>
<tr>
<td>Liability for off-balance sheet credit losses – contingent</td>
<td>5,000</td>
</tr>
<tr>
<td>Allowance for credit losses – premium receivable</td>
<td>1,000</td>
</tr>
</tbody>
</table>

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 financial 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)

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.

Topic 460 does not prescribe accounting guidance for the non-contingent aspect of financial 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.
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 financial 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]

### 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 financial guarantee recognizes a financial 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 financial 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 financial 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.

<table>
<thead>
<tr>
<th>Legacy US GAAP scenario</th>
<th>Adjustment(s) required on adoption of Topic 326</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legacy policy is to recognize either the non-contingent or contingent component – whichever is greater</td>
<td></td>
</tr>
<tr>
<td>Contingent component recognized – i.e. contingent component is greater than non-contingent component.</td>
<td>— Contingent component is remeasured based on the guidance in Subtopic 326-20.</td>
</tr>
<tr>
<td></td>
<td>— Non-contingent component is re-established.</td>
</tr>
<tr>
<td>Non-contingent component recognized – i.e. non-contingent component is greater than contingent component.</td>
<td>— Contingent component is recognized and measured based on the guidance in Subtopic 326-20.</td>
</tr>
<tr>
<td></td>
<td>— No adjustment is required for the non-contingent component.</td>
</tr>
</tbody>
</table>
### Legacy US GAAP scenario vs. Adjustment(s) required on adoption of Topic 326

<table>
<thead>
<tr>
<th>Legacy policy was to recognize a separate, independent liability for each component</th>
<th>Adjustment(s) required on adoption of Topic 326</th>
</tr>
</thead>
</table>
| 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 financial 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 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’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.

<table>
<thead>
<tr>
<th></th>
<th>Balance recognized under legacy US GAAP</th>
<th>Balance on adoption of Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent component</td>
<td>$ 0</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Non-contingent component</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$15,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

As of January 1, 2020 (adoption of Topic 326), Guarantor records the following journal entry to recognize expected credit losses.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Liability for off-balance sheet credit losses – contingent¹</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>To record cumulative effect adjustment of estimate of expected credit losses on guarantee</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th></th>
<th>Balance recognized under legacy US GAAP</th>
<th>Balance on adoption of Subtopic 326-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent component</td>
<td>$25,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Non-contingent component</td>
<td>0¹</td>
<td>15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$25,000</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

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 reestablish the non-contingent component balance.

\[
\begin{array}{ccc}
\text{Debit} & \text{Credit} \\
\text{Retained earnings} & 20,000 \\
\text{Financial guarantee liability – non-contingent}^1 & 15,000 \\
\text{Liability for off-balance sheet credit losses – contingent}^2 & 5,000 \\
\text{To record cumulative effect adjustment of estimate of expected credit losses on guarantee and reestablish non-contingent component.} & \\
\end{array}
\]

Notes:
1. Represents the amount needed to re-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.

\[
\begin{array}{ccc}
\text{Balance recognized under legacy US GAAP} & \text{Balance on adoption of Subtopic 326-20} \\
\text{Contingent component} & $25,000 & $30,000 \\
\text{Non-contingent component} & 15,000 & 15,000 \\
\text{Total} & $40,000 & $45,000 \\
\end{array}
\]

As of January 1, 2020 (adoption of Topic 326), Guarantor records the following journal entry to recognize expected credit losses.

\[
\begin{array}{ccc}
\text{Debit} & \text{Credit} \\
\text{Retained earnings} & 5,000 \\
\text{Liability for off-balance sheet credit losses – contingent}^1 & 5,000 \\
\text{To record cumulative effect adjustment of estimate of expected credit losses on guarantee.} & \\
\end{array}
\]

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

15.2 Allocating equity method investment losses to additional investments

15.2.10 Overview

Question

15.2.10 Is an additional investment’s allowance for credit losses estimated before or after allocating equity method losses?

Example

15.2.10 Interaction of Subtopic 326-20 and Subtopic 323-10
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

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Excerpt from ASC 323-10

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> 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, or 321-10 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
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. We believe 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) and 321-10 (equity securities) to the adjusted basis of the other investments in the investee, as applicable. We believe this step includes estimating credit losses under Topic 326, as applicable.

— Apply relevant US GAAP to other investments that are outside the scope of Subtopics 310-10 (and Topic 326), 320-10 or 321-10.

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Investee operating income (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$(300)</td>
</tr>
<tr>
<td>2</td>
<td>(150)</td>
</tr>
<tr>
<td>3</td>
<td>450</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculated based on $100 principal balance</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount expected to be collected</td>
<td>Expected credit losses¹</td>
</tr>
<tr>
<td>1</td>
<td>$30</td>
<td>$70</td>
</tr>
<tr>
<td>2</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>3</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning adjusted loan basis¹</th>
<th>Investor’s share of operating income (loss) applicable to the loan²</th>
<th>Credit loss expense³</th>
<th>Ending adjusted loan basis⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100</td>
<td>$(60)</td>
<td>$10</td>
<td>$30</td>
</tr>
<tr>
<td>2</td>
<td>30</td>
<td>(30)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>0</td>
<td>90</td>
<td>30</td>
<td>60</td>
</tr>
</tbody>
</table>

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:
   - 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. [323-10-35-26(b)]

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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss¹</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Loan to Investee</td>
<td></td>
<td>60</td>
</tr>
<tr>
<td>To record equity method loss for Investee.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit loss expense²</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>To record expected credit losses on loan to Investee.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet – assets</td>
<td></td>
</tr>
<tr>
<td>Investment in Investee common stock</td>
<td>$0</td>
</tr>
<tr>
<td>Loan to Investee</td>
<td>$40</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>$(10)</td>
</tr>
<tr>
<td>Income statement</td>
<td></td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>$(10)</td>
</tr>
<tr>
<td>Income (loss) from equity method investment in Investee</td>
<td>$(60)</td>
</tr>
</tbody>
</table>

Journal entries for Year 2

At the end of Year 2, Investor records the following journal entry.
Credit impairment

15. Other investments in equity method investees

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss (^1)</td>
<td>30</td>
</tr>
<tr>
<td>Loan to Investee</td>
<td>30</td>
</tr>
<tr>
<td><strong>To record equity method loss for Investee.</strong></td>
<td></td>
</tr>
</tbody>
</table>

Note:

1. \( \$150 \) (Investee’s operating loss in Year 2) \( \times 20\% \) (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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
</tr>
<tr>
<td>Investment in Investee common stock</td>
<td>$0</td>
</tr>
<tr>
<td>Loan to Investee</td>
<td>$10</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>$(10)</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>$0</td>
</tr>
<tr>
<td>Income (loss) from equity method investment in Investee</td>
<td>$(30)</td>
</tr>
</tbody>
</table>

**Journal entries for Year 3**

At the end of Year 3, Investor records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan to Investee</td>
<td>90</td>
</tr>
<tr>
<td>Equity method income (^1)</td>
<td>90</td>
</tr>
<tr>
<td><strong>To record equity method income for Investee.</strong></td>
<td></td>
</tr>
<tr>
<td>Credit loss expense (^3)</td>
<td>30</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>30</td>
</tr>
<tr>
<td><strong>To record expected credit losses on loan to Investee.</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1. \( \$450 \) (Investee’s operating income in Year 3) \( \times 20\% \) (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 ($80 + $30 - $90) and previously recognized credit losses of ($10) = $30.

At the end of Year 3, Investor’s financial statements reflect the following amounts.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
</tr>
<tr>
<td>Investment in Investee common stock</td>
<td>$0</td>
</tr>
<tr>
<td>Loan to Investee</td>
<td>$100</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>$(40)</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>$(30)</td>
</tr>
<tr>
<td>Income (loss) from equity method investment in Investee</td>
<td>$90</td>
</tr>
</tbody>
</table>
16. Net investment in leases

Detailed contents

New item added to this chapter: **

16.1 How the standard works

16.2 Measuring impairment
  16.2.10 Overview
  Questions
  16.2.10 Why is the unguaranteed residual asset included with the lease receivable when measuring impairment of the net investment in the lease?
  16.2.20 Does the lessor consider the cash flows it expects from the underlying asset after the end of the lease term?
  16.2.30 Should a lessor consider expected gains from the subsequent disposal of leased assets when measuring its loss allowance? **

Examples
  16.2.10 Estimating the loss allowance for a pool of leases
  16.2.20 Estimating the loss allowance when a gain is expected upon disposition of leased assets **

16.3 Sale of the lease receivable
  16.3.10 Overview

16.4 Lease termination
  16.4.10 Overview
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.

For an in-depth analysis of the accounting for leases under Topic 842, see KPMG’s 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 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 underlying 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 underlying asset after the end of the lease term?

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 underlying asset following the end of the lease term should 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 underlying 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 underlying 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. The estimate of this assumed cash inflow 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
Credit impairment

16. Net investment in leases

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.
<table>
<thead>
<tr>
<th>Risk</th>
<th>Unadj. historical rates</th>
<th>GDP growth rate</th>
<th>Bulldozer model XYZ values</th>
<th>Expected rates (^4)</th>
<th>Original bal. (^7)</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability of default</td>
<td>5%</td>
<td>1%</td>
<td></td>
<td>6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss given default(^5)</td>
<td>22%</td>
<td>2%</td>
<td></td>
<td>24%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total loss rate(^1)(^6)</td>
<td>1.10%</td>
<td>1.44%</td>
<td></td>
<td>$12,000,000</td>
<td>$172,800</td>
<td></td>
</tr>
<tr>
<td><strong>Non-credit risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Original unguaranteed residual balance</td>
<td>$840,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability no default will occur</td>
<td>95%</td>
<td>-1%</td>
<td></td>
<td>94%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss if no default occurs(^4)</td>
<td>11%</td>
<td>0.5%</td>
<td></td>
<td>11.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total loss rate(^1)(^6)</td>
<td>10.45%</td>
<td>10.81%</td>
<td></td>
<td>$840,000</td>
<td>$90,804</td>
<td></td>
</tr>
</tbody>
</table>

**Pool A – Total expected losses** $263,604

Notes:
1. Probability of default $\times$ loss given default.
2. Probability no default will occur $\times$ loss if no default occurs.
3. Unadjusted historical loss rates + adjustments for current conditions and reasonable and supportable forecasts.
4. 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).
5. These rates are expressed as a percentage of the original net investment in the lease balance.
6. These rates are expressed as a percentage of the original balance of unguaranteed residual assets.
Question 16.2.30**

Should 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 should be reflected in the lessor’s loss allowance. [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]

Further, when a lessor aggregates its leases into pools for collective measurement of impairment based on similar risk characteristics, the lessor is not precluded from including leases for which it expects to realize gains from subsequent disposal with leases for which it expects to realize losses.

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% x -5%).
LR calculates its estimate of the loss allowance as follows.

<table>
<thead>
<tr>
<th>Risk</th>
<th>Unadj. historical rates</th>
<th>GDP growth rate</th>
<th>Bulldozer model XYZ values</th>
<th>Expected rates²</th>
<th>Original balance¹</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability of default</td>
<td>5%</td>
<td>1%</td>
<td>6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss given default¹</td>
<td>22%</td>
<td>2%</td>
<td>24%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total loss rate¹⁵</td>
<td>1.10%</td>
<td>1.44%</td>
<td>$12,000,000</td>
<td>$172,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-credit risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Original unguaranteed residual balance</td>
<td>$840,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability no default will occur</td>
<td>95%</td>
<td>-1%</td>
<td>94%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (gain) if no default occurs¹</td>
<td>-5%</td>
<td>0.5%</td>
<td>-4.5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total loss (gain) rate¹⁵</td>
<td>-4.75%</td>
<td>-4.23%</td>
<td>$840,000</td>
<td>$(35,532)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Pool A – Total expected losses** $137,268

Notes:
1. Probability of default × loss given default.
2. Probability that no default will occur × loss (gain) if no default occurs.
3. Unadjusted historical rates + adjustments for current conditions and reasonable and supportable forecasts.
4. 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).
5. These rates are expressed as a percentage of the original net investment in the lease balance.
6. These rates are expressed as a percentage of the original balance of unguaranteed residual assets.
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

New item added to this chapter: **

17.1 How the standard works

17.2 Scope
   17.2.10 Overview

Future developments
Reinsurance recoverables measured on a discounted basis **

Question
17.2.10 Are premiums receivable, policy loan receivables, funds withheld assets and retrospective premiums receivable in the scope of Subtopic 326-20?

17.3 Measurement of reinsurance recoverables
   17.3.10 Exposure to risks other than credit risk
   17.3.20 Collective measurement
   17.3.30 Credit enhancements
   17.3.40 Collateral maintenance provisions

Example
17.3.10 Evaluation of whether credit enhancements are freestanding or embedded for certain reinsurance arrangements
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 reinsurance recoverables:

— which risks are included in the estimate of expected credit losses;
— whether to estimate expected credit losses collectively;
— how to determine whether a credit enhancement is considered when estimating expected credit losses; and
— whether a collateral maintenance provision can support an expected credit loss of zero.
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. Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance
   5. Receivables that relate to repurchase agreements and securities lending agreements within the scope of Topic 860

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 measured at amortized cost:

— financing receivables; [326-20-15-2(a)(1)]
— an asset is a financing receivable if the balance represents a contractual right to receive money on demand or on fixed or determinable dates. For example, a mortgage loan and note receivable are financing receivables; [326-20 Glossary, 310-10-55-14]
— 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(a)(4)]

Future developments **

Reinsurance recoverables measured on a discounted basis

The FASB’s recently proposed amendments to Subtopic 326-20 would clarify that reinsurance recoverables measured on a discounted basis under Topic 944 are in the scope of Subtopic 326-20. [Proposed ASU]
Question 17.2.10
Are premiums receivable, policy loan receivables, funds withheld assets and retrospective premiums receivable in the scope of Subtopic 326-20?

Interpretive response:

**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. 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 agreements. Funds withheld assets are financial assets measured at amortized cost and therefore are in the scope of Subtopic 326-20.

**Retrospective premiums receivable**
Yes. Retrospective premiums receivable arise when a policyholder pays an initial premium and, at the end of the policy year (or longer period), the initial premium is adjusted to reflect the actual loss experience of the business.

Depending on the terms of the insurance policy, 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.

17.3 Measurement of reinsurance recoverables

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, as discussed in chapter 5. Determining whether reinsurance recoverables have similar risk characteristics requires judgment. Example 17 in Section 326-20-55 (reproduced above) provides factors to consider when making this determination. For additional discussion of collective assessments, see chapter 5.
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 are met:

- 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.

Certain reinsurance arrangements require the reinsurer to provide credit enhancements. 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. For further guidance about the evaluation of whether a credit enhancement is freestanding, see chapter 9.

---

**Example 17.3.10**

**Evaluation of whether credit enhancements are freestanding or embedded for certain reinsurance arrangements**

Life Insurer writes term life business. Life Insurer has entered into coinsurance reinsurance treaties with various reinsurers; in each, Life Insurer retains 75% of the risk and cedes 25% of the risk.

Life Insurer recognizes reinsurance recoverables related to these arrangements that reflect the amount of ceded risk. Life Insurer manages exposure to the reinsurers’ credit risk in part by obtaining a credit enhancement from the reinsurer.

The following table provides an evaluation of whether two examples of credit enhancements in different forms – trust assets and letters of credit – are considered to be freestanding contracts. However, an insurance entity would need to evaluate its individual facts and circumstances when evaluating whether a credit enhancement is considered freestanding.
### Description of the credit enhancement

The reinsurer is required to hold assets in a designated trust account for the benefit of Life Insurer based on a specified percentage (100%) of ceded reserves. The trust agreement that addresses the administration of the trust account is specifically referred to in the coinsurance reinsurance treaty.

If the assets held at the end of any reporting period are less than the specified percentage (100%) of ceded reserves, the reinsurer must transfer additional assets to the trust account within five business days to fund the shortfall.

### Is the credit enhancement entered into separate and apart from, or in conjunction with, the coinsurance reinsurance treaty?

The trust agreement is entered into in conjunction with the coinsurance reinsurance treaty. The trust agreement is issued at the same time, and is referenced in, the coinsurance reinsurance treaty.

The letter of credit is entered into separate and apart from the coinsurance reinsurance treaty. Life Insurer enters into two contractually distinct instruments with separate, unrelated counterparties.

- The coinsurance reinsurance treaty is entered into with the reinsurer.
- The letter of credit is with a separate financial institution.

Therefore, the letter of credit was entered into separate and apart from Life Insurer’s other transactions and is considered a freestanding contract.

<table>
<thead>
<tr>
<th>Trust assets</th>
<th>Letter of credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>The reinsurer is required to hold assets in a designated trust account for the benefit of Life Insurer based on a specified percentage (100%) of ceded reserves. The trust agreement that addresses the administration of the trust account is specifically referred to in the coinsurance reinsurance treaty. If the assets held at the end of any reporting period are less than the specified percentage (100%) of ceded reserves, the reinsurer must transfer additional assets to the trust account within five business days to fund the shortfall.</td>
<td>The reinsurer is required to provide Life Insurer with a letter of credit equal to a specified percentage (102%) of ceded reserves. The letter of credit is entered into separate and apart from the coinsurance reinsurance treaty. Life Insurer enters into two contractually distinct instruments with separate, unrelated counterparties. — The coinsurance reinsurance treaty is entered into with the reinsurer. — The letter of credit is with a separate financial institution. Therefore, the letter of credit was entered into separate and apart from Life Insurer’s other transactions and is considered a freestanding contract.</td>
</tr>
</tbody>
</table>
### 17. Specific considerations for insurance entities

<table>
<thead>
<tr>
<th>Is the credit enhancement legally detachable and separately exercisable?</th>
<th>Trust assets</th>
<th>Letter of credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>The trust agreement is not transferable separately from the coinsurance reinsurance treaty. The trust agreement is also not separately exercisable. If the reinsurer defaults and the trust assets are used to satisfy its obligation to Life Insurer, Life Insurer has no remaining claim against the reinsurer. Therefore, the credit enhancement is not legally detachable and separately exercisable.</td>
<td></td>
<td>N/A When an instrument is entered into separate and apart from other transactions, it is considered freestanding and this evaluation is not required.</td>
</tr>
</tbody>
</table>

| Is the credit enhancement freestanding? | No, the trust agreement is not freestanding. | Yes, the letter of credit is freestanding. |

| Consideration of credit enhancement in estimating credit losses | Should be considered in estimating expected credit losses because the credit enhancement is not a freestanding contract. See also discussion of collateral maintenance provisions in section 17.3.40. | Should not be considered in estimating expected credit losses because the credit enhancement is considered a freestanding contract. |

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### 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 arrangements 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. Subtopic 326-20 refers to these arrangements as collateral maintenance provisions. An example is a clause that requires the fair value of assets in a designated trust to equal or exceed 102% of ceded reserves. [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 amortized cost basis of the financial asset and (2) the insurance entity expects the reinsurer to continue to replenish the collateral as necessary. [326-20-35-6]
18. Specific considerations for commercial entities and trade receivables

Detailed contents

18.1 How the standard works

18.2 Topic 606 assets in the scope of Subtopic 326-20
   18.2.10 Overview

18.3 Estimating credit losses for Topic 606 assets
   18.3.10 Overview

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?
18.1 How the standard works

Topic 326 is applicable to all entities, including commercial entities, if they hold financial assets within 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 within this publication that address common activities of commercial entities:

<table>
<thead>
<tr>
<th>Type of activities</th>
<th>Relevant chapters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lending activities</td>
<td>3 - 8</td>
</tr>
<tr>
<td>Investments in HTM debt securities</td>
<td>3 - 8</td>
</tr>
<tr>
<td>Investments in AFS debt securities</td>
<td>19</td>
</tr>
<tr>
<td>Other investments in equity method investees</td>
<td>15</td>
</tr>
</tbody>
</table>

The commercial entities that are most likely to be significantly affected by Topic 326 are those that either:

— engage in lending activities, exclusive of accounts receivable arrangements;
— invest in debt securities that are classified as either HTM or AFS.

This chapter discusses the types of assets under Topic 606 that are in the scope of Subtopic 326-20. Further, it discusses some of the considerations specific to estimating credit losses for trade receivables.
18.2 Topic 606 assets in the scope of Subtopic 326-20

18.2.10 Overview

**Excerpt from ASC 606-10**

**Pending Content**

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

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’s 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]

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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.

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

<table>
<thead>
<tr>
<th>Past-Due Status</th>
<th>Amortized Cost Basis</th>
<th>Credit Loss Rate</th>
<th>Expected Credit Loss Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$5,984,698</td>
<td>0.27%</td>
<td>$16,159</td>
</tr>
<tr>
<td>1-30 days past due</td>
<td>8,272</td>
<td>7.2%</td>
<td>596</td>
</tr>
<tr>
<td>31-60 days past due</td>
<td>2,882</td>
<td>23.4%</td>
<td>674</td>
</tr>
<tr>
<td>61-90 days past due</td>
<td>842</td>
<td>52.2%</td>
<td>440</td>
</tr>
<tr>
<td>More than 90 days past</td>
<td>1,100</td>
<td>73.8%</td>
<td>812</td>
</tr>
<tr>
<td></td>
<td><strong>$5,997,794</strong></td>
<td></td>
<td><strong>$18,681</strong></td>
</tr>
</tbody>
</table>
19. Targeted changes for AFS debt securities

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

19.1 How the standard works

19.2 Scope of Subtopic 326-30
   19.2.10 Overview

   Question
   19.2.10 Why does Topic 326 include a separate model for AFS debt securities?

19.3 Determining whether a security is impaired
   19.3.10 Overview
   19.3.20 Assessing whether a credit loss exists

   Questions
   19.3.10 Can a qualitative assessment be performed to determine whether a credit loss exists?
   19.3.20 What factors cannot be considered when assessing whether a credit loss exists?

19.4 Estimating the allowance for credit losses
   19.4.10 Overview
   19.4.20 Specific considerations for variable rate securities

Future developments
Projections of interest rate environment **

Questions
   19.4.10 How does an entity determine a best estimate of credit losses?
   19.4.20 Does a decrease in expected cash flows solely due to an increase in expected prepayments result in a credit loss?
   19.4.30 What should an entity consider when determining the EIR for a variable rate debt security?

Example
   19.4.10 Impairment of AFS securities
19.5 Accounting for a credit loss

19.5.10 Overview

19.5.20 Credit losses when an entity intends to sell, or more likely than not will be required to sell, a debt security

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

19.6 Accounting for a debt security subsequent to credit impairment

19.6.10 Overview

19.6.20 Accounting subsequent to a writedown to fair value

Questions

19.6.10 Should an entity continue to accrue interest income for AFS debt securities with credit losses?

19.6.20 Does an entity have to account for both writeoffs and recoveries under Subtopic 326-30?

Example

19.6.10 Subsequent accounting for impairment of individual AFS securities

19.7 Comparison of accounting for debt securities as AFS and HTM

19.8 Purchased AFS securities with credit deterioration

19.8.10 Overview

19.8.20 Identifying purchased AFS securities with credit deterioration

19.8.30 Initially measuring purchased AFS securities with credit deterioration

19.8.40 Subsequently measuring purchased AFS securities with credit deterioration

Questions

19.8.10 Are there different concepts for assessing whether AFS and HTM debt securities qualify for PCD accounting?

19.8.20 Can an entity place a purchased AFS debt security with credit deterioration on nonaccrual status? #

Example

19.8.10 PCD AFS debt securities – initial measurement
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.

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

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.

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.
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

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Subtopic 326-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit losses recognized through a direct writedown of the amortized cost basis. [320-10-35-34E]</td>
<td>Allowance approach.</td>
</tr>
<tr>
<td>Credit losses can exceed total unrealized losses. [320-10-35-34D]</td>
<td>Fair value floor for credit losses.</td>
</tr>
<tr>
<td>No immediate reversals of previously recognized credit losses. [320-10-35-34E, 320-10-35-35]</td>
<td>Reversals of credit losses are recognized immediately.</td>
</tr>
<tr>
<td>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]</td>
<td>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.</td>
</tr>
</tbody>
</table>

### 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

**35-8** 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:

- The remaining payment terms of the security
- Prepayment speeds
- The financial condition of the issuer(s)
- Expected defaults
- 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:

- Industry analyst reports and forecasts
- Credit ratings
- 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. The FASB recently proposed amendments to the guidance in Subtopic 326-30 to permit an entity 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. [Proposed ASU]

This policy election only applies to the EIR used to discount expected cash flows when estimating credit losses. It does not affect existing guidance for determining the EIR for interest income recognition. For further discussion of the EIR, see section 4.3.

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]

Additionally, as discussed in Question 19.4.10, the FASB recently proposed amendments that would permit an entity to make an accounting policy election to apply a prepayment-adjusted EIR when discounting expected cash flows. This 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. [Proposed ASU]

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 AFS debt securities that bear the same CUSIP number.

At the end of Year 1, the debt securities have the following characteristics.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value:</td>
<td>$875,000</td>
</tr>
<tr>
<td>Par value:</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Amortized cost basis:</td>
<td>$952,000</td>
</tr>
<tr>
<td>Coupon:</td>
<td>5%</td>
</tr>
<tr>
<td>EIR at acquisition date:</td>
<td>6.8%</td>
</tr>
<tr>
<td>Maturity date:</td>
<td>End of Year 4</td>
</tr>
<tr>
<td>Principal due:</td>
<td>Only on maturity</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flows</th>
<th>Present value of future expected cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 45,000</td>
<td>$ 42,127</td>
</tr>
<tr>
<td>3</td>
<td>45,000</td>
<td>39,437</td>
</tr>
<tr>
<td>4</td>
<td>975,000</td>
<td>799,912</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>$881,476</strong></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense¹</td>
<td>70,524</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>70,524</td>
</tr>
<tr>
<td><em>To record impairment related to credit losses.</em></td>
<td></td>
</tr>
<tr>
<td>Unrealized loss on AFS debt securities (other comprehensive income)²</td>
<td>6,476</td>
</tr>
<tr>
<td>AFS debt securities – fair value adjustment</td>
<td>6,476</td>
</tr>
<tr>
<td><em>To record non-credit related losses.</em></td>
<td></td>
</tr>
</tbody>
</table>

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.
19.4.20 Specific considerations for variable rate securities

\[\text{Debit} \quad \text{Credit}\]

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense(^1)</td>
<td>57,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td></td>
<td>57,000</td>
</tr>
<tr>
<td>To record impairment related to credit losses.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The difference between the amortized cost basis ($952,000) and the fair value of the AFS debt securities ($895,000).

---

19.4.20 Specific considerations for variable rate securities

Excerpt from ASC 326-30

\[\text{Impairment in Earnings and Other Comprehensive Income}\]

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 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. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

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.
Question 19.4.30

What should an entity consider when determining the EIR for a variable rate debt security?

Interpretive response: The two 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.

Future developments**

Projections of interest rate environment

The FASB’s recently proposed amendments to the guidance in Subtopic 326-30 would allow an entity 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 would be used in determining the EIR (the discount rate) that is used to discount those cash flows. [Proposed ASU]

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>70,524</td>
</tr>
<tr>
<td>AFS debt securities – fair value adjustment</td>
<td>6,476</td>
</tr>
<tr>
<td>AFS debt securities – amortized cost</td>
<td>77,000</td>
</tr>
<tr>
<td>To write off allowance for credit losses, reverse fair value adjustment, and adjust amortized cost basis.</td>
<td></td>
</tr>
<tr>
<td>Impairment loss</td>
<td>6,476</td>
</tr>
<tr>
<td>Unrealized loss on AFS debt securities (other comprehensive income)</td>
<td>6,476</td>
</tr>
<tr>
<td>To record additional impairment loss in net income.</td>
<td></td>
</tr>
</tbody>
</table>

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 and recoveries of available-for-sale debt securities in accordance with paragraphs 326-20-35-8 through 35-9.

> Other Presentation Matters

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.

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. As with all financial assets, at no point should the allowance for credit losses be reduced below zero. [326-30-35-12]

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

Should 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 both writeoffs and recoveries under Subtopic 326-30?**

**Interpretive response:** Yes. Subtopic 326-30 requires the recognition of writeoffs and recoveries of AFS debt securities.

Writeoffs of AFS debt securities are recorded in the period in which they are deemed uncollectible. Recoveries of AFS debt securities are recorded when they are received. 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 and recoveries. [326-30-35-13, 326-20-35-8]

**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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flows</th>
<th>Present value of future expected cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>$60,000</td>
<td>$56,169</td>
</tr>
<tr>
<td>4</td>
<td>1,000,000</td>
<td>876,378</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>$932,547</strong></td>
</tr>
</tbody>
</table>

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.
Credit impairment

19. Targeted changes for AFS debt securities

<table>
<thead>
<tr>
<th>Allowance for credit losses</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>36,071</td>
<td>36,071</td>
</tr>
</tbody>
</table>

To record recovery in credit losses.

<table>
<thead>
<tr>
<th>Unrealized loss on AFS debt securities (other comprehensive income)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS debt securities – fair value adjustment</td>
<td>16,071</td>
<td>16,071</td>
</tr>
</tbody>
</table>

To record non-credit related losses.

ABC calculates the above entries as follows.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>$(70,524)</td>
<td>$(34,453)</td>
<td>$36,071</td>
</tr>
<tr>
<td>Unrealized loss (other comprehensive income)</td>
<td>(6,476)</td>
<td>(22,547)</td>
<td>16,071</td>
</tr>
</tbody>
</table>

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.
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. \[326-30-35-15\]

### 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 estimates of credit losses for debt securities.

<table>
<thead>
<tr>
<th></th>
<th>AFS</th>
<th>HTM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Intent to sell or more likely than not required to sell</strong></td>
<td><strong>No intent to sell; not more likely than not required to sell</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Unit of account</strong></td>
<td>Individual security/CUSIP.</td>
<td>Individual security/CUSIP.</td>
</tr>
<tr>
<td><strong>Is there a threshold for evaluating if credit losses exist?</strong></td>
<td>No, when the security is impaired – i.e. fair value is less than amortized cost – that impairment is recognized in net income.</td>
<td>Yes, evaluate when the security is impaired – i.e. fair value is less than amortized cost.</td>
</tr>
</tbody>
</table>
Credit impairment

19. Targeted changes for AFS debt securities

<table>
<thead>
<tr>
<th>AFS</th>
<th>HTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intent to sell or more likely than not required to sell</td>
<td>No intent to sell; not more likely than not required to sell</td>
</tr>
</tbody>
</table>

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).
- Credit loss expected to be incurred over the life of the financial asset, not constrained by the fair value of the financial asset.

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
19. Targeted changes for AFS debt securities

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 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.

<table>
<thead>
<tr>
<th>Par value:</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price:</td>
<td>$750,000</td>
</tr>
<tr>
<td>Contractual term (acquired at the end of Year 1):</td>
<td>Five years</td>
</tr>
<tr>
<td>Coupon:</td>
<td>5%</td>
</tr>
<tr>
<td>Principal due:</td>
<td>Only at maturity</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Contractual cash flows</th>
<th>Expected cash flows</th>
<th>Credit losses</th>
<th>Present value of credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 50,000</td>
<td>$ 40,000</td>
<td>$ 10,000</td>
<td>$ 9,238</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>35,000</td>
<td>15,000</td>
<td>12,802</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>35,000</td>
<td>15,000</td>
<td>11,827</td>
</tr>
<tr>
<td>5</td>
<td>1,050,000</td>
<td>900,000</td>
<td>150,000</td>
<td>109,263</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$143,130</strong></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS debt securities</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>143,130</td>
</tr>
<tr>
<td>AFS debt securities – non-credit discount</td>
<td>106,870</td>
</tr>
<tr>
<td>Cash</td>
<td>750,000</td>
</tr>
</tbody>
</table>

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). [326-30-35-16]

**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

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   Questions
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   20.3.30 Beneficial interests that are not PCD
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   20.4.10 Credit losses
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   20.4.30 Writeoffs and recoveries
20.4.40 Comparison to legacy US GAAP

**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?

**Example**

20.4.10 Subsequent measurement of PCD beneficial interests
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 when acquired.

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

<table>
<thead>
<tr>
<th>Beneficial interests classification</th>
<th>Accounting for PCD assets is applied</th>
<th>Accounting for PCD assets is not applied</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Held-to-maturity</strong></td>
<td>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 change in expected cash flows has reduced the allowance to zero, the accretable yield is adjusted on a prospective basis.</td>
<td>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 the change in expected cash flows has reduced the allowance to zero, the accretable yield is adjusted on a prospective basis.</td>
</tr>
<tr>
<td><strong>Available-for-sale</strong></td>
<td>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.</td>
<td>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.</td>
</tr>
</tbody>
</table>
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.


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.
Therefore, 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]

<table>
<thead>
<tr>
<th>Question 20.2.10</th>
<th>What does ‘high credit quality’ mean when determining whether a beneficial interest is in the scope of Subtopic 325-40?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interpretive response:</strong></td>
<td>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)]</td>
</tr>
</tbody>
</table>
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).

**Question 20.2.20**

Should a beneficial interest initially considered of high credit quality be 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.

<table>
<thead>
<tr>
<th>Assessment method</th>
<th>Application</th>
<th>KPMG commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-time assessment</td>
<td>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.</td>
<td></td>
</tr>
</tbody>
</table>

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### Credit impairment

20. Beneficial interests

<table>
<thead>
<tr>
<th>Assessment method</th>
<th>Application</th>
<th>KPMG commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assessment at acquisition and upon recognition of credit losses</strong></td>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td><strong>Continuous assessment</strong></td>
<td>Determine if a beneficial interest is in the scope of Subtopic 325-40 at the date of acquisition and reassess at each reporting date.</td>
<td>We generally believe that the continuous assessment policy is preferable.</td>
</tr>
</tbody>
</table>

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.
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’:

- 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 acquisition.

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.

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.
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 should contractual cash flows be 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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Contractual cash flows</th>
<th>Expected cash flows</th>
<th>Expected credit losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$280,000</td>
<td>$224,000</td>
<td>$56,000</td>
</tr>
<tr>
<td>2</td>
<td>300,000</td>
<td>240,000</td>
<td>60,000</td>
</tr>
<tr>
<td>3</td>
<td>260,000</td>
<td>208,000</td>
<td>52,000</td>
</tr>
<tr>
<td>4</td>
<td>180,000</td>
<td>144,000</td>
<td>36,000</td>
</tr>
<tr>
<td>5</td>
<td>65,881</td>
<td>52,705</td>
<td>13,176</td>
</tr>
<tr>
<td>Total</td>
<td>$1,085,881</td>
<td>$868,705</td>
<td>$217,176</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beneficial interests – AFS</td>
<td>1,085,881</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>700,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td></td>
<td>175,000</td>
</tr>
<tr>
<td>Beneficial interests – AFS – non-credit discount (accretable yield)</td>
<td></td>
<td>210,881</td>
</tr>
</tbody>
</table>

*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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
</tr>
<tr>
<td>Beneficial interests – AFS (amortized cost of $875,000, allowance for credit losses of $175,000)</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

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

The following table provides a summary comparison of Topic 326 and Subtopic 325-40 (as amended) to legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Topic 326 and Subtopic 325-40 (as amended)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No allowance recognized at acquisition. [325-40-30-1]</td>
<td>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.</td>
</tr>
<tr>
<td>Legacy US GAAP</td>
<td>Topic 326 and Subtopic 325-40 (as amended)</td>
</tr>
<tr>
<td>---------------</td>
<td>------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>For non-PCD beneficial interests, no allowance recognized at initial recognition, similar to legacy US GAAP.</td>
</tr>
</tbody>
</table>

### Income statement

- No impairment losses recognized in net income at initial recognition.

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.
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 4 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:

— a favorable change in expected cash flows has reduced the allowance for credit losses to zero for HTM or AFS beneficial interests; 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. [325-40-35-1, 35-4 – 35-4A]

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.

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortized cost beginning balance</th>
<th>Cash payments</th>
<th>Interest income</th>
<th>Writeoffs</th>
<th>Amortized cost ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$875,000</td>
<td>$224,000</td>
<td>$81,269</td>
<td>$56,000</td>
<td>$676,269</td>
</tr>
<tr>
<td>2</td>
<td>676,269</td>
<td>240,000</td>
<td>62,811</td>
<td>60,000</td>
<td>439,080</td>
</tr>
<tr>
<td>3</td>
<td>439,080</td>
<td>208,000</td>
<td>40,781</td>
<td>52,000</td>
<td>219,861</td>
</tr>
<tr>
<td>4</td>
<td>219,861</td>
<td>144,000</td>
<td>20,421</td>
<td>36,000</td>
<td>60,282</td>
</tr>
<tr>
<td>5</td>
<td>60,282</td>
<td>52,705</td>
<td>5,599</td>
<td>13,176</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$868,705</strong></td>
<td><strong>$210,881</strong></td>
<td><strong>$217,176</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Allowance for credit losses beginning balance</th>
<th>Change in present value due to passage of time</th>
<th>Changes in present value due to changes in expected cash flows</th>
<th>Writeoffs</th>
<th>Allowance for credit losses ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$175,000</td>
<td>$16,254</td>
<td>0</td>
<td>$56,000</td>
<td>$135,254</td>
</tr>
<tr>
<td>2</td>
<td>135,254</td>
<td>12,562</td>
<td>0</td>
<td>60,000</td>
<td>87,816</td>
</tr>
<tr>
<td>3</td>
<td>87,816</td>
<td>8,156</td>
<td>0</td>
<td>52,000</td>
<td>43,972</td>
</tr>
<tr>
<td>4</td>
<td>43,972</td>
<td>4,084</td>
<td>0</td>
<td>36,000</td>
<td>12,056</td>
</tr>
<tr>
<td>5</td>
<td>12,056</td>
<td>1,120</td>
<td>0</td>
<td>13,176</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$42,176</strong></td>
<td>0</td>
<td><strong>$217,176</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Contractual cash flows</th>
<th>Expected cash flows</th>
<th>Expected credit losses</th>
<th>Increase (decrease) in expected cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$300,000</td>
<td>$230,000</td>
<td>$70,000</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>3</td>
<td>260,000</td>
<td>200,000</td>
<td>60,000</td>
<td>(8,000)</td>
</tr>
<tr>
<td>4</td>
<td>180,000</td>
<td>140,000</td>
<td>40,000</td>
<td>(4,000)</td>
</tr>
<tr>
<td>5</td>
<td>65,881</td>
<td>50,000</td>
<td>15,881</td>
<td>(2,705)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$805,881</strong></td>
<td><strong>$620,000</strong></td>
<td><strong>$185,881</strong></td>
<td><strong>$(24,705)</strong></td>
</tr>
</tbody>
</table>

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.
Credit impairment

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20. Beneficial interests

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortized cost beginning balance¹</th>
<th>Cash payments²</th>
<th>Interest income³</th>
<th>Writeoffs⁴</th>
<th>Amortized cost ending balance⁵</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (actual)</td>
<td>$875,000</td>
<td>$224,000</td>
<td>$81,269</td>
<td>$56,000</td>
<td>$676,269</td>
</tr>
<tr>
<td>2</td>
<td>676,269</td>
<td>230,000</td>
<td>62,811</td>
<td>70,000</td>
<td>439,080</td>
</tr>
<tr>
<td>3</td>
<td>439,080</td>
<td>200,000</td>
<td>40,781</td>
<td>60,000</td>
<td>219,861</td>
</tr>
<tr>
<td>4</td>
<td>219,861</td>
<td>140,000</td>
<td>20,421</td>
<td>40,000</td>
<td>60,282</td>
</tr>
<tr>
<td>5</td>
<td>60,282</td>
<td>50,000</td>
<td>5,599</td>
<td>15,881</td>
<td>0</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Original expected cash flows</th>
<th>Current expected cash flows</th>
<th>Favorable (adverse) change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$240,000</td>
<td>$230,000</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>3</td>
<td>208,000</td>
<td>200,000</td>
<td>(8,000)</td>
</tr>
<tr>
<td>4</td>
<td>144,000</td>
<td>140,000</td>
<td>(4,000)</td>
</tr>
<tr>
<td>5</td>
<td>52,705</td>
<td>50,000</td>
<td>(2,705)</td>
</tr>
<tr>
<td>Total</td>
<td>$644,705</td>
<td>$620,000</td>
<td>$(24,705)</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Allowance for credit losses beginning balance</th>
<th>Change in present value due to passage of time</th>
<th>Changes in present value due to changes in expected cash flows</th>
<th>Writeoffs</th>
<th>Allowance for credit losses ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (actual)</td>
<td>$175,000</td>
<td>$16,254</td>
<td>$20,808</td>
<td>$56,000</td>
<td>$156,062</td>
</tr>
<tr>
<td>2</td>
<td>156,062</td>
<td>14,495</td>
<td>0</td>
<td>70,000</td>
<td>100,557</td>
</tr>
<tr>
<td>3</td>
<td>100,557</td>
<td>9,340</td>
<td>0</td>
<td>60,000</td>
<td>49,897</td>
</tr>
<tr>
<td>4</td>
<td>49,897</td>
<td>4,634</td>
<td>0</td>
<td>40,000</td>
<td>14,531</td>
</tr>
<tr>
<td>5</td>
<td>14,531</td>
<td>1,350</td>
<td>0</td>
<td>15,881</td>
<td>0</td>
</tr>
</tbody>
</table>

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 to 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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beneficial interests – AFS – non-credit discount¹</td>
<td>81,269</td>
</tr>
<tr>
<td>Interest income¹</td>
<td>81,269</td>
</tr>
<tr>
<td>To record interest income at the EIR.</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>224,000</td>
</tr>
<tr>
<td>Beneficial interests – AFS</td>
<td>224,000</td>
</tr>
<tr>
<td>To record receipt of cash during Year 1.</td>
<td></td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>56,000</td>
</tr>
<tr>
<td>Beneficial interests – AFS</td>
<td>56,000</td>
</tr>
<tr>
<td>To record writeoffs of contractual cash flows.</td>
<td></td>
</tr>
</tbody>
</table>
Credit impairment
20. Beneficial interests

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense(^2) Allowance for credit losses</td>
<td>37,062</td>
</tr>
<tr>
<td><em>To record changes in present value of estimated credit losses.</em></td>
<td></td>
</tr>
<tr>
<td>Unrealized loss on beneficial interest – AFS (other comprehensive income)(^3) Beneficial interests – AFS</td>
<td>15,372</td>
</tr>
<tr>
<td><em>To record impairment not reflected in the allowance for credit losses.</em></td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying amount beginning balance(^1)</th>
<th>Cash payments received</th>
<th>Interest income</th>
<th>Credit loss expense</th>
<th>Unrealized loss (decline in fair value)</th>
<th>Carrying amount ending balance(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (actual)</td>
<td>$700,000</td>
<td>$224,000</td>
<td>$81,269</td>
<td>$37,062</td>
<td>$15,372</td>
<td>$504,835</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
</tr>
<tr>
<td>Beneficial interests – AFS (amortized cost of $676,269, allowance for credit losses of $156,062)</td>
<td>$504,835</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income – unrealized loss on beneficial interest AFS for which an allowance for credit losses has been reported</td>
<td>$(15,372)</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>$81,269</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>$(37,062)</td>
</tr>
</tbody>
</table>
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. [326-40-45-1]

20.4.30 Writeoffs and recoveries

Topic 326 requires the recognition of writeoffs and recoveries of both HTM and AFS debt securities. This guidance also applies to beneficial interests in the scope of Topic 325-40. [326-20-35-8, 326-3035-13]

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.

20.4.40 Comparison to legacy US GAAP

The following table provides a summary comparison of Topic 326 and Subtopic 325-40 (as amended) to legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Topic 326 and Subtopic 325-40 (as amended)</th>
</tr>
</thead>
<tbody>
<tr>
<td>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. [325-40-354]</td>
<td>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 amortized cost down to the fair value floor for AFS beneficial interests, the accretable yield is adjusted on a prospective basis.</td>
</tr>
</tbody>
</table>
21. Subsequent events

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

21.1 How the standard works #

21.2 Recognition

21.2.10 Overview #

Questions

21.2.10 Should an entity adjust its estimate of credit losses for information received after the reporting date but before the financial statements are issued? #

21.2.20 Is an entity required to incorporate economic data available through the reporting date in its estimate of credit losses?

21.2.30 Is an entity required to incorporate economic data available after the reporting date (but before the financial statements are issued) in its estimate of credit losses? **
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

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]

### ASC 855-10

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 following adoption of the new credit losses standard. 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#

Should 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:

- 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.

---

1. If an entity concludes that 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
   - 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...
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**

Is an entity required to 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**

Is an entity required to 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]

<table>
<thead>
<tr>
<th>Timing of announcement</th>
<th>Information indicates a weakness or deficiency in the entity’s estimation process</th>
<th>Information does not indicate a weakness or deficiency in the entity’s estimation process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before the entity has completed its estimation process</td>
<td>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).</td>
<td>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.</td>
</tr>
<tr>
<td>After the entity has completed its estimation process</td>
<td>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).</td>
<td>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.</td>
</tr>
</tbody>
</table>
22. Income taxes

Detailed contents

22.1  How the standard works

22.2  Deferred income taxes

22.2.10  Overview
22.2.20  AFS securities
22.2.30  PCD financial assets

Questions

22.2.10  Will the increase in deferred tax assets on transition to Topic 326 require additional analysis of the potential need for a valuation allowance?
22.2.20  Will the requirement to estimate expected credit losses on a collective basis have an effect on the timing of federal income tax deductions?
22.2.30  Will the allowance for credit losses established for an AFS debt security result in a deferred tax asset?
22.2.40  Can temporary differences arise after the acquisition date of a PCD asset due to changes in the allowance for credit losses?
22.2.50  Can temporary differences arise after the acquisition date of a PCD asset due to the timing and amount of income recognized for book and tax purposes?
22.2.60  Do all PCD assets have a ‘market discount’ that subjects them to the tax treatment for assets acquired at a discount?

Examples

22.2.10  Tax implications arising from recognizing credit losses on AFS debt securities
22.2.20  Book-tax differences for PCD assets

Comparison of book and tax

Book vs. tax basis on acquisition date
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.

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), similar to legacy US GAAP, there will be no net book-tax basis difference on the acquisition date. However, 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 the 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:

— 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. [740-10-30-18]

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.

However, if the adoption of Topic 326 increases the deferred tax assets, an entity’s taxable income in carryback years and deferred tax liabilities may no longer be sufficient to support realization of the entire asset. In that case, the entity needs to expand its valuation allowance analysis to consider other sources of taxable income, such as projections of future taxable income and tax-planning strategies.

---

Question 22.2.20

**Will the requirement to estimate expected credit losses on a collective basis have an effect on 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 where 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 will result in an allowance for expected credit losses that is similar to the specific reserves under legacy US GAAP, which under certain circumstances can often be used to support a 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 can create 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.

The timing of federal income tax deductions for OTTI recorded under legacy US GAAP (Subtopic 320-10) generally has been based on guidance in a 2014 IRS field directive. Under that directive, a taxpayer 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 is determined to be a current deduction for federal income tax purposes, there would be no deferred tax asset. Any subsequent decrease in the allowance for credit losses would then give rise to current taxable income.

**Example 22.2.10**

**Tax implications arising from recognizing credit losses on AFS debt securities**

In Year 1, ABC Corp. 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 ABC determines that the entire decline is due to credit risk and estimates credit losses of $100.

In Year 2, the fair value increases to $940 and ABC estimates that the credit losses have decreased to $60. ABC therefore reverses credit losses of $40 through the allowance account.

The security is redeemed for $940 in Year 3.
The following table summarizes the fact pattern.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortized cost</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Fair value</td>
<td>900</td>
<td>940</td>
<td>940</td>
</tr>
<tr>
<td>Credit loss</td>
<td>100</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

ABC’s tax rate is 30%.

This example assumes that ABC 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, ABC 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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>100</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>100</td>
</tr>
<tr>
<td>To record allowance for credit losses.</td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset¹</td>
<td>30</td>
</tr>
<tr>
<td>Deferred income tax benefit</td>
<td>30</td>
</tr>
<tr>
<td>To record tax effect of allowance for which current tax deduction is not recognized.</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The allowance for credit losses of $100 × 30% tax rate.

In Year 2, ABC reduces the deferred tax asset by $12 to $18 and records a deferred tax expense of $12 as a result of the reduction in the allowance for credit losses for book purposes.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>40</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>40</td>
</tr>
<tr>
<td>To record reduction in allowance for credit losses.</td>
<td></td>
</tr>
<tr>
<td>Deferred income tax expense¹</td>
<td>12</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>12</td>
</tr>
<tr>
<td>To record tax effect of reduction in allowance.</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The reduction in the allowance for credit losses of $40 × 30% tax rate.

When the security is redeemed for $940 in Year 3, ABC takes a current tax deduction of $60 and records a current tax benefit of $18. It also reduces its
deferred tax asset by $18 and records a deferred tax expense of $18 (resulting in no net tax expense).

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>940</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>60</td>
</tr>
<tr>
<td>AFS debt security</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>To record redemption of security and writeoff of allowance.</td>
</tr>
<tr>
<td>Current tax receivable¹</td>
<td>18</td>
</tr>
<tr>
<td>Current income tax expense</td>
<td>18</td>
</tr>
<tr>
<td>Deferred income tax expense²</td>
<td>18</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>To record tax effect of loss on redemption and writeoff of allowance.</td>
</tr>
</tbody>
</table>

Notes:
1. The redemption loss of $60 × the 30% tax rate.
2. Written off allowance for credit losses of $60 × 30% tax rate.

Scenario 2: The allowance for credit losses is a deduction for federal income tax purposes

In Year 1, ABC 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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>100</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>100</td>
</tr>
<tr>
<td>To record loss allowance.</td>
<td></td>
</tr>
<tr>
<td>Current tax receivable¹</td>
<td>30</td>
</tr>
<tr>
<td>Current income tax benefit¹</td>
<td>30</td>
</tr>
<tr>
<td>To record tax effect of allowance for which current tax deduction is recognized.</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The allowance for credit losses of $100 × 30% tax rate.

In Year 2, ABC recognizes current taxable income of $40 and current tax expense of $12 as a result of the reduction in the allowance for credit losses.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>40</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>40</td>
</tr>
<tr>
<td>To record reduction in allowance for credit losses.</td>
<td></td>
</tr>
</tbody>
</table>
Credit impairment

Debit | Credit
--- | ---
Current income tax expense | 12
Current tax payable | 12

*To record tax effect of reduction in allowance.*

Note:
1. Reduction in the allowance for credit losses of $40 × 30% tax rate.

In Year 3, ABC 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 $940.

Debit | Credit
--- | ---
Cash | 940
Allowance for credit losses | 60
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, 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 equals the federal tax basis at acquisition, offsetting temporary differences exist at acquisition in the form of 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 for tax purposes (tax acquisition 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 on acquisition date

<table>
<thead>
<tr>
<th></th>
<th>Book basis</th>
<th>Tax basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>PCD asset</td>
<td>Face/contractual par amount</td>
<td>Purchase price</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>Day 1 allowance for credit losses</td>
<td>No tax basis</td>
</tr>
<tr>
<td>Non-credit premium or discount</td>
<td>Day 1 non-credit premium or discount</td>
<td>No tax basis</td>
</tr>
</tbody>
</table>

Question 22.2.40
Can temporary differences arise after the acquisition date of a PCD asset due to changes in the allowance for credit losses?

Interpretive response: Yes, temporary differences can arise 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 arise 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 arise 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 acquisition discount) is 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 face/contractual par amount of the asset and the amounts actually collected is generally recognized as a tax deduction.
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 taking the tax deduction for uncollected amounts.

**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.

ABC Corp. 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.

<table>
<thead>
<tr>
<th>Term:</th>
<th>Five years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortizable?</td>
<td>Yes</td>
</tr>
<tr>
<td>Prepayable?</td>
<td>No</td>
</tr>
<tr>
<td>Initial par amount:</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Coupon:</td>
<td>5%</td>
</tr>
<tr>
<td>Annual payments (contractual):</td>
<td>$230,975</td>
</tr>
</tbody>
</table>

After using a discounted cash flow method to determine the Day 1 allowance for credit losses, ABC records the following journal entry on the acquisition date.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>819,025</td>
</tr>
<tr>
<td>Cash</td>
<td>600,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>165,464</td>
</tr>
<tr>
<td>Loans – non-credit discount</td>
<td>53,561</td>
</tr>
</tbody>
</table>

*To record acquisition of PCD loans, estimate of expected credit losses and non-credit discount.*

ABC 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.

<table>
<thead>
<tr>
<th>Item</th>
<th>Financial statement basis</th>
<th>Tax basis</th>
<th>Temporary deductible/(taxable) difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>$819,025</td>
<td>$600,000</td>
<td>$(219,025)</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>(165,464)</td>
<td>0</td>
<td>165,464</td>
</tr>
<tr>
<td>Loans – non-credit discount</td>
<td>(53,561)</td>
<td>0</td>
<td>53,561</td>
</tr>
<tr>
<td>Total</td>
<td>$600,000</td>
<td>$600,000</td>
<td>0</td>
</tr>
</tbody>
</table>

The following summarizes the activity for financial statement purposes in Years 2-5.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash payments received (actual)</th>
<th>Ending loan balance</th>
<th>Ending allowance for credit losses</th>
<th>Ending non-credit discount balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$230,975</td>
<td>$629,001</td>
<td>$178,658</td>
<td>$33,476</td>
</tr>
<tr>
<td>3</td>
<td>161,682</td>
<td>429,476</td>
<td>123,611</td>
<td>17,440</td>
</tr>
<tr>
<td>4</td>
<td>161,682</td>
<td>219,975</td>
<td>64,175</td>
<td>6,059</td>
</tr>
<tr>
<td>5</td>
<td>161,681</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$716,020</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. After the effect of the cash payments received and amounts written-off, equals the ending loan balance based on contractual amortization.

The following summarizes the activity for tax purposes in Years 2-5.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash payments received (actual)</th>
<th>Ending tax basis – loan balance</th>
<th>Tax deduction for writeoff</th>
<th>Taxable income recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$230,975</td>
<td>$487,932</td>
<td>$0</td>
<td>$118,908</td>
</tr>
<tr>
<td>3</td>
<td>161,682</td>
<td>422,949</td>
<td>0</td>
<td>96,699</td>
</tr>
<tr>
<td>4</td>
<td>161,682</td>
<td>334,348</td>
<td>0</td>
<td>73,081</td>
</tr>
<tr>
<td>5</td>
<td>161,681</td>
<td>0</td>
<td>217,007</td>
<td>44,339</td>
</tr>
<tr>
<td>Total</td>
<td>$716,020</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. The ending tax basis loan balance includes the application of borrower payments, and accrued interest income.
2. At the maturity date, the difference between the cumulative amounts recognized for tax purposes – i.e. the initial tax basis of the loans plus the accrued interest – and the cumulative amounts collected from the borrowers is recorded as a tax deduction.
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 acquisition discount).
The following summarizes the amortization of the acquisition discount for tax purposes in Years 2-5.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning acquisition discount</th>
<th>Recognition of acquisition discount as income</th>
<th>Ending acquisition discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$219,025</td>
<td>$ 77,957</td>
<td>$141,068</td>
</tr>
<tr>
<td>3</td>
<td>141,068</td>
<td>65,249</td>
<td>75,819</td>
</tr>
<tr>
<td>4</td>
<td>75,819</td>
<td>48,614</td>
<td>27,205</td>
</tr>
<tr>
<td>5</td>
<td>27,205</td>
<td>27,205</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$219,025</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. The Day 1 acquisition discount for tax purposes represents the difference between the purchase price and the outstanding principal balance on the acquisition date.
2. Income recognition is based on the loans’ contractual amortization.

The following summarizes the cumulative income recognized for book and tax purposes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial statement basis</th>
<th>Tax basis</th>
<th>Change in temporary differences</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Interest income^1</td>
<td>Credit loss expense^2</td>
<td>Interest income^3</td>
</tr>
<tr>
<td>Year 2</td>
<td>$ 61,037</td>
<td>$13,194</td>
<td>$118,908</td>
</tr>
<tr>
<td>Year 3</td>
<td>47,486</td>
<td>14,246</td>
<td>96,699</td>
</tr>
<tr>
<td>Year 4</td>
<td>32,855</td>
<td>9,857</td>
<td>73,081</td>
</tr>
<tr>
<td>Year 5</td>
<td>17,057</td>
<td>5,118</td>
<td>44,339</td>
</tr>
<tr>
<td><strong>Cumulative</strong></td>
<td><strong>$158,435</strong></td>
<td><strong>$42,415</strong></td>
<td><strong>$333,027</strong></td>
</tr>
</tbody>
</table>

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 acquisition discount).
4. At the maturity date, the difference between the cumulative amounts recognized for tax purposes – i.e. the initial tax basis of the loans plus the accrued interest – and the cumulative amounts collected from the borrower is recorded as a tax deduction.
The following summarizes the temporary differences in Years 2-5.

<table>
<thead>
<tr>
<th>Loans</th>
<th>Financial statement basis</th>
<th>Tax basis</th>
<th>Temporary deductible/(taxable) difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR/(CR)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition date (Year 1)</td>
<td>$819,025</td>
<td>$600,000</td>
<td>$(219,025)</td>
</tr>
<tr>
<td>Year 2</td>
<td>629,001</td>
<td>487,932</td>
<td>(141,069)</td>
</tr>
<tr>
<td>Year 3</td>
<td>429,476</td>
<td>422,949</td>
<td>(6,527)</td>
</tr>
<tr>
<td>Year 4</td>
<td>219,975</td>
<td>334,348</td>
<td>114,373</td>
</tr>
<tr>
<td>Year 5</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Allowance for credit losses</th>
<th>Financial statement basis</th>
<th>Tax basis</th>
<th>Temporary deductible/(taxable) difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR/(CR)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition date (Year 1)</td>
<td>$(165,464)</td>
<td>0</td>
<td>$165,464</td>
</tr>
<tr>
<td>Year 2</td>
<td>(178,658)</td>
<td>0</td>
<td>178,658</td>
</tr>
<tr>
<td>Year 3</td>
<td>(123,611)</td>
<td>0</td>
<td>123,611</td>
</tr>
<tr>
<td>Year 4</td>
<td>(64,175)</td>
<td>0</td>
<td>64,175</td>
</tr>
<tr>
<td>Year 5</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-credit discount</th>
<th>Financial statement basis</th>
<th>Tax basis</th>
<th>Temporary deductible/(taxable) difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR/(CR)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition date (Year 1)</td>
<td>$(53,561)</td>
<td>0</td>
<td>$53,561</td>
</tr>
<tr>
<td>Year 2</td>
<td>(33,476)</td>
<td>0</td>
<td>33,476</td>
</tr>
<tr>
<td>Year 3</td>
<td>(17,440)</td>
<td>0</td>
<td>17,440</td>
</tr>
<tr>
<td>Year 4</td>
<td>(6,059)</td>
<td>0</td>
<td>6,059</td>
</tr>
<tr>
<td>Year 5</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total temporary differences related to PCD loans</th>
<th>Total financial statement basis</th>
<th>Total tax basis</th>
<th>Total temporary deductible/(taxable) difference</th>
<th>Change in temporary differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition date (Year 1)</td>
<td>$600,000</td>
<td>$600,000</td>
<td>$</td>
<td>$ 0</td>
</tr>
<tr>
<td>Year 2</td>
<td>416,867</td>
<td>487,932</td>
<td>71,065</td>
<td>71,065</td>
</tr>
<tr>
<td>Year 3</td>
<td>288,425</td>
<td>422,949</td>
<td>134,524</td>
<td>63,459</td>
</tr>
<tr>
<td>Year 4</td>
<td>149,741</td>
<td>334,348</td>
<td>184,607</td>
<td>50,083</td>
</tr>
<tr>
<td>Year 5</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>(184,607)</td>
</tr>
</tbody>
</table>
**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 PCD assets. 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 entire acquisition discount is taken into taxable income with a subsequent tax deduction for the difference between the face value of the asset and the amounts actually collected. 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, when a financial asset is acquired at a premium, the entire amount of premium results in a federal income tax deduction. An entity can elect to amortize the entire premium as a tax deduction over the life of the financial asset or it may deduct the entire premium upon maturity, sale or final settlement of the financial asset. 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.
23. Presentation

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

23.1 How the standard works #

23.2 Financial instruments in the scope of Subtopic 326-20
   23.2.10 Overview
   
   Future developments
   Accrued interest receivable **

   Questions
   23.2.10 Is an entity required to separately present the allowance for credit losses for financial assets with different measurement attributes?

23.3 AFS debt securities
   23.3.10 Overview
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 FASB recently proposed amendments to the guidance in Subtopic 326-20 that would permit an entity to elect to present accrued interest receivable and the related allowance for credit losses separately from the associated financial assets or net investments in leases.
23.2 Financial instruments in the scope of Subtopic 326-20

23.2.10 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 …

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.
**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]

**Future developments**

**Accrued interest receivable**

Stakeholders raised concerns about issues associated with accrued interest, including the operational burden and cost of tracking accrued interest at the individual loan level. Additionally, some entities have current nonaccrual practices of reversing accrued interest receivable through interest income, and stakeholders were concerned about changing these practices. As a result, the FASB’s recently proposed amendments to the guidance in Subtopic 326-20 would provide relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances. [Proposed ASU]

The proposed amendments would permit an entity to elect 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 entity may present the net amount: [Proposed ASU]

— 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 also section 4.2.10 for future developments related to measuring the allowance for credit losses for accrued interest receivables.

**Income statement presentation**

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.
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.

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. For collateral-dependent financial assets see chapter 10. [326-20-35-4 – 35-6, 326-20-45-4]

Comparison to legacy US GAAP
Presentation of expected credit losses

The following table provides a summary comparison of the presentation requirements under Topic 326 and legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Topic 326</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
</tr>
<tr>
<td>No specific presentation required; there is diversity in practice regarding whether and how an allowance for loan losses is presented on the balance sheet.</td>
<td>The allowance for credit losses for financial assets measured at amortized cost is separately presented as a deduction from the assets’ amortized cost basis. See the future developments in this section related to the presentation of accrued interest receivable and the related allowance for credit losses.</td>
</tr>
<tr>
<td>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]</td>
<td>Similar presentation to legacy US GAAP.</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Loans and receivables</strong></td>
<td><strong>Loans and receivables</strong></td>
</tr>
<tr>
<td>Credit losses are reported as provision for loan losses (bad debt expense) in the income statement. 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]</td>
<td>Credit losses are presented as 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.</td>
</tr>
<tr>
<td><strong>HTM debt securities</strong></td>
<td><strong>HTM debt securities</strong></td>
</tr>
<tr>
<td>Credit losses are presented in the income statement as impairment losses.</td>
<td>Credit losses are presented as credit loss expense.</td>
</tr>
</tbody>
</table>
Question 23.2.10

Is an entity required to 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.

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.

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.

### Comparison to legacy US GAAP

#### Presentation of expected credit losses

The following table provides a summary comparison of the presentation requirements under Topic 326 and legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>Topic 326</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
</tr>
<tr>
<td>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]</td>
<td>The amortized cost and allowance for credit losses for AFS debt securities are parenthetically presented. [326-30-45-1]</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
</tr>
<tr>
<td>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]</td>
<td>Credit losses for AFS debt securities are presented as credit loss expense. 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]</td>
</tr>
</tbody>
</table>
24.  Disclosures

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

24.1  How the standard works

24.2  General disclosure considerations

24.2.10  Overview
24.2.20  Pre-adoption disclosures

Question
24.2.10  What is an SEC registrant required to disclose related to the potential effects of Topic 326 before adoption?

24.3  Financial instruments measured at amortized cost (Subtopic 326-20)

24.3.10  Overview
24.3.20  Credit quality information
24.3.30  Allowance for credit losses
24.3.40  Roll-forward of the allowance for credit losses
24.3.50  Past-due status
24.3.60  Nonaccrual status
24.3.70  PCD financial assets
24.3.80  Collateral-dependent financial assets
24.3.90  Off-balance sheet credit exposures

Future developments
Accrued interest receivable **

Questions
24.3.10  Are both public and nonpublic business entities required to provide credit quality disclosures by origination year (vintage year)?
24.3.20  Is a PBE required to disclose gross writeoffs and recoveries by vintage year? **

Examples
24.3.10  Disclosing credit quality of HTM debt securities
24.3.20  Disclosing past-due status of HTM debt securities

24.4  AFS debt securities (Subtopic 326-30)

24.4.10  Overview
24.4.20 AFS debt securities in unrealized loss positions without an allowance for credit losses
24.4.30 Allowance for credit losses
24.4.40 Roll-forward of the allowance for credit losses
24.4.50 Purchased financial assets with credit deterioration

**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?
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.
24.2.20 Pre-adoption disclosures

Excerpt from ASC 250-10


Facts: An accounting standard has been issued 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. 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.

MD&A requirements 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 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)


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.

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

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.

Entities need to exercise judgment when determining the nature, extent and location of the SAB 74 disclosures. The SEC staff believes recently issued accounting standards may constitute material matters, and therefore disclosure in the financial statements should be considered if 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. MD&A may contain cross references to these disclosures that appear in the notes to the financial statements. [250-10-S99-5 – S99-6]

— If the change in accounting is deemed by the entity to be pervasive or material to the overall financial statements, we believe that may be an indicator that the SAB 74 disclosure is required to be placed in the notes to the financial statements.
If the entity expects the adoption of Topic 326 to have a significant, but not pervasive, effect on its financial statements, we believe there is more flexibility in the location of the SAB 74 disclosures.

An auditor’s responsibility for SAB 74 disclosures depends on where the information is disclosed. The auditor’s responsibility over information disclosed in MD&A is governed by AS 2710, Other Information in Documents Containing Audited Financial Statements, which requires the auditor to read the information in MD&A and consider whether it (or the manner in which it is presented) is materially inconsistent with information (or the manner in which it is presented) that appears in the audited financial statements. In addition, certain procedures are required under AS 2710 if the auditor believes that there is a material misstatement of fact in the other information that is not a material inconsistency.

Disclosures about the adoption of new accounting standards that are included in the notes to the audited financial statements are subject to audit procedures, because it is not permissible to label these disclosures as ‘unaudited’.

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

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.

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.

<table>
<thead>
<tr>
<th>Financing receivables and net investment in leases</th>
<th>HTM debt securities</th>
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</thead>
<tbody>
<tr>
<td>Information provided by either portfolio segment or class of financing receivable, depending on the requirements for the specific disclosure topic. [326-20-50-3]</td>
<td>Information provided by major security type. [326-20-50-3]</td>
</tr>
<tr>
<td>A portfolio segment is the level at which an entity develops and documents a</td>
<td>Major security types are based on the nature and risks of the security. In</td>
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<tr>
<td>Financing receivables and net investment in leases</td>
<td>HTM debt securities</td>
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<td>systematic methodology to determine its allowance for credit losses.</td>
<td>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:</td>
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<td>Examples of portfolio segments include:</td>
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<td>— type of financing receivable;</td>
<td>— shared activity or business sector;</td>
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<tr>
<td>— industry sector of the borrower;</td>
<td>— vintage;</td>
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<tr>
<td>— risk rating.</td>
<td>— geographic concentration;</td>
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<td>— credit quality;</td>
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<td></td>
<td>— economic characteristic.</td>
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</table>

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. It is generally a disaggregation of a portfolio segment and may include consideration of factors such as:

| — categorization of borrowers – e.g. commercial or consumer borrowers; | — credit quality; |
| — type of financing receivable – e.g. mortgage, credit card, or interest-only loans or finance leases; | — economic characteristic. |
| — 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. 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.
Stakeholders raised concerns about issues associated with accrued interest, including the operational burden and cost of tracking accrued interest at the individual loan level. Additionally, some entities have policies to reverse accrued interest receivable against interest income when they place delinquent assets on nonaccrual, and stakeholders were concerned about changing this practice. As a result, the FASB’s recently proposed amendments to the guidance in Subtopic 326-20 would provide relief for the measurement, presentation and disclosure requirements for accrued interest receivable balances. [Proposed ASU]

The proposed amendments would permit an entity to elect a practical expedient to exclude the applicable accrued interest receivable that is included in the amortized cost from the disclosure requirements in paragraphs 326-20-50-4 to 50-22. If an entity elects the practical expedient, it would provide the total amount of accrued interest excluded from the disclosed amortized cost basis. [Proposed ASU]

For example, when a PBE presents the amortized cost basis within each credit quality indicator by year of origination (see section 24.3.20), the entity would be permitted to disclose the total amount of accrued interest receivable. This would be instead of tracing accrued interest amounts included in the amortized cost basis to each origination year and by class of financing receivable. [FASB 08-18]

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;
- 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 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. [326-20-50-6]

### 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, an entity 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, an entity may present the amortized cost basis 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.

The requirement to present the amortized cost basis within each credit quality indicator by year of origination does not apply to an entity that is not a PBE.

#### Guidance on current period originations [326-20-50-7]

An entity 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 or renewal of a financing receivable 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**

Is a PBE required to disclose gross writeoffs and recoveries by vintage year?

Background: Paragraph 326-20-50-6 requires a PBE to disclose 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 illustrates disclosure of credit quality information – includes disclosure of gross writeoffs and recoveries within each credit quality indicator by vintage year.
Interpretive response: No. We believe that an entity 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.

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, the FASB’s recently proposed amendments to the guidance in Subtopic 326-20 would permit an entity to elect to use a practical expedient related to accrued interest receivable for certain disclosure requirements; see the future developments in section 24.3.10.

Excerpt from ASC 326-20

>> 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.
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<th>Amortized Cost Basis by Origination Year</th>
<th>Revolving Loans Amortized Cost Basis</th>
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<td>loans:</td>
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<tr>
<td>Current-period gross</td>
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<td>$-</td>
<td>$-</td>
<td>$-</td>
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<td>writeoffs</td>
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<td>Current-period</td>
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<tr>
<td>recoveries</td>
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<tr>
<td>Current-period net</td>
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<td>$-</td>
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<tr>
<td><strong>Commercial mortgage:</strong></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Risk rating:</td>
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<tr>
<td>1-2 internal grade</td>
<td></td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
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<td>$-</td>
<td>$-</td>
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<tr>
<td>3-4 internal grade</td>
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<td>-</td>
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<tr>
<td>5 internal grade</td>
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<td>6 internal grade</td>
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<tr>
<td>Total commercial</td>
<td></td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
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<tr>
<td>mortgage:</td>
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<td>loans:</td>
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<td></td>
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</tr>
<tr>
<td>Current-period gross</td>
<td></td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>-</td>
<td></td>
<td></td>
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<tr>
<td>writeoffs</td>
<td></td>
<td>-</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Current-period</td>
<td></td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
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<td></td>
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<tr>
<td>recoveries</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current-period net</td>
<td></td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>$-</td>
<td>-</td>
<td></td>
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<tr>
<td>writeoffs</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Amortized cost of HTM debt securities by credit rating</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC – C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury and government agencies</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Obligations of US states and municipalities</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
</tr>
<tr>
<td>Corporate debt securities</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
</tr>
<tr>
<td>Residential MBS</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
</tr>
<tr>
<td>Residential MBS issued by US government-sponsored enterprises or US government agencies</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
</tr>
<tr>
<td>Commercial MBS</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
<td>XX,XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
</tbody>
</table>

**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:

- 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:

- a description of how expected loss estimates are developed;
Disclosures

- 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]

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
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 of amounts previously written off, if applicable; 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**

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 | | | | | | |
| Commercial real estate: | | | | | | |
| Commercial real estate – construction | 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 |
| Consumer: | | | | | | |
| Consumer – credit card | 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 |
| Consumer – auto | 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 |
| Residential – subprime | 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 |
Age Analysis of Past-Due Financial Assets As of December 31, 20X5, and 20X4 Past Due

<table>
<thead>
<tr>
<th>20X4</th>
<th>30-59 Days</th>
<th>60-89 Days</th>
<th>Greater Than 90 Days</th>
<th>Total</th>
<th>Current</th>
<th>Total</th>
<th>Amortized Cost &gt; 90 Days and Accruing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Commercial real estate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial real estate – construction</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Commercial real estate – other</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Consumer:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer – credit card</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Consumer – other</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Consumer – auto</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Residential:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential – prime</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Residential – subprime</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
<tr>
<td>Finance leases</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>As of December 31, 20XX</th>
<th>30-59 days</th>
<th>60-89 days</th>
<th>Greater than 90 days</th>
<th>Total</th>
<th>Current</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury and government agencies</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Obligations of US states and municipalities</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Corporate debt securities</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Residential MBS</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Residential MBS issued by US government-sponsored enterprises or US government agencies</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Commercial MBS</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
<tr>
<td>Total</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
<td>$XX,XXX</td>
</tr>
</tbody>
</table>
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**

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.
24.4 AFS debt securities (Subtopic 326-30)

Excerpt from ASC 326-30

<table>
<thead>
<tr>
<th>General</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> 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:</td>
</tr>
<tr>
<td>a. <strong>Available-for-sale debt securities</strong> in unrealized loss positions without an allowance for credit losses</td>
</tr>
<tr>
<td>b. Allowance for credit losses</td>
</tr>
<tr>
<td>c. <strong>Purchased financial assets with credit deterioration.</strong></td>
</tr>
</tbody>
</table>

**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.

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

**50-4** For available-for-sale debt securities, including those that fall within the scope of Subtopic 325-40 on beneficial interests in securitized financial assets, in an unrealized loss position for which an allowance for credit losses has not been recorded, an entity shall disclose all of the following in its interim and annual financial statements:

| a. As of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment—each major security type that the entity discloses in accordance with this Subtopic—in tabular form: |
| 1. The aggregate related **fair value** of investments with unrealized losses |
| 2. The aggregate amount of unrealized losses (that is, the amount by which **amortized cost basis** exceeds fair value). |

| b. As of the date of the most recent statement of financial position, additional information (in narrative form) that provides sufficient information to allow a financial statement user to understand the quantitative disclosures and |
the information that the entity considered (both positive and negative) in reaching the conclusion that an allowance for credit losses is unnecessary. The disclosures required may be aggregated by investment categories, but individually significant unrealized losses generally shall not be aggregated. This disclosure could include all of the following:

1. The nature of the investment(s)
2. The cause(s) of the impairment(s)
3. The number of investment positions that are in an unrealized loss position
4. The severity of the impairment(s)
5. Other evidence considered by the investor in reaching its conclusion that an allowance for credit losses is not necessary, including, for example, any of the following:
   i. Performance indicators of the underlying assets in the security, including any of the following:
      01. Default rates
      02. Delinquency rates
      03. Percentage of nonperforming assets.
   ii. Debt-to-collateral-value ratios
   iii. Third-party guarantees
   iv. Current levels of subordination
   v. Vintage
   vi. Geographic concentration
   vii. Industry analyst reports
   viii. Credit ratings
   ix. Volatility of the security’s fair value
   x. Interest rate changes since purchase
   xi. Any other information that the investor considers relevant.

50-5 The disclosures in (a)(1) through (a)(2) in paragraph 326-30-50-4 shall be disaggregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.

50-6 The reference point for determining how long an investment has been in a continuous unrealized loss position is the balance sheet date of the reporting period in which the impairment is identified. For entities that do not prepare interim financial information, the reference point is the annual balance sheet date of the period during which the impairment was identified. 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.

> Allowance for Credit Losses

50-7 For interim and annual periods in which an allowance for credit losses of an available-for-sale debt security is recorded, an entity shall disclose by major security type, the methodology and significant inputs used to measure the amount related to credit loss, including its accounting policy for recognizing writeoffs of uncollectible available-for-sale debt securities. Examples of significant inputs include, but are not limited to, all of the following:
a. Performance indicators of the underlying assets in the security, including all of the following:
   1. Default rates
   2. Delinquency rates
   3. Percentage of nonperforming assets
b. Debt-to-collateral-value ratios
c. Third-party guarantees
d. Current levels of subordination
e. Vintage
f. Geographic concentration
g. Industry analyst reports and forecasts
h. Credit ratings
i. Other market data that are relevant to the collectibility of the security.

Paragraph 326-30-45-3 explains that an entity may report the change in the allowance for credit losses due to changes in time value as credit loss expense (or reversal of credit loss expense) but also may report the change as interest income. An entity that chooses the latter alternative shall disclose the amount recorded to interest income that represents the change in present value attributable to the passage of time.

**Rollforward of the Allowance for Credit Losses**

For each interim and annual reporting period presented, an entity shall disclose by major security type, a tabular rollforward of the allowance for credit losses, which shall include, at a minimum, all of the following:

a. The beginning balance of the allowance for credit losses on available-for-sale debt securities held by the entity at the beginning of the period
b. Additions to the allowance for credit losses on securities for which credit losses were not previously recorded
c. Additions to the allowance for credit losses arising from purchases of available-for-sale debt securities accounted for as purchased financial assets with credit deterioration (including beneficial interests that meet the criteria in paragraph 325-40-30-1A)
d. Reductions for securities sold during the period (realized)
e. 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
f. 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
g. Writeoffs charged against the allowance
h. Recoveries of amounts previously written off
i. The ending balance of the allowance for credit losses related to debt securities held by the entity at the end of the period.

**Purchased Financial Assets with Credit Deterioration**

To the extent an entity acquired purchased financial assets with credit deterioration during the current reporting period, an entity shall provide a
reconciliation of the difference between the purchase price of the assets and the par value of the available-for-sale debt securities, including:

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

24.4.10 Overview

The objectives of required financial statement disclosures about AFS debt securities are to help financial statement users understand the following: [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.

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.

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(a)]

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(a)]

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;


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**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.

<table>
<thead>
<tr>
<th>Description of Securities</th>
<th>Less Than 12 Months</th>
<th>12 Months or Greater</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fair Value</td>
<td>Unrealized Losses</td>
<td>Fair Value</td>
</tr>
<tr>
<td>U.S. Treasury obligations and direct obligations of U.S. government agencies</td>
<td>$172</td>
<td>$2</td>
<td>$58</td>
</tr>
<tr>
<td>Federal agency mortgage-backed securities</td>
<td>367</td>
<td>5</td>
<td>18</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>150</td>
<td>7</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$689</strong></td>
<td><strong>$14</strong></td>
<td><strong>$76</strong></td>
</tr>
</tbody>
</table>

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;
Credit impairment

24. Disclosures

- 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.

Comparison to legacy US GAAP

Roll-forward of the allowance for credit losses

Under legacy US GAAP, the credit loss impairment on an AFS security is recognized as a direct writedown that reduces the security’s amortized cost basis. Moreover, a roll-forward of credit losses recognized in net income is disclosed. [320-10-50-8B, 320-10-35-34]

Under Subtopic 326-30, credit losses are recognized through an allowance for credit losses and a roll-forward of that allowance is disclosed. As indicated in section 25.3.30 an allowance for credit losses is generally not expected to be recorded for AFS debt securities on adoption of Topic 326. As a result, the activity in the roll-forward of the allowance for credit losses generally will comprise credit losses arising subsequent to adoption of Topic 326. [320-10-50-8B, 326-20-50-9]

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.
25. Effective dates and transition

Detailed contents

New item added to this chapter: **
Item significantly updated in this chapter: #

25.1 How the standard works #

25.2 Effective dates
   25.2.10 Public business entities
   25.2.20 Entities that are not PBEs #

Question
   25.2.10 Is an entity permitted to early adopt Topic 326 at an interim date? **

25.3 Transition
   25.3.10 Overview
   25.3.20 PCI assets
   25.3.30 Debt securities with OTTI recognized before adoption
   25.3.40 Financial guarantees
   25.3.50 Troubled debt restructurings

Future developments
Fair value option for financial assets other than HTM debt securities **

Example
   25.3.10 Journal entries when entity uses a non-discounted cash flow method at adoption for a previously impaired HTM debt security

25.4 Transition disclosures
   25.4.10 Disclosures before adoption
   25.4.20 Disclosures about adoption
   25.4.30 Disclosure of credit quality indicators by year of origination
## 25.1 How the standard works

<table>
<thead>
<tr>
<th>Effective date:</th>
<th>PBEs that are SEC filers</th>
<th>PBEs that are not SEC filers</th>
<th>All other entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>[326-10-65-1(a)]</td>
<td>Annual and interim periods in fiscal years beginning after December 15, 2019</td>
<td>Annual and interim periods in fiscal years beginning after December 15, 2020</td>
<td>Annual and interim periods in fiscal years beginning after December 15, 2021</td>
</tr>
</tbody>
</table>

**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]

**Note:**

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]
25.2 Effective dates

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:

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, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years
   2. For public business entities that do not meet the definition of an SEC filer, for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years
   3. For all other entities, including not-for-profit entities within the scope of Topic 958 and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, for fiscal years beginning after December 15, 2021, 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**

Is an entity permitted to 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)]
25.2.10 Public business entities

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.

Topic 326 has different mandatory effective dates for PBEs that are SEC filers and those that are not. [326-10-65-1(a)(1), 65-1(a)(2)]

— For PBEs that are SEC filers, 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 PBEs that are not SEC filers, it is effective for annual and interim periods in fiscal years beginning after December 15, 2020 – e.g. January 1, 2021 for calendar year-end entities.

The FASB considered whether the January 1, 2020 mandatory adoption date for calendar year-end entities should apply to all PBEs. However, it wanted to provide additional time for smaller financial institutions to prepare for adoption, and acknowledged that many of them meet the definition of a PBE in US GAAP even though they do not file or furnish financial statements with the SEC. As a result, the FASB decided that the earlier date should only apply to SEC filers. [ASU 2016-13.BC122]
25.2.20 **Entities that are not PBEs #**

Entities that are not PBEs – including not-for-profit entities in the scope of Topic 958 and employee benefit plans in the scope of Topics 960 to 965 – are required to adopt Topic 326 in annual and interim periods in fiscal years beginning after December 15, 2021 – e.g. January 1, 2022 for calendar year-end entities.

ASU 2016-13 originally required these entities to adopt Topic 326 for annual periods in fiscal years beginning after December 15, 2020, and for interim periods in fiscal years beginning after December 15, 2021. However, the FASB decided to mitigate transition complexity for these entities by aligning the effective date for their annual financial statements with the effective date for their interim financial statements. [ASU 2018-19]

25.3 **Transition**

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**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:

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.

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 is applicable for the following:

— 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). [326-10-65-1(d) – 65-1(e)]

Future developments**

Fair value option for financial assets other than HTM debt securities

The FASB recently proposed amendments that would allow an entity to irrevocably elect the fair value option under Subtopic 825-10 (financial instruments) on adoption of Topic 326. This election would be available 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 that it would not be available for HTM debt securities. [Proposed FVO ASU]

This proposal was made in response to financial statement preparers indicating that they intend to elect the fair value option for newly originated or purchased financial assets that are in the scope of Subtopic 326-20. The proposal will allow an entity to use that same measurement basis for previously originated or purchased financial assets (other than HTM debt securities), thereby improving financial statement comparability for those entities. [Proposed FVO ASU]
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)]

The FASB provided this transition relief 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 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]

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. [326-10-65-1(e), 326-20-30-5]

Therefore, depending on the loss estimation method selected, 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 credit losses. 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), 326-20-30-4]

Legacy US GAAP requires the use of a discounted cash flow method for estimating and recognizing credit loss impairment for debt securities. Topic 326
requires the use of a discounted cash flow method when estimating credit losses for AFS debt securities and permits, but does not require, a discounted cash flow method when estimating expected credit losses for HTM debt securities.

Whether a debt security with OTTI recognized before adoption requires an allowance for credit losses on adoption generally depends on the allowance method selected under Topic 326, as reflected in the following table.

<table>
<thead>
<tr>
<th>Classification of debt security</th>
<th>Allowance method selected on adoption</th>
<th>Is an allowance for credit losses expected to be recognized on transition?</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS</td>
<td>Discounted cash flow (required)</td>
<td>Generally, no.</td>
</tr>
<tr>
<td>HTM</td>
<td>Discounted cash flow</td>
<td>Generally, no.</td>
</tr>
<tr>
<td>HTM</td>
<td>Other than discounted cash flow</td>
<td>Maybe, depending on whether there are expected credit losses of the amortized cost basis that had not been reflected through previously recognized credit impairment (see Example 25.3.10).</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expected cash flows</th>
<th>Present value of expected cash flows, discounted at EIR of 12.70% (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$0</td>
<td>$278,935</td>
</tr>
<tr>
<td>3</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>$450,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$450,000</td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit impairment loss (earnings)(^1)</td>
<td>30,993</td>
</tr>
<tr>
<td>Non-credit impairment loss (OCI)(^2)</td>
<td>2,942</td>
</tr>
<tr>
<td>HTM security</td>
<td></td>
</tr>
<tr>
<td>HTM security – valuation allowance (non-credit impairment)</td>
<td>30,993</td>
</tr>
<tr>
<td>To record OTTI and non-credit related loss.</td>
<td>2,942</td>
</tr>
</tbody>
</table>

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)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractual cash flows expected not to be collected as of Jan. 1, 2020</td>
<td>$50,000</td>
</tr>
<tr>
<td>Credit losses previously recognized</td>
<td>30,993</td>
</tr>
<tr>
<td>Allowance for credit losses as of Jan. 1, 2020 (transition) – represents expected credit losses of the amortized cost basis</td>
<td>$19,007</td>
</tr>
</tbody>
</table>

As of January 1, 2020, Investor records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>19,007</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>19,007</td>
</tr>
</tbody>
</table>

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 and
therefore 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.

<table>
<thead>
<tr>
<th>Nature of change in cash flow subsequent to adoption</th>
<th>How change is reflected in financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvements in credit</td>
<td>— To the extent there is an allowance for credit losses, it is reduced for improvements in credit.</td>
</tr>
<tr>
<td></td>
<td>— Additional improvements in credit that represent recoveries of amounts previously written off are recognized in the income statement in the period received.</td>
</tr>
<tr>
<td>Deterioration in credit</td>
<td>Allowance for credit losses is recorded based on the guidance in:</td>
</tr>
<tr>
<td></td>
<td>— Subtopic 326-20 (HTM debt securities); or</td>
</tr>
<tr>
<td></td>
<td>— Subtopic 326-30 (AFS debt securities).</td>
</tr>
</tbody>
</table>

**Effective interest rate**

As discussed above, 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 Financial guarantees**

An entity applies Topic 326 to financial 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 financial guarantee recognizes a financial 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 financial guarantee liability.

See chapter 14 for additional information on how financial guarantees in the scope of Topic 460 will be affected by the adoption of Subtopic 326-20.
25.3.50 Troubled debt restructurings

As discussed in Question 4.3.50, 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.

In a December 2017 meeting, the FASB provided 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. An entity is not required to calculate the prepayment-adjusted EIR for each financial asset previously modified in a TDR in accordance with the decision reached at the TRG meeting. Instead, it may calculate the prepayment-adjusted EIR based on the original contractual terms of the loan and prepayment assumptions as of the date of adoption. [TRG 06-17.6C]

25.4 Transition disclosures

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.
Credit impairment

25. Effective dates and transition

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)]
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A2.30 Selecting an approach for estimating the impact of premiums and discounts

A2.40 Calculating the historical loss rate

A3.10 Overview

A3.20 Asset-specific risk characteristics – differences in underwriting standards

A3.30 Current conditions and reasonable and supportable forecasts
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.

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).

<table>
<thead>
<tr>
<th>Superprime Loans</th>
<th>Prime Loans</th>
<th>Subprime Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originated in Q1 2X10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2X10-Q1 Super-Auto 4-yr</td>
<td>2X10-Q1 Prime-Auto 4-yr</td>
<td>2X10-Q1 Sub-Auto 4-yr</td>
</tr>
<tr>
<td>2X10-Q1 Super-Auto 5-yr</td>
<td>2X10-Q1 Prime-Auto 5-yr</td>
<td>2X10-Q1 Sub-Auto 5-yr</td>
</tr>
<tr>
<td>2X10-Q1 Super-Auto 6-yr</td>
<td>2X10-Q1 Prime-Auto 6-yr</td>
<td>2X10-Q1 Sub-Auto 6-yr</td>
</tr>
</tbody>
</table>
Credit impairment
A. Illustrative example

<table>
<thead>
<tr>
<th>Superprime Loans</th>
<th>Prime Loans</th>
<th>Subprime Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Originated in Q2 2X10</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2X10-Q2 Super-Auto 4-yr</td>
<td>2X10-Q2 Prime-Auto 4-yr</td>
<td>2X10-Q2 Sub-Auto 4-yr</td>
</tr>
<tr>
<td>2X10-Q2 Super-Auto 5-yr</td>
<td>2X10-Q2 Prime-Auto 5-yr</td>
<td>2X10-Q2 Sub-Auto 5-yr</td>
</tr>
<tr>
<td>2X10-Q2 Super-Auto 6-yr</td>
<td>2X10-Q2 Prime-Auto 6-yr</td>
<td>2X10-Q2 Sub-Auto 6-yr</td>
</tr>
<tr>
<td><strong>Originated in Q3 2X10</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2X10-Q3 Super-Auto 4-yr</td>
<td>2X10-Q3 Prime-Auto 4-yr</td>
<td>2X10-Q3 Sub-Auto 4-yr</td>
</tr>
<tr>
<td>2X10-Q3 Super-Auto 5-yr</td>
<td>2X10-Q3 Prime-Auto 5-yr</td>
<td>2X10-Q3 Sub-Auto 5-yr</td>
</tr>
<tr>
<td>2X10-Q3 Super-Auto 6-yr</td>
<td>2X10-Q3 Prime-Auto 6-yr</td>
<td>2X10-Q3 Sub-Auto 6-yr</td>
</tr>
<tr>
<td><strong>Originated in Q4 2X10</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2X10-Q4 Super-Auto 4-yr</td>
<td>2X10-Q4 Prime-Auto 4-yr</td>
<td>2X10-Q4 Sub-Auto 4-yr</td>
</tr>
<tr>
<td>2X10-Q4 Super-Auto 5-yr</td>
<td>2X10-Q4 Prime-Auto 5-yr</td>
<td>2X10-Q4 Sub-Auto 5-yr</td>
</tr>
<tr>
<td>2X10-Q4 Super-Auto 6-yr</td>
<td>2X10-Q4 Prime-Auto 6-yr</td>
<td>2X10-Q4 Sub-Auto 6-yr</td>
</tr>
</tbody>
</table>

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

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 the present value of 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 it becomes collateral-dependent. [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 20X10 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).

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 premiums and discounts

The Bank’s historical loss information reflects the amortized cost basis that was written off – 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.

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 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 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:

- **Numerator.** Net losses experienced within the corresponding period (month) in the historical vintage, which reflects the amortized cost basis that was written off, 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 4.2.10, 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) 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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Missed payment rate(^1)</th>
<th>Prepayment rate(^2)</th>
<th>Periodic net loss rate based on pool’s original UPB(^3)</th>
<th>Periodic net loss rate based on exposure at default(^4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>19.62%</td>
<td>1.05%</td>
<td>5.16%</td>
<td>5.16%</td>
</tr>
<tr>
<td>Year 2</td>
<td>19.23%</td>
<td>1.88%</td>
<td>5.92%</td>
<td>7.39%</td>
</tr>
<tr>
<td>Year 3</td>
<td>18.85%</td>
<td>2.78%</td>
<td>3.34%</td>
<td>5.71%</td>
</tr>
<tr>
<td>Year 4</td>
<td>18.47%</td>
<td>3.00%</td>
<td>1.71%</td>
<td>4.45%</td>
</tr>
<tr>
<td>Year 5</td>
<td>18.10%</td>
<td>3.20%</td>
<td>0.25%</td>
<td>1.32%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>16.38%</td>
<td></td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Management’s estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractual principal amortization</td>
<td>Based on the contractual terms of the auto loans underlying the pool.</td>
</tr>
<tr>
<td>Missed payment rate</td>
<td>Management expects the missed payment rate to be approximately the same as that for the 20X2-Q1 vintage.</td>
</tr>
<tr>
<td>Prepayment rate</td>
<td>Management expects the prepayment rate to be approximately the same as that for the 20X2-Q1 vintage.</td>
</tr>
<tr>
<td>Expected credit losses</td>
<td>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.</td>
</tr>
</tbody>
</table>

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 consider the effect of prepayments when estimating the allowance for credit losses. Additionally, for periods beyond the reasonable and supportable forecasts, 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 forecasts 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, 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. Through this analysis, it determined that there was a strong correlation.¹

Management next estimates the extent to which a change in consumer credit scores resulted in a change in losses.² It estimates the effect of the difference

¹ This was performed using Microsoft® Excel.
² This was performed using Microsoft® Excel.
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.

<table>
<thead>
<tr>
<th>Periodic historical loss rate (based on original pool balance)</th>
<th>Adjustment to historical experience for less stringent underwriting standards (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Increased losses to be recognized over remaining term to maturity:</strong></td>
<td></td>
</tr>
<tr>
<td>Year 2 (2X11)</td>
<td>5.92%</td>
</tr>
<tr>
<td>Year 3 (2X12)</td>
<td>3.34%</td>
</tr>
<tr>
<td>Year 4 (2X13)</td>
<td>1.71%</td>
</tr>
<tr>
<td>Year 5 (2X14)</td>
<td>0.25%</td>
</tr>
</tbody>
</table>

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.

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**KPMG observation (g)**

**Methods for determining the extent of adjustments to historical loss information**

Subtopic 326-20 does not provide specific guidance for determining the extent of adjustments to make to historical loss information, other than indicating that the adjustments may be qualitative in nature and should reflect changes related to 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]

Selecting the appropriate method to determine the adjustments to historical loss experience for differences created by asset-specific risk characteristics and/or economic conditions requires management to exercise significant judgment. We believe there are several methods available, including statistical analysis and anchoring approaches. Alternative or simplified methods for given facts and circumstances also may be appropriate. Regardless of the approach used, the adjustments to the historical loss information used may be positive or negative.
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. Or, an equation developed through regression analysis for estimating the extent of the adjustment may not identify that the correlation between the variables is weak. 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

Another approach for estimating the extent of the adjustment to be made for the 2X10-Q1 Sub-Auto 5-yr Loans is to perform an anchoring analysis. One way of performing an anchoring analysis is for management to gather historical data (e.g. for each of the past 10 years) representative of its current portfolios and determine a period with higher loss experience. Management then subtracts the selected historical loss rates used for estimating the allowance for credit losses (e.g. the historical loss experience from the 2X02-Q1 Sub-Auto vintage) from the loss rates for the period with the highest loss experience to determine the potential incremental amount of loss that the portfolio may realize in an adverse scenario.

Management then allocates the differences between the loss rates in the period with the higher loss experience and the loss rates used to estimate the allowance for credit losses to the underlying causes of those differences based on its judgment – e.g. a portion of the difference relates to each of the following, underwriting standards, delinquency rates, used car prices, and unemployment rates.

When estimating expected credit losses for the current vintage, management uses the allocations for each of the different factors to determine the adjustment necessary to estimate the effect of differences in the risk characteristic or economic condition. Management also considers whether this approach may result in the need to make additional adjustments to the estimate of expected credit losses.

The use of an anchoring analysis may not be appropriate in all circumstances, specifically in situations where there are no historical periods 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 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) and in 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.

— **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.
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.

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**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.

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**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 it 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.

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.

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual unemployment rate during corresponding year in 20X2-Q1 vintage</th>
<th>Forecasted unemployment rate during reasonable and supportable forecast period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 (actual)</td>
<td>5.10%</td>
<td>4.95%</td>
</tr>
<tr>
<td>Year 2</td>
<td>5.50%</td>
<td>4.80%</td>
</tr>
<tr>
<td>Year 3</td>
<td>5.10%</td>
<td>4.75%</td>
</tr>
<tr>
<td>Year 4</td>
<td>5.10%</td>
<td>4.75%</td>
</tr>
<tr>
<td>Year 5</td>
<td>5.25%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

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. Factors to consider when making this determination may include the following.

— 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.

— We believe an entity is required to reevaluate the reasonable and supportable forecast period at each reporting date because the length could change – e.g. different or additional supporting information may be considered or the period covered by the supporting information may change.

— The length of the reasonable and supportable forecast period may differ when different economic assumptions are relevant for different types of financial assets. 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. However, we expect an entity to consider whether the assumptions are consistent with one another, especially when different sources are used for different assumptions.

— We generally expect that an entity will consider the relevant economic forecasts it uses 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. 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.

Read more: Section 7.3.20

Extent of adjustment needed

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. 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). 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 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. 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.

<table>
<thead>
<tr>
<th>Adjustments to historical experience for forecasted unemployment</th>
<th>Decreased losses to be recognized over remaining term to maturity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2 (2X11)</td>
<td>-0.10%</td>
</tr>
<tr>
<td>Year 3 (2X12)</td>
<td>-0.07%</td>
</tr>
<tr>
<td>Year 4 (2X13)</td>
<td>-0.07%</td>
</tr>
</tbody>
</table>

The effect of the adjustment to historical experience for forecasted unemployment on the allowance for credit losses is further demonstrated in section A4.

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**

The Bank elects to revert to historical loss information at the input level. Management determines that the straight-line reversion approach is appropriate, which it applies by amortizing the adjustment that was made to the

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3 This was performed using Microsoft® Excel.
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.

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.

An entity can choose to revert to historical loss information at either the input level or based on the entire estimate. If the entity reverts based on the entire estimate, rather than the input level, we believe the reasonable and supportable forecast period generally is limited to the shortest period of the significant economic inputs (i.e. less stringent underwriting and unemployment rates) that can be forecasted.

**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.

<table>
<thead>
<tr>
<th>Remaining term to maturity</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Periodic net loss rate based on exposure at default (section A2.20)</td>
<td>7.39%</td>
<td>5.71%</td>
<td>4.45%</td>
<td>1.32%</td>
</tr>
<tr>
<td>Adjustments for asset-specific characteristics (section A3.20):</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less stringent underwriting (rounded)</td>
<td>0.36%</td>
<td>0.20%</td>
<td>0.10%</td>
<td>0.02%</td>
</tr>
<tr>
<td>Adjustments for other conditions (section A3.30):</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower unemployment</td>
<td>-0.10%</td>
<td>-0.07%</td>
<td>-0.07%</td>
<td></td>
</tr>
<tr>
<td>Straight-line reversion for unemployment</td>
<td></td>
<td></td>
<td>-0.035%</td>
<td></td>
</tr>
<tr>
<td>Used car prices</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Delinquencies</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Expected credit loss rate (rounded)</td>
<td>7.64%</td>
<td>5.84%</td>
<td>4.48%</td>
<td>1.30%</td>
</tr>
</tbody>
</table>

| Expected exposure at default – section 2.40 | | | | |
| 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 | 19.23% | 18.85% | 18.47% | 18.10% |
| Expected effect of missed payments | 364,980 | 375,979 | 387,311 | 398,985 |
| Expected prepayment rate | 1.88% | 2.78% | 3.00% | 3.20% |
| Expected prepayments | 35,681 | 55,462 | 62,913 | 70,541 |
| Expected credit losses | 614,894 | 342,162 | 172,294 | 24,615 |
| Ending balance | 5,862,232 | 3,845,557 | 1,900,562 | 0 |
| Expected credit losses | 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 Q&As

New item added: **
Item significantly updated: #

2. Scope of Subtopic 326-20
   2.2.10 Are cash equivalents in the scope of Subtopic 326-20?
   2.2.20 Is preferred stock in the scope of Topic 326?
   2.2.30 Are perpetual preferred securities in the scope of Subtopic 326-20?
   2.2.40 Are held-for-sale loans in the scope of Subtopic 326-20? #
   2.2.50 Are investments in bank-owned or corporate-owned life insurance policies in the scope of Subtopic 326-20? **
   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?
   2.3.20 When does the scope exclusion for loans and receivables between entities under common control apply?
   2.3.30 Are assets that arise from recognizing lease income on a straight-line basis in the scope of Subtopic 326-20? **

3. Recognition of expected credit losses
   3.2.10 Is there a recognition threshold for credit impairment under Subtopic 326-20?
   3.2.20 What regulatory capital effect will Topic 326 have on financial institutions?

4. Methods to estimate expected credit losses
   4.2.10 Does Subtopic 326-20 provide specific guidance on how to estimate expected credit losses?
   4.2.20 Can an entity leverage its existing allowance method to meet the requirements of Subtopic 326-20?
   4.2.30 Can 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?
   4.2.35 Is an entity permitted to discount some, but not all, cash flows when applying a method other than a discounted cash flow method? **
   4.2.36 Is an entity permitted to discount cash flows or inputs to a date other than the reporting date? **
   4.2.40 Does an entity reserve for future interest when applying a method other than a discounted cash flow method to estimate expected credit losses? #
4.2.50 What effect do unamortized premiums and discounts have on the estimate of expected credit losses?

4.2.60 Does an entity have to accumulate new data if it measures the components of the amortized cost separately?

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

4.2.80 Should anticipated expenses and losses on foreclosed assets (other than costs to sell) be included in the estimate of expected credit losses? **

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

4.3.10 How is the EIR calculated under Subtopic 326-20?

4.3.20 Is the EIR calculated under Subtopic 326-20 also used to recognize interest income under Subtopic 310-20?

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

4.3.40 Should the EIR be adjusted when a loan is transferred from held-for-sale to held-for-investment? #

4.3.50 When estimating expected credit losses, can an entity use a prepayment-adjusted EIR to discount cash flows? #

4.3.60 How is the prepayment-adjusted EIR determined? #

4.3.70 When discounted cash flows are used to estimate credit losses, can the EIR change over the life of the financial asset?

5. Collective assessment

5.2.10 Is an entity required to pool assets based on similar risk characteristics?

5.2.20 Is an entity required to revise pools of financial assets if risk characteristics change?

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

5.2.40 Should the collective assessment guidance be applied to off-balance sheet credit exposures?

6. Contractual term

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?

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?

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

6.2.40 Can the weighted-average remaining life be used as the contractual term for a portfolio of loans? #
6.2.50  Is a lender required to use the loan modification guidance to
determine whether a refinancing should be considered a
prepayment? #

7. **Historical loss experience, forecasts and reversion**

7.2.10  Under what circumstances may an entity use external data?

7.2.20  Is an entity required to select a historical period that
represents its expectation for future periods?

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

7.2.40  [Not used]

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

7.3.15  Is an entity required to consider multiple economic scenarios
when developing its economic forecast? **

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

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

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

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

7.3.60  Is an entity required to reevaluate the reasonable and
supportable forecast period?

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

7.3.80  How is the reasonable and supportable forecast period
determined when reversion is based on the entire estimate?

7.3.90  Is the reversion method a practical expedient?

7.3.100 Can an entity revert to historical loss experience over a
period shorter than the remaining contractual term of the
financial assets?

8. **No allowance for credit losses**

8.2.10  What financial assets are eligible for the zero loss
expectation exception?

8.2.20  What information should an entity consider when evaluating
historical loss experience?
9. **Credit enhancements**

9.2.10 When is a credit enhancement entered into separate and apart from other transactions?

9.2.20 When is a credit enhancement entered into in conjunction with a financial asset?

9.2.30 When is a credit enhancement legally detachable?

9.2.40 When is a credit enhancement separately exercisable?

10. **Practical expedients**

10.2.10 Do expected selling costs reduce the fair value of collateral when foreclosure is probable?

10.2.20 How should an entity determine the present value of estimated selling costs?

10.2.30 What types of costs should be considered in estimated selling costs?

10.2.40 Should an entity consider credit enhancements when estimating expected credit losses when foreclosure is probable?

10.2.50 How should an entity determine if the debtor is experiencing financial difficulty?

10.2.60 Does an entity continue to apply the practical expedient once the borrower is no longer experiencing financial difficulty?

10.2.70 Should the practical expedient be applied at the individual financial asset level?

10.2.80 Should an entity consider credit enhancements when estimating expected credit losses when applying the practical expedient?

10.2.90 When a loan is considered collateral-dependent, is an entity required to use the fair value of collateral to estimate expected credit losses for bank regulatory reporting purposes?

10.3.10 To apply the practical expedient, does an entity need to assess whether the borrower will be able to replenish collateral?

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?

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?

11. **Troubled debt restructurings**

11.2.10 Should an entity include an estimate of future TDRs in its estimate of expected credit losses?
<table>
<thead>
<tr>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>11.2.20</td>
</tr>
<tr>
<td>11.2.30</td>
</tr>
<tr>
<td>11.3.10</td>
</tr>
<tr>
<td>11.3.20</td>
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<tr>
<td>11.3.30</td>
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<tr>
<td>11.3.40</td>
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<td>11.3.45</td>
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<tr>
<td>11.3.50</td>
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<tr>
<td>11.3.60</td>
</tr>
<tr>
<td>12.</td>
</tr>
<tr>
<td>12.2.10</td>
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<td>12.2.12</td>
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<tr>
<td>12.2.15</td>
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<tr>
<td>12.2.20</td>
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<td>12.2.30</td>
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<td>12.2.40</td>
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<tr>
<td>12.3.10</td>
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<tr>
<td>12.3.20</td>
</tr>
<tr>
<td>12.3.30</td>
</tr>
<tr>
<td>12.3.40</td>
</tr>
<tr>
<td>12.3.50</td>
</tr>
</tbody>
</table>
12.4.10 Why are subsequent changes in expected credit losses for PCD assets recognized immediately in net income?

12.4.20 Is an entity required to maintain the integrity of a PCD pool?

12.5.10 Can an entity recognize interest income for PCD assets at the pool level?

12.5.20 Can a PCD asset be placed on nonaccrual status? #

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?

12.6.20 Should an entity capture the effects of previous interest rate concessions for PCI assets when estimating expected credit losses on adoption? **

12.6.30 If an entity uses a method other than a discounted cash flow method, should it capture the effect of TDRs when estimating expected credit losses? **

13. Off-balance sheet credit exposures

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?

13.3.20 What is the contractual term used for estimating expected credit losses for loan commitments?

15. Other investments in equity method investees

15.2.10 Is an additional investment’s allowance for credit losses estimated before or after allocating equity method losses?

16. Net investment in leases

16.2.10 Why is the unguaranteed residual asset included with the lease receivable when measuring impairment of the net investment in the lease?

16.2.20 Does the lessor consider the cash flows it expects from the underlying asset after the end of the lease term?

16.2.30 Should a lessor consider expected gains from the subsequent disposal of leased assets when measuring its loss allowance? **

17. Specific considerations for insurance entities

17.2.10 Are premiums receivable, policy loan receivables, funds withheld assets and retrospective premiums receivable in the scope of Subtopic 326-20?

18. Specific considerations for commercial entities and trade receivables

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?

19. **Targeted changes for AFS debt securities**
   19.2.10 Why does Topic 326 include a separate model for AFS debt securities?
   19.3.10 Can a qualitative assessment be performed to determine whether a credit loss exists?
   19.3.20 What factors cannot be considered when assessing whether a credit loss exists?
   19.4.10 How does an entity determine a best estimate of credit losses?
   19.4.20 Does a decrease in expected cash flows solely due to an increase in expected prepayments result in a credit loss?
   19.4.30 What should an entity consider when determining the EIR for a variable rate debt security?
   19.6.10 Should an entity continue to accrue interest income for AFS debt securities with credit losses?
   19.6.20 Does an entity have to account for both writeoffs and recoveries under Subtopic 326-30?
   19.8.10 Are there different concepts for assessing whether AFS and HTM debt securities qualify for PCD accounting?
   19.8.20 Can an entity place a purchased AFS debt security with credit deterioration on nonaccrual status? #

20. **Beneficial interests**
   20.2.10 What does ‘high credit quality’ mean when determining whether a beneficial interest is in the scope of Subtopic 325-40?
   20.2.20 Should a beneficial interest initially considered of high credit quality be included in the scope of Subtopic 325-40 if the credit quality subsequently declines?
   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?
   20.3.20 Could beneficial interests other than residual interests have a significant difference between their contractual and expected cash flows?
   20.3.30 How should contractual cash flows be determined when evaluating whether the PCD guidance should be applied to a beneficial interest that does not have specified contractual cash flows?
   20.3.40 What prepayment assumptions should be used when determining a beneficial interest’s contractual cash flows?
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?

21. **Subsequent events**

21.2.10 Should an entity adjust its estimate of credit losses for information received after the reporting date but before the financial statements are issued? #

21.2.20 Is an entity required to incorporate economic data available through the reporting date in its estimate of credit losses?

21.2.30 Is an entity required to incorporate economic data available after the reporting date (but before the financial statements are issued) in its estimate of credit losses? **

22. **Income taxes**

22.2.10 Will the increase in deferred tax assets on transition to Topic 326 require additional analysis of the potential need for a valuation allowance?

22.2.20 Will the requirement to estimate expected credit losses on a collective basis have an effect on the timing of federal income tax deductions?

22.2.30 Will the allowance for credit losses established for an AFS debt security result in a deferred tax asset?

22.2.40 Can temporary differences arise after the acquisition date of a PCD asset due to changes in the allowance for credit losses?

22.2.50 Can temporary differences arise after the acquisition date of a PCD asset due to the timing and amount of income recognized for book and tax purposes?

22.2.60 Do all PCD assets have a ‘market discount’ that subjects them to the tax treatment for assets acquired at a discount?

23. **Presentation**

23.2.10 Is an entity required to separately present the allowance for credit losses for financial assets with different measurement attributes?

24. **Disclosures**

24.2.10 What is an SEC registrant required to disclose related to the potential effects of Topic 326 before adoption?

24.3.10 Are both public and nonpublic business entities required to provide credit quality disclosures by origination year (vintage year)?

24.3.20 Is a PBE required to disclose gross writeoffs and recoveries by vintage year? **
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?

25. **Effective dates and transition**

25.2.10 Is an entity permitted to early adopt Topic 326 at an interim date? **
Index of examples

New item added: **

4. **Methods to estimate expected credit losses**
   4.2.10 Applying the combined approach
   4.2.20 Applying the separate approach
   4.3.10 EIR used to calculate the allowance for credit losses – variable rate loan
   4.3.20 Isolating the effect of different EIR approaches
   4.3.30 Discounted cash flow method – changes in EIR due to additional costs

6. **Contractual term**
   6.2.10 Loan with no lender contractual obligation to renew
   6.2.20 Effect of extensions on the contractual term
   6.2.30 Loan with borrower conditional option to extend
   6.2.40 Callable loan
   6.2.50 Weighted-average remaining life

7. **Historical loss experience, forecasts and reversion**
   7.3.05 Multiple scenarios vs. single best estimate for economic forecasts **
   7.3.10 Adjusting for differences in asset-specific risk characteristics and economic conditions
   7.3.20 Reversion at input level
   7.3.30 Reversion based on the entire estimate
   7.3.40 Applying immediate and straight-line reversion

8. **No allowance for credit losses**
   8.2.10 Investment grade security
   8.2.20 Collateralized loan
   8.2.30 Residential mortgage loan

9. **Credit enhancements**
   9.2.10 Credit insurance
   9.2.20 Insurance-wrapped debt security

10. **Practical expedients**
    10.2.10 Application of the practical expedient when the debtor operates the property
    10.3.10 Repurchase agreement
11. **Troubled debt restructurings**
   11.2.10 Evaluating whether the debtor is experiencing financial difficulties
   11.2.20 Evaluating whether a concession was granted

12. **Purchased financial assets with credit deterioration**
   12.3.10 Initial measurement of PCD assets
   12.3.20 [Not used]
   12.3.30 Initial measurement of PCD assets using a discounted cash flow method
   12.3.40 Initial measurement of PCD assets using a non-discounted cash flow method
   12.4.10 Subsequent measurement of PCD assets using a discounted cash flow method
   12.4.20 Subsequent measurement of PCD assets using a non-discounted cash flow method
   12.6.10 Journal entries on adoption for loans measured at amortized cost and PCI loans

13. **Off-balance sheet credit exposures**
   13.3.10 Contractual term
   13.3.20 Irrevocable loan commitment
   13.3.30 Revocable loan commitment

14. **Financial guarantees**
   14.3.10 Financial standby letter of credit: up-front cash premium
   14.3.20 Financial standby letter of credit: premium receivable
   14.5.10 Journal entries on adoption for a financial guarantee

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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 of the following: Jennifer Austin, Kimber Bascom, Matthew Boran, Thomas Canfarotta, Jude Fernandes, Lindsey Freeman, Alan Goad, Michael Hall, Kayreen Handley, Jack Pohlman, Joan Rood, Julie Santoro and Todd Voss.