

Financial Instruments — Impairment



SPECIAL REPORT



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Financial Instruments – Impairment

Financial instruments are prevalent across all industries and entities. Examples of financial instruments are loans, receivables (including trade receivables) and securities. These instruments are subject to complex accounting rules on impairment. The impairment rules help ensure that the financial instruments are not overvalued in an entity's financial statements.

Current GAAP uses incurred loss models to account for the impairment of many financial instruments. Under an incurred loss model, an entity does not record an impairment loss until the loss is probable. For years, incurred loss models have drawn stakeholder criticism, from preparers to users of the financial statements. Overall, critics have asserted that incurred loss models delay the recognition of credit losses in an entity's financial statements.

The financial crisis in 2008 reinvigorated the criticisms about incurred loss models. Stakeholders blamed the delayed recognition of credit losses for inflating the balance sheets of financial institutions, especially those with distressed mortgage loans. Consequently, the FASB and the IASB created an advisory group, the Financial Crisis Advisory Group, to help identify areas of financial reporting that could be improved following the financial crisis. The advisory group identified incurred loss models as an area for improvement.

For years, incurred loss models have drawn stakeholder criticism, from preparers to users of the financial statements.

Figure 1 – Criticisms of the Incurred Loss Model



Users want information about expected — not incurred — credit losses on an entity's various financial assets, such as trade receivables and investment portfolios. Since users do not have this information readily available in the financial statements, users often were left to make their own estimates of expected credit losses. Users generally incorporate forecasts of future conditions into these estimates.



Preparers have expressed concern about the probability threshold in current GAAP. Under current GAAP, even if a preparer expects a loss, the preparer cannot record the loss in its financial statements until the loss is probable.

In response, the FASB and the IASB began a joint project to improve the accounting and reporting for impairment of financial instruments.

The goals and objectives of the joint project were to create a single impairment model for financial assets that allows for the timely recognition of credit losses and to improve the usefulness of information provided to users of the financial statements.

Ultimately, the boards did not agree on how to address the feedback received on the proposal, and therefore each developed its own impairment approach. In July 2014, the IASB issued its final guidance on impairment as part of IFRS 9, Financial Instruments. In June 2016, the FASB issued its final guidance on impairment in Accounting Standards Update (ASU) No. 2016-13, Financial Instruments — Credit Losses (Topic 326).

This special report discusses the FASB's new guidance on expected credit losses. It also provides a high-level summary of the IASB's impairment model in IFRS 9.



Overview of the FASB's New Guidance on Expected Credit Losses

ASU No. 2016-13 fundamentally eliminates the current incurred loss models and replaces them with expected loss models. To accomplish this, the ASU:

- Overhauls the existing impairment guidance for financial assets measured at amortized cost and introduces a new current expected credit loss (CECL) model
- Makes targeted improvements to the existing rules for available-for-sale debt securities

Under the new guidance, an entity must record an allowance for expected credit losses over the contractual term of a financial instrument. An entity's estimate of expected credit losses must be based on not only information about current and past conditions, but also forecasts about the future. Although it is likely that the financial services industry will be the most affected, the FASB has made it clear that no entity is exempt from this guidance.

The primary objective of ASU No. 2016-13 is to give users of the financial statements more helpful information about the expected credit losses on financial instruments. The FASB focused on the following key areas of improvement to achieve this objective:

- Eliminating the probability threshold that exists in current GAAP
- Expanding the information considered to estimate expected credit losses
- Requiring the consideration of forecasts
- Improving the accounting for purchased financial assets with credit deterioration
- Enhancing disclosures
- Requiring credit losses on available-for-sale debt securities to be recorded through an allowance

Each of these improvements is discussed in more detail in Figure 2.

The primary objective of ASU No. 2016-13 is to give users of the financial statements more helpful information about the expected credit losses on financial instruments.

Figure 2 – Main Improvements

Improvement	Description
<p>Eliminating the probability threshold that exists in current GAAP</p>	<p>Current GAAP is based on incurred losses. Stakeholders criticize the incurred loss model because it delays the recognition of a loss or impairment until the loss is probable.</p> <p>The guidance in ASU No. 2016-13 is based on expected (not incurred) losses. Therefore, an entity no longer waits for a loss to be probable before the loss is recognized. Instead, an entity records an allowance that reflects management's current estimate of expected credit losses over the life of the asset.</p> <p>The change from an incurred loss model to an expected loss model generally will result in the earlier recognition of credit losses. In theory, the change will affect the timing (but not the total amount) of credit losses recognized.</p>
<p>Expanding the information considered to estimate expected credit losses</p>	<p>Under current GAAP, an entity estimates incurred losses using only information about past events and current conditions. In other words, under current GAAP, an entity does not consider forecasts about the future.</p> <p>ASU No. 2016-13 requires an entity to estimate expected credit losses using information about past events, current conditions, and reasonable and supportable forecasts.</p> <p>The FASB thinks that expanding the information considered to estimate expected credit losses ultimately helps to increase the usefulness of the information provided to users of the financial statements. It also aligns the preparation of the financial statements with the same principles that issuers consider in the underwriting process.</p>
<p>Requiring the consideration of forecasts</p>	<p>Under ASU No. 2016-13, reasonable and supportable forecasts must be considered to determine expected credit losses.</p> <p>Constituents have asserted that considering forecasts is essential to developing an estimate of credit losses over the life of a financial instrument. Ignoring forecasts would produce a misleading estimate of expected credit losses.</p> <p>Forecasts must be reasonable and supportable to be included in an entity's estimate of expected credit losses.</p>



Improvement	Description
<p>Improving the accounting for purchased financial assets with credit deterioration</p>	<p>ASU No. 2016-13 makes the accounting for purchased financial assets with credit deterioration (PCD assets) more consistent with the accounting for other financial instruments.</p> <p>Under current GAAP, no allowance is recorded on the day that a financial asset with credit deterioration is purchased. Under ASU No. 2016-13, however, an entity must record an allowance for credit losses on the purchase date.</p> <p>This change better aligns the accounting for purchased assets and originated assets. Under ASU No. 2016-13, an entity must estimate expected credit losses and record an allowance regardless of whether an asset is purchased or originated. Ultimately, this will make it easier for users of financial statements to compare purchased assets and originated assets.</p>
<p>Enhancing disclosures</p>	<p>Although many of the disclosure requirements in ASU No. 2016-13 are similar to current GAAP, the ASU does include some new or enhanced disclosures. The disclosures are intended to provide better information about:</p> <ul style="list-style-type: none"> • The credit risk associated with the entity’s portfolio of assets • How management monitors this risk • The entity’s estimate of expected credit losses • Any changes in the entity’s estimate <p>One of the most notable changes to the disclosures is a new disclosure required for public business entities. A public business entity must disclose credit quality information for assets by vintage (year of origination). The FASB thinks that this disclosure provides users of the financial statements with better information about an entity’s underwriting standards. For instance, this disclosure may provide insight into how strictly an entity looks at credit quality before transacting with another party and whether the entity has tightened or loosened its underwriting policies over time.</p> <p>Similar to current GAAP, the disclosures in ASU No. 2016-13 generally must be provided by portfolio segment, class of financial assets, or major security type.</p>
<p>Requiring credit losses on available-for-sale debt securities to be recorded through an allowance</p>	<p>Under current GAAP, an entity records credit losses as a write down to an available-for-sale debt security. If the issuer’s credit improves in a subsequent period, an entity is prohibited from adjusting the security for the improvement.</p> <p>Under ASU No. 2016-13, credit losses on an available-for-sale debt security must be recorded through an allowance. If the issuer’s credit improves in a subsequent period, an entity must adjust the allowance to reflect the improvement.</p> <p>The use of an allowance permits changes in an issuer’s credit (both improvements and deteriorations) to be reflected in an entity’s income statement in the periods in which the changes occur. This gives users of financial statements better information about changes in expected credit losses.</p>

Compared to current GAAP, ASU No. 2016-13 generally will require an entity to apply a larger degree of judgment as part of its impairment assessment. The ASU also is expected to result in recognizing credit losses earlier in an entity's financial statements.

ASU No. 2016-13 adds a new topic to the Codification — Topic 326, Financial Instruments — Credit Losses. Topic 326 is further broken down into subtopics that provide separate guidance for financial assets measured at amortized cost and available-for-sale debt securities. Topic 326 also addresses the accounting for purchased financial assets with credit deterioration (PCD assets). The guidance in Topic 326 is intended to be measurement guidance, not recognition guidance. Specifically, Topic 326 discusses how to measure expected credit losses on financial instruments.

In addition, ASU No. 2016-13 makes various revisions to other topics of the Codification. The revisions primarily conform the language in the other topics with the new impairment rules in Topic 326. The revisions, however, also make notable changes to the guidance on beneficial interests in Subtopic 325-40, Investments — Other — Beneficial Interests in Securitized Financial Assets.

Compared to current GAAP, ASU No. 2016-13 generally will require an entity to apply a larger degree of judgment as part of its impairment assessment. The ASU also is expected to result in recognizing credit losses earlier in an entity's financial statements.

ASU No. 2016-13 is a significant new standard and is expected to require considerable cost and effort to implement. The FASB expects to receive a number of implementation questions about the standard and has created a transition resource group to help field questions as they arise.

Scope of the FASB's New Guidance for Reporting Expected Credit Losses

ASU No. 2016-13 applies to all entities. While financial institutions may be affected the most by the new standard, all entities with financial instruments (including net investments in leases and trade receivables) are expected to be affected to some degree.



Observation: The degree to which an entity is affected by ASU No. 2016-13 will depend on various factors, such as:

- The size of an entity's portfolio of assets
- The composition of the portfolio
- The level of credit risk associated with the portfolio
- The availability of data for estimating expected credit losses
- The company's existing capabilities and expertise around modeling and estimates

ASU No. 2016-13 applies to a wide range of instruments, including:

- Financial assets measured at amortized cost, such as:
 - Loans
 - Held-to-maturity debt securities
 - Trade receivables from revenue transactions with customers
 - Reinsurance recoverables
 - Receivables related to repurchase agreements or securities lending agreements
- Lease receivables (specifically, net investments in leases)
- Loan commitments, standby letters of credit and other similar off-balance-sheet credit exposures that are not accounted for as insurance
- Available-for-sale debt securities



Observation: ASU No. 2016-13 does not apply to equity securities. In January 2016, as part of the FASB's overall project to improve the accounting for financial instruments, the FASB issued ASU No. 2016-01, Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. Equity securities are within the scope of ASU No. 2016-01, which generally requires these instruments to be reported at fair value with changes in fair value recorded in net income.

Financial Assets Measured at Amortized Cost

ASU No. 2016-13 introduces a new impairment model for financial assets measured at amortized cost, such as held-to-maturity debt securities, loans and receivables. The new impairment model for these assets is referred to as the current expected credit loss (CECL) model.

The CECL model is discussed in detail in Subtopic 326-20, Financial Instruments — Credit Losses — Measured at Amortized Cost.

The CECL model is based on expected losses. An entity must establish an allowance that reflects management's estimate of expected credit losses over the life of the asset.



Observation: The concept of an allowance is new for certain instruments subject to the CECL model. For example, under current GAAP, an entity does not record an allowance for held-to-maturity debt securities. Instead, current GAAP requires an entity to record a direct write down to the amortized cost basis of a held-to-maturity debt security that is other-than-temporarily impaired. The removal of the concept of "other-than-temporary impairment" is one of the most significant changes by ASU No. 2016-13.

Under ASU No. 2016-13, an entity has the flexibility to determine which method it will use to determine the allowance. An entity might use methods that consider discounted cash flows, loss rates, roll rates, probability of default, aging analyses or other factors.



Observation: An entity is not required to use a complex estimation method. Public entities, however, typically will be held to a higher standard than nonpublic entities. In other words, public entities generally will be expected to have more sophisticated and precise estimation methods than nonpublic entities because public entities tend to have access to more resources and expertise. Therefore, it is likely that many public entities will use a discounted cash flow method to project their expected future cash flows and in turn, derive current expected credit losses.

An entity must estimate expected credit losses on a collective (pool) basis for assets that have similar risk characteristics. An entity must estimate expected credit losses on an individual basis for an asset that has unique risk characteristics.



Observation: The concept of assessing impairment for a pool of assets is new for certain instruments subject to the CECL model. For example, under current GAAP, an entity evaluates individual held-to-maturity securities separately for impairment.



Observation: An entity must establish an allowance for an asset on either an individual basis or a collective basis. An entity must be careful not to double count an asset by both evaluating it individually and including it in a pool of assets.

To estimate expected credit losses, an entity must consider all available information that is relevant to the assessment. This includes information about past events, current conditions and reasonable and supportable forecasts. An entity must make a reasonable effort to obtain the relevant information. An entity, however, is not expected to use undue cost and effort.

An entity must estimate expected credit losses over the life of the asset (not a shorter period, such as 12 months). The life of the asset is the contractual term of the asset. An entity must not consider future extensions, renewals or modifications of a loan or receivable unless the entity reasonably expects to enter into a troubled debt restructuring with the debtor.

An entity records an allowance for expected credit losses even if the risk of loss is remote.

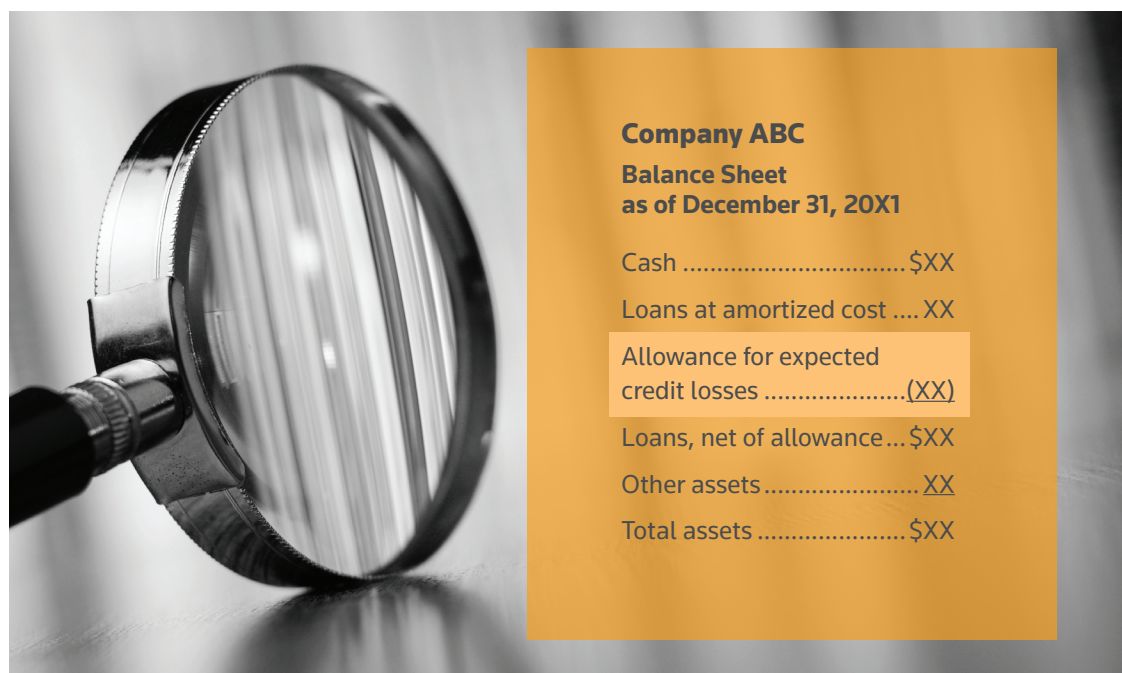


Observation: In very limited cases, an entity might not expect any credit losses over the life of the asset. Thus, the entity might record an allowance equal to zero. For instance, this might be the case for a U.S. Treasury security or an instrument that is expected to be 100-percent collateralized over the life of the instrument.

Before reaching a conclusion that no credit losses are expected, an entity must consider all of the facts and circumstances. If an entity reaches this conclusion, it is important for the entity to maintain appropriate documentation to support its conclusion. The FASB expects these cases to be rare. In other words, an entity typically will foresee at least some credit losses over the life of an asset.

The allowance for expected credit losses is presented on the balance sheet as a reduction to the amortized cost basis of the assets, as shown in Figure 3.

Figure 3 — Balance Sheet Presentation for Financial Assets Measured at Amortized Cost



Company ABC	
Balance Sheet	
as of December 31, 20X1	
Cash	\$XX
Loans at amortized cost	XX
Allowance for expected credit losses	(XX)
Loans, net of allowance ...	\$XX
Other assets	XX
Total assets	\$XX

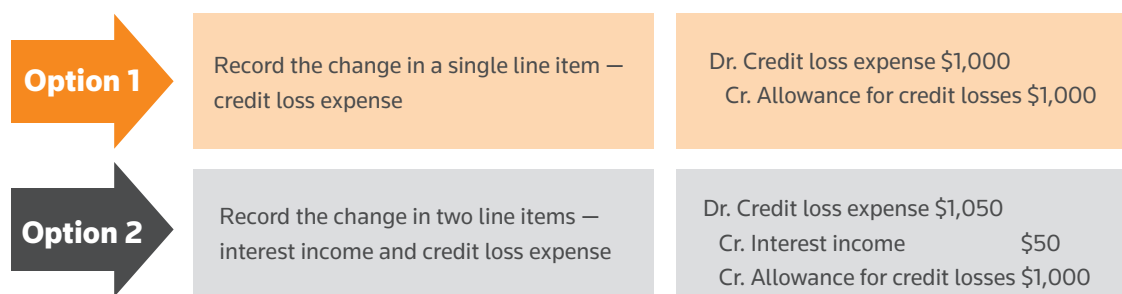
For off-balance-sheet credit exposures, an entity must present expected credit losses as a liability on the balance sheet. This liability must be presented separately from the allowance for credit losses. Examples of off-balance-sheet credit exposures are off-balance-sheet loan commitments, standby letters of credit and financial guarantees that are not insurance.

The allowance must be remeasured each reporting period to reflect management's current estimate of expected credit losses. If an entity establishes an allowance for a pool of assets, the entity must continue to evaluate if the assets in the pool have similar risk characteristics.

Changes in the allowance are recorded in income. Changes in the allowance generally must be recorded as credit loss expense. An entity has a choice of how to reflect the change, however, if it uses a discounted cash flow approach to estimate expected credit losses. Figure 4 shows the two options available. This figure uses the following assumptions:

- An entity uses a discounted cash flow approach to estimate expected credit losses
- The entity has a loan receivable. The allowance for credit losses at the beginning of the period is \$5,000. The entity's estimate of expected credit losses at the end of the period is \$6,000. Therefore, the total change in the allowance is \$1,000. Of the total change in the allowance, \$50 relates to the passage of time.

Figure 4 – Two Options if an Entity Uses a Discounted Cash Flow Approach



The effect on the balance sheet is the same under both options. The effect on the income statement, however, is different. An entity that chooses option 2 must disclose the amount of the change in the allowance recorded as interest income.

An entity must write off all or a portion of the carrying amount of a financial asset when the entity determines that the asset is uncollectible. The writeoff can be a full or partial writeoff. The writeoff is recorded against the allowance for credit losses. For instance, assume that an entity determines that \$50,000 of a particular loan is uncollectible and records a partial writeoff of the loan. Figure 5 shows the journal entry recorded for the partial writeoff.

Figure 5 – Journal Entry for Writeoff

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General ledger account	Debit	Credit
Allowance for credit losses	\$50,000	
Loan receivable		\$50,000
Total	\$50,000	\$50,000

Practical Expedients for Financial Assets Measured at Amortized Cost

ASU No. 2016-13 provides practical expedients for:

- Financial assets secured by collateral, also referred to as collateral-dependent financial assets
- Financial assets secured by collateral maintenance provisions

The first practical expedient pertains to financial assets secured by collateral. In the event that a borrower experiences financial difficulty, an entity may expect to be repaid substantially from the operation or sale of the collateral. If so, as a practical expedient, the entity can use the fair value of the collateral at the reporting date to determine the allowance for expected credit losses. The allowance is calculated as shown in Figure 6.



Figure 6 – Practical Expedient for Financial Assets Secured by Collateral

<p>If repayment is expected from the operation of the collateral ...</p> <p>Amortized cost basis of asset</p> <p>– Fair value of collateral</p> <hr/> <p>Allowance for expected credit losses</p>	<p>If repayment is expected from the sale of the collateral ...</p> <p>Amortized cost basis of asset</p> <p>– Fair value of collateral</p> <p>+ Estimated costs to sell (discounted)</p> <hr/> <p>Allowance for expected credit losses</p>
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The second practical expedient is for financial assets secured by collateral maintenance provisions. The terms of a loan may require the borrower to adjust constantly the amount of collateral securing the loan as the fair value of the collateral changes. If so, as a practical expedient, an entity can measure the allowance for expected credit losses as the difference between the amortized cost basis of the loan and the fair value of the collateral at the reporting date.

Available-for-Sale Debt Securities

ASU No. 2016-13 makes targeted improvements to the impairment guidance for available-for-sale debt securities. The FASB decided not to overhaul the existing impairment model for these securities. The FASB cited various reasons for having a separate model (other than CECL):

- Available-for-sale debt securities are measured at fair value
- These securities are managed differently than other financial assets
- The existing impairment model is well understood
- Making targeted improvements to the existing model (such as removing the probability threshold) provides for more timely recognition of credit losses


The model for available-for-sale debt securities is discussed in Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities.

The model for available-for-sale debt securities is largely based on the impairment guidance that exists under current GAAP in Topic 320, Investments – Debt and Equity Securities. The main change, however, is that the ASU eliminates the concept of an “other-than-temporary impairment.” Instead, an entity must record an allowance for available-for-sale debt securities. The allowance represents management’s estimate of expected credit losses over the life of the asset. The way that an entity determines expected credit losses on available-for-sale debt securities is similar to the impairment guidance that existed in Topic 320, but with targeted improvements. For instance, to estimate expected credit losses, an entity must consider not only information about past events and current conditions (as required under current GAAP), but also reasonable and supportable forecasts.

Available-for-sale debt securities must be presented on the balance sheet at fair value. An entity must indicate the allowance for credit losses and the amortized cost basis of the securities in parentheses, as shown in Figure 7.



Observation: The difference between the amortized cost basis and the fair value of a security may not equal the allowance for expected credit losses on the security. This is because the fair value of a security is affected by not only credit risk, but also other factors. For instance, the difference between the amortized cost basis and the fair value may be comprised of both the allowance for expected credit losses and unrealized gains or losses due to changes in market interest rates.

Figure 7 – Balance Sheet Presentation for Available-for-Sale Debt Securities


Company DEF	
Balance Sheet	
as of December 31, 20X1	
Cash	\$XX
AFS debt securities	XX
(amortized basis of \$XX and allowance for expected credit losses of \$XX)	
Other assets	XX
Total assets	\$XX

The allowance for expected credit losses must be remeasured each reporting period to reflect management's current estimate of expected credit losses. Changes in the allowance are recorded in income. Changes in the allowance generally must be recorded as credit loss expense. Similar to the accounting for financial assets measured at amortized cost, an entity has a choice of how to reflect the change if it uses a discounted cash flow approach to estimate expected credit losses. See Figure 4 for the two options available in this case.



Observation: Under current GAAP, reversals of impairment are not allowed for available-for-sale debt securities. Under Subtopic 326-30, however, reversals of impairment are possible. This is because all changes in the allowance (both increases and decreases) are recorded in income. A decrease to the allowance essentially results in a reversal of an impairment that was recorded in a prior period. A decrease in the allowance happens when an entity's expectations about the future cash flows to be collected on a security improve.

The use of an allowance in ASU No. 2016-13 provides better information to users of the financial statements about changes in an entity's expectations about credit losses. This is because changes (either positive or negative) are reflected in the income statement in the period in which the changes occur. Under current GAAP, an entity records a write down to the amortized cost basis of a security in the period that the other-than-temporary impairment occurs. Under current GAAP, however, subsequent improvements in an issuer's credit are not reflected in the income statement. Also, if an issuer's credit subsequently improves, but then declines again, these effects are not reflected in the income statement. Therefore, under current GAAP, it is more difficult for a user of the financial statements to discern if there have been improvements or declines in credit quality during the period.

There is a limit on the amount of the allowance for available-for-sale debt securities. Specifically, the allowance is limited to the difference between the fair value and the amortized cost of the security.



Observation: The FASB decided to limit the amount of the allowance for available-for-sale debt securities. This is because these securities are considered marketable. In theory, an entity can sell the securities at any point in time to recover their fair value. Therefore, the FASB determined that it is appropriate to limit the allowance to the difference between the fair value and the amortized cost of these securities.

There is no similar limit on the amount of the allowance for assets subject to the CECL model. This is because assets subject to the CECL model generally are held for the purposes of collecting their cash flows (principal and interest). An entity is not expected to sell these assets in an attempt to recover their fair value.

ASU No. 2016-13 makes additional targeted improvements to current GAAP. Figure 8 summarizes the targeted improvements for available-for-sale debt securities.

Figure 8 — Targeted Improvements for Available-for-Sale Debt Securities



Improvement	Description
Recognition of an allowance	<p>The ASU requires an entity to record an allowance for available-for-sale debt securities.</p> <p>Under current GAAP, no allowance is recognized for these securities. Instead, under current GAAP, credit losses are recorded as a write-down of the amortized cost basis of a security.</p>
Length of time a security is under water	<p>Under current GAAP, one factor considered to determine if a credit loss exists is the length of time that the fair value of a security has been less than its amortized cost.</p> <p>The ASU prohibits an entity from considering this factor. The ASU indicates that the length of time that a security is under water must not be used as a reason to avoid recognizing a credit loss.</p> <p>This targeted improvement generally will result in an entity recognizing credit losses sooner as compared to current GAAP.</p>
Changes in fair value after the balance sheet date	<p>Under current GAAP, one factor considered to determine if a credit loss exists is the change in a security's fair value after the balance sheet date. This includes either a recovery or an additional decline in fair value after the balance sheet date.</p> <p>Under the ASU, an entity no longer considers changes in a security's fair value after the balance sheet date. In theory, changes after the balance sheet date do not alter an entity's expectations about credit loss over the lifetime of an asset. These changes are captured already in an entity's expectations about lifetime credit losses.</p>
Historical and implied volatility	<p>Under current GAAP, one factor considered to determine if a credit loss exists is the historical or implied volatility for a security.</p> <p>Under the ASU, this factor is no longer considered to determine if a credit loss exists.</p>



Observation: Under current GAAP, the goal is to determine if an impairment is “other than temporary.” To conclude on whether an impairment is other than temporary, it is relevant to consider various information, including the following three factors:

- The length of time that the security’s fair value has been less than amortized cost
- Any subsequent recoveries in the value of the security
- Historical and implied volatility

ASU No. 2016-13 eliminates the concept of an “other-than-temporary impairment.” Instead, under ASU No. 2016-13, the goal is to estimate expected credit losses over the life of an asset. Therefore, it is no longer appropriate to consider these three factors.

Purchased Financial Assets with Credit Deterioration

ASU No. 2016-13 revises the accounting for purchased financial assets with credit deterioration (PCD assets). This applies to both financial assets measured at amortized cost and available-for-sale securities. ASU No. 2016-13 defines a PCD asset as an asset that has experienced a more than insignificant decline in credit quality from the date of origination to the date of acquisition. Under current GAAP, these assets generally are referred to as purchased credit impaired assets and accounted for under Subtopic 310-30, Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality.



Observation: “PCD assets” is a new term under ASU No. 2016-13.

Under ASU No. 2016-13, PCD assets are subject to a gross-up approach. That is, for a PCD asset, the amortized cost basis reflects the sum of the estimated expected credit losses at the purchase date, plus its purchase price.

The definition of a PCD asset under ASU No. 2016-13 is broader than the definition of a PCI asset under prior GAAP. A PCD asset has experienced a “more than insignificant” credit deterioration since origination. Under current GAAP, an asset is not considered a PCI asset unless it is probable that cash flows will not be collected on the asset. ASU No. 2016-13 does not include a probability threshold. Therefore, more assets may qualify as PCD assets under ASU No. 2016-13.

Under the new guidance:

- On the date of acquisition, an entity must recognize an allowance for expected credit losses. PCD assets typically are purchased at a discount. The allowance for expected credit losses represents the portion of the discount due to expected credit losses.
- The allowance is added to the purchase price on the date of acquisition to determine the initial amortized cost basis of the asset. In other words, the balance sheet is grossed up for the credit impairment.
- An entity does not record credit loss expense on the acquisition date. In other words, there is no income statement effect on the acquisition date.
- Subsequent changes in the allowance (after the acquisition) are recorded in income.



Observation: ASU No. 2016-13 requires an allowance to be recorded for both PCD assets and non-PCD assets. This treatment is intended to make it easier for users of the financial statements to compare and analyze PCD assets and non-PCD assets.

Current GAAP prohibits an entity from recognizing a valuation allowance on the date that a loan was acquired. Therefore, the requirement in ASU No. 2016-13 to record an allowance on day one is a change from current GAAP.



Observation: Purchased financial assets with credit deterioration generally are acquired at a discount. The discount relates to both expected credit losses and other factors – such as changes in market interest rates. The discount related to expected credit losses is recognized as an allowance on the acquisition date. The remaining discount is recorded as interest income over the life of the asset. An entity does not recognize interest income for the discount related to expected credit losses.

Figure 9 illustrates the accounting for a PCD asset on the acquisition date. This figure uses the following assumptions:

- An entity buys a PCD asset that has a par value of \$100,000
- The purchase price is \$60,000
- The entity determines that the discount of \$40,000 relates to:
 - Expected credit losses of approximately \$32,000
 - Changes in market interest rates and other factors (\$8,000)

Figure 9 – Initial Journal Entry for PCD Asset

JOURNAL VOUCHER

General ledger account	Debit	Credit
Loan – par value	\$100,000	
Loan – noncredit discount		\$8,000
Allowance for credit losses		\$32,000
Cash		\$60,000
Total	\$100,000	\$100,000



Observation: The main difference between PCD assets and non-PCD assets is the effect on the income statement on the date of acquisition. When an entity acquires a PCD asset, there is no income statement effect on the acquisition date. When an entity acquires a non-PCD asset, the entity records credit loss expense on the acquisition date; the credit loss expense represents the entity's estimate of expected credit losses over the life of the asset.

In subsequent periods, the noncredit discount is accounted for as interest income and accreted into income over the life of the asset. Also, the allowance for credit losses must be remeasured each reporting period. Any changes in the allowance after the acquisition date are recorded in income as credit loss expense.

Beneficial Interests

ASU No. 2016-13 makes notable revisions to the guidance for beneficial interests in Subtopic 325-40, Investments – Other – Beneficial Interests in Securitized Financial Assets. For instance:

- The amendments require an entity to record an allowance for expected credit losses for beneficial interests
- The amendments require an entity to measure the allowance using a discounted cash flow (present value) technique
- The amendments indicate when an entity must account for a beneficial interest as a purchased financial asset with credit deterioration (PCD asset)



Observation: Under current GAAP, an entity does not use an allowance to account for an impairment of a beneficial interest. Instead, current GAAP requires an entity to write down the amortized cost basis to fair value if there is an other-than-temporary impairment. Therefore, the use of an allowance under ASU No. 2016-13 is a change for beneficial interests.

Under ASU No. 2016-13, an entity must account for a beneficial interest as a PCD asset if either of the following is true:

- The beneficial interest meets the definition of a PCD asset
- At the date of recognition, there is a significant difference between the contractual and expected cash flows

If an entity is required to account for a beneficial interest as a PCD asset, it applies the following guidance:

- Subtopic 326-20, Financial Instruments – Credit Losses – Measured at Amortized Cost, for beneficial interests classified as held-to-maturity
- Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities, for beneficial interests classified as available-for-sale.

Transition and Effective Date Information

ASU No. 2016-13 provides separate effective dates for:

- Public business entities that are SEC filers
- Public business entities that are not SEC filers
- All other entities

Public business entities that are SEC filers must adopt the guidance for annual periods beginning after December 15, 2019 and interim periods within these annual periods.

Public business entities that are not SEC filers must adopt the guidance for annual periods beginning after December 15, 2020 and interim periods within these annual periods.

All other entities must adopt the guidance for annual periods beginning after December 15, 2020 and interim periods within annual periods beginning after December 15, 2021.

Figure 10 summarizes the effective dates for ASU No. 2016-13, assuming that a company has a calendar year end.

Figure 10 – Effective Dates



Public Business Entity: SEC Filer	Public Business Entity: Non-SEC Filer	All Other Entities
December 31 2020	December 31 2021	December 31 2022
Interim Periods:		
March 31, 2020 June 30, 2020 September 30, 2020	March 31, 2021 June 30, 2021 September 30, 2021	March 31, 2022 June 30, 2022 September 30, 2022

Early adoption is allowed for all entities for annual periods beginning after December 15, 2018 and interim periods within these annual periods. An entity, however, cannot adopt the guidance before these dates.



Observation: ASU No. 2016-13 was issued in June 2016. The FASB originally hoped to issue its final standard on credit losses earlier. Given the delay in issuance, the FASB decided to allow early adoption.

To determine whether to adopt early, an entity is encouraged to consider the expectations of the users of its financial statements. For instance, if an entity's competitors plan to adopt the guidance early, the market may expect the entity to do so as well.

Entities also must consider their available resources. Many entities are in the process of adopting multiple major new standards, such as the standards for revenue recognition (ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606)) and leases (ASU No. 2016-02, Leases (Topic 842)). Therefore, resources may be tight for many entities.

Early adoption may be appealing to a multi-national company required to apply both US GAAP and IFRS. Although the IASB's impairment guidance is different from the impairment guidance in ASU No. 2016-13, both standards use the concept of expected credit losses. The IASB's new impairment guidance in IFRS 9 is effective for annual periods beginning on or after January 1, 2018.

Most of ASU No. 2016-13 must be applied using a modified retrospective transition approach.

For two types of assets, however, the ASU offers transition relief by requiring an entity to use a prospective transition approach. The two types are:

- Purchased financial assets with credit deterioration
- Debt securities for which an other-than-temporary impairment (OTTI) was recognized before the effective date



Observation: Using a modified retrospective approach would have been challenging for purchased financial assets with credit deterioration and debt securities for which an OTTI was recognized before the effective date. Stakeholders raised various concerns about the cost and complexity of using a modified retrospective approach for these assets. To address these concerns, the FASB decided to require prospective application for these parts of the guidance. The use of prospective application in these areas is intended to reduce the cost and complexity of transition.

The ASU also provides transition relief by allowing certain companies to "phase in" one of the required disclosures. Specifically, public companies generally must disclose the credit quality of their assets by vintage. Public companies that are not SEC filers can phase in this disclosure according to specific rules in the ASU.



Observation: Implementation will require substantial work. Some entities might be tempted to look for "quick fixes" to their existing systems, processes and controls. This approach, however, generally leads to substantial costs at a later date. Entities are encouraged to put in the time and effort required to implement systems, processes and controls that will work well for them in the long run.

The longer an entity waits to begin implementation, the less time an entity will have to establish long-term solutions. Starting implementation as early as possible ultimately will produce the best outcome.



Comparison to IFRS 9

Although at one time the FASB and the IASB hoped to issue a converged standard on the impairment of financial instruments, convergence has not been achieved.

The IASB's principles for impairment are laid out in IFRS 9. At a high level, the approach uses a dual-measurement objective for expected credit losses—one measurement for assets having experienced a significant increase in credit risk since origination, and a separate measurement for assets that have not experienced such credit deterioration.

Under IFRS 9, if an asset (or group of assets) has not experienced a significant increase in credit risk since origination, an entity estimates expected credit losses over the next 12 months of the asset's life. If an asset (or a group of assets) has experienced a significant decline in credit quality, an entity must estimate expected credit losses over the asset's lifetime.

Topic 326, on the other hand, uses a single measurement objective in which an entity records its total estimate of expected credit losses on a financial asset at origination. This is the main difference between Topic 326 and IFRS 9.

Earlier in its impairment project, the FASB also considered but ultimately rejected an impairment approach with two measurement objectives. Stakeholders for US GAAP raised concerns about the operability and complexity of this approach. In particular, stakeholders indicated that it would be difficult to come up with a reasonable way to determine when a significant credit deterioration has occurred. Therefore, it would be hard to determine when it was appropriate to move an asset from one measurement category to the other (in other words, when to change the measurement basis from 12 months of losses to lifetime losses and vice versa).

Since the FASB and the IASB have introduced different impairment models, there will be differences in the accounting for impairment under US GAAP and IFRS. The primary difference is the partial estimate of lifetime expected credit losses for financial instruments that have not experienced a significant increase in credit risk since origination under IFRS 9. Under IFRS 9, the allowance for these assets is based on 12 months of expected credit losses. Under US GAAP, however, the allowance is based on lifetime expected credit losses. Therefore, the allowance recorded for this category of assets under IFRS 9 likely will be less than the allowance recorded under US GAAP.

Another notable difference is the fact that IFRS 9 explicitly requires an entity to consider the time value of money when estimating the amount of expected credit losses. US GAAP does not require an entity to adjust its estimate for the time value of money. The IFRS standard also requires an entity to use a probability-weighted measurement that considers various scenarios and the likelihood of each scenario occurring. These specific measurement requirements can potentially cause an IFRS entity and a US GAAP entity to compute different amounts of expected credit losses for an identical asset.

Since the FASB and the IASB have introduced different impairment models, there will be differences in the accounting for impairment under US GAAP and IFRS.



Next Steps

Although the effective date of ASU No. 2016-13 may seem far off in the future, companies must not underestimate the effort required for implementation. Many companies have a substantial amount of financial instruments. Also, many are experiencing resource constraints due to the adoption of multiple major new standards, such as the standards for revenue recognition (ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606)) and leases (ASU No. 2016-02, Leases (Topic 842)). Therefore, it is never too early to begin the implementation effort. Starting the implementation of ASU No. 2016-13 as early as possible ultimately will produce the best outcome. The longer a company waits to begin implementation, the less time the company will have to establish processes and controls that will run smoothly and efficiently.

Companies can get started on implementing ASU No. 2016-13 now. For instance, here are a few activities that companies can consider now:

- **Collect data to measure expected credit losses:** Collection of data is a critical starting point for implementation. A company must collect sufficient data to be able to project expected credit losses over the life of the asset. A company may already be collecting some of the data necessary, but must develop processes to accumulate any additional data required to estimate the allowance for expected credit losses. A company also must establish proper controls around the data.
- **Determine estimation methods:** Determining the appropriate methods to estimate expected credit losses is a key implementation decision. The standard provides flexibility for management to identify a method that is reasonable and meets the objectives of the standard. A company may be able to leverage existing systems or worksheets that are used to account for impairment under current GAAP. If a company chooses this approach, it still must add any new inputs to the analysis necessary to estimate expected credit losses. For instance, current GAAP requires an entity to consider information about past events and present conditions to account for impairment. The new standard requires an entity to consider not only past events and present conditions, but also reasonable and supportable forecasts. Therefore, an entity that decides to leverage existing systems and worksheets must make enhancements to incorporate forecasts into its estimate of expected credit losses. A company also may wish to implement estimation methods that will allow for revisions and improvements in future periods.
- **Evaluate the new disclosure requirements:** Providing adequate disclosure is another essential piece to the successful implementation of a new standard. Some companies may use highly sophisticated models to estimate expected credit losses and it may be a challenge for them to prepare disclosures that adequately explain their estimation methods. Also, the standard requires some new disclosures, such as a requirement that public business entities provide information about the credit quality of assets subject to the CECL model by vintage. This disclosure by vintage may take considerable effort to compile the necessary information.
- **Disclose the anticipated effects of the new standard:** SEC registrants must disclose the expected effects of recently issued accounting standards in accordance with Staff Accounting Bulletin (SAB) Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period (commonly referred to as SAB 74). This includes disclosing the potential material effects of ASU No. 2016-13 when adopted. If an entity cannot reasonably estimate the effects, it must disclose this fact, the status of its implementation (including significant items outstanding) and qualitative information to help users evaluate the possible effects.
- **Involve other departments:** Employees from various functions of the business (such as accounting, finance, risk management and IT) may be heavily involved in the implementation of ASU No. 2016-13 and the ongoing processes and controls necessary to comply with the standard in periods following adoption. Therefore, these employees must understand the requirements under the ASU and their roles and responsibilities in ensuring that the company is compliant with the requirements. An entity also is encouraged to engage the tax department to understand and prepare for any tax consequences of the standard on the entity's financial statements.

The longer a company waits to begin implementation, the less time the company will have to establish processes and controls that will run smoothly and efficiently.



The FASB has set up a transition resource group for credit losses to help address issues that constituents have in implementing ASU No. 2016-13.

The purpose of the group is to collect and discuss issues raised by stakeholders, and then inform the FASB if there are areas of the standard that could use clarification. It ultimately will be up to the FASB to decide whether to issue any revisions or clarifications to the standard.

Stakeholders can submit questions to the transition resource group for consideration through the FASB's website.



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