

# A Comprehensive Look at the CECL Model

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On June 16, 2016, the Financial Accounting Standards Board (FASB) released the long-awaited standard updating the guidance on recognition and measurement of credit losses for financial assets. Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*, supersedes today’s guidance and applies to all entities that hold financial assets not measured at fair value through net income. FASB has replaced today’s “incurred loss model” with an “expected credit loss model.” At acquisition and each reporting date, entities will recognize an allowance for lifetime expected credit losses for instruments within the ASU’s scope. The amount recognized will be based on the current estimate of contractual cash flows not expected to be collected. Subsequent changes in the allowance for credit losses will be recognized through net income. Entities will have flexibility to develop the methods to estimate and measure expected credit losses as long as they are appropriate, practical and consistent with the principles of the guidance.

### Scope

The model would apply to these financial assets not measured at fair value:

- Financing receivables
- Held to maturity debt securities
- Loan commitments, standby letters of credit, financial guarantees
- Lease receivables
- Trade receivables
- Reinsurance receivables
- Receivables on repurchase and securities lending agreements

FASB specifically excluded these instruments from the scope of the new standard:

- Financial assets measured at fair value through net income
- Available-for-sale debt securities—existing other than temporary impairment (OTTI) guidance has been superseded
- Participant loans from defined contribution employee benefit plans (EBP)
- Insurance policy loans
- Not-for-profit (NFP) pledges receivable
- Receivables from parties under common control

### Current Expected Credit Loss Model

Range of Information



FASB has broadened the information an entity is required to consider in developing its credit loss estimate. Under current generally accepted accounting principles (GAAP), an entity usually considers past events and current conditions in measuring credit losses. The ASU requires the loss estimate to include relevant information about

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past events, current conditions and reasonable and supportable forecasts. An entity only needs to consider information reasonably available without undue cost and effort, and it can use both internal and external information—including qualitative and quantitative factors—to estimate expected credit losses. For periods an entity is unable to make a reasonable and supportable forecast, entities would revert to historical credit loss experience. An entity may immediately revert to historical loss information or converge to historical losses using a rational and systematic basis.

***Entities cannot rely solely on past events to estimate expected credit losses.***

When estimating expected credit losses, an entity shall evaluate information related to the borrower's creditworthiness, the issuer's underwriting practices and the current and forecasted direction of the economic environment. The ASU does not specify a particular methodology to be applied in determining historical credit loss experience; 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.

Historical loss information generally provides a basis for an entity's assessment of expected credit losses but may not fully reflect an entity's expectations about the future. Management shall adjust historical loss experience, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss experience, considering the asset's relevant characteristics. Management's adjustments shall reflect significant factors impacting expected collectibility. These are examples of factors an entity may consider, depending on the nature of the asset (not all may be relevant to every situation, and other factors not on the list may be relevant):

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

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An entity may use historical periods that represent management’s expectations for future credit losses, including use of other historical loss periods appropriately adjusted for current conditions and other reasonable and supportable forecasts. The adjusted historical credit loss data selected should be applied to pools defined in a manner consistent with the pools for which the historical credit loss experience was observed.

### Loss Probabilities

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 experience adjusted for current conditions and reasonable, supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. An entity shall not expect nonpayment of the amortized cost basis to be zero solely on the current value of collateral securing the financial asset(s); instead, they also shall consider the nature of the collateral, potential future changes in collateral values and historical loss experience for financial assets secured with similar collateral. The final standard does not explicitly state which financial assets might warrant a zero expected loss, but does provide an example, noted below.

*Example – Estimating Expected Credit Losses on a U.S. Treasury Security when Expected Nonpayment Is Zero*

*Reproduced from ASC 326-20-55-48 through 55-50 (Example 8)*

*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.*

*ABC Co. invests in U.S. Treasury securities with the intent to hold to maturity and collect contractual cash flows. ABC classifies its U.S. Treasury securities as held-to-maturity and measures the securities on an amortized cost basis.*

*Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, ABC’s management still believes there is a possibility of default, even if that risk is remote. However, ABC 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 experience, including qualitative factors. In this circumstance, ABC 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 experience should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, ABC does not record expected credit losses for its U.S. Treasury securities*

*The requirement to measure expected credit losses on financial assets with a low risk of loss is likely to result in additional costs and complexity.*

### Measurement of Expected Credit Losses

Currently, depending on the financial asset’s nature, a credit loss must either be probable or other than temporary before recognition. The ASU eliminates a recognition threshold on credit losses. An entity would recognize a “Day 1” impairment allowance for its current estimate of contractual cash flows not expected to be collected on financial assets.

## Individual Versus Pooled Assessment

Entities can develop credit loss estimates on a pooled basis if the assets share similar risk characteristics—if not, an individual evaluation is appropriate.

## Collective Evaluation

In evaluating financial assets on a collective (pool) basis, an entity shall aggregate financial assets on the basis of similar risk characteristics. It may include any one or a combination of the following—consistent with its policies on how it evaluates the credit risk characteristics of financing receivables, held-to-maturity debt securities or off-balance-sheet credit exposures:

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

Entities must remove a financial asset from a pool if its risk characteristics are no longer similar to the other financial assets in the pool. For example, there may be changes in credit risk, borrower circumstances, recognition of write-offs or cash collections that have been fully applied to principal on the basis of nonaccrual practices that may require a reevaluation to determine if the asset has migrated to have similar 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.

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

*Reproduced from ASC 326-20-55-18 through 55-22 (Example 1)*

*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 which are managed on a collective basis based on similar risk characteristics. The loan portfolio was originated over the last 10 years and has an amortized cost of \$3,000,000.*

*After comparing historical information for similar financial assets with the current and forecasted direction of the economic cycle, 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 for loans that existed over the historical period in comparison with the current portfolio. The community bank's cumulative historical lifetime credit loss rate 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 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 an incremental 10-basis-point increase in credit losses due to the expected decrease in real estate values, and a 5 basis point increase due to expected deterioration in unemployment rates. Management estimates the incremental fifteen basis-point increase based on its knowledge of historical loss experience 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 beyond Year 2 of the forecast and decides to immediately revert to the historical credit loss experience after Year 2.*

*The historical loss rate to apply to the amortized cost basis of the loan portfolio would then be adjusted by an incremental 15 basis points to 1.65 percent. The allowance for expected credit losses for the reporting period date would be \$49,500.*

**Example – Estimating Expected Credit Losses on a Vintage-Year Basis**

Reproduced from ASC 326-20-55-28 through 55-31 (Example 3)

Community Bank ABC provides financing to local consumers purchasing new or used farm equipment, originates approximately the same amount of loans each year. The four-year amortizing loans it originates are secured by using a relatively consistent range of loan-to-collateral-value ratios at origination. The underlying farm equipment collateral is repossessed and sold at auction when the borrower becomes 90-days past due. The bank tracks these loans on the basis of the calendar-year of origination. The following pattern of credit loss experience has been developed based on the amount of amortized cost in each vintage that was written off as a result of credit losses. In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, the bank considers its historical loss experience. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans and 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, the bank 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 equipment’s collateral value. Recent severe weather has increased crop insurance cost and this trend is expected to continue. On the basis of those factors, the bank determines the remaining expected losses (represented by the shaded cells in the table below), and arrives at expected losses of \$60, \$260, \$430, and \$510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively.

Year of Origination	Loss Experience in Years Following Origination					
	Year 1	Year 2	Year 3	Year 4	Total	Total Expected
20X1	\$50	\$120	\$140	\$30	\$340	-
20X2	\$60	\$120	\$160	\$50	\$390	-
20X3	\$40	\$110	\$150	\$30	\$330	-
20X4	\$60	\$110	\$150	\$40	\$360	-
20X5	\$50	\$130	\$170	\$50	\$400	-
20X5	\$70	\$150	\$180	\$60	\$460	\$60
20X7	\$80	\$140	\$190	\$70	\$480	\$260
20X8	\$70	\$150	\$200	\$80	\$500	\$430
20X9	\$70	\$160	\$200	\$80	\$510	\$510

**Methods Permitted**

Due to the subjective nature of the credit loss estimate, the ASU does not require a specific approach. An entity should use judgment to develop estimation techniques that are applied consistently over time. The allowance for credit losses may be determined using various methods, e.g., discounted cash flow (DCF), loss rate, roll-rate, probability-of-default methods or methods that use an aging schedule. Entities can consider relevant internal or external information.

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An entity would not offset its estimate of expected credit losses on a financial asset with a free standing contract, e.g., credit-default swap. However, an entity would consider the mitigating impact of other credit enhancements (other than freestanding contracts), including 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.

*Estimating expected credit losses over longer periods of time will require significant judgment.*

### *Example – Estimating Expected Credit Losses Using a Loss-Rate Approach (Individual Evaluation)*

*Reproduced from ASC 326-20-55-23 through 55-27 (Example 2)*

*Community Bank ABC provides residential real estate loans to local borrowers. In the current year, Community Bank ABC started a program to originate commercial loans. The bank has one commercial loan outstanding at period end and because the commercial loan does not share similar risk characteristics, the bank does not believe it is appropriate to pool the commercial loan for purposes of determining its allowance for credit losses. The commercial loan has an amortized cost of \$1,000,000. Historical loss information for commercial loans in the community with similar risk characteristics shows a 0.50 percent loss rate over the contractual term. The bank considers relevant current conditions and reasonable and supportable forecasts that relate to its lending practices and environment and the specific borrower and determines that the significant factors affecting the loan's performance are borrower specific operating results and local unemployment rates. The bank considers other qualitative factors including national macroeconomic conditions but determines that they are not significant inputs to the loss estimates for to this loan.*

*The bank is able to reasonably forecast local unemployment rates and borrower specific financial results for one year only. The bank's reasonable and supportable forecasts indicate that local unemployment rates should remain stable (based on the main employer in the community continuing to operate normally) but 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. The bank determines that an upward adjustment of 10 basis points to the historical 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. The historical loss rate to apply to the amortized cost basis of the individual loan would then be adjusted an incremental 10 basis points to 0.60 percent and the allowance for expected credit losses for the reporting period date would be \$6,000.*

## Discounted Cash Flows

If an entity estimates expected credit losses using a DCF, the entity shall discount expected cash flows at the financial asset's effective interest rate. When a DCF 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. For assets with variable or indexed interest rates, e.g., prime rate or London Interbank Offered Rate, the effective interest rate shall be based on the same factor or index.

## Practical Expedients for Measuring Expected Credit Losses

The ASU contains practical expedients when measuring expected credit losses for two types of financial assets.

## Collateral-Dependent Financial Assets

Consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, only if repayment is dependent on a sale). A collateral-dependent financial asset is defined as 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.

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

*Reproduced from ASC 326-20-55-41 through 55-44 (Example 6)*

*Bank ABC 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, housing prices have dropped significantly, while luxury apartment communities have experienced an increase in vacancy rates. At the end of 2017, Bank ABC reviews its commercial real estate loan to Developer XYZ observes the developer is experiencing financial difficulty due to decreasing rental rates and increasing vacancy rates in its apartment building.*

*After analyzing XYZ's financial condition and the operating statements for the apartment building, Bank ABC believes the developer has no other unencumbered assets and will be unable to repay the loan at maturity in 2019. Therefore, Bank ABC believes the loan can be repaid only through the foreclosure and sale (rather than the operation) of the collateral and, believes that the loan meets the definition of a collateral-dependent loan.*

*As a result, in its financial statements for the period ended December 31, 2017, Bank ABC utilizes the practical expedient and considers the apartment building's fair value, less costs to sell, when developing its estimate of expected credit losses.*

## Financial Assets Secured by Collateral Maintenance Provisions

Under certain agreements, a borrower may be required to continually adjust the collateral amount securing the financial asset due to the collateral's fair value changes, e.g., repurchase agreements or securities lending arrangements. The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the Current Expected Credit Loss (CECL) model, but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value. An entity may determine 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.

## Net Investment in Leases

An entity should include the unguaranteed residual asset with the lease receivable, net of any deferred selling profit, if applicable (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 *Leases (Topic 842)* should be used in place of the effective interest rate.

## Impairment of Available for Sale Securities (OTTI Model Superseded)

As proposed, the CECL model would have applied to available-for-sale (AFS) debt securities. However, during redeliberations, the FASB excluded AFS debt securities from CECL's scope. Because an entity may realize the total value of financial assets either through collection of contractual cash flows or through sale, FASB felt a separate credit loss model continued to be warranted, but decided to eliminate the existing OTTI model. AFS securities would continue to be evaluated at the individual security level.

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AFS debt securities would use an allowance approach, which would permit entities to recognize reversals of credit losses. Entities would be prohibited from considering the length of time the fair value of the AFS debt security has been less than its amortized cost basis, when estimating whether a credit loss exists. Additionally, entities would no longer be required to consider recoveries or additional declines in fair value for AFS debt securities after the balance sheet date.

The ASU creates a “floor,” such that the credit losses on AFS debt securities are limited to the difference between the debt security’s amortized cost basis and fair value.

*These changes likely will result in recognizing losses sooner than under today’s guidance; however, the model allows for immediate gain recognition when there is recovery.*

### Loans Subsequently Identified for Sale

Once a decision has been made to sell loans not currently classified as held for sale, those loans shall be transferred into the held-for-sale classification. Write-off guidance may result in a portion of the amortized cost basis being written off before the loan has been transferred to the held-for-sale classification. Upon transfer, an entity shall measure a valuation allowance equal to the amount by which the amortized cost basis, which is reduced by any previous write-offs but excludes the allowance for credit losses, exceeds the fair value.

*This guidance applies to both mortgage and nonmortgage loans.*

### Assets With Credit Deterioration (Formerly Purchased Credit-Impaired Assets)

The ASU modifies the definition of what were previously known as purchased credit-impaired (PCI) assets. FASB defines purchased financial assets with credit deterioration (PCD) as an acquired financial asset or acquired groups of financial assets with similar risk characteristics that have experienced a more-than-insignificant deterioration in credit quality since origination, based on the buyer’s assessment. This differs from current U.S. GAAP, which includes assets with contractual cash flows that, at acquisition, are probable of not being collected.

PCD assets would follow the same approach as originated assets for purposes of credit impairment; upon acquisition and at each reporting date, an entity would recognize a credit impairment allowance for its current estimate of the contractual cash flows not expected to be collected. At acquisition, the allowance for credit losses should be added to the purchase price to determine the initial amortized cost basis. The “noncredit” remaining portion of the difference between the amortized cost basis and par value would be recognized as a discount or premium and accreted into interest income over the remaining life of the asset. Subsequent changes in expected cash flows would be recorded as gains and losses through the credit loss provision.

Entities using a DCF method would use a rate that equates the present value of the expected cash flows with the asset’s purchase price. Entities using other methods would estimate expected credit losses based on the asset’s unpaid principal balance.

*Under today’s model, decreases in expected cash flows are recorded immediately as expense and expected improvements are recognized prospectively. Under the revised PCD model, both positive and negative changes in expected cash flows will be recorded immediately—either through provision expense or a negative provision in the case of improving credit loss estimates.*

*Example – Identification of PCD Assets*

*Reproduced from ASC 326-20-55-57 through 55-60 (Example 11)*

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

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

*ABC assesses what is more-than-insignificant credit deterioration since origination and considers the purchased assets with the following characteristics to be consistent with the factors that affect collectibility in paragraph 326-20-55-4. Entity N records the allowance for credit losses in accordance with paragraph 326-20-30-13 for the following assets:*

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

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

*Example – Recognition of Purchased Financial Asset with Credit Deterioration*

*Reproduced from ASC 326-20-55-61 through 55-65 (Example 12)*

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

*Assume that Bank ABC pays \$750,000 for a bond with a par amount of \$1,000,000. The bond is measured at amortized cost basis. At purchase, the allowance for credit loss on the unpaid principal balance is estimated at \$175,000. At acquisition, the balance sheet would reflect an amortized cost basis for the financial asset of \$925,000 (the amount paid plus the allowance for credit loss) and an associated allowance for credit losses of \$175,000. The difference between par of \$1,000,000 and the amortized cost of \$925,000 is a noncredit related discount. The acquisition-date journal entry is as follows.*

<i>Loan—par amount</i>	<i>\$1,000,000</i>
<i>Loan—noncredit discount</i>	<i>\$75,000</i>
<i>Allowance for credit losses</i>	<i>\$175,000</i>
<i>Cash</i>	<i>\$750,000</i>

*The \$75,000 noncredit discount would be accreted into interest income over the bond’s life consistent with other Topics. The \$175,000 credit loss allowance should be updated in subsequent periods for any changes in expected cash flows, with changes in the allowance for credit losses on the unpaid principal balance reported immediately in the statement of financial performance as a credit loss expense.*

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

Reproduced from ASC 326-20-55-66 through 55-70 (Example 13)

This Example illustrates the application of the guidance to determine the expected credit loss using a loss rate for an individual purchased financial asset with credit deterioration.

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

Original Amortization Table

	Beginning				
	Balance	Payment	Interest	Principal	Ending Balance
1	\$5,000,000	\$1,186,982	\$300,000	\$886,982	\$4,113,018
2	\$4,113,018	\$1,186,982	\$246,781	\$940,201	\$3,172,817
3	\$3,172,817	\$1,186,982	\$190,369	\$996,613	\$2,176,204
4	\$2,176,204	\$1,186,982	\$130,572	\$1,056,410	\$1,119,794
5	\$1,119,794	\$1,186,982	\$67,188	\$1,119,794	\$0
Totals		\$5,934,910	\$934,910	\$4,999,588	

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

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

The contractual interest rate is adjusted for the noncredit discount of \$40,025 to determine the discount rate of 7.33 percent, which excludes the purchaser’s assessment of expected credit losses at the acquisition date. The 7.33 percent is computed as the rate that equates the amortized cost of \$2,136,179 (computed by adding the purchase price of \$1,918,559 to the gross-up adjustment of \$217,620) with the net present value of the remaining contractual cash flows on the purchased asset (\$1,186,982 in each of Years 4 and 5).



## Contractual Term & Extensions

An entity would consider the entire contractual term of the financial assets, including expected prepayments, and would only consider extensions renewals and modifications if a troubled debt restructuring is reasonably expected. For off-balance sheet credit exposures, the credit losses would reflect the entire contractual period an entity is exposed to credit risk from its present contractual obligation to extend credit, unless unconditionally cancellable by the issuer.

### *Example – Application of Expected Credit Losses to Unconditionally Cancelable Loan Commitments*

*Bank ABC has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. The bank's card holder agreements stipulate that the available credit may be unconditionally cancelled at any time. When determining the allowance for credit losses, the bank estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank ABC 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 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.*

## Write-Offs

Write-offs of financial assets (full or partial) shall reduce the allowance and be recorded in the period when the financial asset is deemed uncollectible. Recoveries for amounts previously written off shall be recorded when received.

Practices differ between entities, as some industries typically credit recoveries directly to earnings, while financial institutions typically credit the allowance for loan credit losses for recoveries. The combination of this practice and frequent review of the allowance's adequacy results in the same credit to earnings, in an indirect manner.

*Example – Recognizing Write-offs and Recoveries*

*Reproduced from ASC 326-20-55-51 through 55-53 (Example 9)*

*Bank ABC currently evaluates its loan to Entity XYZ on an individual basis because XYZ is 90-days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio. At the end of December 31, 2018, the amortized cost basis for XYZ's loan is \$500,000 with an allowance for credit losses of \$375,000. During the first quarter of 2019, XYZ issues a press release stating that it is filing for bankruptcy. Bank ABC determines that the \$500,000 loan made to XYZ is uncollectible. Bank ABC measures a full credit loss on the loan to XYZ and writes off its entire loan balance, as follows:*

<i>Credit loss expense</i>	<i>\$125,000</i>
<i>Allowance for credit losses</i>	<i>\$125,000</i>
<i>Allowance for credit losses</i>	<i>\$500,000</i>
<i>Loan receivable</i>	<i>\$500,000</i>

*During March 2019, Bank ABC receives a partial payment of \$50,000 from Entity XYZ for the loan previously written off. Upon receipt of the payment, Bank ABC recognizes the recovery, as follows:*

<i>Cash</i>	<i>\$50,000</i>
<i>Allowance for credit losses</i>	<i>\$50,000</i>

*For its March 31, 2019 financial statements, Bank ABC estimates expected credit losses on its financial assets and determines that the current estimate is consistent with the estimate at the end of the previous reporting period. During the period, Bank ABC does not record any change in amounts to its allowance for credit losses account other than the recovery of the loan to XYZ. To adjust its allowance for credit losses to reflect the current estimate, Bank ABC reports the following on March 31, 2019.*

<i>Allowance for credit losses</i>	<i>\$50,000</i>
<i>Credit loss expense</i>	<i>\$50,000</i>

*Alternatively, Bank ABC could have recorded the recovery of \$50,000 directly as a reduction to credit loss expense.*

## Disclosures

The disclosure carries forward some of the requirements of ASU 2010-20—*Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, such as those related to quantitative and qualitative information about credit quality, including the amount of recorded investment by the credit quality indicator. Disclosures generally are required to be broken out by portfolio segment, class of financing receivable or major security type. Judgment will be required in determining the correct level of detail to satisfy financial statement users without aggregating too much data or including excess details. Examples of portfolio segments include type of financing receivable, industry sector or risk rating. The ASU includes guidance in determining level of detail for the class of financial receivables. Entities should consider any of the following factors:

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

## Credit Quality

Information provided should enable a financial statement user to understand how management monitors the credit quality of its financial assets and assess the quantitative and qualitative risks from the credit quality of its financial assets. Quantitative and qualitative information should be provided by class of financing receivable and major security type and include a description of the credit quality indicator, amortized cost basis and credit quality indicator, and for each credit quality indicator, the date or range of dates in which the information was last updated. Examples of credit quality indicators can include consumer credit risk scores, credit-agency ratings, internal credit risk grades, debt-to-value ratios, collateral, collection experience or other internal metrics. Entities using internal-risk ratings must provide qualitative information on how those internal-risk ratings relate to the likelihood of loss.

For financing receivables and net investment in leases, the amortized cost basis within each credit quality indicator should be presented by year of origination (vintage year). For acquired assets, an entity shall use the initial date of

## A Comprehensive Look at the CECL Model

issuance to determine the year of origination, not the date of acquisition. An entity need not present more than the most recent five origination years. An entity can present the amortized cost basis originated before the fifth annual reporting period 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 vintage disclosure is not required for entities that aren't public business entities. For public business entities that aren't SEC filers, transitional relief will allow banks to "build up" the data over time to meet the full disclosure requirements.*

Receivables measured at the lower of amortized cost or fair value and most trade receivables due in one year or less are exempt from disclosing credit quality indicators. However, all credit card receivables must disclose the credit quality indicators.

The following example illustrates the presentation of credit quality disclosures for a financial institution with a narrow range of loan products offered to local customers—both consumer and commercial. Depending on the size and complexity of an entity's portfolio of financing receivables, the entity may present disclosures that are more or less detailed than the following example. An entity may choose other methods of determining the class of financing receivable and may determine different credit quality indicators that reflect how credit risk is monitored. Some entities may have more than one credit quality indicator for certain classes of financing receivables.

	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost	
	20X5	20X4	20X3	20X2	20X1	Prior	Basis	Total
<b>As of December 31, 20X5</b>								
<b>Residential mortgage:</b>								
Risk rating:								
1-2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3-4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
<b>Total residential mortgage loans</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Residential mortgage loans:</b>								
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Current-period recoveries	-	-	-	-	-	-	-	-
<b>Current-period net writeoffs</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Consumer:</b>								
Risk rating:								
1-2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3-4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
<b>Total consumer</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Consumer loans:</b>								
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Current-period recoveries	-	-	-	-	-	-	-	-
<b>Current-period net writeoffs</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Commercial business:</b>								
Risk rating:								
1-2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3-4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
<b>Total commercial business</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Commercial business loans:</b>								
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Current-period recoveries	-	-	-	-	-	-	-	-
<b>Current-period net writeoffs</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Commercial mortgage:</b>								
Risk rating:								
1-2 internal grade	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
3-4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
<b>Total commercial mortgage</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Commercial mortgage loans:</b>								
Current-period gross writeoffs	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Current-period recoveries	-	-	-	-	-	-	-	-
<b>Current-period net writeoffs</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>

### Allowance for Expected Credit Losses

Entities are required to disclose, for each portfolio segment and major security type, a description of how expected loss estimates are developed, the accounting policies and methodology used to estimate the allowance for expected credit losses, including a discussion of the factor that influenced management's current estimate. Any policy or methodology changes from the prior period would be noted, as well as the reasons for significant write-offs. Entities also would discuss the reversion method to revert to historical credit loss experience for periods beyond which the entity is unable to make or obtain reasonable and supportable forecasts.

### Rollforward of the Allowance for Credit Losses

A rollforward of the allowance by portfolio segment and major security type is required. This would include the beginning balance, current-period provision for expected credit losses, the initial allowance for credit losses recognized on PCI assets, write-offs charged against the allowance, any recoveries of amounts previously written off and the ending balance in the allowance for credit losses.

### Past-Due Status

Consistent with current GAAP, for each class of financial receivable and major security type, an entity would provide an aging analysis of the amortized cost for debt instruments that are past due as of the reporting date, as well as a description of when an entity considers a debt instrument to be past due. This disclosure would apply to credit card receivables, but does not apply to other trade receivables due in one year or less or receivables measured at lower of amortized cost, fair value or trade.

### Nonaccrual Status

Consistent with current GAAP, for each class of financing receivable and major security type, an entity would disclose all of the following:

- The amortized cost of nonaccrual financial assets at the beginning and end of the reporting period
- The amount of interest income recognized during the period on nonaccrual financial assets
- The amortized cost of financial assets that are 90 days or more past due, but not on nonaccrual status as of the reporting date
- The amortized cost of nonaccrual financial assets with no related expected credit losses as of the reporting date

This disclosure would apply to credit card receivables, but does not apply to other trade receivables due in one year or less or receivables measured at lower of amortized cost or fair value, or trade.

### PCD Financial Assets

For any PCD assets purchased in the current period, the purchase price, allowance for credit loss, discount, noncredit discount and par value should be disclosed.

### Collateralized Financial Assets

If a borrower is experiencing financial difficulty and when the repayment is expected to be provided substantially through the operation or sale of collateral, an entity would disclose, for each class of financial receivable and major security type, a description of the type of collateral provided and the extent to which the collateral secures an entity's financial assets. Any significant changes in the level of collateralization from the prior period would be disclosed, including general deterioration or any other reason.

## Off-Balance-Sheet Credit Exposures

An entity shall disclose a description of the accounting policies and methodology the entity used to estimate its liability for off-balance-sheet credit exposures and related charges. The description shall identify the factors that influenced management’s judgment, *e.g.*, historical losses, existing economic conditions and reasonable and supportable forecasts, as well as the risk elements for each financial asset category.

## Effective Date

FASB defined a new subgroup of public business entities for the purpose of providing a delayed effective date of the credit impairment standard. This subgroup of smaller public business entities—entities that do not meet the definition of a U.S. Securities and Exchange Commission (SEC) filer—would have an additional year to adopt the standard for both annual and interim periods, *i.e.*, *Federal Deposit Insurance Corporation Improvement Act of 1991* banks. All other entities would have a one-year deferral for annual financial statements, and two years for interim financial statements. This group would include most community banks and credit unions.

The new guidance will be effective for public business entities that are SEC filers for fiscal years (FY) beginning after December 15, 2019, including interim periods, *i.e.*, 2020 for calendar year-end companies. The effective date for smaller public business entities (those that do not meet the definition of an SEC filer) would be FYs beginning after December 15, 2020, including interim periods. For all other entities, including NFP entities and EBPs, the new guidance would be effective for FYs beginning after December 15, 2020, and for interim financial statements for FYs beginning after December 15, 2021. Non-SEC filers would be allowed to early adopt the standard as of the SEC filer’s effective date, including interim periods.

CECL Implementation Dates* (For Entities With Calendar Year-Ends)			
Entity	2020	2021	2022
Public Business Entity (PBE) – SEC filers	Interim & Annual		
PBE – Small (Non-SEC filer)		Interim & Annual	
All Others		Annual	Interim
*Early Adoption Permitted for all Entities for Periods Beginning After December 15, 2018			

## Transition

Transition would be on a modified retrospective transition basis. An entity would apply the guidance to all outstanding financial assets as of the beginning of the first reporting period in which the guidance is effective. The cumulative effect of the change related to periods before the ASU’s effective date would be reflected in the carrying amount of assets as of the effective date, with an adjustment to opening balance of retained earnings. Financial statements for each individual prior period presented would not be adjusted.

## Debt Securities/OTTI

For debt securities with a previous charge due to other-than temporary impairment, transition would be an on **prospective basis**, as of the effective date. The amortized cost basis of the debt security would be unchanged on the date of adoption. Amounts previously recognized in accumulated other comprehensive income as of the date of adoption that relate to improvements in cash flows would continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. After adoption, recoveries of amounts previously written off due to improvements in cash flows would be recorded as a reduction in allowance for credit losses in the period received.

*Prospective application means yields on securities will be comparable from one reporting period to the next.*

## PCI/PCD Assets & Beneficial Interests

Since the criteria for a PCD asset differs from the existing guidance for PCI assets, the ASU provides transition relief so that entities are not forced to reevaluate existing holdings under the new guidance. Assets accounted for under Subtopic 310-30 on loans and debt securities acquired with deteriorated credit quality would be classified as PCD assets at the date of adoption, including those acquired assets for which Subtopic 310-30 has been applied by analogy. Entities would be required to gross up the allowance for expected credit losses for all PCD assets at the date of adoption and would continue to recognize interest income based on the yield of such assets as of the adoption date. Subsequent changes in the expected credit losses would be recorded through the allowance for credit losses, with a corresponding adjustment to the current-period provision for credit losses.

This transition relief also applies to beneficial interests that previously applied PCI guidance or where there is a significant difference between the contractual and expected cash flows at date of recognition.

## Vintage Disclosures

Public business entities that are not SEC filers would be permitted to provide their vintage disclosures using a phase-in transition approach. The phase-in transition approach would require three origination years to be disclosed (including the originations during the first year of adoption), and then an incremental year for every FY thereafter until five separate FYs are disclosed, consistent with SEC filers.

For the Year Ended December 31, 2021					
	Origination Year				
	2021	2020	2019	2018 & Prior	Total
Residential Mortgages	X	X	X	X	X
Consumer Loans	X	X	X	X	X
Commercial Loans	X	X	X	X	X
Total	X	X	X	X	X

For the Year Ended December 31, 2022						
Origination Year						
	2022	2021	2020	2019	2018 & Prior	Total
Residential Mortgages	X	X	X	X	X	X
Consumer Loans	X	X	X	X	X	X
Commercial Loans	X	X	X	X	X	X
Total	X	X	X	X	X	X

For the Year Ended December 31, 2023							
Origination Year							
	2023	2022	2021	2020	2019	2018 & Prior	Total
Residential Mortgages	X	X	X	X	X	X	X
Consumer Loans	X	X	X	X	X	X	X
Commercial Loans	X	X	X	X	X	X	X
Total	X	X	X	X	X	X	X

### Transition Disclosures

The ASU requires transition disclosures similar to those required in *Accounting Changes and Error Corrections (Topic 250)*, with modifications better suited for the cumulative-effect transition method for adopting the new credit impairment model. The transition disclosures are:

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

An entity that issues interim financial statements shall provide the above disclosures in each interim financial statement of the year of change and the annual financial statement of the period of the change.

BKD has prepared several papers on the financial instruments projects and will continue to monitor updates. Visit [our Hot Topics page](#) to access these resources. For more information, contact your BKD advisor.

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