

Accounting Standards Codification 326, Financial Instruments - Credit Losses



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2. How to estimate expected credit losses for purchased financial assets with credit deterioration.

3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.

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Welcome to our “**Uniquis’ ASC Insights Series: Guides to Accounting Standards**”, where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, these guides help you navigate complex accounting scenarios and deepen your knowledge.

This is the ninth publication in our “Uniquis’ ASC Insights Series: Guides to Accounting Standards”, focusing on “**ASC 326, Financial Instruments- Credit Losses**”. In this installment, we delve into the specifics of ASC 326, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners.

ASC 326 provides guidance on the recognition and measurement of Credit impairment of financial assets, along with presentation and disclosure requirements. With the objective of shifting from the incurred loss model to the expected credit loss model for estimating credit impairment, ASC 326 requires an estimate of expected credit losses, measured over the contractual life of an instrument, that considers forecasts of future economic conditions in addition to information about past events and current conditions.

We hope you enjoy reading this document and find this series valuable!

Thank you.

Yours faithfully

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PURPOSE

The Financial Accounting Standards Boards (FASBs), **ASC 326, Financial Instruments- Credit Losses** provide comprehensive guidance on accounting for credit losses on financial instruments and disclosures.

Under legacy GAAP, the credit losses on financial instruments were recognized under “incurred loss” methodology i.e., credit losses were recognized only when it was probable that a loss has been incurred. This approach did not encourage the preparers of financial statements to record credit losses that were expected but did not yet meet the “probable” criteria and failed to prevent the events leading up to the global financial crisis of 2008. Post-crisis, various stakeholders, including regulators acknowledged the limitation of existing guidance and realized the need for a comprehensive and forward-looking approach towards estimating expected credit losses, resulting in the introduction of a new credit impairment model- Current Expected Credit Losses (CECL).

This publication provides an overview of the requirements, implementation matters, and key considerations related to the CECL impairment model (ASC 326-20) for financial assets measured at amortized cost and the available-for-sale (AFS) debt security impairment model (ASC 326-30). The technical views and accounting positions on the framework continue to evolve depending on further technical evaluations and their outcomes.

We sincerely hope you find the enclosed publication informative. We will be happy to participate in any discussions to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.

BACKGROUND

In order to address the concern of stakeholders that credit losses were identified and recorded “too little, too late” in the period under, incurred loss model of credit impairment, In 2016, FASB issued the **Accounting Standard Update (ASU) 2016-13** codified under ASC Topic 326 Financial Instruments – Credit Losses replacing the “incurred-loss” methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate the credit losses on financial instruments. The ASU adds to US GAAP an impairment model known as the current expected credit loss (CECL) model, which is based on expected losses rather than incurred losses. The objectives of the CECL model are to:

- Reduce the complexity in US GAAP by decreasing the number of credit impairment models that entities use to account for debt instruments.
- Eliminate the barrier to timely recognition of credit losses by using an expected loss model instead of an incurred loss model.
- Require an entity to recognize an allowance of lifetime expected credit losses.
- Not require a specific method for entities to use in estimating expected credit losses.

The underlying principle to estimate the credit losses under the CECL model includes -

“

*CECL impairment model requires an estimate of **expected credit losses**, measured over the **contractual life** of an instrument, that considers **forecasts of future economic conditions** in addition to information about **past events and current conditions**.*

”

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Impairment Model- “Expected Loss” Vs “Incurred Loss”

The table below summarizes the key differences between the legacy credit Impairment model and the Current Expected Credit Loss (CECL) model under ASC 326

	Key Differences	
	Incurred Loss	Expected Loss
Recognition threshold	When a loss is incurred as of the balance sheet date.	When lifetime credit losses are expected (i.e., in virtually all cases).
Unit of measurement	Pooling is permitted but not required.	Pooling is required when assets share risk characteristics.
Measurement Basis	Historical loss experience and incurred loss event trigger recognition.	Considers a broader range of information, including historical experience, current conditions, and reasonable forecasts.
Consideration of the contractual term	Not part of the calculation of incurred losses on the balance sheet date.	Measure expected credit losses over the asset's contractual term.
Risk Management Practices	Less direct linkage to an entity's risk management practices.	Encourages alignment with risk management practices, emphasizing the integration of credit risk considerations into financial reporting.
Disclosure Requirements	Emphasis on historical loss experience and incurred loss allowances.	Requires enhanced disclosures on the loss calculation methodology used, significant inputs, and a description of credit quality indicators.



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Credit impairment under Legacy GAAP

Credit impairment under ASC 326

ASC 310-10 — Assets that are identified for individual evaluation

ASC 450-20 — Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment

ASC 310-30 — Assets acquired whose credit quality has deteriorated

ASC 320-10 — Debt securities

ASC 325-40 — Beneficial interest (BI) in securitized assets

• HTM debt Securities
• BI in HTM debt security

• AFS debt Securities
• BI in AFS debt security

ASC 326-20

ASC 326-30 — AFS debt securities



SUMMARY OF TOPIC

A Current Expected Credit Loss Impairment model (ASC 326-20)

1. Scope and Scope Exceptions (ASC 326-20)

The first and foremost step in determining credit impairment loss is the identification of financial assets within the scope of ASC 326.

(a) Scope Inclusion: The following table summarizes the list of financial assets within the scope of ASC 326-20:

	Considerations	Implementation matters
Category 1: Financial assets measured at amortized cost		
Financing Receivables	Includes financing arrangements with the right to receive money on demand or at fixed or determinable dates (excluding debt securities), measured at amortized cost. Such as loans and advances, receivables, etc.	• Employee forgivable loans will be in the scope of ASC 326, provided the employer has the right to receive payment for the loan from the employee, including in circumstances where employment is terminated. The estimate for credit losses- • would only include amounts the employer doesn't expect to collect due to credit (e.g., uncollectible amounts from a terminated employee who defaults on the loan) • would not include amounts the employer expects to forgive when employees meet the conditions for forgiveness • Refundable lease security deposits- will be within the scope of ASC 326 since they represent a contractual right for the lessee to receive money on fixed or determinable dates. • Tax receivable from taxing authorities will not be in the scope of ASC 326 since they do not meet the definition of a financial asset (i.e., they generally do not represent a contractual obligation on the part of the taxing authority). • Loans held for sale will not be in the scope of ASC 326 because the recovery of the asset is expected to result from its sale, not from holding the asset and collecting contractual cash flows.

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HTM debt securities	Includes securities that an entity has the positive intent and ability to hold to maturity.	• Preferred stock instruments that meet the definition of a debt security are within the scope of ASC 326-20 if it is classified as held to maturity However, Preferred stock instruments that meet the definition of equity such as stock not redeemable by the issuing entity either mandatorily or at the investor's option, are subsequently measured at fair value through net income under ASC 321 and are specifically outside the scope of the CECL model.
Trade Receivables	Includes receivables from customers, including short-term trade receivables that result from the sale of goods and services.	• Contract Assets: As per the principles of ASC 606, contract assets should be assessed for impairment in accordance with ASC 326-20.
Receivables that relate to repurchase and securities lending agreements	Includes amounts owed by counterparties on reverse repurchase or securities lending arrangements.	Amounts are generally collateralized and may be eligible for the practical expedient i.e. the borrower is experiencing financial difficulty and if repayment is expected substantial, either through: • Sale of collateral Allowance = amortized cost basis less (fair value of the collateral estimated cost to sell) • Operations of collateral Allowance = amortized cost basis less fair value of the collateral calculated as the present value of expected cash flows from the operation of the collateral
Category 2: Net investment in leases recognized by a lessor		
Net investment in leases	This category includes lease receivable in sales-type and direct financing leases arising in the books of lessors	Amount recognized includes: • Total lease payments discounted using the rate implicit in the lease; • Any guaranteed residual asset; and • Any unguaranteed residual asset (the lessor's right to the expected unguaranteed value of the leased asset at the end of the lease).

Category 3: Off-balance-sheet credit exposures not accounted for as insurance		
Financial guarantees	This category includes credit exposures on off-balance sheet items such as: - Guarantees. - Standby letters of credit.	• Guarantee: For a guarantee to be in the scope of ASC 326-20, the guarantee must relate to the nonpayment of a financial obligation, such as • A financial standby letter of credit, which is an irrevocable undertaking to guarantee payment of a specified financial obligation. • A guarantee of the collection of scheduled contractual cash flows from a loan. • Guarantees Between Entities Under Common Control ASC 326-20-15-3 specifically excludes loans and receivables between entities under common control from the scope of ASC 326-20. However, no specific scope exception exists for off-balance sheet credit exposure, including financial guarantees, between entities under common control. Therefore, guarantee arrangements between common-control entities that are related to third-party credit exposure are within the scope of ASC 326-20
Forward Commitments to Purchase Loans		Forward commitment to purchase loans from a third party is within the scope of ASC 326-20 because it exposes the purchaser to the credit risk associated with the underlying loans to be purchased.
Category 4: Reinsurance recoverable		
Reinsurance recoverable	FASB clarified in ASU 2019-04 that all reinsurance recoverable are within the scope of the model, regardless of the asset's underlying measurement basis,	An entity will need to apply the CECL model to reinsurance recoverable measured on a discounted basis as well as to those measured at amortized cost.

(b) Scope Exclusion: The Following table summarizes the list of items excluded from the scope of ASC 326-20:

Scope Exceptions	Description
Financial assets measured at Fair Value	Loans and Debt Securities measured at fair value through net income are not within the scope of CECL. Changes in fair value are recognized immediately in earnings.
Leases (ASC 842)	Receivables arising from Operating leases are accounted for under ASC 842 and are not subject to CECL. CECL focuses on financial instruments subject to amortized cost measurement.
Promises to give (pledges receivable) of a not-for-profit entity	Pledges made by donors to not-for-profit organizations indicating their commitment to providing financial support in the near future.

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Scope Exceptions	Description
Loans and receivables between entities under common control	Loans and receivables exchanged between entities that are under common control, typically within the same corporate group, are exempt from CECL.
Loans made to participants by defined contribution employee benefit plans	CECL does not apply to financial instruments within the scope of ASC 960 (Defined Benefit Pension Plans) and ASC 965 (Other Post-employment Benefits).
Policy loan receivables of an insurance entity	Policy loans made by insurance entities are excluded from the CECL model.

2. CECL Core Concepts

Based on an **“asset’s amortized cost”**

Allowance for credit loss represents the portion of amortized cost that the entity doesn’t expect to recover due to credit losses.

Reflect the **“risk of loss”**

Allowance for expected credit losses to reflect the risk of loss, even when that risk is remote.

Reflect losses over an **“asset’s contractual life”**

Reflect losses expected over the remaining contractual life of an asset, recognizing that voluntary prepayments reduce expected credit losses.

Consider **“available relevant information”**

Consider available relevant information about the collectability of cash flows, including information about past events, current conditions, and reasonable and supportable forecasts of future economic conditions.



The requirement to reflect even a remote risk of loss means that the allowance for expected credit losses should not solely be based on the most likely outcome if such an outcome ignores potential loss scenarios. This requirement will result in an allowance for expected credit losses greater than zero for most assets in the scope of ASC 326-20, even if management believes no loss has been incurred as of the measurement date. This will result in an entity estimating an expected credit loss for most, if not all, receivables, including:

- Receivables from customers that are current on their payment.
- Individually significant receivables from large customers (e.g., sales to large wholesale customers) that have always paid on time.
- Very short-term receivables that are typically settled in a matter of days (e.g., credit and debit card receivables from banks).

3. Determination of Risk of loss over Contractual Life

Determining the contractual life of the asset is a key part of estimating expected credit losses because it is the time horizon over which an entity will be exposed to credit risk related to a particular financial asset. Longer time horizons generally present more uncertainty in expected cash flows, which will affect the estimate of expected credit losses. Contractual life is the expected duration during which an entity anticipates being exposed to credit risk associated with a particular financial asset. Instead of relying solely on the stated/ initial term of a financial instrument, contractual life considers various factors that may impact the actual period over which credit risk is present. If there are terms that can affect the timing of repayment (e.g., prepayment options, renewal options, call options, extension options), the entity may need to consider them in determining an asset's contractual life. In some cases, payment terms aren't specified, or customers routinely make payments after the stated due date. In these situations, an entity will need to determine the period of time over which it will be exposed to credit risks (i.e., the expected life) in estimating credit losses. The expected life of such a receivable should be determined based on historical experience, current conditions, and reasonable and supportable forecasts of future economic conditions. For example, suppose an entity requests payment within 30 days but expects customers to pay within 90 days. In that case, the entity should incorporate a reasonable and supportable forecast for a period of 90 days rather than 30 days.	
Consideration	Implementation matters
1. Prepayments	
Prepayments or early settlements of a borrowing generally reduce the potential loss on an individual asset by shortening the time period over which the lender or investor is expected to be exposed to credit losses. Therefore, contractual term of a loan must be adjusted for expected prepayments. Prepayments should be separately accounted for as input in the credit loss estimation method, or they may be embedded in the credit loss information. Estimated prepayments should be factored into future principal and interest cash flows when utilizing the method to determine credit loss.	Management is required to exercise significant judgment to determine the effect of prepayments on the allowance for credit losses. An entity will need to consider whether it can accurately estimate prepayments and support the estimate. An entity will likely have less observable experience of prepayment rates on certain types of receivables (e.g., commercial loans) than it does on others (e.g., residential mortgages). In addition to historical experience, management should also consider reasonable and supportable forecasts of economic conditions. For example, forecasted changes in interest rates or other economic conditions to estimate expected prepayments.
 Consideration of prepayment conditions could have a significant effect on the estimate of expected credit losses, and that impact will vary on the basis of whether the entity is estimating such losses by using a DCF method or another measurement method. When an entity uses a DCF method to project expected future cash flows, expected prepayments will affect the amount and timing of cash flows expected to be collected. When a loss estimation method other than a DCF method is used, prepayments will be either reflected in the entity's historical loss information or considered as a separate input to the estimate of expected credit losses. ASC 326-20 requires entities to consider the effect of estimated prepayments on the measurement of expected credit losses. In this regard the bigger question is what constitutes a "prepayment" for the measurement of expected credit	

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losses. The lack of a generally accepted definition of prepayment has led to different views on how an entity should consider certain transactions or events in estimating prepayments under ASC 326.

Such an evaluation is difficult under the circumstances wherein lenders has to evaluate whether refinancings of an existing loan to be prepayments when measuring expected credit losses. Loans are commonly refinanced with lenders before maturity (through a contractual modification or the creation of a new loan), and the proceeds are used to repay the existing loan.

At an August 2018 meeting, the FASB indicated that an entity should not be prohibited from defining prepayments in the manner that best reflects management's expectation of credit losses.

Considering the fact that the guidance does not define a specific framework for considering prepayments, in our view, as with other elements of the CECL model, an entity should use judgment in determining whether a loan refinancing or restructuring transaction should be considered a prepayment in the measurement of expected credit losses.

Consideration	Implementation matters
2. Extension or Renewal Option	
Contractual life considers the potential for contract extensions beyond the initial term. This may involve options granted to the borrower to extend the loan. These extension options generally fall into two categories: • Borrower has the unilateral right to extend the loan — This would be the case for options where the conditions to extend or renew the loan are non-substantive or administrative in nature (e.g., the borrower needs to provide written notice of its election to extend). • Borrower must meet certain conditions — This would be the case for an extension option where the borrower has to meet certain conditions, including conditions that are not in its control (e.g., an option becomes exercisable upon changes in regulations or tax law). <i>Note: The unconditional option to extend the contractual term should not be considered by the lender when determining the contractual term.</i>	• In these circumstances, the lender considers the likelihood that the borrower will request the extension in its assessment of the life of the loan in determination of contractual term. • In these circumstances, the lender determines the contractual life of the asset considering both the probability that the conditions will be met and the likelihood that the borrower will request the extension.

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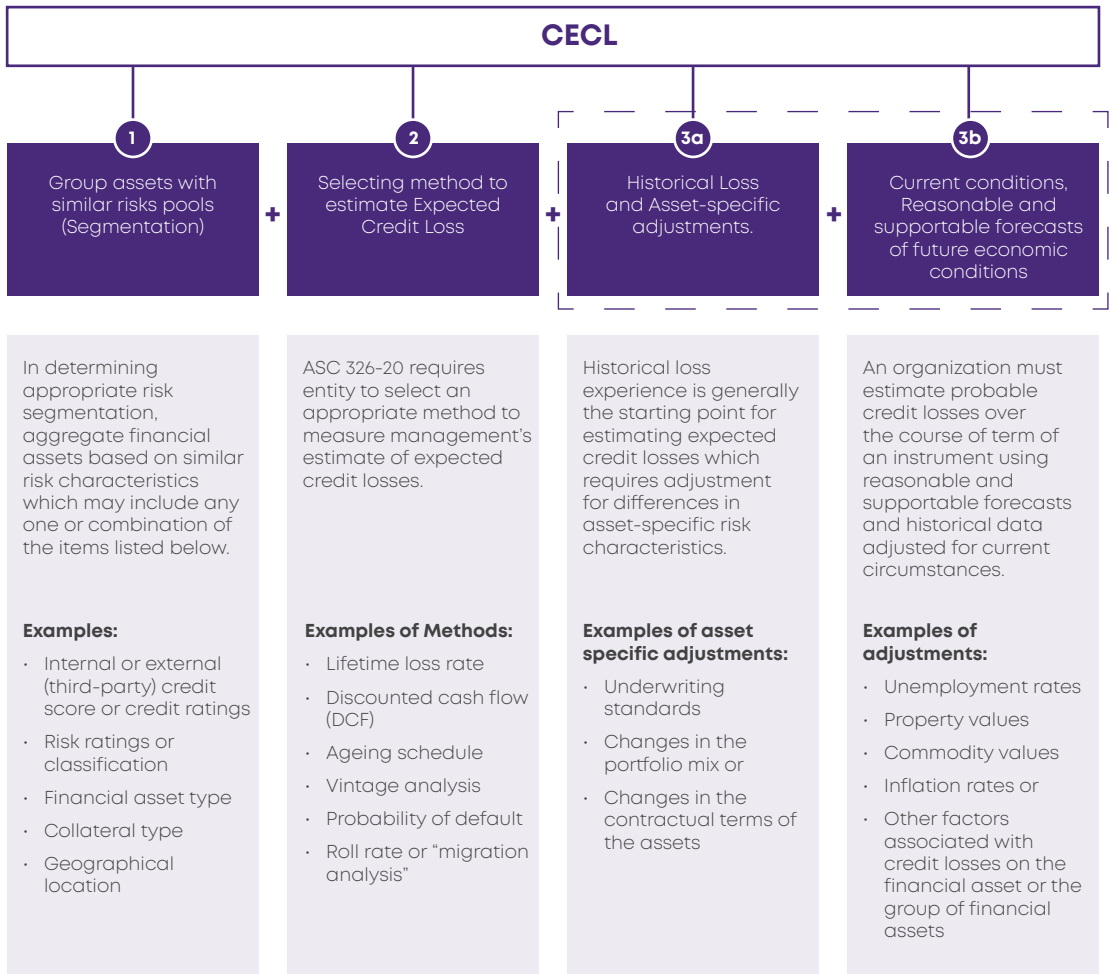
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4. CECL model and components of risk



Initial recognition and at each reporting date, an entity recognizes an allowance for remaining lifetime expected credit losses. The allowance is deducted from the amortized cost basis of a financial asset or a group of financial assets so that the balance sheet reflects the net amount an entity expects to collect.



Subsequent changes (favorable and unfavorable) in expected credit losses are recognized immediately in net income as a credit loss expense or a reversal of credit loss expense.

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1 Segmentation of financial assets

An entity estimates expected credit losses of financial assets with similar risk characteristics on a collective (pool) basis. A financial asset is measured individually only if it does not share similar risk characteristics with other financial assets. Both credit and non-credit related characteristics are relevant in determining whether certain assets share similar risk characteristics.

If a financial asset's risk characteristics change, it should be evaluated to determine whether it is appropriate to keep the same in its existing pool or move to a different pool that may be more consistent with its current risk characteristics.

ASC 326-20-55-5 provides a list of risk characteristics that can be utilized to pool assets. An organization is allowed to consider one or more risk characteristics when assessing its pooling.

The following illustration provides an application guidance on the pooling of trade receivables based on similar risk characteristics:

Manufacturer A is a manufacturer of toys. It makes sales under different arrangements, including Business-to-business sales (B2B), direct-to-customer sales (D2C), and intercompany sales. The payment terms are 30 days from the date of invoice.

Manufacturer A notes that its historical credit loss experience correlates with delinquency status. Manufacturer A categorizes the customer type into three broad geographical categories.

Based on historical experience, Manufacturer A pools the trade receivables first by geography and customer type, which are disputed and undisputed trade receivables that are further pooled under appropriate risk categories as Considered good, credit impaired, and have a significant increase in credit risk, and then by delinquency status. Manufacturer A pools its \$8 million in outstanding trade receivables as of 31 December 20X4 into the following pools

Geography	Customer type	Disputed/Undisputed	Risk Type	Not due	1-30 days delinquent	31-90 days delinquent	90+ days delinquent
USA	B2B	Undisputed	Considered good	\$2,200,000	\$20,000	\$25,000	\$3,000
		Disputed	Credit impaired		\$20,000		
		Undisputed	which has a significant increase in credit risk		\$20,000	\$18,000	
	D2C	Undisputed	Considered good	\$2,000,000	\$10,000		\$5,000
		Undisputed	Credit impaired				
		Undisputed	which has a significant increase in credit risk		\$5,000	\$30,000	\$8,000
India	B2B	Undisputed	Considered good	\$2,600,000	\$50,000		
		Disputed	Credit impaired		\$15,000		\$10,000
		Undisputed	which have significant increase in credit risk				
	D2C	Undisputed	Considered good	\$900,000		\$14,000	\$15,000
		Disputed	Credit impaired			\$15,000	
		Disputed	which has a significant increase in credit risk			\$8,000	\$9,000



New Credit impairment model requires entities to pool financial assets but allows them to choose which risk characteristics to use. It states that an entity should aggregate based on “any one or a combination” of the characteristics listed in the accounting standard. In requiring a pool-based estimate, the FASB reasoned that while an entity may expect to collect all the contractual cash flows on an individual asset, “it ordinarily would expect some level of losses in a group of assets with similar risk characteristics. **Therefore, an estimate of expected credit losses should reflect a collective assessment if similar risk characteristics exist.”**

The segmentation of assets based on risk characteristic is not a onetime exercise, entity needs to assess at each reporting period, whether assets in a pool continue to display similar risk characteristics or not requiring allocation to different pool. Segmentation of assets into a pool requires assessment of qualitative and quantitative factors which may involve management judgement.

There may be circumstances in which an entity would be permitted to estimate expected credit losses on an individual basis, despite sharing similar risk characteristics with other financial assets. In such case an entity would need to support (either qualitatively or quantitatively) that the estimation method applied would generally be expected to achieve results similar to a collective estimate.

2 Method for determining losses

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

Entities are permitted to use estimation techniques that are practical and relevant to their circumstances. Following is the Illustrative list of methods, which are acceptable:

Approach	Methodology
Methods that use an aging schedule	Impairment is calculated based on how long a receivable has been outstanding (e.g., under 30 days, 30–60 days). This method is commonly used to estimate the allowance for bad debts on trade accounts receivable.
Loss-rate method	Impairment is calculated using an estimated loss rate and multiplying it by the asset's amortized cost at the balance sheet date
DCF Method	- Impairment is determined by comparing the asset's amortized cost to the present value of estimated future principal and interest cash flows. - The FASB staff has clarified that if an entity intends to incorporate discounting into its credit loss estimate, it must discount all inputs to the estimate. The discounting effect should be measured as of the reporting date.
Roll-rate methods	Expected losses are projected using historical trends in credit quality indicators (e.g., delinquency, risk ratings)
Probability of default and loss given default methods	Impairment is calculated by multiplying the Probability of default (probability the asset will default within a given timeframe) by the Loss given default (percentage of the asset not expected to be collected due to default)

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As previously noted, entities can use various methods to measure expected credit losses. ASC 326-20 does not mandate a particular methodology for assessing credit loss experience, allowing flexibility based on factors such as entity size, range of activities, and the nature of financial assets. Some of the commonly used methods are summarized below:

1. **Ageing method:** This involves pooling receivables based on their age and applying different loss rates to each category (e.g., current, 0–30 days past due, 31–90 days past due, more than 90 days past due).

Illustration: The following example provides application guidance on the ageing method used by an entity for estimating expected credit losses for trade receivables using an aging schedule.

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

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

Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved compared to the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects an additional unemployment decrease over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

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

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

2. Loss rate method: This involves applying a historical rate to the outstanding balance of financial assets to estimate potential credit losses by considering the historical performance of similar assets.

Illustration: The following example provides application guidance on the Loss rate method used by an entity for estimating expected credit losses for trade receivables.

Entity F manufactures and sells one product to wholesale customers. The customers operate in the same industry and geography. Customers typically are provided with payment terms of one year. Entity F has tracked historical loss information for its trade receivables on an amortized cost basis, using the contractual life of one year, and compiled the following historical credit-loss percentages:

	Y1	Y2	Y3
Annual net write-offs	4,02,000	4,38,900	4,69,920
Annual average receivables	30,000,000	33,000,000	35,600,000
Annual loss rate	1.34%	1.33%	1.32%

Average annual loss rate 1.33%

At the end of Y4, all of entity F's receivables are homogenous and current, and they can be grouped into one pool. It determines that historical loss information is a reasonable basis on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the risk characteristics of its customers and its credit practices have not changed significantly over time).

Identifying that adopting advanced automation is a key factor influencing credit risk, Entity F observes that economic conditions have changed due to the integration of automation. While current economic conditions indicate increased operational efficiency, Entity F foresees potential challenges arising from the transitional phase, anticipating that certain customers may face difficulties adapting to automated processes.

As a result, Entity F adjusts its historical loss rate, factoring in the technological shift, and **estimates a higher average loss rate of 1.8%.**

Entity F applies the average loss rate of 1.8% (adjusted for current conditions and reasonable and supportable forecasts) to its reporting date at Y5 receivables balance of USD 38,900,000 and calculates an estimated expected credit loss of USD 700,200.

3. DCF Model: This method involves discounting expected cash flows at the financial asset's effective interest rate, considering variations in contractual interest rates linked to independent factors (such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average). If changes in these factors are projected, the same projections are used for determining the effective interest rate, with adjustments made for the timing of expected cash flows and prepayments. An entity can choose to adjust the effective interest rate used to discount expected cash flows for each class of financing receivable or major security type to account for the timing of expected prepayments. However, if a an asset is restructured in a troubled debt restructuring, the effective interest rate for discounting expected cash flows should not be adjusted due to subsequent changes in the expected timing of cash flows.

Illustration: The following example provides application guidance on DCF model method used by an entity for estimating expected credit losses for financial asset.

On 31 Dec 20X0, Company B originates a loan with the following details:

Par value (unpaid principal balance):	\$900,000
Contractual interest rate:	10%
Amortized cost:	\$9,15,076
Effective interest rate (EIR):	9.48%
Prepayment-adjusted effective interest rate:	9.2%
Maturity date:	31 Dec 20X4

a. Option 1: Computation of credit allowance using EIR without adjustment of expected prepayments.

Company B estimates the allowance on the loan using the guidance in ASC 326-20-30-4 and the effective interest rate of 9.48% (which is based on the contractual timing of cash flows) as follows:

Date	Contractual Cash Flows	Prepayment	Estimated Expected Cash Flows
31 December 20X1	\$90,000		\$90,000
31 December 20X2	\$90,000		\$90,000
31 December 20X3	\$90,000	\$900,000	\$985,000*
31 December 20X4	\$990,000		0
Total	\$1,260,000		\$1,075,000

*Expected to receive only \$85,000 interest in 20X4

Present value of expected cash flows discounted at 9.48%: (considering the impact of prepayment)	\$907,935 ¹
Amortized cost basis:	\$915,076
Difference between amortized cost and the present value of cash flows:	\$7,140

Based on management's forecast of expected cash flows discounted at an EIR of 9.48%, Company B would recognize an allowance for expected credit losses of \$7,140 as of 31 December 20X1.

¹ $[900,000/(1.0948)^3 + 90,000/((1.0948)^1) + 90,000/((1.0948)^2) + 85,000/((1.0948)^3)]$

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b. Option 2: Computation of allowance for credit losses using the prepayment-adjusted effective interest rate.

Company B estimates the allowance on the loan using the guidance ASC 326-20-30-4 (i.e. An entity can choose to adjust the effective interest rate used to discount expected cash flows for each class of financing receivable or major security type to account for the timing of expected prepayments.) and the prepayment-adjusted effective interest rate of 9.2%. The effective interest rate of 9.2% is calculated using the expected cash flows based on the expected prepayment in year 20X3 and reflects the lost interest in 20X4. The prepayment-adjusted EIR would be determined by adjusting the contractual cash flows for expected prepayments and determining the required rate to equate the prepayment-adjusted cash flows to the purchase price. The impairment calculation is as follows:

Date	Contractual Cash Flows	Prepayment	Estimated Expected Cash Flows
31 December 20X1	\$90,000		\$90,000
31 December 20X2	\$90,000		\$90,000
31 December 20X3	\$90,000	\$900,000	\$985,000*
31 December 20X4	\$990,000		0
Total	\$1,260,000		\$1,075,000

*Expected to receive only \$85,000 interest in 20X4

Present value of expected cash flows discounted at 9.21%: \$914,321#

Amortized cost basis: \$915,076

Difference between amortized cost and the present value of cash flows: \$755

$[900,000/(1.092)^3 + 90,000/(1.092)^1 + 90,000/(1.092)^2 + 85,000/(1.092)^3]$

Based on management's forecast of expected cash flows discounted at a prepayment-adjusted effective interest rate of 9.2%, Company B would recognize an allowance of \$755 for expected credit losses as of 31 December 20X1. This result illustrates that when an asset's contractual interest and principal payments are expected to be recovered by the lender earlier than the contractual term, a prepayment-adjusted interest rate will result in the lender not recognizing an allowance solely because of a change in the timing of cash flows.

4. Probability of default and loss given default (PD and LGD) method

Current expected Credit Loss (CECL) is a key metric in credit risk management used by financial institutions (FIs) to estimate potential credit losses. One of the most common approaches to compute CECL involves the estimation of three critical components:

1. Probability of Default (PD)

2. Loss Given Default (LGD)

3. Exposure at Default (EAD)

$$CECL = \frac{(PD * LGD * EAD)}{(1 + i_{eff})^{Tm}}$$

Tm = time to maturity

i_{eff} = Discounting rate as per the financial instrument (i.e., effective interest rate)

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Probability of Default

PD is probability of default which defines the likelihood that the borrower will default on its obligations when they come due within specific time.

Through-the-Cycle (TTC) Probability of Default (PD) represents the average likelihood of a borrower defaulting over a long-term period, covering both good and bad economic conditions. It smooths out short-term economic fluctuations and reflects the overall stability of a borrower's credit risk. This measure is less influenced by current economic conditions and is often used for regulatory purposes, such as calculating capital requirements.

In contrast, Point-in-Time (PIT) Probability of Default focuses on the likelihood of default over a specific short-term period, such as one year, and reflects the borrower's credit risk based on current economic and financial conditions. It is more sensitive to changes in the economic environment, making it ideal for real-time credit assessments and accounting purposes. FIs can compute either TTC PD and convert that to PIT PD with macroeconomic overlay

Here's a simple example to calculate the **historic Probability of Default (PD)** under the **Net Flow Rate (NFR)** approach. This method calculates PD by analyzing the net movement of loans across delinquency buckets over a defined period.

Scenario:

A bank has the following loan delinquency data for a specific segment over two consecutive months:

Delinquency Bucket	Number of Loans (Month 1)	Number of Loans (Month 12)
Current (0 days past due)	10,000	9,900
30–60 days past due	500	600
60–90 days past due	200	300
Default (>90 days past due)	100	200

Step 1: Define the formula

The Net Flow Rate (NFR) for each bucket is calculated as:

$$\text{NFR} = \text{Number of loans flowing into default} \div \text{Total number of loans in the prior period}$$

Step 2: Calculate the flows into default

- Loans flowing into default in Month 12:
 - From the 60–90 days past due bucket: $300 - 200 = 100$
 - From the 30–60 days past due bucket: $600 - 500 = 100$

Total flows into default = $100 + 100 = 200$

Step 3: Calculate the total number of loans in Month 1 = 10,800

Step 4: Calculate the Probability of Default (PD)

$$\text{PD (NFR)} = \text{Total flows into default} \div \text{Total loans in Month 1} = 200 \div 10,800 = 0.0185 \text{ or } 1.85\%$$

Result:

The **historic Probability of Default** using the Net Flow Rate approach is **1.85%** for this loan segment.

Loss Given Default

Loss Given Default (LGD) measures the percentage of an asset's exposure that is likely to be lost if a borrower defaults. It is expressed as a percentage of the total exposure and is a critical component in credit risk modeling,

$$LGD = 1 - \frac{\text{Recovery Amount}}{\text{Exposure at Default (EAD)}}$$

Types of LGD



Observed LGD

Observed LGD is calculated using historical data on defaults and recoveries. It is based on actual losses experienced in the past, considering the amount recovered compared to the exposure at default. This approach relies on empirical data and is often used as a baseline for understanding the performance of a portfolio over time.



Exposure-Specific LGD

This type of LGD calculation considers the specific attributes of a loan or exposure. Factors such as whether the exposure is secured or unsecured, the type of collateral, and the borrower's profile are included. This approach provides a more granular and accurate estimate of potential losses tailored to the unique characteristics of each exposure.



Discounted Cash Flow (DCF) LGD

DCF LGD uses the present value of expected recoveries to determine the loss percentage. Future cash flows from recoveries, such as payments from the borrower or proceeds from collateral liquidation, are discounted back to their present value. This approach takes into account the time value of money, recovery timelines, and potential delays in realizing recoveries.



Workout LGD

Workout LGD involves a detailed assessment of the entire recovery process, including legal proceedings, administrative costs, and the time required to recover funds. It factors in the net cash flows generated during the recovery period and the associated costs, providing a comprehensive measure of losses.



Market LGD

Market LGD is based on the market prices of distressed assets or loans. It reflects the value that market participants attribute to defaulted or at-risk exposures. This type of LGD is often used in trading or valuation scenarios, as it represents the expected loss implied by current market conditions.

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Example of Discounted LGD Calculation

Scenario:

A bank has a defaulted loan with the following details:

- **Exposure at Default (EAD): \$100,000**
- **Expected Recovery Cash Flows:**
 - Year 1: \$20,000
 - Year 2: \$30,000
 - Year 3: \$40,000
- **Recovery Costs:** \$5,000 (legal and administrative expenses)
- **Discount Rate:** 10% (annual)

Steps for Calculation:

1. Calculate the Present Value (PV) of Recovery Cash Flows:

Use the formula for PV:

$$PV = \text{Cash Flow} / (1 + \text{Discount Rate})^t$$

$$\text{o Year 1: } 20,000 / (1 + 0.10)^1 = 18,182$$

$$\text{o Year 2: } 30,000 / (1 + 0.10)^2 = 24,793$$

$$\text{o Year 3: } 40,000 / (1 + 0.10)^3 = 30,052$$

$$\text{Total Present Value of Recoveries: } 18,182 + 24,793 + 30,052 = 73,027$$

2. Subtract Recovery Costs from PV of Recoveries:

$$\text{Net Recovery} = 73,027 - 5,000 = 68,027$$

3. Calculate LGD: Use the formula:

$$LGD = 1 - \text{Net Recovery EAD}$$

$$LGD = 1 - 68,027 / 100,000 = 1 - 0.68027 = 0.31971 \text{ or } \mathbf{31.97\%}$$

Summary:

- The Workout Discounted LGD for this loan is **31.97%**, meaning the bank expects to lose approximately 32% of the exposure after considering discounted recoveries and costs.

Final CECL calculation

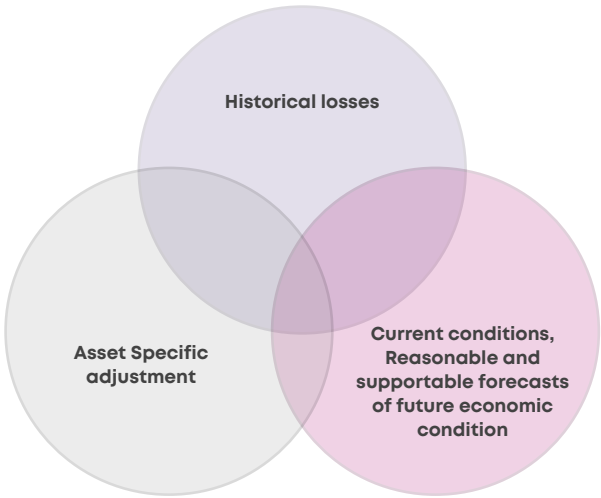
$$CECL = \frac{(PD * LGD * EAD)}{(1 + i_{eff})^{tm}}$$

$$T = \frac{1.85\% * 31.97\% * 100,000}{(1 + 15\%)^3}$$

$$= 1.85\% * 31.97\% * 100,000 * 0.66$$

$$= 388.89$$

3 Historical losses and adjustment



Estimation of expected credit losses should reflect available information that is relevant to assessing the Collectability of cash flows. That information should include historical loss information adjusted:

- For current asset-specific risk characteristics
- For current conditions
- For reasonable and supportable forecasts of future economic condition

3a Historical losses and adjustment for Asset-Specific Risk Characteristics and Current condition

Historical credit loss experience for similar assets is likely a relevant and starting data point for estimating the expected credit losses that will emerge for assets currently held by the entity. The following categories of historical information relevant to the entity's expected credit loss experience may be required to satisfy the requirements of the standard:

- Asset characteristics (e.g., term, amortization period, collateral type, borrower type)
- Loss experience, including migration statistics, charge-offs and recoveries, and the components of amortized cost affected by the default event
- The effect of modifications, prepayments, and extensions on loss experience
- Macroeconomic conditions that correlate to historical loss experience

The following summarizes key considerations related to Historical loss information and its adjustment-

Key Consideration	
Gathering Relevant Historical Loss Data	Historical loss information generally forms the basis for assessing expected credit losses. Entities have the option to use historical periods representing management's expectations for future credit losses. Entities may also choose to use alternative historical loss periods, adjusted for current conditions and other reasonable and supportable forecasts.
Basis for Assessment	The foundation for assessing expected credit losses is the historical credit loss experience of financial assets with similar risk characteristics. This means looking at past data on credit losses for financial assets with similar risk characteristics.
Sources of Historical Loss Information	Entities can use both internal and external historical loss information, or a combination of both, to assess expected credit losses.

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Key Consideration

Adjustments for Asset-Specific Risk Characteristics

Entities must consider adjustments to historical loss information for differences in current asset-specific risk characteristics. This includes underwriting standards, portfolio mix, or asset term variations within a pool at the reporting date.

Reflecting Contractual Terms

Adjustments are crucial when historical loss information does not accurately reflect the contractual term of the financial asset or group of financial assets.

Consideration of Current Conditions

Entities using historical loss information must adjust it to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from past conditions.

Qualitative Adjustments

Adjustments are crucial when historical loss information does not accurately reflect the contractual term of the financial asset or group of financial assets.

Limitation Forecast

Adjustments to historical loss information for existing or future economic conditions are not allowed for periods beyond the reasonable and supportable forecast period.

Reversion Options

Entities may revert to historical loss information at the input level or for the entire estimate. Reversion can be immediate, on a straight-line basis, or using another rational and systematic basis.



Significant judgment will be required to determine the historical data that should be used and the adjustments that may need to be made to historical loss information. When an entity prepares the estimate, it is important to understand the interaction between the historical loss data chosen, the application of current conditions and the reasonable and supportable forecast of future economic conditions, the data used during the reversion period, and the method of reversion. Key considerations when using historical data include:

Complete and Reliable?

Management to assess-

- Controls over historical data
- Data gaps related to acquired portfolios.
- Granularity of historical data relative to the requirements of the model
- Sufficiency of the historical periods relative to asset life

Relevant to current portfolio?

To adjust the asset-specific risk, management may assess-

- Differences in loan terms or structure
- Differences in the borrower profile or underwriting standards
- Differences in the correlation of loss and economic factors
- Time period covered by the historical data

Reflects current conditions?

To adjust the historical loss information to reflect the current condition, management need to assess-

- Changes to market, regulatory, or technological environment affecting the borrower or the receivable
- Consistency of current economic conditions with the historical period used

Adjustment for Reasonable and supportable forecasts of future economic conditions

Estimation of expected credit losses shall consider the effect of forecasted future economic conditions. This includes adjustments for external economic factors that are expected to differ in future periods and are not already reflected in the historical loss experience. In the absence of explicit guidance, it is very difficult to forecast future economic conditions in terms of how a forecast should be developed or how long the forecast period should be. Significant judgment will be required to develop the forecast.

If an entity is unable to make or obtain a reasonable and supportable forecast of future economic conditions beyond a certain point in time, there is no basis to determine what economic adjustments should be made in those periods. Therefore, for periods beyond the reasonable and supportable forecasts, an entity may consider using the historical credit loss information – adjusted for asset-specific risk characteristics and the effect of the reversion method without further adjustments for future economic conditions. In other words, in periods for which an entity can no longer reasonably and supportably forecast economic conditions, the entity cannot estimate zero credit losses. At the point that the reasonable and supportable forecast is no longer a better estimate of expected credit losses than “using historical loss information, entities should revert to historical loss information for the remaining contractual term of the financial asset.”

Example: Toy Co.’s customer base until Year 20X4 includes wholesaler customers. While estimating credit losses for the year ended Year 20X5, management realized that when the country’s inflation rate increased, the default rate increased, and hence, it experienced a credit loss.

Illustrated below is the correlation between the inflation rate and default rate experienced by management in the given year.

Year	Inflation rate	Default rate	Change in losses from prior years
20X0	3%	5%	
20X1	4%	6%	1%
20X2	4.50%	7%	1%
20X3	5%	8%	1%
20X4	6%	10%	2%

When estimating the allowance for expected credit losses for the year ending 31 December 20X5, management concludes that it needs to adjust for the effect of future inflation rates on receivables from wholesalers. As the inflation rate is predicted to increase in 20X5 (on account of forecast economic conditions), an adjustment of 2% of expected credit losses is to be made.

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Adjustment for forecast economic conditions is dependent upon management's ability to develop the forecast. This requires significant judgment in terms of the determination of the forecast period, which in turn depends upon economic variables being forecasted and the entity's ability to forecast the variables over time. Without explicit guidance on the appropriate length of a forecast period. Factors to consider include:

- Availability and reliability of information — The availability and reliability of information may limit an entity's ability to develop a reasonable and supportable forecast of future economic conditions for the full contractual life of an asset.
- Relevance of the economic conditions to the entity's portfolio — The forecasted economic variables must be relevant to the portfolio based on factors such as asset type, geography, and whether a variable is truly correlated to losses. Entities may determine that one or more variables are relevant to their forecast of future economic conditions, and these choices may differ from entity to entity.

Entities have flexibility to determine the relevant economic indicators, length of the forecast period and sources of forecasted information. Due to the amount of judgment involved, different entities are likely to have different reasonable and supportable forecast periods. In our view, for long-term receivables, it may be difficult to forecast future economic conditions for the entire contractual life; however, for short-term receivables and contract assets, entities will be able to forecast future economic conditions for the entire contractual life.



5. Write-off and Recoveries

A

Write-off:

When an entity deems all or a portion of a financial asset to be uncollectible, it should reduce the allowance for expected credit losses by the same amount as the portion that is being written off.

The write-offs are recorded in the period when the financial asset(s) are deemed uncollectible.

B

Recoveries:

Recoveries of financial assets and trade receivables previously written off are recorded when received. When a financial asset that was previously written off becomes collectible, the entity recognizes the recovery, and this is reflected in the financial statement.

Illustration on how an entity may implement the guidance in paragraphs 326-20-35-8 through 35-9 relating to write-offs and recoveries of expected credit losses on financial assets.

December 31, 20X3:

In respect of the loan advanced by Bank K to Entity L

Amortized cost basis for Entity L's loan:	\$500,000
Allowance for credit losses:	\$375,000
Credit loss expense:	\$125,000
Resulting Allowance for Credit Losses:	\$500,000

Journal Entry:

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

March 20X6 - Receipt of Partial Payment:

Bank K receives a partial payment of \$50,000 from Entity L.

Journal Entry:

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

March 31, 20X6 - Adjusting Allowance for Credit Losses:

Bank K assesses 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.
No change is recorded to the allowance for credit losses account, except for the recovery of the loan to Entity L.

Journal Entry:

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

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

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6. CECL Reversal

Step 1

A CECL reversal is recognized when the credit quality of a financial asset improves, leading to a reduction in the previously recognized expected credit loss. The reversal is recognized in the income statement as a reversal of credit loss expense, effectively increasing profit.

Step 2

The amount of the reversal is the difference between the previously recognized expected credit loss and the updated estimate of expected credit loss based on the current credit quality.

Step 3

The allowance for credit losses (ACL) account on the balance sheet is adjusted to reflect the reversal. If the reversal fully eliminates the previously recognized allowance, the ACL account is reduced accordingly.

Step 4

The income statement reflects the CECL reversal as a reduction in credit loss expense, contributing to higher reported profits. The balance sheet shows a reduced allowance for credit losses, indicating the improvement in the credit quality of the financial asset.

Step 5

Entities are required to disclose the nature and amount of CECL reversals in the financial statements.

B

Available for Sale (AFS) Debt Securities impairment model (ASC 326-30)

One of the key principles for applicability of CECL credit impairment model is that “it is based on amortized cost”. The impairment model for debt securities classified as AFS differs from the CECL model because AFS debt securities are measured at fair value rather than amortized cost. Considering the nature of classification, the proceeds can be realized by either selling them or collecting the contractual cash flows. Consequently, the guidance requires an estimate of expected credit losses only when the fair value of an AFS debt security is below its amortized cost basis, and credit losses are limited to the amount by which the security’s amortized cost basis exceeds its fair value.

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Implementation Challenges and Way Forward

Key Issues/Considerations

1. Estimating expected credit losses when loans are acquired at a discount

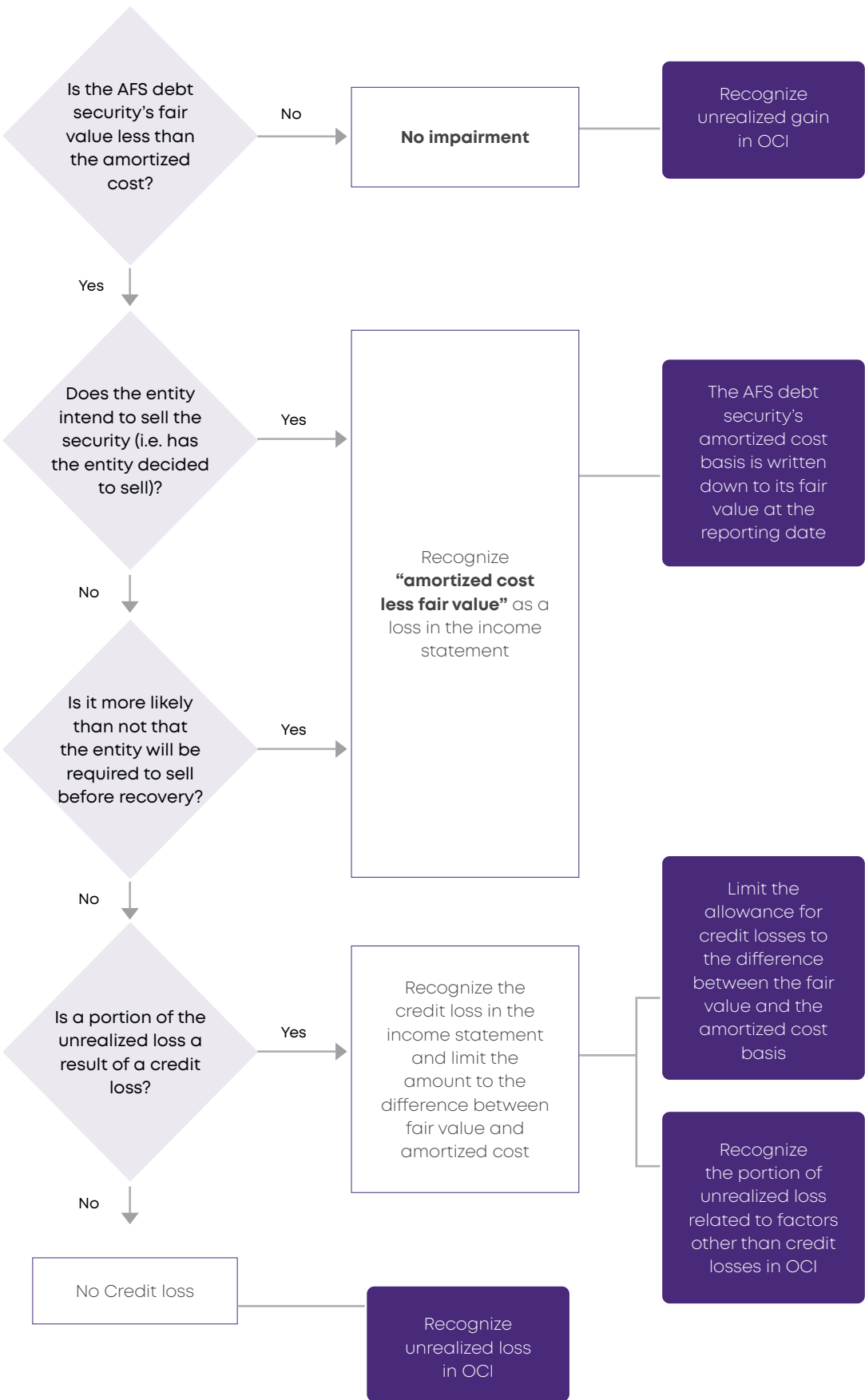
2. How to estimate expected credit losses for purchased financial assets with credit deterioration.

3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.

Proposed Accounting Standard Update- Exposure Draft

Comparison with IFRS

The following flow chart summarizes the impairment model for debt securities classified as AFS-



Summary of Topic**A. Current Expected Credit Loss Impairment model (ASC 326-20)**

1. Scope and Scope Exceptions (ASC 326-20)

2. CECL Core Concepts

3. Determination of Risk of loss over Contractual Life

4. CECL model and components of risk

5. Write-off and Recoveries

6. CECL Reversal

B. Available for Sale (AFS) Debt Securities impairment model (ASC 326-30)

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Consideration	Implementation matters
1. Determining whether credit loss has occurred	
For AFS debt securities, which are neither intended to be sold nor it is more likely that the entity will be required to sell the security prior to recovery of its amortized cost basis, if it is determined that the decline in fair value below the amortized cost basis is entirely or partially due to credit-related factors, it must measure the credit loss and recognize an allowance for credit losses along with the related charge to earnings. Following are some of the factors that should be considered to assess whether a decline in fair value is due to credit-related factors: - Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or the case of asset-backed debt security, changes in the financial condition of the underlying loan obligors. - Any changes to the security rating by a rating agency. - Failure of the issuer of the security to make scheduled interest or principal payments.	The fact that a security's fair value is below its amortized cost is not a determinative indicator of credit loss. To conclude that a decline in fair value is due to credit-related factors, a critical assessment of the factors causing the decline in fair value is required. When determining whether a credit loss exists, management should consider all available information relevant to the collectability of the cash flows of the debt security, including information about past events, current conditions, and reasonable and supportable forecasts. Entity shall consider both issuer-specific and other factors that may have an indirect effect on the issuer that may qualitatively indicate that a credit loss exists Such factors may include: a. Issuer Specific factors - Decrease in credit rating - Adverse legal or regulatory events (e.g., a regulatory limit is imposed on the issuer, the issuer fails to obtain or sustain a challenge on a significant patent) - Missed interest or principal payments or an event of default - Adverse change in issuer's or analysts' expectations of the issuer's future performance - Increase in entity-specific credit spreads b. Other factors - Significant deterioration in the market environment that may affect the value of collateral (e.g., decline in real estate prices). - Significant deterioration in economic conditions. - Disruption in the business model resulting from changes in technology or new entrants to the industry.
2. Measurement of allowance for credit loss	
- Expected credit loss represents the difference between the debt security's amortized cost basis and the present value of expected cash flows. The allowance should not exceed the amount by which the amortized cost basis exceeds fair value. - Determination of the present value of expected cash flows requires considering all reasonably available data points, including industry analyses, credit ratings, expected defaults, and the remaining payment terms of the debt security. Entity shall consider the following factors-: - understanding of the security, - its structure, - guarantors (if any) and - collateral that supports repayment.	In our view, for entities with large portfolios of AFS debt securities, determining the allowance for credit loss for AFS debt securities may require investments in technology to support processes to estimate and discount expected cash flows. Making these estimates will be challenging when current conditions or reasonable and supportable forecasts indicate an adverse credit environment. A detailed analysis supporting these estimates may be required for a large portion of an entity's AFS portfolio. The assumptions used to estimate expected cash flows will depend on the asset class, structure, and credit rating of the security. In complying with ASC 326-30, an entity may be able to leverage the process it has in place to make fair value estimates.

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3. Determination of Risk of loss over Contractual Life

4. CECL model and components of risk

5. Write-off and Recoveries

6. CECL Reversal

B. Available for Sale (AFS) Debt Securities impairment model (ASC 326-30)

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Proposed Accounting Standard Update- Exposure Draft

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Consideration	Implementation matters
3. Interest rate to be used to discount expected cash flows	
For determination of the present value of expected Cash flows, the same should be discounted at the security's effective interest rate, which is determined using contractual cash flows, or the effective interest rate adjusted for the entity's current prepayment expectations, which is determined using contractual cash flows adjusted for expected prepayments (i.e., using a prepayment-adjusted discount rate).	In the case of variable-rate AFS debt security, an entity should use, as a discount rate, the same rate it uses to determine the cash flows expected to be collected. This approach is consistent with the concept in ASC 326-30 that changes in interest rates do not cause credit losses. ASC 326-30-35-11 allows entities to determine the EIR and expected cash flows (including expected prepayments and defaults) using their own expectations (projections) of future interest rate environments when estimating credit losses on variable-rate financial assets using a DCF method. An entity may use • spot rates, • current forward curves or • internally projected interest rates that are reasonable and supportable.

Illustration on determination and recognition of impairment loss on AFS debt securities.

Assume that Entity E purchases a five-year, \$10,000 par bond with a 5% coupon (a market rate at the time of purchase) on 1 January 20X0 and classifies it as an AFS debt security. As of 31 December 20X0, the amortized cost basis of the AFS debt security is \$10,000 (interest accrued during the year was collected) and the fair value of the security is \$6,000. Entity E does not intend to sell the debt security, and it is not more likely than not Entity E will be required to sell the debt security before recovery of its amortized cost basis. Entity E notes that the issuer of the AFS debt security has recently had its credit rating downgraded due to the loss of a significant customer. As on 31 December 20X0, Entity E estimates based on current conditions and reasonable and supportable forecasts cash flows for the years 20X1 through 20X4. Entity E's single best estimate of cash flows indicates that it will collect only \$250 of interest in 20X3, only \$9,000 of the principal balance and no interest in 20X4. How Entity E should estimate and recognize the allowance for credit losses for an AFS debt security? Analysis: Determine whether the AFS debt security is impaired Total impairment is measured as follows: Amortized cost- \$10,000 Less: Fair value- (6,000) Total impairment \$4,000 Determine whether the entity intends to sell or will more likely than not be required to sell the security Entity E does not intend to sell the debt security, and it is unlikely that it will be required to sell it before recovering its amortized cost basis.
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Determine whether a credit loss exists

Entity E notes that the issuer of the AFS debt security has recently had its credit rating downgraded due to the loss of a significant customer. As a result, Entity E believes that a credit loss may exist. As a result, Entity E must estimate the present value of expected cash flows to confirm whether a credit loss exists and, if so, determine the amount of the expected credit loss.

Measure the credit loss

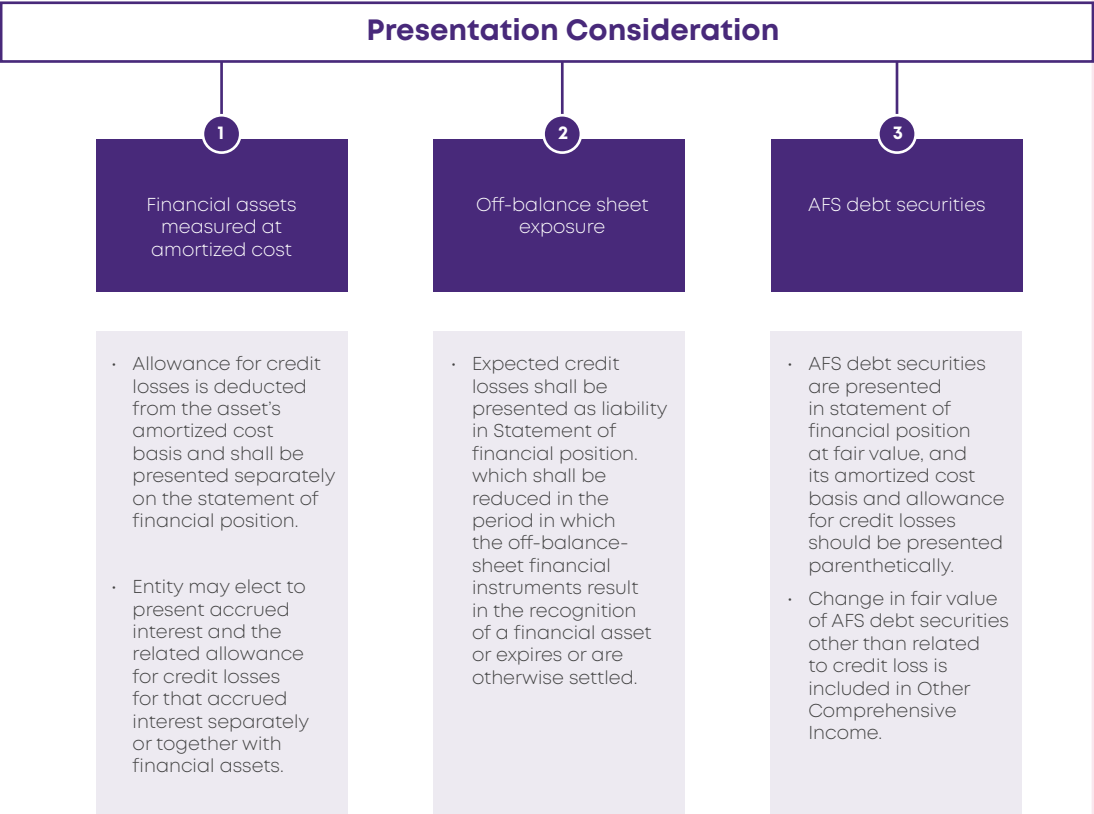
The table below shows the original and revised cash flows expected to be collected. It illustrates how Entity E will estimate the allowance for expected credit losses and the amount attributable to other factors:

Consideration	Year	Original cash flows expected to be collected	Revised cash flows expected to be collected	Decrease in cash flows expected to be collected
	20X0	\$ 500	(collected)	n/a
	20X1	500	\$ 500	\$ -
	20X2	500	500	-
	20X3	500	250	(250)
	20X4	10,500	9,000	(1,500)
Total gross cash flows		12,500	10,250	
Present value of expected cash flows discounted at 5% (original effective rate)		\$ 10,000	\$ 8,550	\$ (1,450)
Impairment due to credit			\$ 1,450	
Impairment due to other factors (non-credit)			\$ 2,550	
			(4,000-1,450)	
Summary:				
Initial carrying amount		\$ 10,000		
Plus: Interest recognized in 20X0		500		
Less: Interest collected in 20X0		(500)		
Credit loss impairment at the end of 20X0		(1450)		
Noncredit impairment at the end of 20X0		(2550)		
Total impairment		(4,000)		
Fair value at end of 20X0		\$ 6,000		
Journal entries to be recorded				
Credit loss expense		\$ 1,450	\$ 1,450	
Allowance for credit losses				
AFS securities — other comprehensive income		\$ 2,550		
AFS securities — fair value adjustment			\$ 2,550	



KEY PRESENTATION AND DISCLOSURE CONSIDERATIONS

a. Presentation requirements



b. Disclosure requirements

The primary objective of disclosure requirements is to enable the users of the financial statements to understand:

- The credit risk inherent in a portfolio and how credit quality of portfolio is monitored by management,
- Management's estimate of expected credit losses,
- What are the changes in the estimate of expected credit losses during the period.

1. CECL key disclosure requirements:

The disclosure guidance covers the following aspects:

a. Credit quality information – The entity is required to disclose the information related to the credit quality of financial assets. Such information enables the users of financial statements to understand management's process of:

- monitoring the credit quality of an entity's financial assets, and
- assessing the qualitative and quantitative risks associated with the credit quality of its financial assets.

Credit quality indicators such as Consumer credit risk scores, Credit rating agency ratings, collateral, collection experience, etc., are disclosed as part of credit quality information. For example, as of year-end, 75% of the entity's loan portfolio is rated 'A' or above, reflecting a high credit quality.

b. Allowance for credit losses – The entity is required to disclose the information related to determination of allowance for credit losses to enable the user of financial statements to understand:

- methodology used for developing the allowance for credit losses
- information used to estimate credit losses
- circumstances causing change in allowance for credit losses, thereby resulting in related credit loss expense (or reversal) reported for the period

As per the guidance, the following are some of the key disclosures that enable the user of financial statements to understand the key drivers for allowance of credit loss recognized in the current period:

- A description of the entity's accounting policies and methodology used for estimating the allowance for credit losses, along with a discussion of the factors that influenced management's current estimate of expected credit losses, including: Past events, Current conditions and Reasonable and supportable forecasts about the future.
- Risk characteristics related to each portfolio segment.
- Reversion method, if any, applied for periods beyond the reasonable and supportable forecast period.

For e.g., entity's allowance for credit losses increased by \$5 million in Q3 2023, primarily due to a reassessment of the economic environment.

c. Past-due status – The entity is required to disclose the information on aging analysis of the amortized cost basis for financial assets that are past due as of the reporting date disaggregated by class of financing receivable, so as to enable the users of financial statements to understand the performance of the entity's financial assets. This is also helpful in evaluating historical estimates of credit losses.

For e.g., As of the reporting date, 10% of entity's receivables are 30 days past due, reflecting a moderate level of payment delays.

d. Non-accrual status – The entity is required to disclose the information related to non-accrual assets disaggregated by class of financing receivable to enable the user of financial statements to understand credit risk and interest income recognized on financial assets on nonaccrual status. As per the guidance, the entity is required to make disclosure for the amortized cost basis of financial assets on nonaccrual status-

- As of the beginning and at the end of the reporting period.
- That are 90 days or more past due, but are not on nonaccrual status as of the reporting date.
- For which there is no related allowance for credit losses as of the reporting date.

The Entity shall also disclose the amount of interest income recognized during the period on nonaccrual financial assets.

For e.g., nonaccrual loans totaled \$20 million in Q4 2023, primarily related to borrowers experiencing financial difficulties.

e. Collateral-dependent financial assets - The entity is required to disclose information related to the details of collateral securing financial assets and how changes in collateral value impact credit risk for a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty.

For e.g., Collateral for entity’s commercial loans includes real estate and equipment, and changes in collateral value are monitored for potential credit risk.

f. Off-balance-sheet credit exposures - The entity is required to disclose information related to a description of the accounting policies and methodology it used to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures.

2. Disclosures for AFS debt securities

The disclosure of credit quality information (ASC 326-30-50-1a), involves providing details about the credit distribution of AFS debt securities, typically categorized by credit rating.

Entities are also mandated to disclose information about the allowance for credit losses (ASC 326-30-50-1b), elucidating the methodology employed for the calculation of the allowance, as well as any alterations made to the allowance during the reporting period. Additionally, disclosures pertaining to purchased financial assets with credit deterioration are necessary (ASC 326-30-50-1c), involving information about assets acquired with evident credit deterioration since their origination.

To fulfill the objectives of these disclosures (ASC 326-30-50-2), entities must offer insights into the inherent credit risk associated with AFS debt securities, communicate management’s estimates of credit losses, and outline any changes in these estimates over the reporting period.

The level of detail for these disclosures is subject to the entity’s judgment, considering a balance between providing meaningful information and avoiding excessive aggregation (ASC 326-30-50-3). Practical considerations must be considered to strike the right balance, ensuring that important information is not obscured or overwhelmed by irrelevant details.

**Key Presentation and
Disclosure Considerations**

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Key Issues/Considerations

- 1. Estimating expected credit losses when loans are acquired at a discount
- 2. How to estimate expected credit losses for purchased financial assets with credit deterioration.
- 3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.

Proposed Accounting
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Comparison with IFRS



IMPLEMENTATION CHALLENGES AND WAY FORWARD

For the effective implementation of the new guidance, entities are required to review existing policies, procedures, credit risk monitoring systems & processes, and storage, and maintenance of historical loss data. In addition to the internal systems and policies, entities may be required to involve external vendors and models to compute CECL. The table below provides examples of specific considerations to be kept in mind by the entities –

Key Aspects	Considerations
Policies and Procedures	- Align or formulate credit risk management policies as per the guidance of ASC 326 - Define roles and responsibilities for the credit review process, including review frequencies - Establish procedures for sourcing, collection, and usage of data, key assumptions, and inputs used for the estimation of credit losses
Historical loss data	Selection of sources of historical loss data, i.e., external generated or internally generated loss data, depending on the type of financial assets. For instance, for Level 1 financial assets, external credit ratings and related loss data can be utilized, whereas for Level 3 assets, internally generated historical loss experience information is appropriate.
Models and Methodologies, including third-party vendors	- Select of appropriate methodology(ies) for each class of asset. - Evaluate the accuracy and complexity of the models proposed by third-party vendors. Ensure that the models are sufficiently accurate in predicting expected credit losses while being understandable and transparent. - Consider whether the vendor's models have undergone independent validation by qualified parties. Model validation helps verify the models' accuracy, reliability, and appropriateness for your organization's specific needs.
Overall Documentation	- Data Quality: Ensure accurate, complete, and reliable data; document its sources and any alterations made. - Methodology Transparency: Document the chosen CECL methodology, including models, assumptions, and validations. - Model Validation: Document the validation process and any adjustments made to CECL models based on validation results. - Policy and Procedure Documentation: Document policies, procedures, and internal controls related to CECL implementation to ensure consistency and compliance



In our experience, many entities that have already implemented the standard have made significant changes to their business processes, data collection processes and internal control over financial reporting.

Successful implementation requires a determination of the instruments in the scope of the guidance, effective communication with stakeholders, and a detailed plan for managing the change. During the implementation process, entities have to spent significant time and effort on obtaining and enhancing the required data, building or purchasing models to calculate impairment and enhancing their processes or implementing new ones to analyze their information about credit losses and to forecast economic conditions.

KEY ISSUES/CONSIDERATIONS

1. Estimating expected credit losses when loans are acquired at a discount

Bank Z purchases a portfolio of loans that share similar risk characteristics from Bank B with the following terms:

- Acquisition date (Day 1): 30 January 20X4
- Face value of portfolio: \$10 million
- Purchase price of portfolio: \$9.8 million
- Discount: \$0.2 million

Bank Z assesses the portfolio and determines that it has not experienced more-than-insignificant credit deterioration since origination and, therefore, is not subject to Purchase with Credit Deterioration (PCD) asset accounting. In addition, Bank A assesses the acquired portfolio under the CECL model using loss rate method and determines that the loss rate on the amortized cost of \$9.8 million is 2% considering its historical loss experience, current conditions, and a reasonable and supportable forecast.

Is a discount embedded in the purchase of a financial asset of \$0.2 million possible to offset the allowance for expected credit losses?

Analysis:

As per the principles of ASC 326-20 the estimate of credit loss is based on a financial asset's amortized cost. However, entities are not permitted to follow an "accrete to impair" policy. It also states that when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. In other words, the discount embedded in the purchase price of a financial asset cannot be used to avoid recognizing an allowance.

Basis the above guidance on day 1, Bank Z shall record the following entries:

30 January 20X4 journal entries

Purchased loans \$10,000,000

Cash	\$9,800,000
Discount	\$200,000

To recognize purchased loans acquired at a discount.

Expected credit losses over the lifetime of the portfolio are \$0.196 million. Based on the guidance in ASC 326-20, Bank Z cannot use the \$0.2 million purchase price discount to offset the required allowance of \$0.196 million because Bank Z expects to accrete the discount into interest income. Therefore, Bank Z would make the following additional journal entry on acquisition:

Credit loss expense (P&L)	\$196,000
Allowance for expected credit losses (balance sheet)	\$196,000

To recognize Day 1 allowance on purchased loans.

As a result of the entries above, Bank Z would present the following on its 30 January 20X4 balance sheet:

Par value of the loan	\$	10,000,000
Less: Discount		200,000
Amortized cost		9,800,000
Less: Allowance for expected credit losses		(196,000)
Carrying value of the loan		9,604,000

The estimate of expected credit losses is assessed on the amortized cost of the financial asset. Bank Z should recognize an allowance at initial recognition, even when the amount of the purchase discount is greater than the calculated Day 1 allowance. The discount is accreted into interest income in subsequent periods, and the allowance is reassessed.

2. How to estimate expected credit losses for purchased financial assets with credit deterioration.

Analysis:

Purchased financial assets with credit deterioration (PCD assets) are recognized at the purchase price plus the allowance for credit losses expected at the time of acquisition. Upon acquisition, there is no credit loss expense affecting net income. Changes in estimates of expected credit losses after acquisition are recognized as credit loss expense (or reversal of credit loss expense) in subsequent periods as they arise.



Because the initial estimate for expected credit losses is added to the purchase price to establish the Day 1 amortized cost, PCD accounting is commonly referred to as a “gross-up” approach. No credit loss expense is recognized upon acquisition of a PCD asset because the initial allowance is established through the gross-up.

PCD accounting is applied upon initial recognition of a purchased financial asset within the scope of ASC 326-20 if the asset has experienced more-than-insignificant credit deterioration since its origination. As the term implies, PCD accounting applies to assets that are both:

- Purchased — PCD assets can be purchased in an asset acquisition or as part of a business combination. PCD accounting does not apply to originated assets.
- Credit deteriorated — PCD assets have experienced more-than-insignificant credit deterioration since origination. While virtually all purchased assets have inherent credit risks, only those that have experienced more-than-insignificant credit deterioration since origination are considered PCD assets.

Purchased assets that have not experienced more-than-insignificant credit deterioration since origination are initially recognized at the purchase price. Expected credit losses are measured under the credit impairment model that applies to that type of financial asset, and credit loss expense is recognized in the income statement upon acquisition. This treatment is similar to that of an originated financial asset.





One of the key factors to apply PCD accounting is, “existence of more-than-insignificant credit deterioration”. ASC 326-20 provides limited guidance on assessing whether a purchased financial asset has experienced a more-than-insignificant deterioration in credit quality since origination. Management may consider the following factors to assess the same:

- The customer's or borrower's financial condition, credit rating, credit score, asset quality or business prospects
- The customer's or borrower's ability to make scheduled interest or principal payments
- The volume and severity of past due financial assets and the volume and severity of adversely classified or rated financial assets
- The value of any underlying collateral

It is not appropriate to consider an asset as PCD merely because these are purchased at a discount to par or at an acquisition price that includes an expectation of credit losses greater than zero. These factors are not determinative in the analysis of whether there is more-than-insignificant deterioration in credit quality since origination. A discount on acquisition could also reflect changes in market interest rates since origination or the selling entity's desire for a quick and efficient sale process rather than a change in credit risk.

3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.

XYZ Inc. holds a group of trade receivables that are classified as held for investment. XYZ Inc. has decided to sell trade receivables with an unpaid principal balance of \$1,000,000. Accordingly, it reclassifies the trade receivables to held-for-sale. Based on its policy, XYZ Inc. determines that the receivables were not uncollectible and did not have significant credit deterioration.

XYZ Inc. transfers the receivables to an unconsolidated securitization entity for \$980,000 in cash and a beneficial interest in the securitization trust. XYZ Inc. continues to service the transferred receivables.

The \$1,000,000 of receivables have unamortized deferred origination costs (net) of \$50,000 resulting in a carrying amount of \$1,050,000. The allowance for credit losses is \$15,000.

XYZ Inc. determines that the fair values of the beneficial interest and servicing assets are \$100,000 and \$20,000, respectively.

What is the gain on sale of receivables and how allowance for credit losses associated with a transfer of financial assets shall be accounted for?

Analysis:

As per the guidance of **ASC 860** in a transfer of financial assets accounted for as a sale, a transferor:

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

In the given case XYZ Inc. determines that the transfer meets the criteria to be accounted for as a sale. It calculates the gain on the sale of the receivables as follows.

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5. Write-off and
Recoveries

6. CECL Reversal

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(AFS) Debt Securities
impairment model
(ASC 326-30)

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Comparison with IFRS

Fair value of assets obtained in the sale (i.e. calculation of net proceeds)

Cash	\$980,000
Beneficial interest	\$100,000
Servicing asset	\$20,000
Fair value of assets obtained (net proceeds)	\$1,100,000

Calculation of gain (or loss) on sale of receivables

Fair value of assets obtained in the sale (net proceeds)	\$1,100,000
Less: Carrying amount of transferred receivables	\$1,050,000
Gain on sale of receivables	\$50,000

When an entity decides to sell a loan classified as held-for-investment, the same is reclassified to held-for-sale. As per the facts of the given case XYZ Inc. decides to sell receivables in a transfer accounted for as a sale, therefore it shall first apply the guidance on transfers from held-for-investment to held-for-sale. Therefore, an XYZ Inc.:

- shall reverse in earnings any allowance for credit losses previously recorded on the receivables;
- shall reclassify and transfers the loan into the held-for-sale classification at its amortized cost basis; and

XYZ Inc. shall record the following journal entry to account for the reversal of allowance of credit loss arising due to the transfer of receivable from held-for-investment to held-for-sale.



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loans are acquired at a
discount

2. How to estimate
expected credit losses
for purchased financial
assets with credit
deterioration.

**3. Allowance for credit
losses associated with
a transfer of financial
assets accounted for as
a sale.**

Proposed Accounting
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Comparison with IFRS

Particulars	Debit	Credit
Allowance for credit losses	\$15,000	
Credit loss expense		\$15,000
<i>To reverse existing allowance for credit losses on held-for-investment receivables.</i>		
Receivables – held-for-sale	\$1,000,000	
Deferred origination costs (net) – held-for-sale	\$50,000	
Receivables – held-for-investment		\$1,000,000
Deferred origination costs (net) – held-for-investment		\$50,000
<i>To record the transfer of receivables from held-for-investment to held-for-sale.</i>		

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

Particulars	Debit	Credit
Cash	\$980,000	
Beneficial Interest	\$100,000	
Servicing asset	\$20,000	
Receivables – held for sale		\$1,000,000
Deferred origination costs (net) – held for sale		\$50,000
Gain on sale		\$50,000
<i>To derecognize the carrying amount of assets sold, recognize the fair value of assets obtained, and recognize gain on sale.</i>		

PROPOSED ACCOUNTING STANDARD UPDATE- EXPOSURE DRAFT

On December 3, 2024, FASB published an Exposure draft of the proposed Accounting Standards Update (ASU) on the **measurement of credit losses for accounts receivable and contract assets for private companies and certain not-for-profit entities**. Stakeholders are encouraged to review and provide input on the proposed ASU. The following summarizes the key highlights of the proposed ASU:

Key Highlights:

1. Applicability	Private companies and not-for-profit entities
2. Financial assets within the scope of the Proposed ASU	Current accounts receivable and current contract assets arising from transactions accounted for under Topic 606.
3. Existing Provisions	- As discussed in Section 4 above, an organization must estimate probable credit losses over the course of term of an instrument using reasonable and supportable forecasts and historical data adjusted for current circumstances. - Existing guidance requires that an entity consider available information that is relevant to assessing the collectability of cash flows when developing an estimate of expected credit losses. - The historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. - An entity is required to consider adjustments to that information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. - Those adjustments may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets) during the forecast period. In addition, under Topic 326, an entity is not permitted to consider collections received after the balance sheet date when developing its estimate of expected credit losses.
4. Proposed Amendment	The proposed ASU allows entities with a practical expedient and an accounting policy election as stated below when estimating expected credit losses: 1. Practical expedient. In developing reasonable and supportable forecasts, an entity may elect a practical expedient that assumes that current conditions as of the balance sheet date persist throughout the reasonable and supportable forecast period. 2. Accounting policy election. An entity that elects the practical expedient would be eligible to make an accounting policy election to consider collection activity after the balance sheet date when estimating expected credit losses.
5. Transition requirements	An entity that elects the practical expedient and accounting policy election would apply them prospectively.
6. Effective date	This has yet to be finalized, and early adoption will be permitted.

Application Guidance of Proposed ASU

(a) Practical expedient

As per existing guidance, the estimation of expected credit losses should reflect available information that is relevant to assessing the Collectability of cash flows. That information should include historical loss information adjusted for:

- Current asset-specific risk characteristics
- Current conditions
- Reasonable and supportable forecasts of future economic condition

As per the proposed amendment an entity exercising the practical expedient would assume that current conditions as of the balance sheet date persist throughout the forecast period and does not require to make adjustment to historical loss information for reasonable and supportable forecasts of future economic conditions. There is no relaxation on adjustment for current asset-specific risk characteristics and for current conditions.

For example- A private company that has identified an individual customer that is experiencing financial distress would consider that information in its estimate of expected credit losses even if that information has not yet affected its historical loss experience or current conditions (that is, even if the customer has remained current on existing receivables as of the balance sheet date). Similarly, a private company that has recently expanded its credit policies to offer credit to lower-quality customers would consider that information in its estimate of expected credit losses even if that change has not yet affected its historical loss experience (that is, even if the new, lower credit-quality customers have remained current as of the balance sheet date).

(b) Accounting Policy Election

An entity that applies the practical expedient may apply an accounting policy election that would allow the entity to consider collection activity after the balance sheet date but before financial statements are available to be issued (or the date after the balance sheet date but before the financial statements are available to be issued selected by the entity) when estimating expected credit losses. In such cases, a credit loss allowance for current accounts receivable and current contract assets that have been fully collected as of the date the financial statements are available to be issued shall be recorded as Zero.

(c) Combined application of Practical expedient and accounting policy election

An entity applying the practical expedient and electing the accounting policy shall estimate its expected credit losses on current accounts receivable and current contract asset balances as follows:

- The entity shall first consider subsequent collections of current accounts receivable and current contract asset balances arising from transactions accounted for under Topic 606 that were outstanding as of the balance sheet date. No credit loss allowance shall be recorded for assets that have been fully collected before the date the financial statements are available to be issued (or the date after the balance sheet date but before the financial statements are available to be issued selected by the entity).
- The entity shall then evaluate any remaining uncollected amounts as of the date the financial statements are available to be issued (or the date after the balance sheet date but before the financial statements are available to be issued selected by the entity) using the practical expedient.

For more information on proposed Accounting Standard Update, see the [press release](#) on the FASB's Website.

COMPARISON WITH IFRS

Both **ASC-326, Financial Instruments- Credit Losses** under USGAAP and **IFRS 9, Financial Instruments** under IFRS, provide guidance on the determination of credit impairment of financial assets adopting an expected credit loss approach, as opposed to the incurred loss approach under legacy guidance. Under both standards, the credit loss for financial assets measured at amortized cost will be recorded by establishing an allowance account. The allowance will be presented as an offset to the amortized cost basis of the related asset or as a separate liability (in the case of off-balance sheet exposures, such as loan commitments and guarantees). Under both models, an allowance is recognized upon initial recognition of financial assets measured at amortized cost and off-balance sheet commitments. This means that a “day 1 credit loss” will be recognized under both frameworks for most financial assets measured at amortized cost. However, the amount of this initial loss will typically differ under the two standards.

The following table summarizes the key differences:

	US GAAP – ASC 326	IFRS Accounting Standard – IFRS 9
Scope-Loans and receivables between entities under common control	ASC 326-20-15-3 specifically excludes loans and receivables between entities under common control from the scope of ASC 326-20.	Loans and receivables between entities under common control are subject to IFRS 9 credit impairment assessment in the separate financial statements of the lender.
Scope-Reinsurance receivables	Reinsurance receivables are in the scope of ASC 326 for purposes of the measurement of expected losses related to credit risk.	Reinsurance receivables are not in the scope of IFRS 9.
Expected credit loss- Initial recognition	For instruments in the scope of the CECL model, lifetime expected credit losses are recorded upon initial recognition of the instrument as an allowance for loan losses. Key Focus area: Reflects high credit risk and historical loss experience.”	Upon initial recognition, only the portion of lifetime ECL that results from default events that are possible within 12 months after the reporting date are recorded (“stage 1”). Lifetime expected credit losses are subsequently recorded only if there is a significant increase in the credit risk of the asset (“stage 2”). Once there is objective evidence of impairment (“stage 3”), lifetime ECL continues to be recognized, but interest revenue is calculated on the net carrying amount (that is, amortized cost net of the credit allowance). Key Focus area: Reflects a significant increase in credit risk (SICR) and the likelihood of credit loss.” in next line.
Recognition of change in estimate of credit loss on reporting date	In each reporting period, changes in the estimate of ECL are generally recognized through earnings as a credit expense or a reversal of credit expense.	In each reporting period, the estimate of the loss allowance is adjusted, with changes recognized in profit or loss, as an impairment gain or loss.

Foreword	Collective and individual assessment	When estimating CECL, reporting entities must calculate the ECL on a "pooled" basis when instruments have similar risk characteristics.	When reasonable and supportable information to measure lifetime ECL on an individual basis is not available without undue cost or effort, ECL should be recognized on a collective basis. Instruments are grouped on the basis of shared credit risk characteristics.
Purpose			
Background			
Summary of Topic		If financial instruments do not share similar risk characteristics, the ECL would be calculated on an individual basis but must incorporate risk of loss that may be based on internal or external expected loss assumptions from groups of similar assets.	IFRS 9 requires calculating a probability-weighted amount in the measurement of expected credit losses. Hence, entities need to consider the possibility that a credit loss occurs even if the possibility is very low.
A. Current Expected Credit Loss Impairment model (ASC 326-20)			
1. Scope and Scope Exceptions (ASC 326-20)	Periods to estimate credit losses	An entity's estimate of ECL should include a measure of the expected risk of credit loss, even if that risk is remote.	
2. CECL Core Concepts			
3. Determination of Risk of loss over Contractual Life			
4. CECL model and components of risk		The CECL model requires an estimate of the credit losses expected over the life of an exposure (or pool of exposures). The measurement should include consideration of estimated prepayments but exclude expected extensions and renewals (unless a Troubled Debt Restructuring is reasonably expected or the borrower can unilaterally exercise these options).	The maximum contractual period (including extension options held by the borrower that the borrower is able to unilaterally exercise) should be considered when measuring expected credit losses. Expected prepayments should also be considered.
5. Write-off and Recoveries			
6. CECL Reversal	Reversion to historical information		
B. Available for Sale (AFS) Debt Securities impairment model (ASC 326-30)			
Key Presentation and Disclosure Considerations			
Implementation Challenges and Way Forward		For periods beyond which an entity can develop a reasonable and supportable forecast, the guidance discusses reversion to historical loss information that reflects the contractual term of the financial instrument (or group of financial instruments). The guidance discusses a variety of reversion techniques, including reversion for specific inputs or the entire estimate.	The standard does not discuss how to estimate ECL for periods beyond those for which reasonable and supportable forecasts exist. Different methods could be acceptable depending on the facts and circumstances.
Key Issues/Considerations			Historical data could be used as a base from which to measure ECL. Such data should be adjusted to reflect current conditions and forecasts of future conditions not reflected in the historical data and to remove the effects of the conditions in the historical period that are irrelevant to future contractual cash flows. The most reasonable and supportable information might be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to the circumstances at the reporting date.
1. Estimating expected credit losses when loans are acquired at a discount			
2. How to estimate expected credit losses for purchased financial assets with credit deterioration.			
3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.			
Proposed Accounting Standard Update- Exposure Draft			

Comparison with IFRS

Foreword	Zero expected credit loss	The CECL model generally requires that the estimate of expected credit losses include a measure of the expected risk of credit loss, even if that risk is remote. However, ECL does not need to be estimated when the expectation of non-payment of the amortized cost basis is zero.	When measuring expected credit losses, an entity should consider the risk that a credit loss may occur, even if the possibility of a credit loss occurring is very low. As an exception to the general model, if the credit risk of a financial instrument is low at the reporting date (e.g., investment grade), the entity can measure impairment using a 12-month ECL. It would not have to assess whether a significant increase in credit risk has occurred. The use of this practical expedient is optional. To qualify for this practical expedient, the instrument should meet the description of low credit risk given in IFRS 9.
Purpose			
Background			
Summary of Topic			
A. Current Expected Credit Loss Impairment model (ASC 326-20)	Write-off and default	Reporting entities are required to write off financial assets (or a portion thereof) in the period in which a determination is made that the financial asset (or portion thereof) is uncollectible. This generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted.	IFRS 9 requires an entity to reduce the gross carrying amount of a financial asset (in its entirety or a portion thereof) when the entity has no reasonable expectations of recovering a financial asset.
1. Scope and Scope Exceptions (ASC 326-20)			
2. CECL Core Concepts			
3. Determination of Risk of loss over Contractual Life			
4. CECL model and components of risk	Applicability of guidance to trade receivables and contract assets	Full-day 1 credit loss recognition is required by the general model for instruments and assets subject to its scope, such as trade receivables and contract assets.	The model includes some operational simplifications for trade receivables, contract assets, and lease receivables. These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred, as they allow (or in some cases require) measurement of the loss allowance at initial recognition and throughout the life of an instrument at an amount equal to lifetime ECL.
5. Write-off and Recoveries			
6. CECL Reversal			
B. Available for Sale (AFS) Debt Securities impairment model (ASC 326-30)			
Key Presentation and Disclosure Considerations	Effective Interest rate (EIR) method	Calculation of the EIR is generally based on contractual cash flows over the asset's contractual life	Calculation of the EIR is generally based on the estimated cash flows (excluding future credit losses) over the expected life of the asset.
Implementation Challenges and Way Forward			
Key Issues/Considerations	Reversal of Credit Impairment	Basis of Reversal: Improvement in credit quality, leading to lower lifetime ECL. Staging of Assets: No staging; lifetime ECL applies to all assets. Recognition of Reversal: Direct reduction in allowance for credit losses and increase in net income. Interest Revenue: No impact on interest revenue calculation. Impact: Reversal is simpler and applies uniformly.	Basis of Reversal: Improvement in credit quality, leading to movement between stages or lower ECL. Staging of Assets: Three-stage model (Stage 1, 2, 3); reversal depends on stage movement. Recognition of Reversal: Reduction in allowance and potential recalculation of interest revenue (if moving out of Stage 3). Interest Revenue: Interest revenue reverts to a gross basis if the asset moves out of Stage 3. Impact: Reversal is more complex due to staging and potential interest revenue adjustments.
1. Estimating expected credit losses when loans are acquired at a discount			
2. How to estimate expected credit losses for purchased financial assets with credit deterioration.			
3. Allowance for credit losses associated with a transfer of financial assets accounted for as a sale.			
Proposed Accounting Standard Update- Exposure Draft			

Comparison with IFRS

Foreword

Purpose

Background

Summary of Topic

A. Current Expected
Credit Loss Impairment
model (ASC 326-20)

1. Scope and Scope
Exceptions (ASC 326-20)

2. CECL Core Concepts

3. Determination of
Risk of loss over
Contractual Life

4. CECL model and
components of risk

5. Write-off and
Recoveries

6. CECL Reversal

B. Available for Sale
(AFS) Debt Securities
impairment model
(ASC 326-30)

Key Presentation and
Disclosure Considerations

Implementation
Challenges and Way
Forward

Key Issues/Considerations

1. Estimating expected
credit losses when
loans are acquired at a
discount

2. How to estimate
expected credit losses
for purchased financial
assets with credit
deterioration.

3. Allowance for credit
losses associated with
a transfer of financial
assets accounted for as
a sale.

Proposed Accounting
Standard Update-
Exposure Draft

**Available for sale
assets measured
at FVOCI**

US GAAP has a separate
model for AFS securities,
which prescribes the
following steps:

(1) Assess if the investment
is considered impaired (i.e.,
the fair value is less than the
amortized cost).

(2) If the asset is impaired,
consider whether
management has: (i) the
intent to sell or (ii) will more
likely than not be required
to sell the impaired security
before recovery of its
amortized cost basis. If
either of these requirements
are met, the reporting entity
should record the entire
impairment loss in earnings
against the amortized cost
basis of the security.

(3) If neither of the
conditions in (2) apply,
determine how much of the
decline in fair value below
the amortized cost of the
security is "credit related."
An allowance for loan losses
is only required for "credit-
related" losses and is limited
to the difference between
the fair value and amortized
cost.

Under IFRS, the same general impairment
model applies to debt investments
measured at FVOCI.

Movements in the ECL allowance should
be recognized in the income statement,
including movements in the allowance
for financial assets classified in the FVOCI
category. However, for financial assets
measured at FVOCI, the allowance itself
is credited to a FVOCI reserve. It is not
recognized as a liability on the balance
sheet (or as a valuation account that
reduces the gross carrying amount).

Since the general impairment model
applies to FVOCI assets, there's no
"trigger" for impairment, but the general
staging model is used (i.e., 12-month ECL
upon initial recognition and lifetime ECL
if there is a significant increase in credit
risk).

**Presentation
requirements**

- Entities are required
to present separately
on the statement of
financial position the
allowance for credit
losses that is deducted
from the amortized cost
basis of the loan.

- The allowance related
to AFS securities
should be presented
parenthetically

- IFRS 9 does not require a separate
presentation of the loss allowance on
the face of the statement of financial
position. According to the general
requirement in paragraph 55 of IAS 1,
an entity should present additional line
items, headings, and subtotals in the
statement of financial position when
such presentation is relevant to an
understanding of the entity's financial
position because of the size, nature, or
function of an item.

- For financial assets that are measured
at FVOCI, the accumulated impairment
amount is recorded in OCI and not
separately presented in the statement
of financial position. However, an entity
should disclose the loss allowance in
the notes to the financial statements.

**Data
Considerations**

**Forward-Looking
Information:** Requires
reasonable and
supportable forward-
looking information.

Data Emphasis: Internal and
external data; adjusted for
current conditions.

Forward-Looking Information: Emphasizes
historical data adjusted for current
conditions and forecasts.

Data Emphasis: Strong emphasis on
historical loss experience.

Comparison with IFRS

A TEAM THAT YOU CAN TRUST TO DELIVER



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