FORV/S

ASSURANCE

An Updated Look at CECL

September 2022

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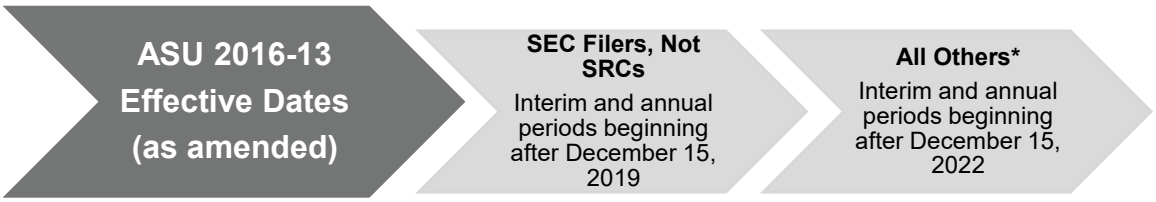
Introduction

Six years have passed since the issuance of Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which updated the guidance on recognition and measurement of credit losses for financial assets. Large SEC registrants finalized changes during a global pandemic and the implementation deadline has now arrived for all other entities. For all other companies, it is effective for fiscal years beginning after December 15, 2022. That means January 1, 2023, for all those that have not yet adopted and have a calendar year end.



*Includes all other public business entities (PBE) (including smaller reporting companies (SRC)), private companies, nonprofits (NFP), and employee benefit plans (EBP).

Overview

This ASU supersedes several portions of current guidance highlighted in the graphic below. Part of this new model, Accounting Standards Codification (ASC) 326-20, has come to be known as the CECL model and replaces today's "incurred loss model" with an "expected credit loss model." At acquisition and each reporting date, entities will recognize an allowance for lifetime expected credit losses for instruments within the ASU's scope. The amount recognized will be based on the current estimate of contractual cash flows not expected to be collected. Subsequent changes in the allowance for credit losses will be recognized through net income. Entities will have flexibility to develop the methods to estimate and measure expected credit losses as long as they are appropriate, practical, and consistent with the guidance's principles. The standard updates the definition and accounting treatment for purchased financial assets with credit impairment (PCI), which will be referred to as purchased financial assets with credit deterioration (PCD).

Because an entity may realize the total value of financial assets either through collection of contractual cash flows or through sale, FASB felt a separate credit loss for the available-for-sale (AFS) debt securities model continued to be warranted but eliminated the existing other-than-temporary impairment (OTTI) model. AFS securities will continue to be evaluated at the individual security level and use an allowance approach, which would permit entities to recognize reversals of credit losses. Entities would be prohibited from considering the length of time the fair value of the AFS debt security has been less than its amortized cost basis, when estimating whether a credit loss exists. In addition, entities would no longer be required to consider recoveries or additional declines in fair value for AFS debt securities after the balance sheet date. While some of the credit impairment concepts are similar to the CECL model, there are several key differences.

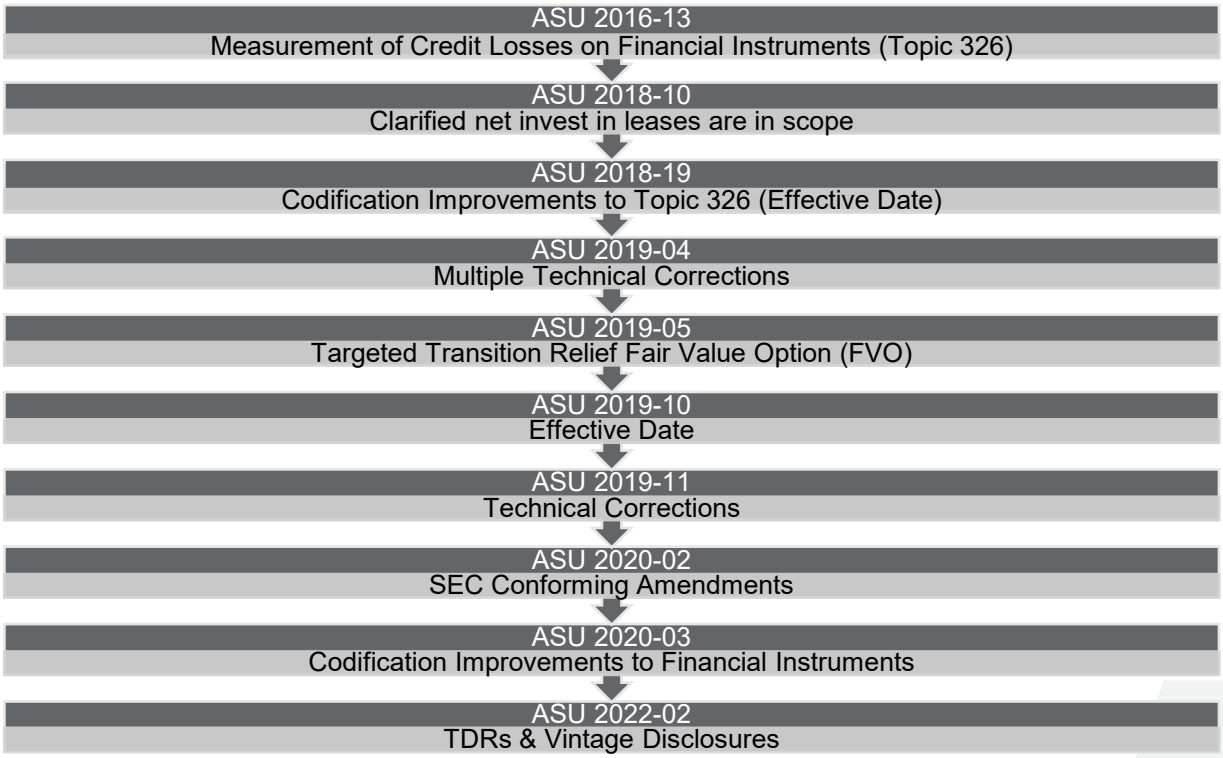
This guidance is principles-based, which provides greater flexibility in implementation but will require significantly more management judgment and documentation to support conclusions reached and how the updated methodology complies with the new guidance. As with other recent updates like ASC 606, Revenue Recognition, and ASC 842, Leases, there are substantial new qualitative and quantitative disclosures.

Given the magnitude of the changes, FASB issued several subsequent amendments to clarify implementation and transition issues that are reflected in this white paper. FASB also established a Transition Resource Group (TRG) for Credit Losses, which addressed a number of additional questions that did not merit standard setting but provide meaningful insights as implementation efforts get underway. This paper contains a summary of all the issues discussed at the three public TRG meetings held to date, information from banking regulator speeches, webinars and public documents, and American Institute of CPAs (AICPA) guidance.

Impairment Guidance – Overview of Codification Changes

Legacy		ASU 2016-13	
Topic	Scope	Topic	Scope
ASC 450 – 20 (FAS 5)	Contingencies – Loss Contingencies	ASC 326 – 20	Financial Instruments – Credit Losses – Amortized Cost (CECL)
ASC 310 – 30 (FAS 114)	Receivables – Loans & Debit Securities – Deteriorated Credit Quality		
ASC 310 – 10	Receivables – Overall		
ASC 320 – 10	Investments – Debt Securities	ASC 326 – 30	Financial Instruments – Credit Losses – AFS Debt Securities

Subsequent Amendments



Scope

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

- Financing receivables
- Held-to-maturity (HTM) debt securities
- Loan commitments, standby letters of credit, and financial guarantees
- Net investments in leases recognized by a lessor in accordance with Topic 842, Leases
- Trade receivables
- Reinsurance recoverables that result from insurance transactions within Topic 944's scope on insurance, regardless of their measurement basis
- Receivables on repurchase and securities lending agreements

FASB specifically excluded the following items from scope:

- Financial assets measured at fair value through net income
- AFS debt securities – Existing OTTI guidance has been superseded
- Participant loans from defined contribution EBPs
- Insurance policy loans
- NFP pledges receivable
- Receivables from parties under common control – This scope exception applies at all standalone reporting levels, both parent and subsidiary

Financial Guarantees

Financial guarantees—except for those accounted for as insurance or recorded at fair value through net income—are treated the same way as loan commitments under CECL. Like loan commitments, financial guarantors are under legal obligation to extend credit if certain events occur or fail to occur.

Operating Lease Receivables

Amendments in ASU 2018-19 clarify that receivables arising from operating leases are not within CECL's scope. Instead, impairment of receivables arising from operating leases should be accounted for in accordance with Topic 842, Leases.

Beneficial Interests (BI)

The November 2018 TRG meeting clarified that an entity is not required to maintain an allowance for credit losses for BIs classified as trading. As noted above, ASC 326-20 excludes financial assets measured at fair value through net income. Such BIs should be accounted for under existing guidance in ASC 325-40, Investments—Other.

Undrawn Credit Facilities

Another big change is that entities must evaluate undrawn credit facilities that can be unconditionally canceled by the lender. Under CECL, a credit facility's contractual term includes only periods not subject to a lender call option. (U.S. retail credit cards generally are considered unconditionally cancelable by the issuer.)

CECL Model

FASB has broadened the information an entity is required to consider in developing its credit loss estimate. Under the incurred loss model, an entity usually considers past events and current conditions in measuring credit losses. ASU 2016-03 requires the loss estimate to include relevant information about past events, current conditions, and reasonable and supportable forecasts. An entity only needs to consider information reasonably available without undue cost and effort, and it can use both internal and external information—including qualitative and quantitative factors—to estimate expected credit losses. For periods an entity is unable to make a reasonable and supportable forecast, entities would revert to historical credit loss experience. An entity may immediately revert to historical loss information or converge to historical losses using a rational and systematic basis.

The ASU does not specify a particular methodology to determine estimated credit losses; methodology may vary depending on the entity's size, the range of the entity's activities, the nature of the entity's financial assets, and other factors.

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

When estimating expected credit losses, an entity should evaluate the borrower's creditworthiness, the issuer's underwriting practices, and the current and forecasted direction of the economic environment.

An entity is not required to consider **all** sources of available information; an entity should consider relevant information that is **reasonably** available and can be obtained without undue cost and effort. An entity should not ignore available information that is relevant to the estimated collectibility of the reported amount. This should not be interpreted to mean an entity must always default to only using external data, *e.g.*, consensus forecasts, if its internal data is sufficient and more appropriate in the circumstances.

For example, external data may be available for purchase, but an entity may conclude that obtaining that information will result in an undue cost and reviewing the external information and incorporating this external information into the entity's processes will require too much effort when internal information is sufficient in determining collectibility.

An entity can estimate expected credit losses only using internal data. Alternatively, an entity may have limited internal data for a particular portfolio to estimate the reported amount's collectibility. Therefore, the entity could need to rely on external data for the purposes of developing an estimate of expected credit losses.

The variables identified may vary between product lines. For consumer portfolios, common variables include unemployment rates, housing price index, gross domestic product (GDP), and interest rates. Other consumer variables include household income, disposable income, new vehicle sales, and employment growth. For commercial portfolios, the most common variables include unemployment, GDP, interest rates, and the commercial property price index. Other variables include crude oil future prices, stock market volatility, consumer confidence, and real estate price indexes.

A KPMG survey found preparers using more variables than expected—respondents were using an average of 6.3 variables for commercial lines and 5.5 variables for consumer lines.

Historical Loss Information

Historical loss information should be the starting point in an entity's assessment of expected credit losses but may not fully reflect an entity's expectations about the future. Management will need to adjust historical loss experience, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss experience, considering the asset's relevant characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date. Management's adjustments shall reflect significant factors affecting expected collectibility. These are examples of factors an entity may consider, depending on the asset's nature (not all may be relevant to every situation, and other factors not on the list may be relevant):

- The borrower's financial condition, credit rating, credit score, asset quality, or business prospects
- The borrower's ability to make scheduled interest or principal payments
- The remaining payment terms of the financial asset(s)
- The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)
- The nature and volume of the entity's financial asset(s)
- The volume and severity of past-due financial asset(s) and adversely classified or rated financial asset(s)
- The value of underlying collateral on financial assets in which the collateral-dependent practical expedient has not been used

- The entity's lending policies and procedures, including changes in underwriting standards, collection and write-off and recovery practices, as well as knowledge of the borrower's operations or the borrower's standing in the community
- The quality of the entity's credit review system
- The experience, ability, and depth of the entity's management, lending staff, and other relevant staff
- The environmental factors of a borrower and the areas where the entity's credit is concentrated, such as:
  - Regulatory, legal, or technological environment to which the entity has exposure
  - Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
  - Changes and expected changes in international, national, regional, and local economic and business conditions and developments in which the entity operates, including the condition and expected condition of various market segments

Historical Period

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

An entity should use judgment in determining which period or periods to consider when determining which historical loss information is most appropriate and is not limited to the most recent period. An entity may determine that 20X2-20X5 historical loss information best represents the specific risk characteristics of the entity's current portfolio. Using that historical loss information as a model input, an entity would then consider how current conditions and reasonable and supportable forecasts affect the loss estimate. Once the historical period has been chosen, an entity should consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as underwriting standards, portfolio mix or asset term within a pool at the reporting date, or when an entity's historical loss information does not reflect the contractual term of the financial asset or group of financial assets. After the reasonable and supportable forecast period, an entity should revert to historical loss information that does not have to be the same period used to estimate its reasonable and supportable forecast. An entity should use historical loss information that reflects the remaining contractual term of the financial assets for periods beyond the reasonable and supportable forecast period.

An entity also may use **nonsequential** historical loss information, such as historical loss percentages based on each year since origination as opposed to an average five-year historical loss percentage. The appropriate historical loss period can vary between loan portfolios, products, pools, and inputs. An entity should consider both the appropriate historical period and the period's appropriate length when developing those estimates.

Loss Probabilities

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss experience adjusted for current conditions and reasonable, supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. An entity shall not expect nonpayment of the amortized cost basis to be zero solely on the current value of collateral securing the financial asset(s); instead, it also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss experience for financial assets secured with similar collateral. The final standard does not explicitly state which financial assets might warrant a zero expected loss but does provide an example and supporting conclusions for U.S. Treasury securities.

The AICPA Auditing and Accounting Guide concluded that a zero-loss probability also could be extended to Ginnie Mae mortgage-backed securities and agency mortgage-backed securities. For collateral-dependent financial assets, ASU 2019-11 clarifies that an entity may determine the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset, such that the collateral's fair value is equal to or exceeds the financial asset's amortized cost basis.

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

Reasonable & Supportable Forecasts

After the appropriate historical loss data for similar assets are determined, the data needs to be adjusted for current conditions and reasonable and supportable forecasts. An entity must compare the conditions that existed during the historical loss period to current conditions and future expectations and make any adjustments needed. Entities may use external data.

Federal Reserve economic data can be found at https://fred.stlouisfed.org/.

Re-Evaluation

Each reporting period, an entity should re-evaluate its reasonable and supportable forecast period, as well as other judgments applied in estimating expected credit losses. If the reasonable and supportable period does not cover the full expected contractual term (adjusted for prepayments), an entity should consider the appropriateness of the duration of its reversion period, *i.e.*, the periods beyond the reasonable and supportable period, and the methodology applied when reverting back to historical loss information. For example, an entity may determine it is appropriate to shorten or lengthen its reasonable and supportable forecast period from prior periods because of changes in the uncertainty of some or all of the inputs and assumptions used to measure expected credit losses.

Commonly used criteria to re-evaluate the reasonable and supportable period include stage of the business cycle, economic volatility, changes in loss model performance, and actual loss volatility.

Correlation & Probability Weighting

An entity is **not** required to correlate or reconcile reasonable and supportable forecasts to macroeconomic data, such as the national unemployment rate. An entity should consider available information relevant to assessing the collectibility of cash flows.

For example, a business closure may not correlate to any macroeconomic phenomena. Instead, an entity may decide to move to another state to receive a more lucrative tax treatment. In this instance, the macroeconomic factors may indicate a very strong job market with low nationwide or statewide unemployment rates, but the business closure may have a significant effect for the entity in the local economic environment when assessing the collectibility of amounts owed by its borrowers. In this instance, correlating a local economic event to macroeconomic data may not be appropriate because the macroeconomic data are not relevant.

In other instances, an entity may consider whether a national trade agreement will have a favorable or unfavorable effect on its ability to collect contractually owed cash flows from its borrowers. The entity may decide to review its internal information that has not indicated any changes in employment to date, but based on a government decision, there may be an effect on the entity's local economy that will result in a change to expected credit losses.

ASC 326 does not require an entity to probability-weight multiple economic scenarios when developing an estimate of expected credit losses. One entity may choose to probability-weight multiple economic scenarios when developing its estimate of expected credit losses, while another entity may rely on a single economic scenario to develop reasonable and supportable forecasts.

Consistency

Regulators and auditors will be checking for internal consistency in forecasts and assumptions used for CECL and elsewhere within an organization—budgeting, asset liability management, valuation allowances, or regulatory projections including stress tests.

Reversion

An entity is not required to develop forecasts over the entire contractual term (adjusted for prepayments) of the financial asset or group of financial assets. For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it is required to revert to historical loss information that reflects expected credit losses during the remainder of the asset's contractual term (adjusted for prepayments).

When reverting to historical loss information, an entity should consider whether the historical loss information is still relevant to estimating expected credit losses and not adjust historical loss information in the reversion period and post-reversion period for existing economic conditions or expectations of

future economic conditions. However, this historical loss information should be adjusted for differences in current asset-specific risk characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date. The reversion to an entity's historical loss information emphasizes the relevance of known loss experience that has occurred in the past on similar financial assets or groups of financial assets.

FASB did not prescribe a single methodology for reverting to historical loss information—an entity may revert to historical loss information immediately on a straight-line basis or by using another rational and systematic basis. In addition, the guidance permits an entity to apply different reversion methods for different inputs and asset classes.

The reversion method is not a policy election but rather a component of the overall estimate of expected credit losses.

Like other components used to measure expected credit losses, an entity should support the reversion methodology and period it uses to develop its estimates of expected credit losses. In addition, reversion to historical loss information—whether immediately on a straight-line basis or using another reasonable methodology—is required only for periods that cannot be forecasted based on reasonable and supportable information.

Measurement of Expected Credit Losses

Currently, depending on the financial asset's nature, a credit loss must either be probable or other than temporary before recognition. The new model eliminates the recognition trigger for credit losses—entities will now recognize a "Day One" impairment allowance for lifetime expected credit losses.

An entity cannot offset a financial asset's expected credit losses with a free-standing contract, *e.g.*, credit default swap. However, an entity can consider the mitigating effect of other credit enhancements, *i.e.*, the guarantor's financial condition, the guarantor's willingness to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets.

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

Portfolio Segmentation/Collective Evaluation

Entities can develop credit loss estimates on a pooled basis if the assets share similar risk characteristics—if not, an individual evaluation is appropriate. In evaluating financial assets on a collective (pool) basis, an entity shall aggregate financial assets on the basis of similar risk characteristics. It may include any one or a combination of the following—consistent with its policies on how it evaluates the credit risk characteristics of financing receivables, HTM debt securities, or off-balance-sheet credit exposures:

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

Banking regulators have indicated that for smaller, less complex financial institutions, segments can be similar to those used in current methodologies or call report categories, whichever is more granular.

Management will need to document how portfolio segments were developed and support why those categories have sufficiently similar risk characteristics.

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

Example – Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation) *Reproduced from ASC 326-20-55-18 through 55-22 (Example 1)*

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

Community Bank A provides 10-year amortizing loans to customers that are managed on a collective basis based on similar risk characteristics. The loan portfolio was originated over the last 10 years and has an amortized cost of $3 million.

After comparing historical information for similar financial assets with the current and forecasted direction of the economic cycle, Community Bank A believes its most recent 10-year period is a reasonable period on which to base its expected credit loss-rate calculation after considering the underwriting standards for loans that existed over the historical period in comparison with the current portfolio. The community bank's cumulative historical lifetime credit loss rate for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which the bank expects to remain unchanged.

Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the community's unemployment rate has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates an incremental 10-basis-point increase in credit losses due to the expected decrease in real estate values, and a five-basis-point increase due to expected deterioration in unemployment rates. Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss experience during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment beyond Year Two of the forecast and decides to immediately revert to the historical credit loss experience after Year Two.

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

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

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

Community Bank ABC provides financing to local consumers purchasing new or used farm equipment and originates approximately the same amount of loans each year. The four-year amortizing loans it originates are secured by using a relatively consistent range of loan-to-collateral-value ratios at origination. The underlying farm equipment collateral is repossessed and sold at auction when t he borrower becomes 90-days past due. The bank tracks these loans on the basis of the calendar year of origination. The following pattern of credit loss experience has been developed based on the amount of amortized cost in each vintage that was written off as a result of credit losses. In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, the bank considers its historical loss experience. It notes that the majority of losses historically emerge in Year Two and Year Three of the loans, historical loss experience has worsened since 20X3, and loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5, even though the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5. In considering current conditions and reasonable and supportable forecasts, the bank notes that there is an oversupply of used farm equipment in the resale market that is expected to continue, thereby putting downward pressure on the equipment's collateral value. Recent severe weather has increased crop insurance cost and this trend is expected to continue. Based on these factors, the bank determines the remaining expected losses (represented by the shaded cells in the table below) and arrives at expected losses of $60, $260, $430, and $510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively.

Year of Origination	Loss Experience in Years Following Origination					
	Year 1	Year 2	Year 3	Year 4	Total	Total Expected
20X1	$50	$120	$140	$30	$340	-
20X2	$60	$120	$160	$50	$390	-
20X3	$40	$110	$150	$30	$330	-
20X4	$60	$110	$150	$40	$360	-
20X5	$50	$130	$170	$50	$400	-
20X6	$70	$150	$180	$60	$460	$60
20X7	$80	$140	$190	$70	$480	$260
20X8	$70	$150	$200	$80	$500	$430
20X9	$70	$160	$200	$80	$510	$510

Accrued Interest

This topic generated substantial discussion at TRG meetings, which resulted in additional standard setting to clarify FASB's intent. ASU 2016-13 defines amortized cost basis as the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion or amortization of premium, discount and net deferred fees or costs, collection of cash, write-offs, foreign exchange, and fair value hedge accounting adjustments.

Several financial statement preparers noted that their financial reporting systems, which are separate from loan systems that track individual loan details, do not track accrued interest amounts on an individual loan basis, which is necessary to (a) measure expected credit losses on a pool basis, (b) implement presentation requirements, and (c) prepare certain disclosures. Stakeholders asked whether including accrued interest in the definition of amortized cost basis was appropriate. FASB clarified that the original intent in defining amortized cost basis was for financial assets held at amortized cost basis to represent the net amount expected to be collected. Therefore, contractual interest that has been earned but not yet received on the financial asset must be included in the amortized cost basis, which is adjusted by the allowance for credit losses to reflect the net amount expected to be collected on the balance sheet.

FASB did not intend to impose significant system and operational changes because of the change in amortized cost definition and issued subsequent amendments in ASU 2019-04 that provide the following optional relief:

- Allow an entity to measure an allowance for credit losses on accrued interest receivables separately from the allowance for credit losses related to the unpaid principal balance and other components of the amortized cost basis. An entity would still be required to apply the guidance that requires an entity to measure expected credit losses on a collective (pool) basis when similar risk characteristics exist when measuring the allowance for credit losses for accrued interest.
- Allow an entity to make an accounting policy election to present separately on the statement of financial position the accrued interest receivable balance net of the allowance for credit losses (if applicable) or to present the accrued interest receivable balance net of the allowance for credit losses (if applicable) within another statement of financial position line item if the entity discloses the accrued interest receivable balance, the applicable allowance for credit losses (if any) related to the accrued interest receivable balance, and the line item in which the accrued interest receivable balance is included.
- Apply a practical expedient to disclose separately the total amount of accrued interest as a single balance in certain disclosure requirements within ASC 326-20.

Models

Due to the credit loss estimate's subjective nature, the ASU does not require a specific approach. An entity should use judgment to develop estimation techniques that are consistently applied over time. Selecting an appropriate model or even multiple models for different portfolios will be a critical management decision. Considerations include:

- The entity's size and complexity
- Models/methods currently used
- Auditor, regulator, and stakeholder expectations
- Data limitations
- Future growth plans
- Portfolio composition

Entities also are free to select different estimation techniques for different portfolio segments. Common challenges can exist regardless of the loss-rate method selected by an entity. These include—but are not limited to—situations involving minimal loss history, losses that are sporadic with no predictive patterns, low numbers of loans in each pool, data that is only available for a short historical period, a composition that varies significantly from historical pools of financial assets, or changes in the economic environment.

Existing models can be leveraged, but the data and assumptions used will have to be adjusted to reflect future expectations. Management will need to appropriately document the model selection criteria and any adjustments made.

Commonly used models include:

- Loss-rate approaches
  - Migration
  - Vintage
  - Weighted-average remaining maturity (WARM)
- Probability of default (PD)/loss given default (LGD)
- Discounted cash flow (DCF) method

Loss-Rate Models

A cumulative loss-rate model freezes all the loans in a segment pool at a particular point in time, then tracks the loss history on those loans over the remaining lives. There are a variety of approaches available, including using cohorts, static pools, or open pools.

Example – Estimating Expected Credit Losses Using a Loss-Rate Approach (Individual Evaluation) *Reproduced from ASC 326-20-55-23 through 55-27 (Example 2)*

Community Bank ABC provides residential real estate loans to local borrowers. In the current year, Community Bank ABC started a program to originate commercial loans. The bank has one commercial loan outstanding at period-end, and because the commercial loan does not share similar risk characteristics, the bank does not believe it is appropriate to pool the commercial loan for purposes of determining its allowance for credit losses. The commercial loan has an amortized cost of $1 million. Historical loss information for commercial loans in the community with similar risk characteristics shows a 0.5 percent loss rate over the contractual term. The bank considers relevant current conditions and reasonable and supportable forecasts that relate to its lending practices and environment and the specific borrower and determines the significant factors affecting the loan's performance are borrower-specific operating results and local unemployment rates. The bank considers other qualitative factors, including national macroeconomic conditions, but determines they are not significant inputs to the loss estimates for this loan.

The bank is able to reasonably forecast local unemployment rates and borrower-specific financial results for one year only. The bank's reasonable and supportable forecasts indicate local unemployment rates should remain stable—based on the main employer in the community continuing to operate normally—but there will be a deterioration in the borrower's financial results (based on an evaluation of rent rolls). Management determines no adjustment is necessary for local unemployment rates because they are expected to be consistent with the conditions in the 0.5 percent loss-rate estimate. However, the current and forecasted conditions related to borrower-specific financial results are different from the conditions in the 0.5 percent loss-rate estimate, based on borrower-specific information. The bank determines an upward adjustment of 10 basis points to the historical loss information is appropriate based on those factors. Management estimates the 10-basis-point adjustment based on its knowledge of commercial loan loss history in the community when borrowers exhibit similar declines in financial performance. The historical loss rate to apply to the amortized cost basis of the individual loan would then be adjusted an incremental 10 basis points to 0.6 percent and the allowance for expected credit losses for the reporting period date would be $6,000.

Loss-Rate Approaches	
Pros	Cons
Less complex model	May be reliant on older periods that are not relevant today or data may be hard to obtain
Data fields and inputs are less complex	Q factor and forecast adjustments are harder to support
Q factor adjustment process will be similar to current practice	
Overall process is simple	

Loss Rate – Data Required for Historical Periods			
Loan #	Book balance	Current available credit	TDR status
Nonaccrual flag	Unamortized premium or discount	Net deferred loan fees or costs	Fair value premium or discount
Individual loan charge off	Individual loan recoveries	Collective segmentation characteristics	Individual loan segmentation
Government guarantee	Guaranteed percentage	Guaranteed amount	

Vintage Loss-Rate Models

This technique considers losses over the full life cycle of loan pools. A vintage is a group of loans originated in the same time period (monthly, quarterly, annually, etc.). Analysis can be based on any type of shared pooling criterion and assets originated in a similar time period, *i.e.*, loans originated from 2008 to 2013 based on FICO bands. This also is called a closed pool or age period cohort.

Vintage Loss-Rate Approach	
Benefits	Limitations
Can be used to better isolate pools by changes in economic conditions, collateral value, or underwriting standards	May require tracking of more loss pools
Improved ability to forecast as more historical data is collected	May be challenging if loan pools are not homogenous
Eliminates changes in portfolio growth	May be reliant on older periods that are not relevant today
	Does not work well for nonamortizing pools or balloon loans

Vintage Method – Data Required for Historical Periods			
Loan #	Book balance	Current available credit	TDR status
Nonaccrual flag	Unamortized premium or discount	Net deferred loan fees or costs	Fair value premium or discount
Individual loan charge off	Individual loan recoveries	Collective segmentation characteristics	Individual loan segmentation
Government guarantee	Guaranteed percentage	Guaranteed amount	Individual loan origination dates
Individual loan origination amounts	Collective segmentation characteristics		

Vintage Method Key Assumptions

- Pooling based on similar risk characteristics, including vintage time period
- Estimated life of loan pools included in payment
- Look-back period for historical loss experience
- Potential use of peer data
- Forecast sources & period
- Forecast & Q-factor adjustments
- Reversion technique

WARM Method

The WARM methodology, while not appropriate for all institutions, can be applicable in some circumstances. Data is one of the biggest challenges for financial institutions transitioning to CECL. For institutions struggling with gaps in their data or lacking in loan-level data, the WARM method may be a viable option. Since the WARM method uses an average annual charge-off rate, entities can use data readily available from Call Reports.

The WARM method considers an estimate of expected credit losses over the remaining life of the financial assets and uses average annual charge-off rates to estimate the allowance for credit losses. For amortizing assets, the remaining contractual life is adjusted by the expected scheduled payments and prepayments, *i.e.*, paydowns. The average annual charge-off rate is applied to the amortization-adjusted remaining life to determine the unadjusted lifetime historical charge-off rate.

For additional educational information, the archived webinar hosted by the bank regulatory agencies is available here.

WARM Method	
Benefits	Limitations
Better leverages current processes, including annualized historical loss rates and Q-factor adjustments	May be difficult to determine expected principal payments
Less complex model	Use of a constant annualized loss rate does not align with lifetime loss experience
Can be performed in-house	Q-factor and forecast adjustments are harder to support (same as current challenges)
Easier to accumulate historical loss rate data if pooling at call code level	May result in higher reserves

WARM Method Key Assumptions

- Pooling segmentation by similar risk characteristics
- Average annual charge-off rate & look-back period
- Amortization-adjusted remaining life – Contractual life & principal payments, prepayments
- Qualitative adjustments
- Forecast adjustments – Forecast period, reversion method, & historical loss experience after reversion

PD & LGD

Many entities frequently use this model to calculate the regulatory reserves under the Basel capital framework. The formula is straightforward:

However, determining the values for each of these inputs can be complicated.

This model separates credit loss into separate components:

- PD – This is a financial term describing the likelihood of a default over a particular time horizon. It provides an estimate of the likelihood that a borrower will be unable to meet its debt obligations. An entity must settle on the definition of a “default” and determine over what length of time it should be

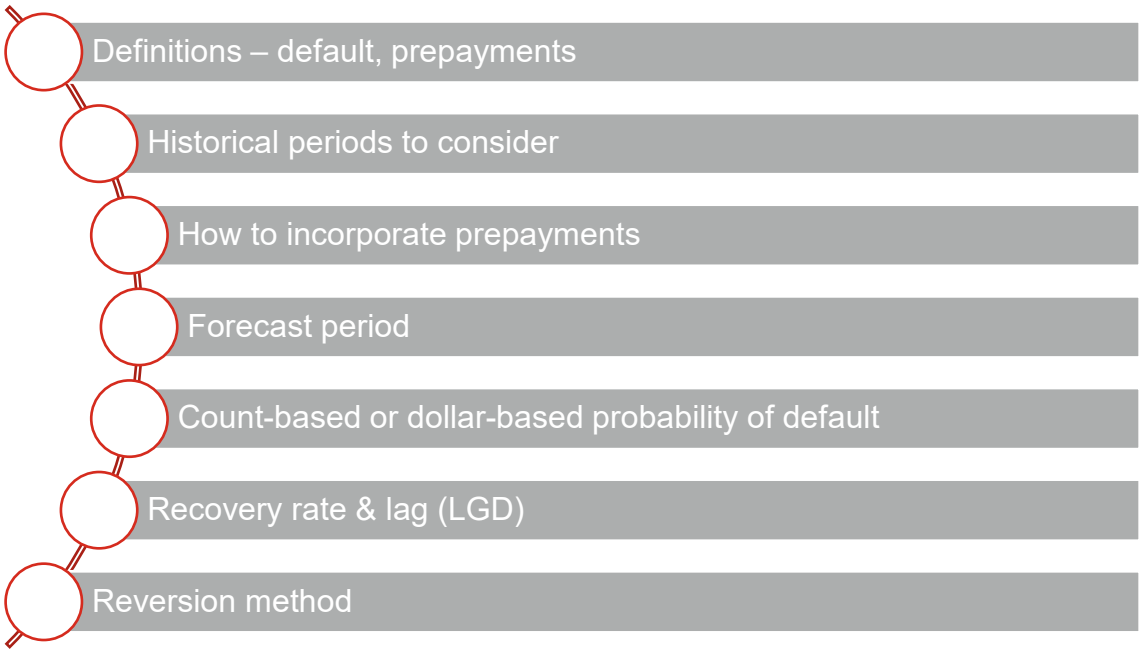
measured. One example definition of default is 90 days past due, but other indications may be used as well, including possible definitions outlined in Basel II.

- LGD – This is the projected amount of exposure at default (EAD) that will be lost after considering recoveries. Like PD, there are several ways LGD can be measured. One way is to determine the percentage of loss by facility or collateral type. LGD estimates also could be driven—or influenced—by product type, industry, or geography. Also, like PD, LGD can be difficult to determine internally. Although inputs can be calculated using simple historical averages, once inputs are calculated they often require regression modeling, which can be challenging without appropriate resources. Many financial institutions find it easier to source data externally.
- EAD – This is simply the borrower's balance. However, further adjustments may be warranted. EAD could be the value of the financial asset today, or, depending on the product type, it could be lower or higher. The economic environment may further complicate the calculation.

The advantage of a PD/LGD model over other methodologies is that it is usually more precise since it relies on more quantitative information. Even qualitative factors for current and forecasted changes are typically based on historical data, and these qualitative factors can be reflected directly in the model rather than being "added on" to the quantitative part as in other methodologies.

Financial institutions will need more data to accurately estimate the three inputs to the model. Additional data will be needed to determine whether and how economic factors affect the variables so they can be adjusted for current and forecasted changes. In addition, all of these calculations will probably require some statistical analysis, which may require specialized software or sophisticated in-house built models.

PD/LGD Assumptions



The PD/LGD model can be used as a standalone to estimate estimated credit losses or as part of the inputs to a DCF model.

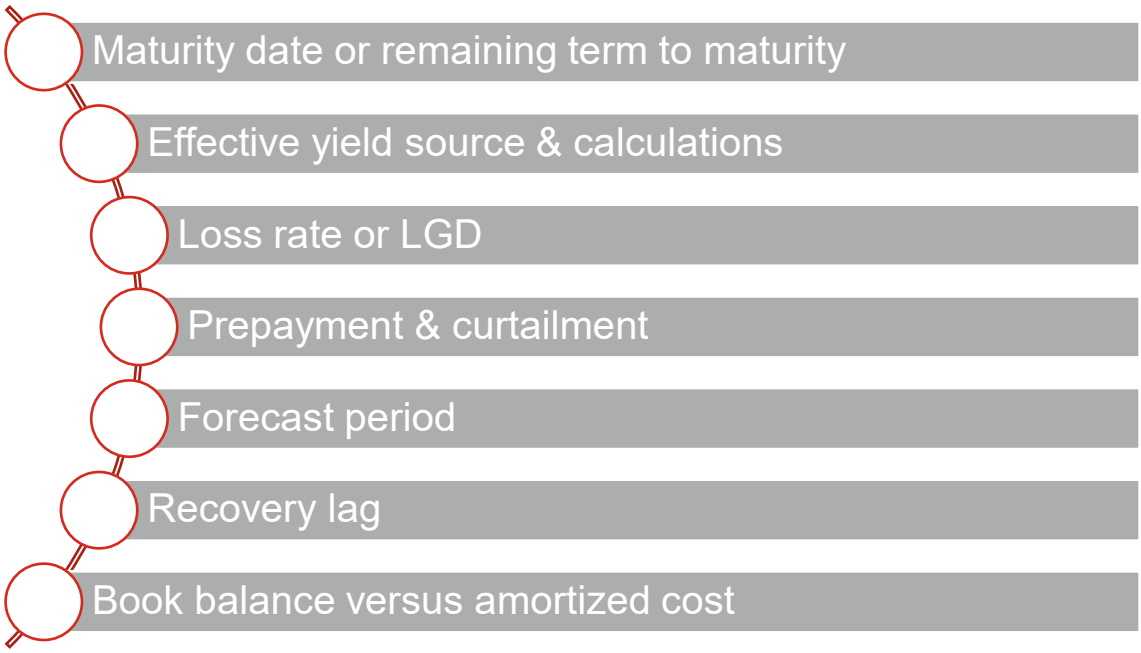
DCF Model

Financial institutions are probably familiar with the DCF method since it is often used to measure the impairment of troubled debt restructurings (TDR). Most institutions will continue to use this method for individual impairment calculations that are not collateral dependent.

If a DCF model is used to estimate expected credit losses, the entity shall discount expected cash flows at the financial asset's effective interest rate (EIR). When a DCF method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. For assets with variable or indexed interest rates, *e.g.*, prime rate or London Interbank Offered Rate, the EIR shall be based on the same factor or index.

The calculation of the expected value of future cash flows can be determined from simple assumptions or another model, *i.e.*, PD/LGD. This can be helpful when there is a lack of historical data—industry benchmarks can be used to develop assumptions to generate expected cash flows.

DCF Key Assumptions



Projections of Interest Rate Environments for Variable-Rate Financial Instruments

As written, an entity that chooses to use a DCF method to determine expected credit losses on a variable-rate financial instrument is precluded from forecasting changes in the variable rate for the purposes of estimating expected cash flows and determining the EIR with which to discount those cash flows.

Subsequent amendments removed the prohibition of using projections of future interest rate environments when using a DCF method to estimate credit losses for variable-rate financial instruments. An entity should use the same projections or expectations of future interest rate environments in estimating expected cash flows and in determining the EIR used to discount those expected cash flows. If an entity projects changes in the factor for the purposes of estimating expected future cash flows, it shall adjust the EIR used to discount expected cash flows to consider the timing—and changes in the timing—of expected cash flows resulting from expected prepayments.

Consideration of Prepayments in Determining the EIR

For entities electing a DCF approach for CECL, the use of an unadjusted EIR could misstate credit losses for prepayable assets held at a premium or discount since the EIR does not include prepayment assumptions.

Entities can make an accounting policy election—by class of financing receivable or major security type—to adjust the EIR used to discount expected future cash flows for expected prepayments on financial assets within ASC 326-20's scope and AFS debt securities within ASC 326-30's scope to appropriately isolate credit risk in determining the allowance for credit losses. An entity should not adjust the EIR used to discount expected cash flows for subsequent changes in expected prepayments if the financial asset is restructured in a TDR.

Practical Expedients

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

Collateral-Dependent Financial Assets

Consistent with the incurred loss model, an entity is allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, only if repayment is dependent on a sale). A collateral-dependent financial asset is defined as a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date.

Regardless of the initial measurement method, an entity shall measure expected credit losses based on the collateral's fair value at the reporting date when the entity determines foreclosure is probable. The entity shall adjust the collateral's fair value for the estimated costs to sell if it intends to sell rather than operate the collateral. When an entity determines foreclosure is probable, it shall remeasure the financial asset at the collateral's fair value at the reporting date—less costs to sell, if applicable—so that the reporting of a credit loss is not delayed until actual foreclosure.

The Office of the Comptroller of the Currency's (OCC) Bank Accounting Advisory Series guide requires banks to use the collateral's fair value as the basis for measuring expected credit losses when a loan is collateral-dependent regardless of the likelihood of foreclosure. A KPMG survey indicates almost one-third of SEC filers will use the OCC guidance.

Example – Estimating Expected Credit Losses—Practical Expedient for Collateral-Dependent Financial Assets *Reproduced from ASC 326-20-55-41 through 55-44 (Example 6)*

Bank ABC provides commercial real estate loans to developers of luxury apartment buildings. Each loan is secured by a respective luxury apartment building. Over the past two years, housing prices have dropped significantly, while luxury apartment communities have experienced an increase in vacancy rates. At the end of 2017, Bank ABC reviews its commercial real estate loan to Developer XYZ and observes the developer is experiencing financial difficulty due to decreasing rental rates and increasing vacancy rates in its apartment building.

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

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

Financial Assets Secured by Collateral Maintenance Provisions

Under certain agreements, a borrower may be required to continually adjust the collateral amount securing the financial asset due to the collateral's fair value changes, *e.g.*, repurchase agreements or securities lending arrangements. The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the CECL model but would be limited to the difference between the asset's amortized cost basis and the collateral's fair value. ASU 2019-11 further clarifies that an entity may determine the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset, such that the collateral's fair value is equal to or exceeds the financial asset's amortized cost basis.

Net Investment in Leases

An entity should include the unguaranteed residual asset with the lease receivable—net of any deferred selling profit—if applicable (the net investment in the lease). When measuring expected credit losses on net investment in leases using a DCF model, the discount rate used in measuring the lease receivable under ASC 842, Leases, should be used in place of the EIR.

AFS Debt Securities

Because an entity may realize the total value of financial assets either through collection of contractual cash flows or through sale, FASB felt a separate credit loss model continued to be warranted but decided to eliminate the existing OTTI model. Debt securities are defined as any security representing a creditor relationship with an entity. This includes—but is not limited to—certain preferred stock, U.S. Treasury

and agency securities, municipal and corporate bonds, interest/principal strips, and securitized debt instruments like collateralized mortgage obligations and real estate mortgage investment conduits.

AFS securities would continue to be evaluated at the individual security level. AFS debt securities would use an allowance approach, which would permit entities to recognize reversals of credit losses. Entities would be prohibited from considering the length of time the AFS debt security's fair value has been less than its amortized cost basis when estimating whether a credit loss exists. (Entities must continue to disclose AFS securities in a continuous loss position for less than 12 months and those that have been in a continuous loss position for 12 months or longer.)

In addition, entities would no longer be required to consider recoveries or additional declines in fair value for AFS debt securities after the balance sheet date. Companies are no longer required to consider historical or implied volatilities when evaluating the impairment of AFS securities but are not prohibited from considering such volatility.

An entity should consider how other credit enhancements that are not separate contracts, such as mortgage-backed securities issued with a Fannie Mae or Freddie Mac guarantee, may affect the AFS debt security's expected performance. Companies should consider the current financial condition of the guarantor of a security and whether any subordinated interests can absorb estimated losses on the underlying financial assets. Standalone credit enhancements, such as a standby letter of credit, are not factored into the security's expected performance.

Determining whether a credit loss exists does not require a DCF analysis—an entity may be able to demonstrate through a thorough qualitative assessment that all contractual cash flows will be received in a timely manner.

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

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

Debt Securities Subsequently Identified for Sale

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

Transfer Between Categories for Loans & Debt Securities

Amendments in ASU 2019-04 require that an entity reverse in earnings any allowance for credit losses or valuation allowance previously measured on a loan or debt security, reclassify and transfer the loan or debt security to the new classification or category, and apply the applicable measurement guidance in accordance with the new classification or category. This guidance covers transfers from AFS to HTM as well as from HFS to held for investment.

Recoveries

The guidance states that recoveries of financial assets and trade receivables previously written off should be recorded when received. Without proper clarification, stakeholders noted this guidance could be interpreted to prohibit the inclusion of recoveries in the estimation of expected credit losses on financial assets measured at amortized cost basis.

Expected recoveries of amounts previously written off and expected to be written off should be included in the valuation account and should not exceed the aggregate of amounts previously written off and expected to be written off by the entity. For collateral-dependent financial assets, the amendments clarify that an allowance for credit losses added to the amortized cost basis of the financial asset(s) should not exceed amounts previously written off.

Acquired Assets with Credit Deterioration (Formerly PCI Assets)

The ASU modifies the definition of what were previously known as PCI assets. FASB defines PCD as an acquired financial asset or acquired groups of financial assets with similar risk characteristics that have experienced a more-than-insignificant deterioration in credit quality since origination **based on the buyer's assessment**. This differs from current U.S. GAAP, which includes assets with contractual cash flows that, at acquisition, are probable of not being collected. An example in the standard includes the following factors to be considered in determining PCD status:

- Financial assets that are delinquent as of the acquisition date

- Financial assets that have been downgraded since origination
- Financial assets that have been placed on nonaccrual status
- Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in a bank's policy

This is not an all-inclusive list; other factors may be considered. This will be a key management judgment and should be fully documented for auditors and regulators.

The updated terminology is likely to result in more assets being identified as PCD compared to the current PCI definition.

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

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

PCD Assets (326-20-30-13)	Non-PCD Assets (326-20-30-15, 805-20-30-4A)
• Allowance added to the purchase price to determine the initial amortized cost basis • Gross-up • No provision expense	• Allowance accounted for in a manner consistent with originated assets • Not permitted to net any purchase discount with the allowance • Provision expense recorded

Negative Allowances on PCD Assets

A negative allowance refers to situations where an entity has recorded a full or partial write-off of an asset's unamortized cost basis and now expects to recover all—or a portion—of the amortized cost. This frequently happens in banks that follow regulatory charge-off policies based on delinquency status.

ASU 2019-11 permits an entity to record negative allowances on write-offs or expected write-offs of the amortized cost basis of PCD assets within ASC 326-20's scope. This is not a change to CECL or a new accounting model; rather, it is an accommodation to current regulatory charge-off practices. After a charge off, an entity would be permitted to reflect expected recoveries or improvements to financial conditions in the form of a negative allowance up to the asset's amortized cost basis.

ASU 2019-11 also clarifies that when a method other than a DCF method is used to estimate expected credit losses, expected recoveries should not include any amounts that result in an acceleration of the noncredit discount. An entity may include increases in expected cash flows after acquisition.

> *FASB's basis for conclusion in ASU 2019-11 firmly rejected providing a similar accommodation for negative allowances on AFS debt securities.*

Relief Coming?

While these changes were intended to simplify the accounting for acquired financial assets, these changes are one of the most contentious aspects of the new guidance. In 2020, FASB began outreach as part of the post-implementation review process. On July 14, 2021, FASB added a project to its technical agenda to address the accounting for acquired financial assets within the scope of Update 2016-13. FASB met in February 2022 and tentatively decided to amend the accounting for acquired assets to eliminate the distinction between PCD and non-PCD assets. The PCD accounting model would apply to acquired assets with certain exceptions, including credit cards and other revolving lending arrangements in which the borrower has borrowing privileges and AFS debt securities. The PCD accounting model would apply to assets acquired in a business combination and in an asset acquisition. An element of "seasoning" would be incorporated into the PCD accounting model for assets acquired in both a business combination and an asset acquisition to define whether an asset is an in-substance origination and, therefore, should not apply the PCD accounting model. No further meetings have been held as of the publication date, and no timeline has been established for issuance of an exposure draft or final ASU.

Business Combinations

ASU 2016-13 amended sections of ASC 805, Business Combinations, to require the recognition of an allowance for credit losses in the period of acquisition for both PCD and non-PCD assets. For PCD assets, the allowance for credit losses is added to the purchase price, *i.e.*, fair value, in determining the amortized cost basis rather than as a charge to earnings. However, for non-PCD assets, the

corresponding charge is recorded through provision expense on the acquirer's books. In addition, the acquisition fair value includes an expectation of credit losses as part of the purchase discount. This results in the perceived double counting of expected credit losses on non-PCD assets.

As the fair value of assets in a business combination includes both credit- and noncredit-related adjustments, both adjustments will be amortized as a yield adjustment to the asset over the asset's expected term.

Example – Recognition of PCD Assets

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

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

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

Loan–par amount	*$1,000,000*	
Loan–noncredit discount		*$ 75,000*
Allowance for credit losses		*$175,000*
Cash		*$750,000*

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

Example – Using a Loss-Rate Approach for Determining Expected Credit Losses and the Discount Rate on a PCD Asset

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

This example illustrates the application of the guidance to determine the expected credit loss using a loss rate for an individual PCD asset.

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

Original Amortization Table

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

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

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

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

Continued from Example – Using a Loss-Rate Approach for Determining Expected Credit Losses and the Discount Rate on a PCD Asset

A default occurs in the last year of the loan's life. The amortization of the purchased loan would be recorded as follows for the periods after the purchase date in Years Four and Five of the loan's life.

Book Amortization

	Beginning Balance (a)	Total Payment (b)	Accrued Write-off (c)	Ending Period Interest (d)	Reduction (e)	Balance (f)
4	$2,136,179	$1,186,982		$156,676	$1,030,306	$1,105,873
5	$1,105,873	$969,362	$217,620	$81,109	$1,105,873	
Totals		$2,156,344	$217,620	$237,785	$2,136,179	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $217,620.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The write-off represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 7.33 percent.

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and write-offs recognized (c) (if any), less the interest income recognized (d). The write-off in Year Five represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

The rollforward of the allowance would be as follows:

Beginning allowance for credit losses	$ 217,620
Plus, credit loss expense	
Less, write-offs	(217,620)
Ending allowance for credit losses	$ 0

BIs

The ASU permits the use of the PCD gross-up model for BIs that meet the definition of a PCD financial asset or when a significant difference exists between contractual cash flows and expected cash flows.

For certain BIs, investments in the residual tranche at issuance could qualify for the gross-up approach, even though there may not be deterioration since origination.

Contractual Term & Extensions

An entity must consider an asset's entire contractual term, including expected prepayments, and would only consider extensions, renewals, and modifications if a TDR is reasonably expected. For off-balance-sheet credit exposures, the credit losses would reflect the entire contractual period an entity is exposed to credit risk from its present contractual obligation to extend credit unless unconditionally cancelable by the issuer.

An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless either of the following applies:

- The entity has a reasonable expectation at the reporting date that it will execute a TDR with the borrower.
- The extension or renewal options—excluding those that are accounted for as derivatives in accordance with ASC 815—are included in the original or modified contract at the reporting date and are not unconditionally cancelable by the entity.

Example – Application of Expected Credit Losses to Unconditionally Cancelable Loan Commitments
Bank ABC has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. The bank's cardholder agreements stipulate that the available credit may be unconditionally canceled at any time. When determining the allowance for credit losses, the bank estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank ABC does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank ABC has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancelable by the issuer is not considered to be a liability.

Write-Offs

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

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

Example – Recognizing Write-Offs & Recoveries

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

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

Bank ABC determines the $500,000 loan made to XYZ is uncollectible. Bank ABC measures a full credit loss on the loan to XYZ and writes off its entire loan balance as follows:

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

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

Cash	*$50,000*	
Allowance for credit losses		*$50,000*

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

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

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

TDRs

The CECL standard did not change the guidance on how entities determine and measure a TDR; however, once an entity adopts ASU 2016-13, the CECL credit loss allowance captures the effect of most concessions, making the TDR guidance duplicative and unnecessary. ASU 2022-02 eliminates the TDR accounting guidance in Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements when a borrower is experiencing financial difficulty.

Rather than applying the recognition and measurement guidance for TDRs, an entity would apply the loan refinancing and restructuring guidance in ASC 310-20 to determine whether a modification results in a new loan or a continuation of an existing loan (see Appendix A for current modification guidance).

- If a financial asset is modified and considered to be a continuation of the original asset, an entity shall use the post-modification contractual interest rate to derive the effective interest rate when using a discounted cash flow method.
- For a loan extinguishment, the entity would treat the loan as if it underwrote a new loan and write off any unamortized deferred fees or costs and establish a new effective interest rate based on the loan terms.

TDR Enhanced Disclosures

For each period an income statement is presented, an entity shall disclose the following information related to modifications of receivables made to debtors experiencing financial difficulty during the reporting period. Modifications can include principal forgiveness, interest rate reduction, an other-than-insignificant payment delay, or a term extension. For this disclosure, covenant waivers and modifications of contingent acceleration clauses are not considered term extensions and disclosure is limited to the four items below. However, if a receivable is modified in more than one manner, then—if significant—separate categories for types of combinations of modifications provided to borrowers may be necessary.

- By class of financing receivable, qualitative and quantitative information about:
  - The types of modifications an entity used, including the total period-end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to debtors experiencing financial difficulty relative to the total period-end amortized cost basis of receivables in the class of financing receivable
  - The financial effect of the modification-by-modification type, including changes to the contractual terms as a result of the modification, the incremental effect of principal forgiveness on the amortized cost basis of the modified receivables, or the reduction in weighted-average interest rates (versus a range) for interest rate reductions
  - Receivable performance in the 12 months after a modification of a receivable made to a debtor experiencing financial difficulty
- By portfolio segment, qualitative information about how those modifications and the debtors' subsequent performance are factored into determining the allowance for credit losses

Receivables may be modified in more than one manner. For receivables with multiple modifications, entities should provide disclosures sufficient for users to understand the different types of combinations of modifications provided to borrowers. For example, a receivable may be modified to provide both principal forgiveness and an interest rate reduction. In that case, an entity shall disclose the period-end amortized cost basis of that receivable in a separate category that reflects that a combination of modification types has been granted. If another receivable was modified to provide both an interest rate reduction and a term extension, the period-end amortized cost basis of that receivable shall be presented

in a different category. Multiple separate combination categories may be necessary if significant. The same receivable's period-end amortized cost basis shall not be presented in multiple categories.

For each period an income statement is presented, an entity shall disclose the following information about financing receivables that had a payment default during the period and had been modified (principal forgiveness, interest rate reduction, an other-than-insignificant payment delay, or a term extension) within the previous 12 months preceding the payment default because the debtor was experiencing financial difficulty:

- By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the following:
  - The type of contractual change that the modification provided
  - The amount of financing receivables that defaulted, including the period-end amortized cost basis for receivables that defaulted
- By portfolio segment, qualitative information about how those defaults are factored into determining the allowance for credit losses

The ASU only requires an entity to look back at modifications made in the previous 12-month period before the current restructuring when determining whether a payment delay from the current restructuring is insignificant.

See Appendix B for sample disclosure.

Early Adoption & Transition for ASU 2022-02

For entities that have already adopted CECL, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods. Early adoption is permitted, including adoption in any interim period as of the beginning of the fiscal year that includes that interim period, for financial statements of fiscal years or interim periods that have not been issued or made available for issuance. For entities that have not yet adopted CECL, the changes should be adopted at the same time as ASU 2016-13.

Disclosures

The disclosure carries forward some of the requirements of ASU 2010-20—Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses, such as those related to quantitative and qualitative information about credit quality, including the amount of recorded investment by the credit quality indicator. Disclosures generally are required to be broken out by portfolio segment, class of financing receivable, or major security type. Judgment will be required in determining the correct level of detail to satisfy financial statement users without aggregating too much

data or including excess details. Examples of portfolio segments include type of financing receivable, industry sector, or risk rating. The ASU includes guidance in determining the level of detail for the class of financial receivables or investment in leases. Entities should consider any of the following factors:

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

Presentation of Accrued Interest

Technical corrections in ASU 2019-04 allowed an entity to elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements. However, in a drafting oversight an entity would still be required to include accrued interest in other required disclosures in other guidance. ASU 2019-11 extends this relief to all relevant disclosures involving amortized cost basis.

Credit Quality Indicators

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

For financing receivables and net investment in leases, the amortized cost basis within each credit quality indicator should be presented by year of origination (vintage year). For acquired assets, an entity shall use the initial date of issuance to determine the year of origination, not the acquisition date. An entity need not present more than the most recent five origination years. An entity can present the amortized cost basis originated before the fifth annual reporting period in the aggregate. For interim-period disclosures, the current year-to-date originations in the current reporting period are considered to be the current-period originations.

An entity is required to present the amortized cost basis of line-of-credit arrangements that are converted to term loans in a separate column.

The vintage disclosure is not required for entities that are not PBEs. For PBEs that are not SEC filers, transitional relief will allow banks to "build up" the data over time to meet the full disclosure requirements.

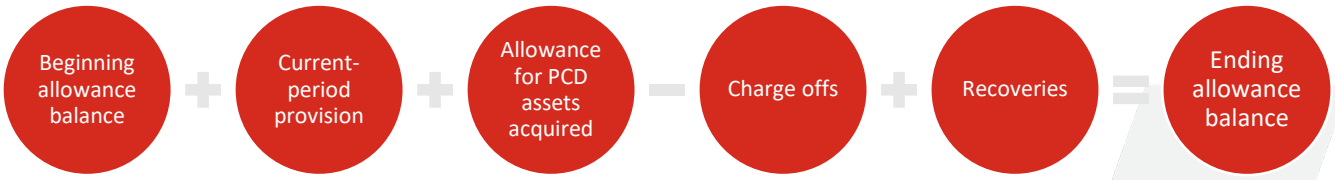
Receivables measured at the lower of amortized cost or fair value and most trade receivables due in one year or less are exempt from disclosing credit quality indicators. However, all credit card receivables must disclose the credit quality indicators.

Allowance for Expected Credit Losses

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

Rollforward of the Allowance for Credit Losses

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



Past-Due Status

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

Nonaccrual Status

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

- The amortized cost of nonaccrual financial assets at the beginning and end of the reporting period
- The amount of interest income recognized during the period on nonaccrual financial assets

- The amortized cost of financial assets that are 90 days or more past due but not on nonaccrual status as of the reporting date
- The amortized cost of nonaccrual financial assets with no related expected credit losses as of the reporting date

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

PCD Financial Assets

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

Collateralized Financial Assets

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

Off-Balance-Sheet Credit Exposures

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

SEC Documentation

In November 2019, the SEC issued Staff Accounting Bulletin (SAB) 119, which updates previous guidance to reflect the CECL model. SAB 119 updates methodologies and supporting documentation requirements for measuring credit losses, focusing on the documentation the SEC staff would normally expect registrants to prepare and maintain to support estimates of current expected credit losses for loan transactions. Entities with a delayed 2023 effective date should continue to use guidance in SAB 102. SAB 119 applies to all registrants that are creditors in loan transactions that—individually or in the aggregate—have a material effect on the registrant's financial condition. This staff guidance is applicable once a registrant adopts Topic 326. At adoption, the staff guidance in SAB Topic 6, Section L: *Financial Reporting Release No. 28 – Accounting for Loan Losses by Registrants Engaged in Lending Activities*, will no longer be applicable.

Transition

Transition would be on a modified retrospective transition basis. An entity would apply the guidance to all outstanding financial assets as of the beginning of the first reporting period in which the guidance is effective. The cumulative effect of the change related to periods before the ASU's effective date would be reflected in the carrying amount of assets as of the effective date, with an adjustment to the opening balance of retained earnings.

Financial statements for each individual prior period presented would not be adjusted.

The adoption dates can be deceptive. An entity has to perform the CECL calculation not only as of the adoption date but also at the beginning of the period for that adoption date. For example, an entity adopting as of March 31, 2022 also would have to perform the calculation as of January 1, 2022 to calculate both the amount of the retained earning adjustment and the CECL provision recognized in the income statement of the quarter. Companies should have methodologies established ahead of the adoption date so they have the necessary data to perform the beginning period calculations.

AFS Debt Securities/OTTI

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

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

PCI/PCD Assets & BIs

Since the criteria for a PCD asset differs from the existing guidance for PCI assets, ASU 2016-13 provides transition relief so entities are not forced to re-evaluate existing holdings under the new guidance. Assets accounted for under ASC 310-30 would be classified as PCD assets at the adoption date, including those acquired assets for which ASC 310-30 was applied by analogy. Entities would be required to gross up the allowance for expected credit losses for all PCD assets on the adoption date and would continue to recognize interest income based on the yield of such assets as of the adoption date. Subsequent changes in the expected credit losses would be recorded through the allowance for credit losses, with a corresponding adjustment to the current-period provision for credit losses.

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

There should be no changes in the PCI population as a result of adoption.

Transition Election Available

At the June 2017 TRG meeting, FASB agreed entities should be given a choice—through an accounting policy election—that the transition relief can be applied both at adoption and on an ongoing basis. This interpretation could provide significant savings to smaller financial institutions. Unlike ASC 310-30, PCD accounting does not permit a pooling for any purpose other than measuring credit losses; any noncredit discount or premium on the pool of acquired assets must be allocated to each individual asset. Upon adoption of ASU 2016-13, there may be several changes to how pooled PCI assets would have previously been accounted for:

- Interest income will be based on the unit of account at an individual asset level.
- Write-offs will be determined at an individual asset level, whereas under ASC 310-30, entities may not have applied their write-off policies to pooled PCI assets and, instead, reflected amounts deemed uncollectible in the expected cash flows of the pool.
- A modification of a PCD asset that is a TDR will be accounted for as such, whereas under ASC 310-30, TDR accounting is not required to be applied when assets are accounted for in a pool.

Entities that elect to maintain existing PCI pools after adoption would not be able to remove assets from the pool until they are paid off, written off, or sold (following existing guidance), but would be required to follow the guidance in ASU 2016-13 for interest income and the allowance for credit losses.

Because the standard was silent on this topic, no FASB standard setting was required.

For larger banks with sophisticated systems, there likely is not much of a benefit in grandfathering and maintaining existing PCI pools after transition. However, for smaller banks, credit unions, and nonbank entities, the transitional relief for PCI pools only at transition would be extremely limited. Day Two operational challenge would be significant due to less sophisticated systems that may not maintain amortized cost basis for individual loans in a pool. Smaller entities would be challenged in allocating a credit allowance down to a single unit of account for existing PCI pools. The lead time for the standard's adoption should permit smaller entities to enhance systems to capture the necessary data for future PCD assets.

This will be a key management decision. According to a September 2019 KPMG survey, 33 percent of SEC filers with PCI portfolios were unsure on their CECL-transition decision.

Loan is not on non-accrual & management has not seen any decline in cash flow expectations since acquisition & therefore no allowance is recorded at December 31, 2019, prior to CECL

Facts for PCI Loan at Transition

Principal balance at 12/31/19	$ 1,750
Nonaccretable discount at 12/31/19	500 (Under current GAAP this reduces the carrying value of loan & is not included on the balance sheet)
Accretable discount at 12/31/19	200
CECL allowance at implementation	505 (Does not have to done using a DCF. Any method is allowable. Most institutions believe the current nonaccretable discount is the floor for this at transition. Does not have to match nonaccretable)

General Ledger	PCI	PCD	
Principal balance	$ 1,750	$ 1,750	
Nonaccretable discount	(500)	-	
Accretable discount	(200)	(195)	*
Loans	1,050	1,555	Gross up
Allowance		(505)	
Net Loans	$ 1,050	$ 1,050	

Transition Entry	Debit	Credit
Nonaccretable discount	500	
Accretable discount	5	
Allowance		(505)

*Effective interest rate for accreting income will be lower given the 195 is applied to a larger grossed up loan balance

Vintage Disclosures

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

ASU 2016-13 originally included a disclosure requirement for PBEs on credit quality. The example provided included lines for gross write-off and gross recoveries for each origination year that were not included in the ASU language. After pushback, FASB removed this disclosure requirement in April 2019. Financial statements users considered this detail decision useful information and lobbied for at least gross write-off information. ASU 2022-02 requires PBEs to present the gross write-offs recorded in the current period—on a current year-to-date basis—for financing receivables and net investments in leases by origination year. This change would be applied on a prospective basis. Beginning in the period of adoption, a PBE would provide current-period gross write-offs in the vintage disclosures. Disclosure would not be required for prior period comparative periods. For origination years before the fifth annual period, a PBE may present the gross write-offs in the current period for financing receivables and net investments in leases in the aggregate. The required effective date for ASU 2022-02 is for fiscal periods beginning after December 15, 2022.

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

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

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

FVO

A subsequent amendment in ASU 2019-05, Financial Instruments—Credit Losses (Topic 326), Targeted Transition Relief, provides a one-time, instrument-by-instrument election to apply the FVO to certain existing financial instruments measured at amortized cost on CECL's adoption. Currently, the FVO can only be elected at an instrument's inception or acquisition. This narrowly focused transition relief would permit a one-time, irrevocable election to apply the FVO to certain amortized cost instruments and would not apply to HTM debt securities. This change would help some companies from having two different accounting models for similar asset portfolios (CECL and fair value). An entity may irrevocably elect the

FVO in accordance with ASC 825-10 for financial instruments within Subtopic 326-20's scope—except for HTM debt securities—that also are eligible items in Subtopic 825-10. The scope was specifically limited to financial assets that are eligible for the FVO in ASC 825-10; therefore, certain assets like a net investment in a lease are excluded.

This election is not expected to have widespread applicability. The relief will mostly benefit subprime auto lenders, dual-filing institutions trying to align U.S. GAAP and international financial reporting standards reporting requirements, and, in certain cases, reverse repo agreements.

FASB categorically rejected requests to extend the transition relief to debt securities classified as HTM either by including HTM securities within the scope of financial instruments eligible for the FVO or by allowing HTM debt securities to be transferred to the AFS category without calling into question an entity's intent to hold other HTM debt securities to maturity.

Transition Disclosures

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

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

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

The adoption of the CECL model will be complex and likely will require significant hours to implement correctly. **FORVIS** can help educate your team, provide implementation tools, and assist with analysis and documentation. If you would like assistance complying with the CECL standard, contact a professional with FORVIS trusted advisor.

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Appendix A – Existing ASC 310 Loan Modification Guidance

ASC 310 provides guidance on whether—as a result of a loan refinancing or restructuring—a modified loan represents a new loan for accounting purposes. For modifications of loans that require new loan accounting, any unamortized net fees or costs and any prepayment penalties from the original loan must be recognized in interest income, and the modified loan must be initially recognized at fair value. However, if new loan accounting is not required, unless fees are received in connection with the modification, there would be no change in the net carrying amount of the loan as a result of the modification.

Under ASC 310-20-35-9 through 35-11, a modification results in a new loan for accounting purposes only if all the following conditions are met:

- The modification is not a TDR.
- The terms of the modified loan are at least as favorable to the lender as the terms of comparable loans to other customers with similar collection risks that are not refinancing or restructuring a loan with the lender. This condition would be met if the modified loan's effective yield is at least equal to the effective yield for such newly originated loans.
- The modification is more than minor, *i.e.*, the present value of the cash flows under the modified terms is at least 10% different from the present value of the remaining cash flows under the original terms, or the specific facts and circumstances otherwise suggest that the modification is more than minor.

Appendix B – Disclosures for Debtors Experiencing Financial Difficulty

The allowance for credit losses incorporates an estimate of lifetime expected credit losses and is recorded on each asset upon asset origination or acquisition. The starting point for the estimate of the allowance for credit losses is historical loss information, which includes losses from modifications of receivables to borrowers experiencing financial difficulty. Entity B uses a probability of default/loss given default model to determine the allowance for credit losses. An assessment of whether a borrower is experiencing financial difficulty is made on the date of a modification.

Because the effect of most modifications made to borrowers experiencing financial difficulty is already included in the allowance for credit losses because of the measurement methodologies used to estimate the allowance, a change to the allowance for credit losses is generally not recorded upon modification. Occasionally, Entity B modifies loans by providing principal forgiveness on certain of its real estate loans. When principal forgiveness is provided, the amortized cost basis of the asset is written off against the allowance for credit losses. The amount of the principal forgiveness is deemed to be uncollectible; therefore, that portion of the loan is written off, resulting ina reduction of the amortized cost basis and a corresponding adjustment to the allowance for credit losses.

In some cases, Entity B will modify a certain loan by providing multiple types of concessions. Typically, one type of concession, such as a term extension, is granted initially. If the borrower continues to experience financial difficulty, another concession, such as principal forgiveness, may be granted. For the real estate loans included in the “combination” columns below, multiple types of modifications have been made on the same loan within the current reporting period. The combination is at least two of the following: a term extension, principal forgiveness, and interest rate reduction.

The following table shows the amortized cost basis at the end of the reporting period of the loans modified to borrowers experiencing financial difficulty, disaggregated by class of financing receivable and type of concession granted (numbers in thousands):

Loan Modifications Made to Borrowers Experiencing Financial Difficulty

	Interest Rate Reduction	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ 40,000	2.0%
Real Estate—Residential	-	0.0
Consumer	10,000	0.2
Total	**$ 50,000**	

	Term Extension	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ -	0.0%
Real Estate—Residential	-	0.0
Consumer	22,000	0.4
Total	**$ 22,000**	

	Principal Forgiveness	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ 20,000	1.0%
Real Estate—Residential	-	0.0
Consumer	-	0.0
Total	**$ 20,000**	

	Combination—Term Extension and Principal Forgiveness	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ -	0.0%
Real Estate—Residential	5,000	0.8
Consumer	-	0.0
Total	**$ 5,000**	

	Combination—Term Extension and Interest Rate Reduction	
	Amortized Cost Basis at 12/31/20X1	% of Total Class of Financing Receivable
Loan Type		
Real Estate—Commercial	$ -	0.0%
Real Estate—Residential	5,000	0.8
Consumer	-	0.0
Total	**$ 5,000**	

The following table describes the financial effect of the modifications made to borrowers experiencing financial difficulty:

Interest Rate Reduction

Loan Type	Financial Effect
Real Estate—Commercial	Reduced weighted-average contractual interest rate from 6% to 3%.
Real Estate—Residential	Reduced weighted-average contractual interest rate from 8% to 5%.
Consumer	Reduced weighted-average contractual interest rate from 4% to 1.5%.

Term Extension

Loan Type	Financial Effect
Real Estate—Residential	Added a weighted-average 2.4 years to the life of loans, which reduced monthly payment amounts for the borrowers.
Consumer	Provided six-month payment deferrals to borrowers through our standard deferral program. The six monthly payments were added to the end of the original loan terms of these borrowers.

Principal Forgiveness

Loan Type	Financial Effect
Real Estate—Commercial	Reduced the amortized cost basis of the loans by $20 million.
Real Estate—Residential	Reduced the amortized cost basis of the loans by $5 million.

Upon Entity B's determination that a modified loan (or portion of a loan) has subsequently been deemed uncollectible, the loan (or a portion of the loan) is written off. Therefore, the amortized cost basis of the loan is reduced by the uncollectible amount and the allowance for credit losses is adjusted by the same amount.

The following table provides the amortized cost basis of financing receivables that had a payment default during the period and were modified in the 12 months before default to borrowers experiencing financial difficulty (numbers in thousands):

	Amortized Cost Basis of Modified Financing Receivables That Subsequently Defaulted				
Loan Type	Interest Rate Reduction	Term Extension	Principal Forgiveness	Combination-Term Extension and Principal Forgiveness	Combination-Term Extension and Interest Rate Reduction
Real Estate—Commercial	$ 1,500	$ -	$ -	$ -	$ -
Real Estate—Residential	-	-	-	-	-
Consumer	500	1,000	-	-	-
Total	**$ 2,000**	**$ 1,000**	**$ -**	**$ -**	**$ -**

Entity B closely monitors the performance of the loans that are modified to borrowers experiencing financial difficulty to understand the effectiveness of its modification efforts. The following table depicts the performance of loans that have been modified in the last 12 months (numbers in thousands):

	Payment Status (Amortized Cost Basis)		
Loan Type	Current	30–89 Days Past Due	90+ Days Past Due
Real Estate—Commercial	$ 55,000	$ 3,500	$ 1,500
Real Estate—Residential	6,000	4,000	-
Consumer	29,000	1,500	1,500
Total	**$ 90,000**	**$ 9,000**	**$ 3,000**

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