Applying the new CECL standard

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments—Credit Losses [codified as Accounting Standards Codification Topic (ASC) 326]. ASC 326 adds to US generally accepted accounting principles (US GAAP) the current expected credit loss (CECL) model, a measurement model based on expected losses rather than incurred losses. Under this new guidance, an entity recognizes its estimate of expected credit losses as an allowance, which the FASB believes will result in more timely recognition of such losses. The new standard is also intended to reduce the complexity of US GAAP by decreasing the number of credit loss models that entities use to account for debt instruments.
Key provisions of the new standard

The new guidance significantly changes the accounting for credit losses. Although it has a greater impact on banks, all entities with in-scope financial assets are subject to the requirements in the new standard.

Here are key considerations related to implementing the new CECL standard. (See A Roadmap to Accounting for Current Expected Credit Losses for further details.)

**Scope**
Many companies will find that they’re subject to the new CECL requirements because the standard applies to a number of commonly held assets:

- Some debt instruments held to maturity (other than those measured at fair value through net income)
- Trade receivables and contract assets recognized under ASC 606
- Lease receivables resulting from sales-type or direct-financing leases
- Reinsurance receivables from insurance transactions
- Financial guarantee contracts
- Loan commitments

The CECL model does not apply to available-for-sale debt securities.

**Recognition**
Unlike the incurred loss models in legacy US GAAP, the CECL model does not specify a threshold for the recognition of an allowance. An entity will instead recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit losses will be recognized as an allowance, which is a contra asset, rather than as a direct write-down of a financial asset’s amortized cost basis.

Because the CECL model does not have a minimum threshold for recognition of credit losses, entities will need to measure expected credit losses on in-scope assets even if there is a low risk of loss (investment-grade, held-to-maturity debt securities, for example). In some limited instances, recognizing zero credit losses may be appropriate.
Measurement
The new CECL standard does not prescribe one mandatory method for estimating expected credit losses. An entity can use various measurement approaches to determine the allowance for credit losses—which may be consistent with methods it previously used. Some approaches, such as a discounted cash flow method, project future principal and interest cash flows, while others project only future principal losses. Either, consistently applied, is acceptable under the new standard.

Regardless of the measurement method used, an entity’s estimate of expected credit losses should reflect the losses that occur over the contractual life of the financial asset. While the entity should consider prepayments, it generally should not consider expected extensions, renewals, and modifications.

An entity should consider all available relevant information, including details about past events, current conditions, and reasonable and supportable forecasts, when estimating credit losses.
Key provisions of the new standard (cont.)

**Unit of account**
An entity must evaluate financial assets within the scope of the model on a collective or pool basis if they share similar risk characteristics. The new standard provides examples of “similar risk characteristics,” including geography, credit ratings, financial asset type, size, and term. If an asset’s risk characteristics are not similar to those of others, the entity would evaluate that asset individually.

**Write-offs**
The write-off guidance in the new standard is similar to legacy US GAAP. An entity is required to write off a financial asset when it is “deemed uncollectible.”

**Available-for-sale debt securities**
The CECL model does not apply to available-for-sale debt securities. However, the FASB made several targeted changes to the credit loss model for available-for-sale debt securities:
- Removed the “other-than-temporary” concept
- Required the use of an allowance limited to the difference between a debt security’s amortized cost and its fair value (as opposed to permanently writing down the security’s cost basis)
- Disallowed considering the length of time fair value has been less than amortized cost
- Disallowed the consideration of recoveries in fair value after the balance sheet date

**Other provisions**
The new CECL standard includes specific guidance to assist entities with developing an estimate of expected credit losses for the following:
- Purchased credit-deteriorated assets
- Certain benefit interests within the scope of ASC 325-40
- Certain collateral-backed financial assets
Disclosure requirements
CECL expands the disclosure requirements related to credit losses. Entities should consider these disclosure requirements early in their implementation efforts to ensure that they are prepared.

Disclosure objectives
The objective of the disclosure requirements in ASC 326 is twofold:
1. Give financial statement users information about the credit risk inherent in an entity’s financial statements.
2. Explain management’s estimate of expected credit losses and the changes in the allowance for such losses.

Disclosure categories
- Credit quality information, including the “vintage” disclosure requirement
- Allowance for credit losses, including a rollforward of the allowance
- Past-due status
- Nonaccrual status
- Purchased financial assets with credit deterioration
- Collateral-dependent financial assets
- Off-balance-sheet credit exposures
The new guidance became effective for SEC filers,\(^1\) excluding those that meet the definition of a smaller reporting company,\(^2\) for annual periods beginning after December 15, 2019 (that is, calendar periods beginning on January 1, 2020), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2022 (that is, calendar periods beginning on January 1, 2023), and interim periods therein. Early adoption has been permitted for all entities for fiscal years beginning after December 15, 2018 (that is, calendar periods beginning on January 1, 2019), and interim periods therein.

An entity adopts ASC 326 for most debt instruments by using a modified retrospective transition approach. Under this approach, the standard is implemented as of the effective date of ASC 326 (that is, January 1, 2020, for a calendar year-end SEC filer) with a cumulative-effect adjustment to equity on the date of adoption. Instead of recasting comparative periods in transition, entities should continue to apply legacy US GAAP (including legacy credit loss models) in the comparative periods. Entities should also continue to disclose information required by legacy US GAAP for comparative periods.

In addition to the general transition provisions discussed above, the ASU provides instrument-specific transition guidance for the following types of financial assets:

- Other-than-temporarily impaired debt securities
- Purchased credit-deteriorated assets
- Certain beneficial interests within the scope of ASC 325-40
- Troubled debt restructurings for which the effective interest rates are adjustment for prepayments

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**Illustrative timeline for an SEC filer (that does not meet the definition of a smaller reporting company) with a December 31 year-end:**

<table>
<thead>
<tr>
<th>January 1, 2018</th>
<th>January 1, 2020</th>
<th>March 31, 2019</th>
<th>December 31, 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning of company’s earliest comparative period to be presented</td>
<td>Comparative periods are not restated under ASC 326</td>
<td>ASC 326 effective date for the company and date of initial application</td>
<td>First quarterly reporting date</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>First annual reporting date</td>
</tr>
</tbody>
</table>

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\(^1\)Under US GAAP, an SEC filer is defined as “An entity that is required to file or furnish its financial statements with either of the following:
- The Securities and Exchange Commission (SEC)
- With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.
Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.”

\(^2\)SEC Regulation S-K, Item 10(f)(1), defines a smaller reporting company, in part, as: “[A]n issuer that is not an investment company, an asset-backed issuer (as defined in § 229.1101), or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (i) Had a public float of less than $250 million; or (ii) Had annual revenues of less than $100 million and either: (A) No public float; or (B) A public float of less than $700 million.”
Did you know?
The CECL model introduced by the new standard does not apply just to financial institutions. Commercial entities must also comply with the new standard and apply the CECL model to financial assets, including trade receivables and contract assets generated under ASC 606. (See Chapter 2 of the CECL Roadmap.)

Did you know?
Although the CECL model does not apply to available-for-sale debt securities, the ASU revised the measurement model that entities should apply to estimate credit losses related to available-for-sale debt securities. (See Chapter 7 of the CECL Roadmap.)

Did you know?
The CECL model does not prescribe a single method for determining expected credit losses. Consequently, entities have latitude to develop processes that are appropriate for the credit risk (and financial statement misstatement risk) associated with assets within the scope of the CECL model. (See Section 4.4 of the CECL Roadmap.)

Did you know?
Reasonable and supportable forecasts do not include all forecasts that an entity may develop related to a financial asset. The new standard does not define “reasonable and supportable” forecasts. As such, an entity will need to apply judgment when evaluating whether a forecast provides reasonable and supportable information that the entity can leverage when developing its estimate of expected credit losses. (See Section 4.3.3 of the CECL Roadmap.)

Did you know?
In addition to the recognition and measurement changes introduced by the CECL model, the quantitative disclosures—specifically, the “vintage” credit quality indicator disclosure—is a significant change for many entities that have assets subject to the disclosure requirement. (See Section 8.2 of the CECL Roadmap.)

Did you know?
The FASB formed a transition resource group that was intended to discuss implementation issues raised by stakeholders related to the new standard. As a result of these discussions, the FASB has issued five additional ASUs to clarify and amend the guidance in ASC 326. (See Section 10.2.1 of the CECL Roadmap.)

Did you know?
Historical evidence, in isolation, is not sufficient for an entity to develop its estimate of expected credit losses. Entities should incorporate information on current conditions and reasonable and supportable forecasts when developing an estimate of expected credit losses. (See Section 4.3 of the CECL Roadmap.)
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